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PALOS

Macro View

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What Is the Consensus Call for 2024?

It’s that time of the year when top-rated strategists expose their predictions for the year to come. 12 months ago, they were convinced that the US was heading into a downturn, resulting in an outright fall for stocks. They were wrong. They did not foresee that Americans would spend a big chunk of the personal savings that they had accumulated during the pandemic nor did they believe that the US economy was in a mini-productivity boom. Currently, most soothsayers are neutral about 2024, thinking the economy and inflation will slow down toward a mild recession - the so-called soft landing - thereby forcing the Fed to cut interest rates by the end of 2024, but with little clarity on what the stock market will be up to. Their case relies on the view that the bulk of the excess savings has already been depleted, the fiscal largesse of the Biden administration is exhausted and higher interest rates will bite. Interest rate futures, however, indicated last week a roughly 65% chance the Fed will adjust rates lower by its May 2024 policy meeting.

Will the Consensus Call for 2024 Be Wrong Again?

I think it’s more probable than possible. There are several superficial reasons why the most anticipated recession in recent history has not arrived in spite of the most aggressive rate hiking cycle in years. NowCasting models like the ones fabricated with real time data by the Atlanta and NYFed, including several private banks and research organizations, still suggest that the economy is chugging along at an annual rate of 1.2% to 2.3%. First, crude oil prices have crashed to where they were in July. The best that Opec+ can now deliver is stabilization. Saudi Arabia has had difficulty in wrangling a deal and US oil inventories have kept on rising, while the energy share of world GDP is presently only 6.0% compared to 9.0% last January. Second, the dollar is no longer ballistic. The DXY has fallen from a high of 107.08 in October to 103.25, as the cost of money has levelled out, easing financial conditions. Third, the Fed policy-makers have publicly announced that they will proceed carefully, moving in lock-steps with other central banks around the world. The beige book, which is a collection of regional surveys of economic activity, reported flat to slight declines in business, continued ease in overall employment and moderating price increases.

Meanwhile, Thursday’s Commerce Department October report on consumer spending and inflation was consistent with the notion that the economy is cooling for the better. Headline PCE rose 3.0% y/y within the Fed’s 1% to 3% target range, while the core PCE deflator, which strips out food and energy prices, rose 3.5%, the lowest since April 2021.There's no indication of either a forthcoming business contraction or a renewed wave of inflation.

The Bond Market Is on the Bull Side:

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The bond market startled the world in November, as the 10-year bond yield fell from 5.00% to 4.21%. Contrary to popular belief, the overall performance of the yield curve revealed during the period under consideration implies that the fall in bond yields was not a predictor of a forthcoming recession, but more one of a natural slowdown in the level of economic activity. First the Fed's policy rate is 5.38%, which is 88 bps above the so-called neutral rate: only measurably restrictive and therefore not enough to basculate the economy into a recession. Second, the swap market is predicting that the rate of consumer inflation will fall to an annual rate of 2.1% by next December. Third, assuming that the stunning November bond rally has returned the term premium back to zero, as Governor John Willams has argued, real rates are consequently still running at 2.3%, directly implying, contrary to the conventional opinions of economists, that this growth path is still on a sustainable track.

A New Era of Productivity May Have Emerged:

What is intriguing in all of this is that the bond market is predicting that growth will continue even though the prospects for further increases in employment are dim and mainly behind us, while the outlook for falling inflation is positive in spite of anticipated increases in level of economic activity. How can this be? The quick answer is productivity, because it is the only way that inflation can cool down more while growth remains positive. Fed Governor Christopher Waller indirectly and surreptitiously implied this notion when he said: " I am increasingly confident that policy is currently well positioned to the economy, without a sharp rise in the unemployment rate, and gets inflation back to 2%." He added: "If the decline in inflation continues for several more months - 3 months, 4 months, 5 months - we could start lowering the policy rate because inflation is lower." The point is that there would be no need to keep the cost of money high, if inflation continues to fall without a recession for it would be consistent with the Fed's own policy rule.

This phenomenon is perhaps remarkable, but the US economy has the power and capacity to keep on trucking because it has the reserves of technological strength found across several industries. Its engine is generating a productivity boom that is resembling the one witnessed in the late 1990s, which was the last time we saw this kind of action when the internet boom occurred.

Many strategists are skeptical, however, that the U.S. economy may have entered into a virtuous cycle of growth, where growth is not necessarily completely dependent on consumer demand. I'm not. Last December, I changed my mind about the long-term state of the U.S. economy. The fundamentals have changed.

Indeed, there is growing evidence that potential growth has shifted from employment to efficiency. Business executives are foresighted and not stupid. They are incentivized to substitute more capital and know-all in their domestic production process for labour, globalization and foreign imports of critical elements. Indeed, surveys are pointing out that the diffusion and implementation of digitalization, artificial intelligence, robotics, cloud services, 3-D printing, AI on smartphones, and internet applications is spreading like wildfire. Incidentally, this phenomenon explains the

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reluctance of companies to let go of workers because they are getting more out of them as the investment in their long term training programs is paying off. In spite of tech lashes by Luddites and a barrage of ridiculous lawsuits, technology is producing a massive transformation, reordering all industries around generative AI. According to a study produced by the McKinsey Global Institute conducted by James Manyika (Stanford University) and Michael Spence (Nobel Prize Economist), the economic potential of generative artificial intelligence could add more than $4.0 trillion annually to the global economy on top of the $11.0 trillion that non-generative AI and other forms of automation could contribute. By comparison, the entire German economy - the world’s fourth largest - is worth about $4.0 trillion. What is particularly important is this eye-popping impact will come largely from gains in productivity and become a leading driver of global prosperity. The study concluded: “The prospective gains to the world economy derive from the rapid advances in AI - now further expanded by generative AI and AI that can create new content, and its potential applications in just about every aspect of human and economic activity. The harnessing of these innovations could reverse the long-term declines in productivity growth that western economies have faced over 2 decades.”

The economy’s odometer proves this. Since the end of the second quarter of 2022, labour productivity rose from -3.5% to +4.7% in Q3 of 2023 for a 4-quarter average annual rate of 2.5%. Outside of recessions, when productivity cyclically spikes, this sort of rise is highly unusual. Those of you who read my weekly comments regularly know full well that I’ve always been in the camp that believed that the U.S. economy was in a “2 plus 2” configuration, which is 2% for inflation and 2% for growth. I now subscribe to 2.5% for growth and 2.5% for inflation. This change of opinion may not seem much on the surface. However, its major shift - a regime change - lies in how future growth will stem from productivity rather than labour.

The Stock Market Outlook:

One of the glaring oddities of the post-pandemic period has been the tendency of stock prices to perform awkwardly in relation to the direction of bond yields. This new anomaly is a strange setup because it is not supported either by historical experience or conventional economic theory, unless something big has changed. I think it may have. The current fast pace of the economy will slow down from the heights achieved in Q3 of 2023, but productivity growth may have resuscitated, making recession and soft landing calls less likely. Perhaps, this explains why the S&P 500 has generated a whopping increase of 27.5% since October 12, 2022. It is now only 4.9% below the record high on January 3, 2022. Thus the bull market is the real deal. While I

acknowledge that the stock market is impossible to forecast accurately, I’m nonetheless comfortable with the prognostication that the S&P 500 will end the year near my original 4650 forecast. If we are in fact, in a new productivity boom that is extendable, it is entirely conceivable this benchmark could make new highs in 2024 and even reach 5300.

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This past week, the market marked time around the resistance line connecting the January 3, 2022 record high and the July 31 high of this year, but broke out to 4594 on Friday. There is a record $5.76 trillion in money market mutual funds and a lot of cash sitting in bank deposits, and with money market rates falling it is conceivable that investors may now move back into stocks and bonds.

The Science of Market Timing:

Timing the direction of the S&P 500 is very difficult, because sentiment can turn on a dime. Although the odds are stacked against forecasters, it's important to have a playbook in order to monitor if one's assumptions upon which calls are conjectured are right or wrong. In my case, it will be important to follow the evolution of productivity. If we are indeed in a new era of productivity that Yardeni Research promotes, it would be dangerous to be without meaningful exposure to stocks. The fact is that the situation is not as bad as surveys of sentiment would lead us to believe. They may overstate a weakening of the economy, perhaps because consumers are not adjusted to the astonishing prices of everyday things. Interestingly, firms are saying pretty good stuff about the details of their business. For example, the hard data produced by the FFIB and Dallas Fed Manufacturing surveys are significantly better than the soft ones. The bottom line is that investors are convinced that we've seen the peak for interest rates at 5% because inflation is cooling and growth is slowing, while profit is rising and so is liquidity. The risk is that the productivity scenario turns out to be a blip - just a 2023 mini-boom. Then the recession that never came, comes. In this regard, the S&P 500 could have a rough ride and trade down to 4000, but it is not my base case. I'm sticking with an earnings per share for the S&P 500 of $250.00 for 2024 versus $225 for 2023.

Huber Marleau's Macro View

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