01-01-2024 – Outlook 2024
Pillow Talk

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MR. MICHAEL CEMBALEST: Good morning, everybody. Welcome to the 2024 Eye on the Market Outlook Podcast which is entitled *Pillow Talk*. Some of you may remember that *Pillow Talk* was the name of a movie from the 1950's with Doris Day and Rock Hudson. If you haven't seen it, there was a Rock Hudson documentary that came out last year that's worth seeing.

Anyway, Pillow Talk here refers to the picture I have with a bunch of bears falling into some pillows which is a metaphor for the increasing talk about a soft landing from a hard landing and from a bear market to a non-bear market. A lot of that talk accelerated at the end of the year when the Fed signaled that they would in fact be easing monetary policy in 2024: some of which was predicted but not quite as much as predicted right now after those Fed announcements.

So I want to walk you through some of the topics that we covered in the Outlook, some of which we'll discuss on the podcast today. And some of which we'll discuss on a couple of podcasts being rolled out over the next couple of weeks.

So. What are the topics? Let's see. We cover really important leading indicators which I think had a large role to play in the Fed changing its tune. The inflation monitor that also is tied into the same thing.

We take a look at equity markets in the U.S. and the issue around the mega-cap stocks which continue to dominate the markets. An antitrust monitor which we'll discuss in this week's podcast. The latest on Europe and Japan which are going in opposite directions at least from the perspective of equity investors. A global fixed income monitor. Some additional comments on U.S. Federal debt sustainability. Information on the U.S. consumer. A section on China.

And then we have a deep dive on weight loss drugs. I've been working in this for a little bit and I thought it was interesting to include it here in the outlook instead of having it on a standalone basis. Maybe we'll issue it on a standalone basis later in the year.

And then in honor of Byron Wien who passed away at the age of 90, Byron used to publish a top 10 surprise list every year. In his honor, I'm going to do one this year as well.

So let's get into the details here. The first chart we have in the outlook is by far the messiest chart I have ever created. But it's worth it -- I promise, it's worth it. Because what it shows is the 7 post-war recessions that too place and the sequencing of when things hit bottom: whether they were the equity markets, or payrolls, or housing starts, default rates, the ISM surveys, GDP.

And what you can see here is that with the exception of the dot-com cycle in 2001, equities bottomed way before the worst readings on the other stuff. So you know obviously everybody's recession forecast or most recession forecasts for 2024 are going down with the Fed. Easy. But even if there is a recession I think the important point is that equities tend to bottom way before a lot of the other economic and market data that people tend to focus on which I think is really important to understand as we head into the next year.

Now. There are 20 or at least 22 different leading indicators that we follow on a weekly basis. I just wanted to share 2 of them that are sending a consistent signal which is that the coincident indicator which tells you what's happening right now looks fine but the leading indicators look weak.

They don't look catastrophically weak. They don't look as weak as they looked in 2020 during COVID. They don't look as weak as what they did during the 1970's and they don't look as -- certainly don't look as weak as they did in 2008-2009.

But they look like they are signaling a run of the mill decline in U.S. economic activity which is consistent with a recession.

And then there's another model that we tend to look at that looks at a few different variables and then we extrapolate it out for 18 months and it does suggest that there will be a decline in corporate profits this year.

And so both of those models are pointing to modest weakness, maybe a very modest recession. Other leading indicators we look at particularly some that we like a lot, which is the relationship between manufacturing orders and inventory, is actually getting better on the margin.

So the big picture here is it looks like an economic slowdown in the first and second quarters of next year. Maybe something like .5% to 1% growth. I have seen recession forecasts of minus 1% and I've also seen a bullish GDP forecast for next year of 2%. So the numbers are all over the place. To us it looks like some modest weakness next year certainly in the first half of the year in the neighborhood of half a percent to 1% GDP growth.

Now the two biggest reasons I think why we haven't had a recession yet in spite of a whole lot of Fed tightening is shown in a couple of charts we have in the Outlook. One of which looks at corporate interest payments and the other one looks at the corporate sector financial balance.

So normally two things happen when the Fed raises rates. Number one, it catches the corporate sector off balance and the corporate sector typically, heading into a recession, is overspending in terms of cash flow generation relative to its capital expenditures.

And so all of a sudden Fed tightening knocks the corporate sector for a loop. They have to tighten their belts really tightly and that contributes to recession.

And on top of that, corporate interest payments go up a lot because of rising interest rates.

Well this time neither of those two things is happening. This time corporate cash flow is in surplus as the Fed tightened. And for whatever reasons, most of which has to do with most companies having termed out their duration of their debts, rising interest rates has not yet led to an increase in net interest payments as a percentage of profits. It's kind of remarkable.

We have a chart in here that shows just how unique that is.

It could have something to do with the fact that this was -- you know people had ten years during a period of financial oppression to term out their debt maturities and so finally they did.

Now usually recessions begin around seven quarters after the first Fed hike. And that's where we stand right here as 2024 begins. And so we don't know for sure if there's not going to be a recession and if there were one it might not have already happened. It might be happening over the next 2-3 quarters. But, again, right now I think it's roughly a 50/50 call and if it does happen it's a mild one.

What's notable is for all of the consternation about commercial real estate, if you look at the cash flows and LI and delinquencies, it's really just the regional malls and commercial urban office space that are getting crushed.

The delinquency data is actually getting much better for hotels, industrials, multifamily, and even retail once you strip out the regional malls. And so we have a chart in here on that. It kind of is consistent with an economy that has some real isolated weak points: namely regional malls and office. But where the rest of it is doing okay.

And similarly in households, the scary cycles are when all the delinquency rates go up together. What we have now is kind of a weird one where subprime auto delinquencies are off the charts bad. But subprime auto is about 20% of the overall auto origination market. That's not terrible.

And credit card delinquencies are weakening. But prime auto loans and first and second mortgage delinquency rates are very well behaved and as tight as they've been over the last decade. So. Again, isolated pockets of weakness but nothing really systemic at this point.

Now. As tarnished a phrase as mission accomplished has been historically in the United States, I think the Fed's mission is mostly accomplished. When we look at different cuts on CPI, and we show three of them here, and then we look at falling supply chain pressures, rising auto inventories, falling used vehicle prices, declines in very timely measures of residential rent inflation and also very large amount of multifamily supply coming online, I think the Fed is justified here in pivoting and thinking about easing rather than tightening.

Similarly, the wage inflation numbers, those are the things that concerned me more a few months ago. I thought we maybe would be in a situation where consumer prices are falling but wages are really sticky and aren’t falling. They’ve started to roll over from high levels, yeah, but they started to roll over and importantly we’re seeing a ton of data, most of which supports the fact that there’s weakness in the labor market: declines in temporary help, manufacturing hours, unit labor costs, job switcher premiums (like how much people get paid when they go from one job to another), female labor force participation rates are rising.

So a bunch of indicators suggest that wage inflation is going to be rolling over as well. So in terms of what the Fed is up to, I think they’re justified in thinking about easing.

Now where does that leave the equity markets? The equity markets are -- they’re not as expensive as they’ve been, but again, they shouldn’t be, right, because now we’re in an environment of positive real interest rates again so those crazy-high multiples in 2020 and ’21 no longer make any sense at all.

Whether you’re looking at the market cap weighted S&P or the equal weighted S&P, the multiples are a little on the high side. To us, 2024 looks like a year with single digit earnings growth, single digit returns on the median stock. And if we have to go hunting for sectors, valuations in industrials and energy look interesting. And there’s nothing, I think that’s going to stop the mega-cap stocks other than a large shift in antitrust enforcement which we'll talk about in a minute.

But the bottom line here is that the rally towards the end of the year ended up with the markets pricing in a very soft landing already. So I think there’s a lot of soft landing good outcomes that are already priced into the market. All things considered, based on our views on growth, profits and interest rates, kind of a diversified portfolio with a U.S., tech, industrial, and energy tilted equities, long duration municipals and Treasuries, and high grade bonds rather than high yield and a decent slug of cash seems to make the most sense heading into 2024.

We spent lots of time looking at the Magnificent 7 and you know I wish we didn’t have to. But we do. And those are the largest 7 companies in the S&P. It kind of reminds me when I joined JPMorgan in 1987 and I worked in emerging markets, the emerging markets fixed income markets at the time were so dominated that basically Brazil, Mexico, and Argentina was all that really mattered and all the other countries that they tried to stuff within the index weren't large enough to affect anyone's portfolio.

We're getting close to that in the S&P 500. We're now at the highest ever market cap, almost 30%, coming from just those largest 7 companies. And if you think about returns last year, the market did great. The market was up 26%. But you had 78% coming from those 7 stocks and 15% from the rest.

And then we have a whole bunch of charts in here that look like the one we're showing here which is these Magnificent 7 stocks generate tons of free cash flow compared to the rest of the market whose cash flow generation has basically been flat over the last 18 to 24 months and rising for the Big 7.

So one of the things that we're very attentive to is are these Magnificent 7 stocks getting too expensive and are going to come back to earth kind of like an Icarus moment? If you look at their relative PE versus the market, it looks like they're getting more expensive.

But because of the nature of these companies I think you have to look at them and adjust the relative PE ratio by their relative earnings growth. And if you do that, they don't look out of line and in which case the higher valuations is a reflection of much higher earnings growth both historical and expected.

So that's why we spend so much time thinking about antitrust issues because to me that's really the one issue that could change the dynamic of profitability that these large companies have been benefiting from over the last decade.

And we have an antitrust monitor in the Outlook. If you're not familiar with some of the concepts I'm about to rattle off, you probably should be, because of how important they are. So in the antitrust monitor we get into the issue of traffic acquisition costs which are the tens of billions of dollars a year that Google pays to Apple in exchange for having prime placement on those devices of Google search engines and play stores and things like that.

We get into the question of Google Play Store and Google Play Billing policies in Android phones which was the topic of some lawsuits recently. Epic Games won a major judicial ruling against Google just this month in December 2023 that is still reverberating but was quite a shock.

Google was forced to settle with 38 state attorney generals last month as well where some restrictions are going to be imposed on them regarding their ability to ensure that other phones, you know Android phones, can't come equipped with other app stores and other billing services.

A judge ruled that Apple is in fact exercising monopoly power and does in fact earn super-competitive commissions but has some pro-competitive justifications for what it's doing. And there are also lawsuits going on with Meta, Amazon and T-Mobile from the Department of Justice and the Federal Trade Commission relating to monopolistic behavior and personal social networking markets. Amazon fulfillment services, anti-discounting tactics, class action suits.

So it's 4 pages. It's worth a read, I think, because it does get into the issues that affect the core dominance of these large cap stocks.

Now on the other hand, let's go to a place which doesn't have any dominant, large cap technology stocks, which is Europe. I'm on strike in terms of writing a long section on Europe. It underperformed the U.S. again in 2023 by around 7%. It is now trading at almost a, depending on how you measure it, a 35% or 40% PE discount to the U.S. And since 2014 this has been a one-way elevator down. This has been the mother of all value traps.

One day this will end. And one day it will make sense to be long Europe and short the U.S. After the history of certainly the last decade and the last 25 years or so, I don't think it's a good bet to think that 2024 is going to be that year.

Japan on the other hand is enacting all sorts of corporate governance reforms that do create a better foundation for investment. We have table in the Eye on the Market that looks at just the stark difference between equity penetration of households and pensions and pay out rations and companies that trade below book value. You think about this: 4% of the U.S. market cap trades below book value, in Japan it's 50%.

So we have this table that looks at some of these statistics. There's a lot of room from very low levels for Japan to enact some corporate governance policies to try to re-equitize its society. It's aggressively trying to do that. We're seeing more outside directors. We're actually seeing the Tokyo Stock Exchange threaten to delist companies that don't take steps to trade above book value.

So Japan had a good year last year but this one does seem like it has some legs.

We have a section in here called the Low Spark of High Yield Bonds. If anybody gets the reference, that's a reference to a Traffic song from 1971 with Steve Winwood.

High yield bond spreads are low. The only thing… close to the lowest they've been since 2009. We just want to make sure people understand that there are some reasons for that. Interest coverage is still pretty strong.

The split between BB's and BBB's is a little better now. Fewer of the borrowers are private equity borrowers that attend to be associated with lower recovery rates in case of default. There's more secure debt. There's very little use of any pick bond payment, in-kind bonds.

So compared to prior cycles, the spreads are a lot lower but the risks are somewhat lower. So we thought that was worth mentioning.

The big issue here for fixed income market is what happens to the 10-year. So obviously we've had a big rally in the 10-year. The simplest way to think about it, our view, is that the 10-year will range from 4-5% in 2024. I'd be really surprised without a deep recession that it traded much tighter than that.

If it does break out of that 4-5% range, my sense is that it might trade slightly above 5% because of bond issuance which has lagged the budget deficit. And we have a chart in the Outlook that shows that the Treasury has kind of fallen behind on issuance. It's a very high level in terms of the T-Bill share of total debt. The Fed's buying less and the banks are buying less because they're already overloaded with too many underwater Treasuries.

So all things being equal, some of the financing pressures I think might push 10-year Treasuries back closer to 5% at which point I think they would represent pretty good value.

So to close, I just want to talk about China for a minute. So I have some colleagues that I've worked with for many years that go to our investment committee gatherings and will talk about the tremendous opportunity that may be brewing in China. I mean it's been a train wreck of epic proportions for equity investors.

It has been hit with really bad timing. And there's a chart in here that I think it makes sense to look at and think about. Over the last decade or so, as Chinese growth slowed, MSCI made the decision because they're the ones that make the decisions about index-weights in countries, they increased China's weight in the Emerging Market Index from let's say 15% to 40%.

So by the beginning of 2021, China represented 40% of the entire Emerging Market Equity Index. So anybody that was anywhere close to index following, would have owned tons of Chinese stocks at that point. And then right then, at that 40% index weight is when China's progressive authoritarianism program began really. It started taking potshots at industry after industry and company after company.

And then the U.S. trade war got worse. Over that time, China has underperformed world equities by more than 50%. The numbers are just eye-poppingly bad. Since January 2009, U.S. is up over 100%. Europe is up 60% trailing. China is down 17%. Right? So this is kind of a train wreck.

And now the U.S. Select Committee on Strategic Competition between the U.S. and China, they don't pass legislation but they're kind of laying out a roadmap. The last bastion of bipartisanship left in the United States Congress are policies targeting the Chinese Communist Party. And there's bipartisan agreement for more tariffs, tighter restrictions on Chinese imports, more restrictions on high tech exports to China, prohibitions on trade with a broader group of Chinese companies.

And then just last week or so, China enacted another policy which drove Tencent stock down 10% in a day. So. This is the ultimate value opportunity. For the last few years it's been a terrible value trap. And we're monitoring the economic data which is getting less bad. But at this point it looks like China would have to do something really unorthodox in order to change sentiment around its economy, international investors, and sentiment about its markets.

Incoming FDI actually went negative last year for the first time in China. So when incoming FDI is negative that means people are actually selling their investments and taking their money and going home.

So I think it's important to monitor anything that gets this cheap. But I'm not seeing too many catalysts right now. If you had a 5 or 7-year horizon, and you believed that China was going to be forced to take steps to reintegrate its markets with the rest of the world, it's worth a look. But the way things stand right now, it's difficult sledding there.

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MR. CEMBALEST: So thanks for listening to this first of three podcasts. Stay tuned. The next one is going to be a deep dive on some research we've been doing around weight loss drugs and how they work, who pays for them, what are their impact on comorbidities, how durable is the weight loss, and then what are the impacts on consumer behavior and equity markets as a result of higher adoption rates.

So thank you very much for listening. And we will see you next time. Thank you.

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