CIO PERSPECTIVES

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Shifting Expectations

December 2023 was another good month for stocks and bonds. The Standard & Poor's 500 (S&P 500) stock index gained 4.5% in December and ended the year higher by 26.3%. Bond yields continued to fall, which means bond prices continued to rise. The 10-Year Treasury yield has fallen more than 100 basis points since October, whereas the 2-Year yield has declined by 80 basis points. The economy remained resilient with gross domestic product (GDP) on track for 2.3% growth in the fourth quarter of last year[1]. Finally, there was further progress on the inflation front, with the inflation rate slowing to 3.1% in November.

The good news led to a dramatic pivot by the Federal Reserve (Fed) at its December meeting. The Fed indicated it would be prepared to cut interest rates three times in 2024, signaling its satisfaction with the latest inflation data and its willingness to support economic growth moving forward. The increased likelihood of rate cuts has significant implications for the economy and the markets. On one hand, it raises the possibility of a "soft landing" or "goldilocks" scenario playing out in 2024—lower inflation coupled with a reasonable level of economic growth, which would be a continuation of the current favorable environment for risk assets. On the other hand, a move towards lower rates raises the possibility of inflation remaining stuck at levels well above the Fed's stated 2% target. Were that to happen, the Fed might eventually be forced to reevaluate its dovish pivot. Any uncertainty about where Fed policy is headed has the potential to introduce more market volatility, including higher interest rates and lower equity valuations later in the year.

Given the S&P 500's current price-to-earnings ratio of nearly 20 times forward earnings—up two points from October—the stock market seems priced for the goldilocks scenario (i.e., stable growth and slowing inflation). Investor sentiment and positioning also reflect a bullish outlook, while lower bond yields reflect expectations of a benign inflation scenario in which central banks embark on a rate cutting cycle. This significant shift in expectations—evidenced by the two-month rally in stocks and bonds—may have pulled forward returns from 2024. As we wrote in our 2024 Outlook, Navigating the Last Mile, our view remains that the U.S. economy will decelerate and inflation will moderate further, but we believe that the disinflationary process will be bumpy and non-linear. The reset phase for inflation, profits and the business cycle should cause market volatility to rise episodically, as should the U.S. election cycle and a fragile geopolitical backdrop.

[1] Atlanta Fed's GDPNow estimate

There are both cyclical and structural forces now at play influencing inflation. Because these forces push and pull in different directions, interpreting them in real time can be difficult. Cyclically, disinflation in goods prices, the normalization of supply chains and the delayed impact of tight monetary policy on borrowing and spending have all eased pricing pressures, while the strength in economic activity and higher wages have worked to prevent inflation from reaching the Fed's 2% target. This cyclical push and pull has yet to play out completely.

Structurally, the U.S. and global economies remain in the throes of long-term transformation, creating new risks and opportunities for investors as well as new influences on prices. The potential for sustained productivity improvements from disruptive new technologies, such as robotics and artificial intelligence, can help tame inflation. So too can today's rising labor force participation. On the other hand, the increasingly fragmented, multi-polar world may encourage reshoring and raise the prices of everyday goods. The Fed has limited influence over these structural forces, which are likely to play out over a longer time frame, with variable and unknowable impacts in the near term. As investors navigate inflation's last mile journey, there is an important consideration to keep in mind: The collision of cyclical forces and structural shifts may lead to a "new normal" for inflation, one higher than the Fed's 2% target over the medium term.

A balanced long-term investment portfolio, based on a 60/40 asset allocation of stocks and bonds, returned 16.7% in 2023, bouncing back from a loss of 17.0% the previous year[2]. We continue to believe that investors should remain invested and diversified in an appropriately balanced, multi-asset-class portfolio—one in sync with their unique financial goals and risk tolerances. This foundational asset allocation is the primary driver of investment outcomes. It can be complemented with marginal tilts towards favorably priced asset classes—those offering attractive absolute and relative valuations, higher quality profiles and the potential to withstand potential policy mistakes by the Fed. In the current environment, high quality bonds fit these criteria and are more attractive than equities or cash.

Cash may be preferable to stocks and bonds when interest rates rise quickly and investors expect economic weakness. It may be less preferable when rates decline and investor sentiment recovers. In the absence of another inflationary shock, cash is likely to lose its appeal since we have likely reached the peak in Fed funds rates for this cycle. From a financial planning perspective, investors may want to first account for cash needed for near-term spending—needs that are essential, aspirational or required to meet upcoming liabilities. Thereafter, investors may want to consider deploying excess cash into their balanced portfolios over the course of the year. Investors who are already fully invested should manage risk appropriately and maintain discipline when it comes to rebalancing to their asset allocation targets.

[2] Bloomberg Global EQ:FI 60:40 Index is designed to measure cross-asset market performance globally. The index rebalances monthly to 60% equities and 40% fixed income. The equities and fixed income are represented by Bloomberg Developed Markets Large & Mid Cap Total Return Index (DMTR) and Bloomberg Global Aggregate Index (LEGATRUU) respectively.

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