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Six questions investors are asking now

April marks my one-year anniversary at TIAA. To celebrate this milestone, I've been crisscrossing the country, meeting with TIAA Wealth Management clients. My biggest takeaway from these conversations? Everyone is wondering and worrying about the same things. The rocket scientist in Pasadena asked me virtually the same question about artificial intelligence (AI) as the law professor in Washington, D.C. Six questions in particular came up over and over and over. With this month's CIO Perspectives, let's answer them.

Q: The U.S. economy appears to be firing on all cylinders, even as the rest of the world is stuck in neutral. What's behind this American exceptionalism, and will it last?

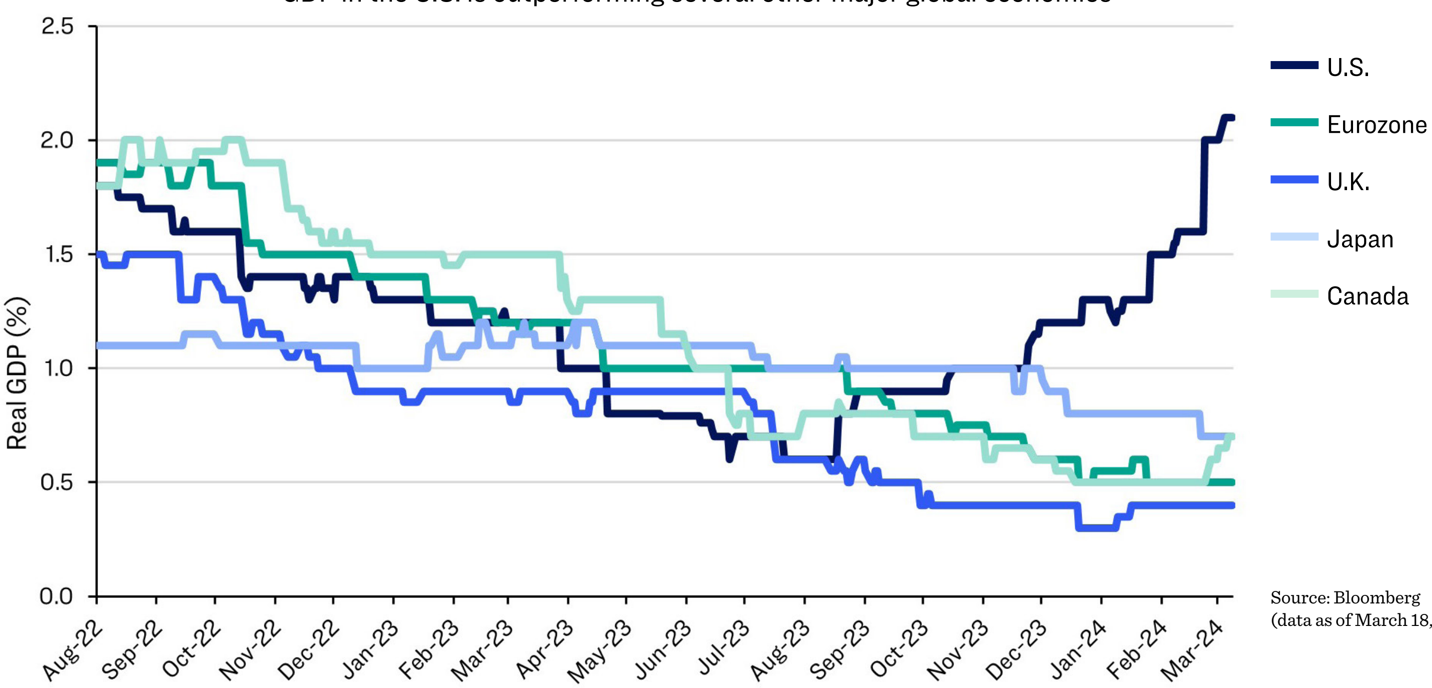
We're now at the four-year anniversary of COVID lockdowns—a period of unmatched global uncertainty that saw 10-year Treasury yields fall to 0.3%, the Standard & Poor's 500 Index (S&P 500) bottoming at 2,200 and the unemployment rate rising to 15%. We have come a long way!

Ever since the end of the pandemic, the U.S. economy and markets have been outperforming the rest of the world. The S&P 500 closed at a record 5,242 on March 21—an increase of 27% and $9 trillion in market cap since October 27, 2023.[i]

Massive injections of fiscal and monetary stimulus provided the initial catalyst. Today, the drivers are a dynamic labor market, large investments in factories and new supply chains, and AI-related technology spending. Productivity growth averaged 3.2% in Q4 2023.[ii] For context, output per hour for nonfarm businesses averaged 2% from 2000 through end of 2019, so recent productivity gains are noteworthy. While the fourth quarter pace is unsustainable, the upsurge in productivity paired with the increase in the size of the labor force could boost GDP growth—widening the gap between the U.S. and the world even more (Figure 1).

Figure 1

GDP in the U.S. is outperforming several other major global economies



Source: Bloomberg
(data as of March 18, 2024)

A strong labor force is what puts the U.S. in an advantaged position. The Congressional Budget Office (CBO) revised population growth higher from 2023 to 2026, citing an increase in immigration that will raise prime-age population growth from 0.2% to 0.8% in 2023, from 0.5% to 1.2% in 2024, from 0.4% to 1.2% in 2025, and from 0.2% to 0.9% in 2026.[iii] Longer term, projections have the U.S.'s working-age population increasing 10% by 2050[iv] —a stark contrast to the 20% declines projected for China and the European Union.[v] Morgan Stanley research posits U.S. population growth will boost demand for products and services. More people will mean more consumption and more government spending.[vi] It will also increase labor supply, adding to disinflation. However, managing this growth requires a delicate balance. If demand for goods increases faster than the supply of labor, inflation could rise.

Q: When will the Federal Reserve start cutting rates?

The Federal Reserve (Fed) is likely to start cutting rates in the second half of this year, but it's hard to give a more precise answer given current policy. In early March, Fed Chair Jerome Powell testified to Congress that the Fed would not cut rates until it has "confidence that inflation is moving sustainably to 2%."[vii] Let's just say I'm confident the Fed isn't yet confident. The latest economic reports have been too inconsistent. Stray data points will need to coalesce into clear trend lines before the Fed finally acts..

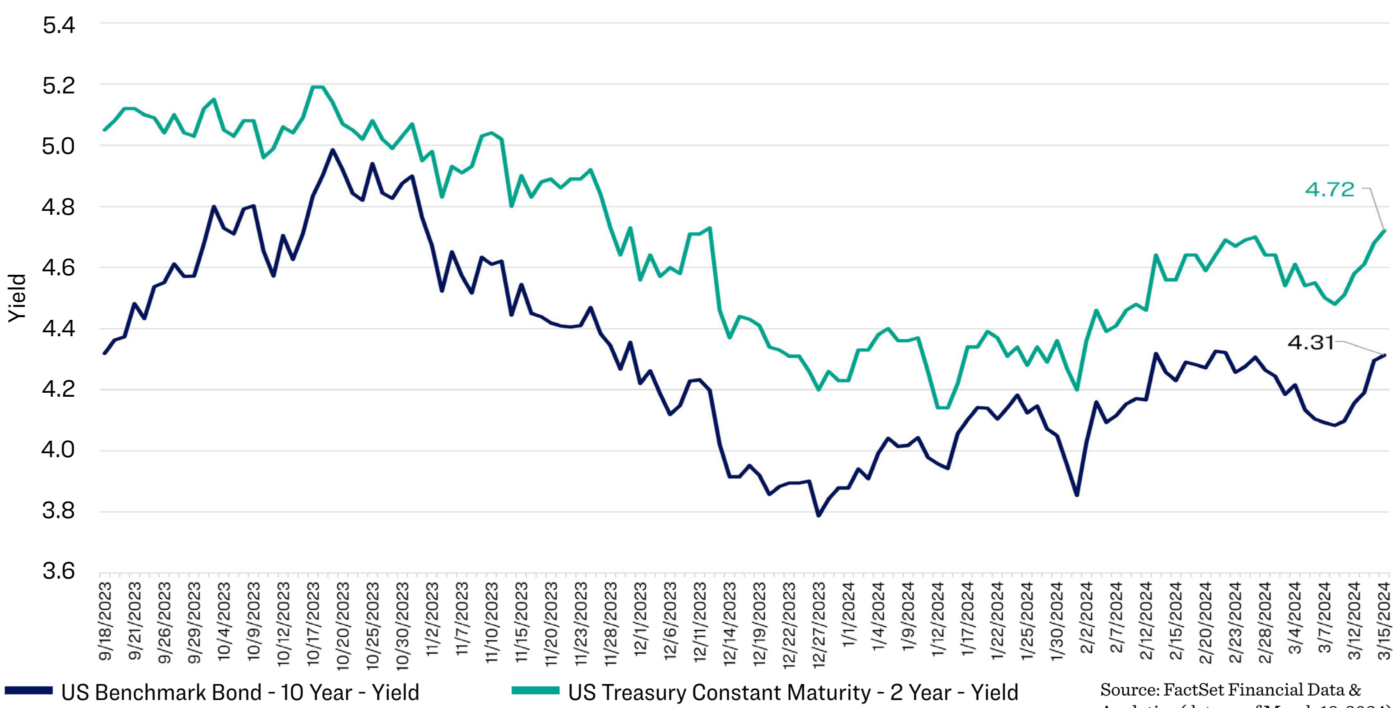
Consider the February jobs report. On the one hand, the economy created 275,000 new jobs, significantly more than the 198,000 economists were predicting. On the other, the unemployment rate rose unexpectedly, to 3.9% from 3.7% after downward revisions to January and February numbers.[viii] Wage and inflation numbers have been equally unpredictable. Wage growth slowed to 0.1% month-over-month in February—down sharply from January's 0.5%—even as the Consumer Price Index (the most common measure of inflation and one usually influenced by wages) surprised on the upside, rising to 3.2% (annualized) from 3.1% in February.[xi] No wonder Powell told Congress the economic outlook is "uncertain."

In late March, the Fed's Federal Open Market Committee (FOMC) met and as expected, made no change to rates. The committee now says to expect three rate cuts in 2024, down from the four projected in December. Our takeaway: At the start of the year, many investors were actually expecting six rate cuts, but now the market and the Fed are more aligned. The Fed also signaled that rates will stay higher for longer, with the FOMC updating its "neutral" interest rate—the rate high enough to restrain inflation but low enough to support economic growth—to 2.6%, up from the previous 2.5%.

The bond market reflects the ongoing uncertainty around timing. Treasury yields have declined since last fall, as investors still anticipate rate cuts. While yields have drifted higher more recently, so too has volatility—a sign those same investors are anxious about the mixed but stronger-than-expected economic data that could ultimately delay when rate cuts take place (Figure 2).

Figure 2

While Treasury yields have recently drifted higher, they are markedly lower than they were in October 2023



Source: FactSet Financial Data & Analytics (data as of March 18, 2024)

The possibility of a "soft landing" scenario playing out this year has risen—lower inflation coupled with a reasonable level of economic growth. That said, a key dynamic for financial markets to digest in this situation is why the Fed might begin cutting rates. If current trends hold, cuts may be made to normalize interest rates, which would be supportive of risk assets like equities. If the economy slows meaningfully and the unemployment rate rises on a sustained basis, however, the Fed might begin cutting rates to defend the economy, leading to a rotation (toward Treasury bonds and away from equities) in the markets.

Moreover, a move towards lower rates would raise the possibility of inflation remaining stuck at levels well above the Fed's stated 2% target. Were that to happen, the Fed might be forced to reevaluate its dovish pivot.

Looking ahead further, Powell's term as Fed chair ends in May 2026. The next president will nominate, and the Senate will confirm, a new Fed chair in 2025 or early 2026. Powell's departure could mean a shift in the Fed's outlook and policy. A generally hawkish (or generally dovish) Fed can have implications for bond yields and growth paths well into the next president's term.

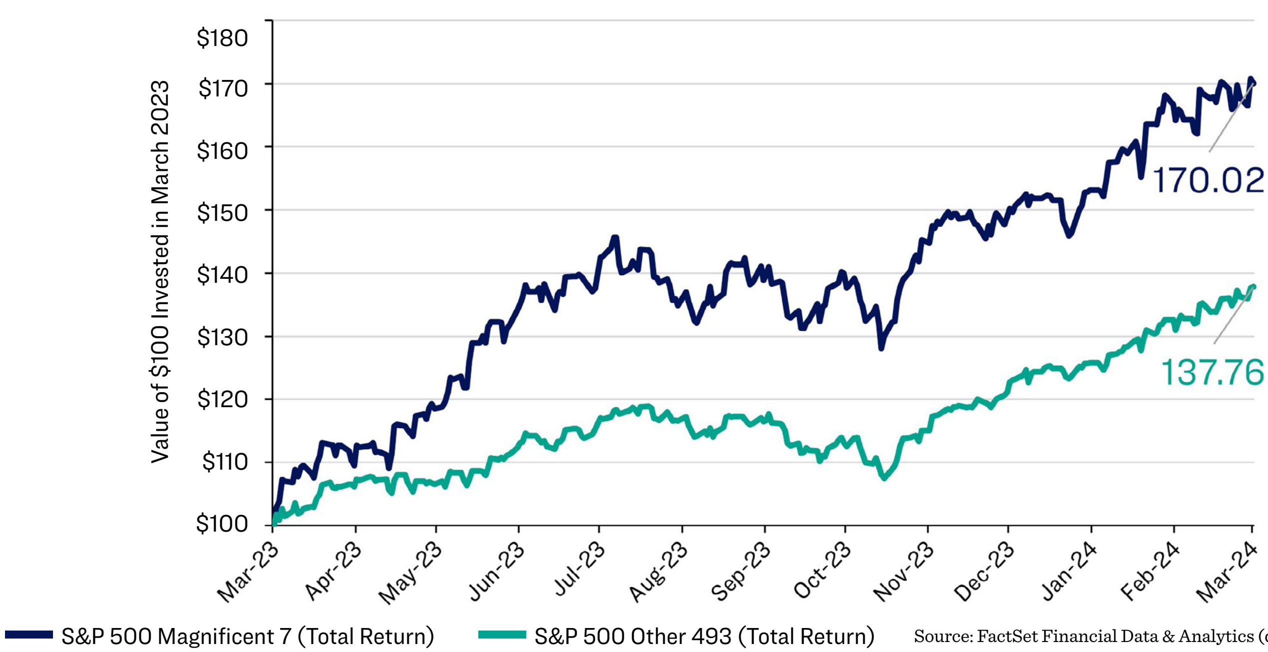
Q: I see so much information in the media about artificial intelligence (AI), and it's confusing. I don't know whether to be excited or scared. It feels like the dot-com era all over again. Should I be investing in AI?

Short answer is probably yes, so long as you're not straying from your asset allocation. The recent surge in AI interest may seem like it came out of the blue, but it's really just the next phase in a long process of technological evolution. The excitement is real, but so too is the trepidation.

AI's future looks a little murkier now than it did a few months ago, as two recent launches—Google's Gemini chatbot and image generator and Microsoft's AI-enabled Bing search engine—failed to live up to expectations. Even so, investors in the big tech firms leading the AI revolution are still being rewarded; most TIAA managed account clients already have exposure to AI stocks, so they are not missing out on the excitement. The AI-related enthusiasm surrounding the so-called Magnificent 7—Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla (yes, one of these is not like the others)—almost single-handedly drove S&P 500 returns last year, producing over 90% of the upside. This trend has continued in 2024 (Figure 3).

Figure 3

AI excitement continues to fuel the magnificent 7's strong performance



Source: FactSet Financial Data & Analytics (data as of March 18, 2024)

Broadly speaking, we do not see a correlation between the current AI boom and the late 1990s dot-com bubble. Collectively, the Magnificent 7 finished 2023 with over $300 billion in free cash flow—they can cut costs if needed.[x] The networked economy puts them at the center of nearly every business and consumer experience. Potential challengers face high barriers to entry. AI's leaders, in other words, are far healthier than the here-today-gone tomorrow upstarts (remember eToys and Pets.com?) that tried and failed to ride the dot-com wave in the '90s.

Pricewise, today's tech stocks are not cheap, but neither are they overly expensive. Back in 2000, the tech-heavy Nasdaq 100 had a forward price-to-earnings ratio (P/E) of ~90. The Nasdaq's current forward P/E is ~26. Forward P/E for the Magnificent 7 is currently ~31, which is steep in comparison to many other big names that make up the "Other 493" with a forward P/E of ~21.[xi] However, other historical bubbles saw even higher valuations: 54x for The Nifty Fifty in the early 1970s,[xii] and 61x for peak Nikkei in 1989.[xiii]

Near term, we see two potential evolutions within AI that could impact investment strategy.

1 Thus far, "AI enablers" have fueled most of the buzz. But over the course of the next 18 to 24 months, we see a rotation from buzz around AI enablers to buzz around "AI adopters." AI tools will move from a development and testing phase to real-world implementation, potentially boosting the profits of companies utilizing the technology. This transition will take time, but this could be a big story in late 2024 and 2025.

2 The AI sector is still an open frontier in many ways, with few guardrails in place to safeguard privacy or protect intellectual property. These challenges must be addressed, and it will create a unique opportunity for companies offering a class of awareness-based tools focused on "AI detection." Hence, the second rotation could be from "AI generation" tools to "AI detection" tools.

Q: This Presidential election year seems particularly heated and rife with uncertainty about the future. What does economic data say about where the general election is headed?

Presidential campaigns create lots of noise, and this year promises to be exceptionally loud. With "Super Tuesday" now behind us, it looks as if the U.S. electorate will be faced in November with a rematch between President Biden and former President Trump.

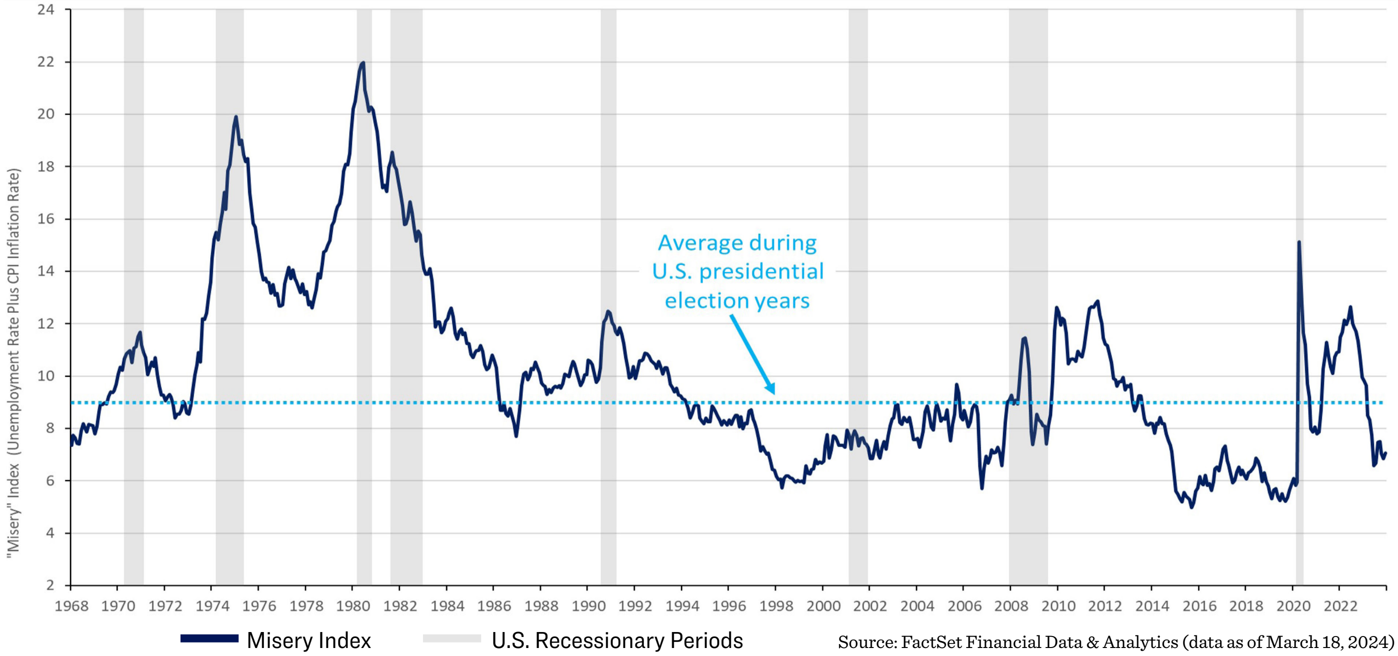
While this situation is unusual, it is not unprecedented: Biden-Trump redux would be the seventh presidential rematch in U.S. history, though the first since Dwight Eisenhour defeated Adlai Stevenson in 1952. Were Trump to win in November, he would join Grover Cleveland as the only other U.S. president in history to serve two non-consecutive terms. Cleveland lost to Benjamin Harrison in 1888 but won a second term in the 1892 rematch.[xiv] Lots of uncertainty remains around the current matchup, and it will be interesting to see which economic issues voters prioritize.

Right now, inflation continues to be top of mind for American voters. Historically, U.S. politics and inflation have been linked, as inflationary pressures can be a major hurdle for incumbent presidents. While inflation has slowed over the past 18 months—from 9% in mid-2022 to 3% by year-end 2023—overall prices are still up 20% since early 2020. The increase is more pronounced for high profile items like groceries (+25%) and vehicles (+22%).

The so-called Misery Index (the inflation rate plus the unemployment rate) has traditionally been a reliable gauge of consumer attitudes toward the economy and the incumbent party. The higher the Misery Index, the worse it is for incumbents. Since 1960, the average reading of the Misery Index in January of presidential election years has been 9. In the years the incumbent party ultimately lost the White House (1960, 1968, 1976, 1980, 1992, 2000, 2008, 2016, 2020), the January Misery Index averaged 10—slightly higher than the average. In January 2024, the Misery Index stood at 7, which was below the average reading when the incumbent lost and well below the four-decade high level of 15 during the pandemic. As of this writing, the current Misery Index reading would suggest an advantage for the incumbent party in 2024 (Figure 4).

Figure 4

The higher the misery index, the worse it is for incumbents during election years



Source: FactSet Financial Data & Analytics (data as of March 18, 2024)

While the Misery Index cannot predict elections, it does provide a snapshot of the electorate's tolerance for the current economic environment. The big question at this juncture is whether the "politics" of the 2024 U.S. election might have an outsized impact on inflation, or if inflation will have a larger impact on the election outcome.

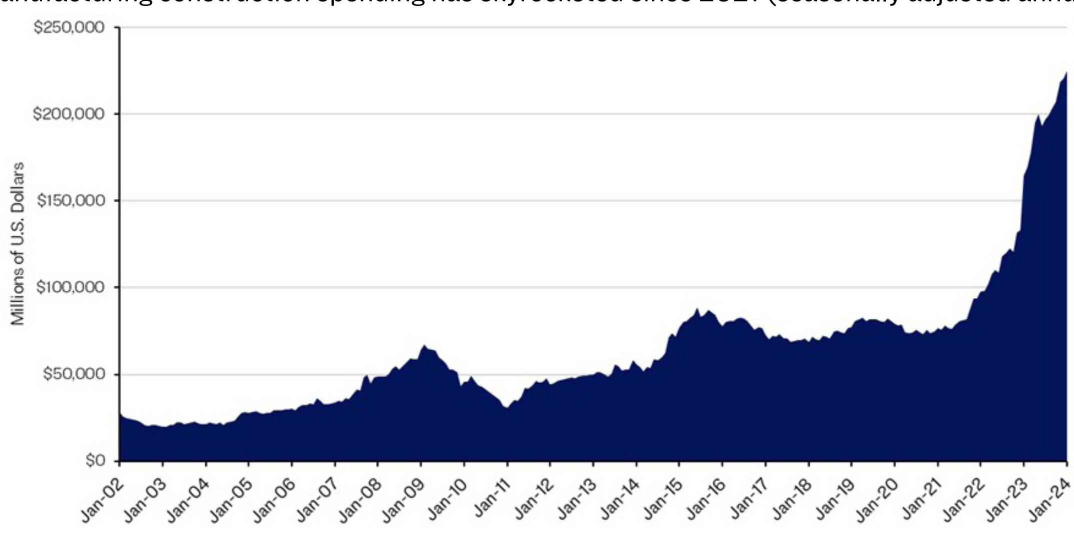
Q: When it comes to markets and the economy, how worried should I be about the messy state of geopolitics—the Russia-Ukraine war, the Israel-Hamas war and rising tensions between the West and Russia & China?

There are several flashpoints in global geopolitics that have the potential to disrupt financial markets. The ongoing conflicts involving Russia-Ukraine and Israel-Hamas could turn at any moment. America's increasingly tense relationship with China continues to simmer. Given the perception that America is itself under strain—politically fractured, racking up debt, losing faith in key institutions—any decisive tilt in one of these conflicts could carry significant geopolitical consequences. It could cause economic shocks that snarl global supply chains and force further reevaluations of trade and investment restrictions.

The rapid pace of globalization that offshored American jobs and tech into China the last several decades hit a wall in 2019. The change in this dynamic underpins the global transformation now taking place. In the wake of Covid-19, national security concerns and deglobalization led to an increase in reshoring and "friendshoring." President Biden has largely maintained the tariffs that former President Trump imposed on China in 2018, while also imposing new restrictions in late 2023 that will limit access to advanced computing, AI technology and related equipment from the U.S. Additionally, investment in U.S. manufacturing capabilities—particularly in high tech manufacturing—has soared over the last three years (Figure 5).

Figure 5

U.S. manufacturing construction spending has skyrocketed since 2021 (seasonally adjusted annual rate)



Source: Federal Reserve Bank of St. Louis (data as of March 18, 2024)

At the same time, Russia and China seem keen to combat these trends by creating a fragmented, multi-polar world. Both nations are in significantly better positions to leverage their influence now than they were in the 1980s. The strategy is effective in that Russia and China can chip away at Western influence by acting in their own self-interests via trade arrangements that are beyond the West's control. China, for instance, has negotiated new trade pacts with Latin American nations such as Chile, Ecuador and Peru.[xv]

Deglobalization can temporarily weigh on the profit margins of the companies that used to benefit from outsourced labor but now have to allocate capital to rebuilding their supply chains. Increased global fragmentation is likely to add to ongoing economic uncertainty and market volatility in the near term.

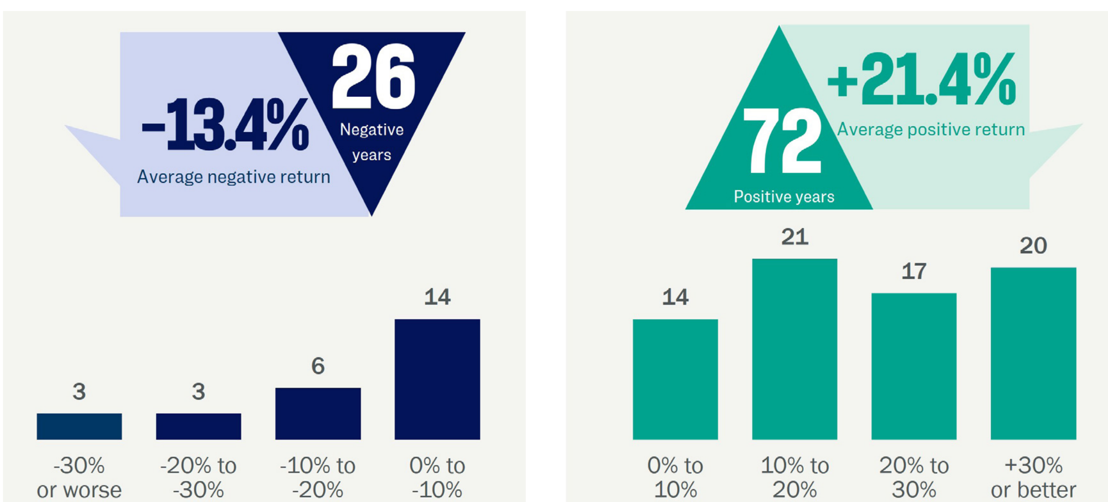
Q: With all of the uncertainty in the world today, should I change my investment strategy or alter my portfolio?

There is no shortage of risks these days—all of which must be digested by financial markets in time. Inflationary pressures, stubborn interest rates, geopolitical tensions, rebalancing labor markets and rising budget deficits remain on the table in 2024, and all may be significant drivers of market volatility.

It's tempting for many investors to overreact, but the S&P 500 has ended the year in positive territory in 72 out of the last 98 years, with an average total market return of over 21% during those positive years (Figure 6). In election years specifically, a long-term 60/40 portfolio has kept up with, and slightly outperformed, non-election years: 8.7% total return in election years versus 8.5% in non-election years. In fact, since 1928, 60/40 portfolio performance has been negative in only four election years, and those occurred amid noteworthy global events (Great Depression, WWII, tech bubble burst and the Great Financial Crisis). By maintaining a well-diversified portfolio, long-term investors can feel more confident about staying the course through periods of turmoil because they are managing risk, not trying to escape it.

Figure 6

Equity returns based on historical S&P 500 performance, 1926–2023



Source: Morningstar Direct (data as of December 31, 2023)

A heightened sense of global uncertainty demonstrates the real need for professional portfolio management when it comes to objectively navigating market volatility. The TIAA Wealth Management team is here to help investors manage these challenging times by identifying and prioritizing their unique, long-term investment goals. By surrounding each investor with a team of experts, we create tailored investment plans that efficiently and effectively align resources, while maintaining focus on a client's financial needs and objectives.

[i] Source: FactSet Financial Data & Analytics: Data as of March 21, 2024
[ii] U.S. Bureau of Labor Statistics. Fourth Quarter and Annual Averages 2023, Revised March 7, 2024
[iii] Morgan Stanley. Immigration, Labor Supply, and Potential Growth. Feb 23, 2024
[iv] https://www.census.gov/content/dam/Census/library/publications/2020/demo/p25-1144.pdf
[v] https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economic-research/publications/specials/en/2024/february/2024-02-14-Migration-AZ.pdf ; https://www.statista.com/statistics/1219212/china-number-of-working-age-persons/
[vi] Morgan Stanley. Immigration, Labor Supply, and Potential Growth. Feb 23, 2024
[vii] https://www.federalreserve.gov/newsevents/testimony/powell20240306a.htm
[viii] https://www.marketwatch.com/livecoverage/jobs-report-for-february-payrolls-data-puts-rally-on-the-line-after-record-s-p-500-high?mod=home_editorspick ; https://www.barrons.com/livecoverage/february-jobs-report-today/card/february-s-jobs-report-is-almost-here-what-to-expect--xOIAx28x37NT98gFUgOL
[ix] U.S. Bureau of Labor Statistics. Consumer Price Index Summary, Revised March 12, 2024
[x] https://www.spglobal.com/marketintelligence/en/news-insights/blog/private-credit-investors-and-alternative-investment-funds
[xi] Source: FactSet Financial Data & Analytics: Data as of March 20, 2024
[xii] Historical data using average P/E ratio. http://csinvesting.org/wp-content/uploads/2015/11/valuing-growth-stocks-revisiting-the-nifty-fifty.pdf
[xiii] https://www.japantimes.co.jp/business/2024/02/22/markets/japan-stocks-hits-record-high/
[xiv] https://www.pbs.org/newshour/politics/the-biden-trump-sequel-isnt-the-first-u-s-presidential-rematch
[xv] https://www.cfr.org/backgrounder/china-influence-latin-america-argentina-brazil-venezuela-security-energy-bri

CIO PERSPECTIVES TIAA

IMPORTANT DISCLOSURES

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