POLICY AND POLITICS

Focus remains on monetary policy with investors parsing Fed minutes and statements. Rate cut hopes drove much of the Santa Claus rally, but the Fed has not committed to investors' full wish list. Politics will battle monetary policy for mindshare; ~40% of the planet can cast a vote this year, including the U.S. and Taiwan (which just reelected its nationalist party). We expect a U.S. soft landing, areas of global economic weakness and hesitant central banks. When joined by elevated U.S. equity valuations and geopolitical risks, the macro backdrop endorses a small underweight to risk and a preference for high yield over equities.

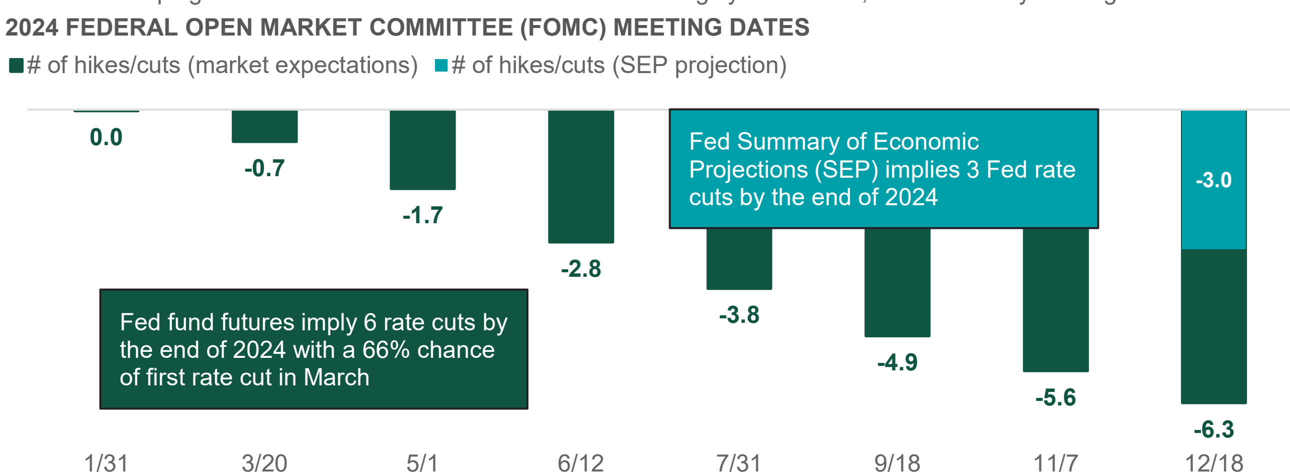
Interest rates will likely show less volatility this year. The 10-year U.S. Treasury (UST) yield ended 2023 at 3.88% – the same level as it ended 2022, but with a rise to a high of 4.99% along the way. Given our call for a U.S. soft landing and modest Fed accommodation, it's reasonable to expect the 10-year UST yield to end 2024 around 4% again, and without last year's detour higher. We side with the Fed's forecast calling for three 0.25% rate cuts this year (versus market calls for roughly six) with the first cut occurring at the June Fed meeting (versus market expectations for March). Such an outcome would likely remove the inversion from most of the yield curve by bringing down the front end more than the back end – presenting a reasonable backdrop for risk-control assets.

Comparing Powell's soft landing to Greenspan's. The last time the Fed achieved a soft landing – in 1995 – the S&P 500 gained 38%, kicking off the dotcom era and a five-year period of 29% annualized returns. Could AI elicit a similar market reaction as the internet revolution? Perhaps. But starting-point equity valuations today are much higher – 24.9 on a price-to-trailing-earnings (P/E) basis (versus 16.9 heading into 1995, ultimately reaching 30.7 at the end of the five-year period). Today's 4.0% S&P 500 earnings yield compares unfavorably to the 7.6% yield on high yield bonds – especially given the ~1.5% real growth environment we expect (versus the 4.2% annual growth from '95-'99). Also, profit margins will be pressured as companies roll over debt at rates around double what was secured post-pandemic (~8% from ~4% in high yield and ~5% from ~2% in investment grade).

Getting paid upfront in a risky, modest-growth world. We like high yield's income generation over the potential price appreciation in developed market equities, wherein U.S. valuations are rich and European growth is at risk. Emerging market equities are looking more attractive but we seek more clarity on the contours of Fed policy and the implications of Taiwan's election before going overweight. We are strategically allocated across all real assets.

RATE CUT RECONCILIATION NEEDED

Markets are hoping for a March start to rate cuts and a total of roughly six in 2024; the Fed is only offering three so far.



Source: Northern Trust Asset Management, Bloomberg. Summary of Economic Projections (SEP) as of 12/13/2023. Market expectations implied by futures. Data as of 1/16/2024.

BASE CASE EXPECTATIONS

Sticking the Landing

Global growth will move below trend but remain positive, supported by a U.S. economic soft landing underpinned by a solid labor market and healthy consumer. Inflation will remain above target but continue to proceed toward 2%. Despite the constructive economic backdrop, high valuations temper risk-taking appetite.

The Fed's Transition

The Fed is very likely done raising rates, but market expectations for a probable rate cut in March, two cuts by June and a total of five-to-six rate cuts in 2024 are too aggressive. More realistic would be three cuts, starting in June and followed by cuts in September and December.

RISK CASE SCENARIOS

Lagged Impacts

The market's enthusiasm for a soft landing proves to be misplaced as the cumulative effect of 5%+ rate hikes in two years starts showing up in economic functioning. TAA is not underweight risk enough in this scenario.

A Bad Goods Environment

Geopolitical tensions in the Red Sea (currently causing significant but manageable goods trade disruptions) intensify or broaden to the Persian Gulf (impacting oil supplies) – potentially causing stagflation.

ViewPoints reflects data as of 1/17/24.