Our View

December 29, 2023

A look ahead: First quarter 2024 outlook

A look ahead: 2024 outlook

If we are right that inflation could fall faster than usual, and the U.S. economy manages to muddle through the lagged effect of monetary tightening over the course of 2024, it will have navigated one of the most aggressive U.S. Federal Reserve (Fed) tightening cycles in 50 years without falling into recession.

Inflation didn't spike in recent years because the economy was too strong, fueled by over investment or excess corporate/consumer borrowing. Rather, inflation surged because a global pandemic upended the global economy, provoking both historic fiscal stimulus and a historic supply-chain morass that created deep and sustained shortages of core goods.

Interest-rate markets have started to forecast more aggressive Fed rate cuts in 2024 in response to falling inflation. Between five and six rate cuts are priced into the short end of the yield curve. While we agree with this bullish sentiment, this many rate cuts strikes us as optimistic given current economic data.

If the economy manages a soft landing, the strength of the "Magnificent Seven" companies that led performance in 2023 should widen to the other 493. With earnings growth—which we believe drives markets in the long-run—recently turning positive on a quarterly basis for the first time in a year, that process may have already begun.

Asset allocation current outlook

Current quarter weighting   Previous quarter weighting (if changed)

Equity vs. fixed income

Whether considering budget battles on Capitol Hill, the sharp disagreement between the markets and the Federal Reserve (Fed), or actual wars in various regions around the world, the cumulative weight of the conflict, and its potential impact on the financial markets, can't be ignored.

While it's not unusual to string back-to-back years of above-average performance together, the feat does not come without challenges.

Despite near-term risks persisting, we suspect the general trend will persist, albeit less aggressively. As such, we continue to maintain a small equity bias.

Equities: U.S. vs. International

We favor domestic over international in the intermediate-to-long term for a variety of reasons including peak globalization, a higher degree of innovation domestically, greater demographic issues internationally, structural issues in Europe, and a more favorable climate for businesses (e.g., regulation) domestically.

International markets may provide some safety on a relative basis in the event the largest names in the S&P 500 give back some of their massive 2023 gains.

While we are not calling for international markets to outperform in the near-term, we retain the capacity to add to our international underweighting if that occurs.

Equities: Market cap

Small caps — Large caps

Our overweighting to small-mid (SMID) is concentrated in mid-caps, while we maintain an overweighting to large-caps.

With the high likelihood of rate cuts this year by the Fed, history suggests that the advantage is skewed in favor of large caps given their higher quality. This was the case even for the soft-landing scenario of 1995.

The prior outperformance of a select group of large cap stocks, combined with lower rates while avoiding a recession (i.e., a soft landing) may provide an environment conducive for SMID caps to make up some ground.

Fixed income: Duration

Short — Long

Long-term interest rates such as the 10-year Treasury were volatile in the quarter, rising sharply on better-than-expected economic data and concerns over growing Treasury bond issuance.

We expect the Fed to start cutting rates around mid-year. The risk to this view is that inflation comes in higher than expectations and prompts the Fed to hold rates high longer or hike again.

We are modestly long duration with roughly neutral positioning across the curve.

We expect rates to be volatile but move lower through 2024 through a combination of lower inflation and slowing economic growth.

Fixed income: Credit quality*

Low quality — High quality

Fixed income credit spreads rallied substantially in the fourth quarter on expectations that the Fed would stop interest rate increases and eventually cut.

Spreads in high-yield and investment-grade corporate bonds entered 2024 below long-term averages.

We expect slowing economic growth and higher defaults, but default rates should remain below prior recessionary peaks given overall solid fundamentals.

Defaults are likely to increase for leveraged loans, where credit quality has deteriorated more.

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*Credit Quality ratings are determined by credit rating agencies Moody's Investor Services, Inc. or Standard & Poor's Financial Services, LLC.