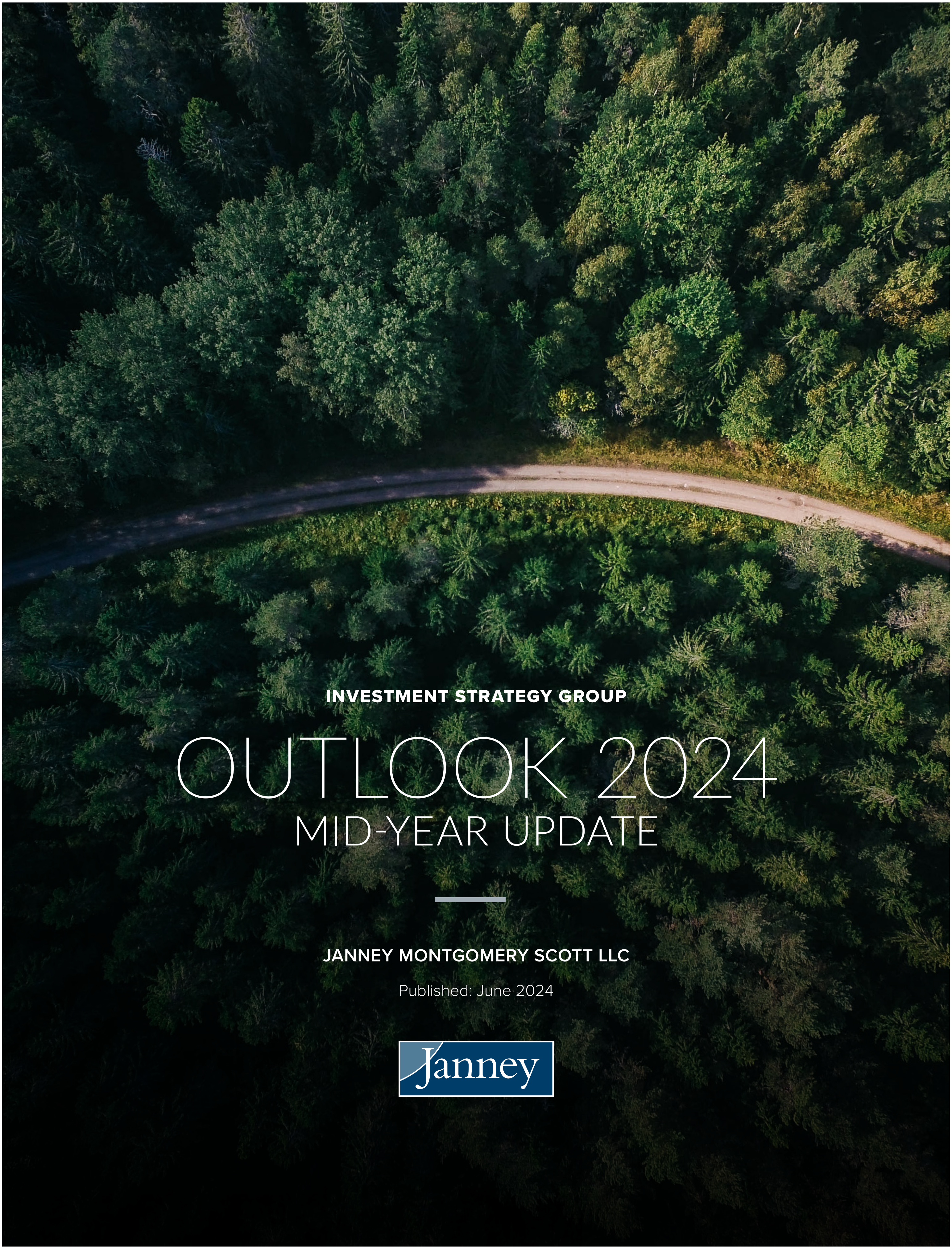


INVESTMENT STRATEGY GROUP

OUTLOOK 2024

MID-YEAR UPDATE

JANNEY MONTGOMERY SCOTT LLC

Published: June 2024

OUTLOOK 2024: MID-YEAR UPDATE

OVERVIEW

The *Mid-Year Update* offers the Janney Investment Strategy Group's baseline prognostications for the economy, the equity and fixed-income markets, their evolution, and investment implications for the rest of 2024.

Economy & Equity Markets .... Page: 3

- Economic growth is moderating, but underlying conditions support its continued expansion. Prospects of a recession have diminished and are likely postponed to 2025.
- The job market is cooling, but the unemployment rate remains low and wage gains continue to outpace inflation. The persistence of these factors will fortify consumer spending.
- Forward estimates for corporate profits, if met, augur well for the equity market to build on its year-to-date gain. Its advance, however, is predicated upon sturdy business activity.
- The political discourse during this Presidential election cycle could induce volatility as November approaches. Geopolitical risks abound, which could also ignite an unpredictable market response.

Fixed Income & Interest Rates .... Page: 7

- Interest rates are close to fair value based on our fundamental economic outlook; we look for 10-year Treasuries to end the year in the 4.00–4.50% range, depending on which economic scenario emerges.
- Market technical CTAs and pension buyers favor strong demand through the summer months, so long as Treasury issuance does not accelerate.
- Investment Grade (IG) and High Yield (HY) corporate bonds remain relatively expensive but show no signs of cheapening amidst strong credit conditions.
- One broad sector we continue to like is MBS and callable agencies, both of which should benefit from falling interest rate volatility.

ECONOMY & EQUITY MARKETS

MARK LUSCHINI, CMT
Chief Investment Strategist

President and Chief Investment Officer, Janney Capital Management

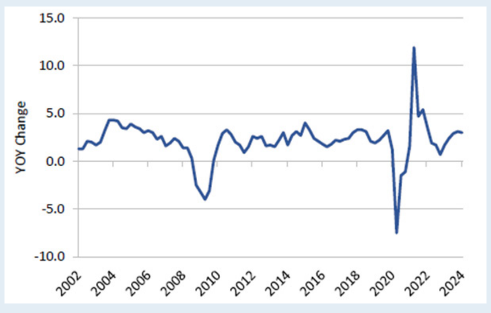
Mark Luschini serves as Janney's Chief Investment Strategist and leads the Investment Strategy Group, which sets the firm's view on macroeconomics, as well as the equity and fixed income markets. In addition, Mark is the President and Chief Investment Officer of Janney Capital Management (JCM), the asset management subsidiary of Janney Montgomery Scott. Under his leadership, JCM has delivered competitive results across its suite of investment strategies and grown its assets under management to more than $3.6 billion.

Mark has spent more than thirty years in the investment industry. He draws on that experience to speak on topics related to macroeconomics and the financial markets at seminars, client events and conferences. He is frequently quoted in publications ranging from the Wall Street Journal and Barron's to the New York Times and USA Today. In addition, he regularly appears in various media outlets including CNBC, Fox Business News, and Bloomberg Television and Radio. He has an undergraduate degree in Psychology and an MBA in Finance from Gannon University and holds the Chartered Market Technician (CMT) designation from the Market Technicians Association.

The U.S. economy's resilience to elevated inflation and tightening monetary conditions is a demonstration of the underlying strength in household consumption. The excess savings accumulated during the pandemic and a tight labor market conspired to produce a thrust in consumer spending that remains stout.

While domestic economic activity has downshifted from last year's torrid pace, it remains quite stout. Arguably, the report on Gross Domestic Product (GDP) for the first quarter (shown below) understates its true momentum. Accounting for the negative impact from its two most volatile components, trade and inventories, growth still exceeded the 1.8% level scored by the Congressional Budget Office as potential for the U.S. in 2024. Perhaps an even better gauge to interpret the influence from the main driver of the economy, consumption, is real final sales to private domestic purchasers. When isolating that factor, important because approximately 68% of U.S. GDP comes from consumer spending, it is apparent that the loss of steam is relatively modest and remains above trend. Therefore, an adage we subscribe to "Get the consumer right, and you'll get the economy right," is richly applied in shaping our views throughout this section of the report.

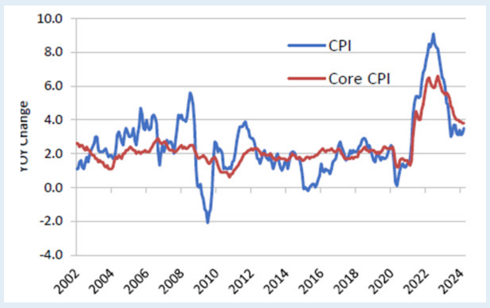
Chart 1: U.S. GDP



(Source: Janney ISG, US Bureau of Economic Analysis)

Inflation's cooperative march lower stalled recently and remains well above the Federal Reserve's target of 2% (shown in Chart 2). This was to be expected as supply chain distortions, a major contributor to spiking prices during the pandemic, have largely been cleared, providing immediate relief to solving price pressures. What has not dissipated quite as rapidly, however, is the impulse from demand. To be sure, spending has shifted from the almost maniacal pace of goods buying, sparked by the COVID-induced lockdowns that inhibited mobility. However, today consumers are purchasing those services that were inaccessible, particularly travel, leisure, and entertainment, which were hindered, and at such a rate that collectively, overall spending is trending at the pre-pandemic pace. Therefore, as goods inflation has normalized, services inflation remains elevated, and the net effect is that prices are still inflating faster than monetary authorities deem to be appropriate for the U.S. economy.

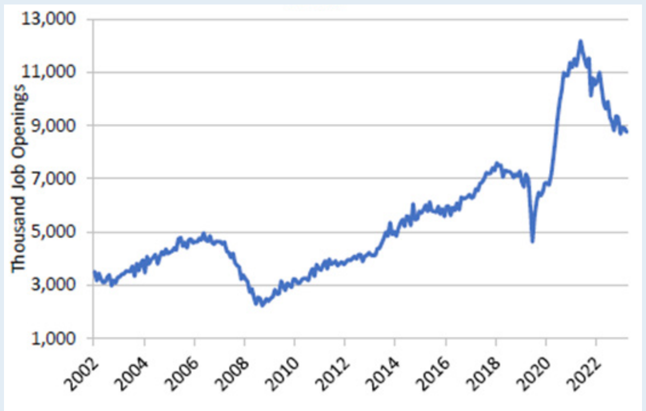
Chart 2: Consumer Price Index vs Core CPI



(Source: Janney ISG, US Bureau of Labor Statistics)

The principal cause is wages, which represents a disproportionate input to services costs. Even as wage gains have slowed, they are still running north of 3%, a level the Federal Reserve suggests corresponds with a 2% rate of inflation. Consequently, eyes must be drawn to the labor market to see if the prospects for further deceleration in wages is likely. We believe it is so. The unemployment rate has been slowly creeping higher, reducing labor's leverage for wage demands; fewer employers are forecasting the need to offer higher compensation to attract and retain employees, and the number of those quitting their jobs for greener pastures has returned to pre-COVID levels (a sign of lessening job security). The number of job vacancies is falling (shown in Chart 3), making it less obvious that those losing their jobs will be quickly reabsorbed into the labor force. We have cited the job vacancy rate as another indicator with strong efficacy. It currently stands well above 4.5%, which, while imprecise, has been a reasonably accurate predictor of the distinction between a labor market tightening or easing. It has fallen from a peak of 7.4% over two years ago to just below 5% today. Should it continue its descent to and below 4.5%, it may trigger a condition in which those laid off will no longer find another job opening, given their geography, skill set, or income requirement, and the ranks of the unemployed could begin to swell. The harmful effect would likely be a diminution in consumer spending accompanied by a retrenchment among those gainfully employed but worried about their own financial picture.

Chart 3: JOLTS



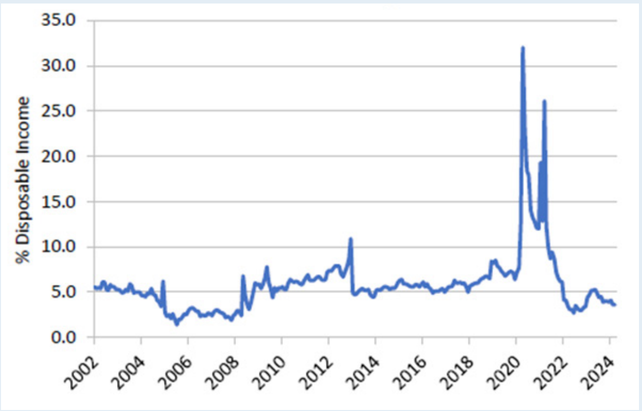
(Source: Janney ISG, US Bureau of Labor Statistics)

The good news is that household finances, in the aggregate, are reasonably well-buttressed. Average hourly earnings have exceeded inflation for the last year, and the most recent release of the Wage Growth Tracker from the Atlanta Federal Reserve posted north of 4% annualized. Rising home and stock market values have also helped to lift household net worth to a record high.

The "wealth effect" or the propensity to spend due to rising asset values will be a likely contributor to spending over the second half of this year, given that prices on homes and stocks have risen further since the most recent report from the Federal Reserve was at the end of last year. While that may be a helpful tailwind for consumption, the bounty of excess savings that rose to more than $2 trillion by August 2021 as supply-constrained pent-up demand boosted household bank accounts, as did the myriad of fiscal transfers from stimulus checks to extended and enhanced unemployment insurance benefits, has now dwindled.

In fact, a study produced by the San Francisco Federal Reserve shows it to be fully depleted at this juncture. With the savings rate about half where it stood pre-pandemic (shown in Chart 4), it seems reasonable to assume its projected path is likely higher rather than lower, leaving income and borrowing to do the heavy lifting for spending going forward.

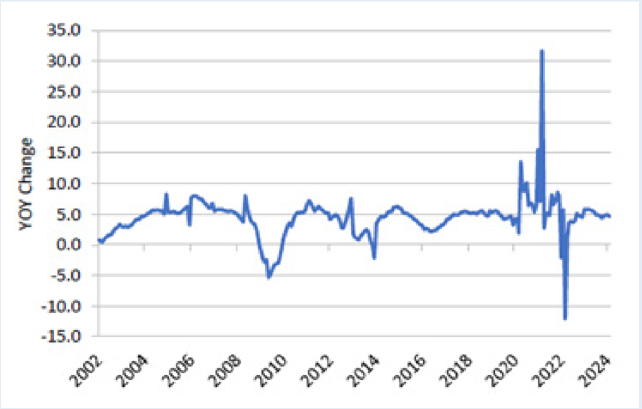
Chart 4: U.S. Personal Savings



(Source: Janney ISG, US Bureau of Economic Analysis)

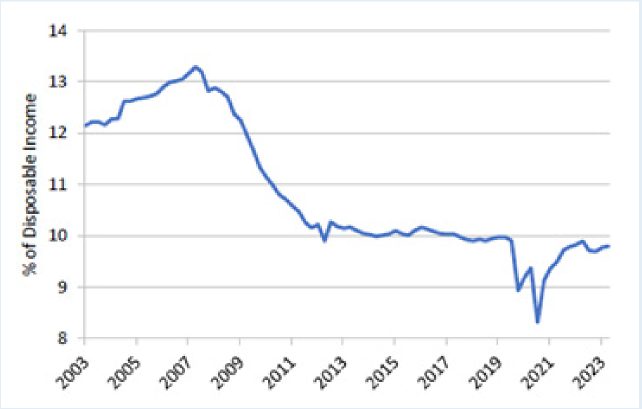
The income component seems reasonably stable for the moment (shown in Chart 5), and importantly, consumer leverage remains benign. To be sure, we have seen delinquencies starting to rise, especially on credit cards and auto loans, so that bears monitoring. However, aggregate debt service costs remain quite low (shown in Chart 6), so the emerging fissures among some borrowing cohorts are not yet a troubling indictment for aggregate consumer balance sheets.

Chart 5: U.S. Personal Income



(Source: Janney ISG, US Bureau of Labor Statistics)

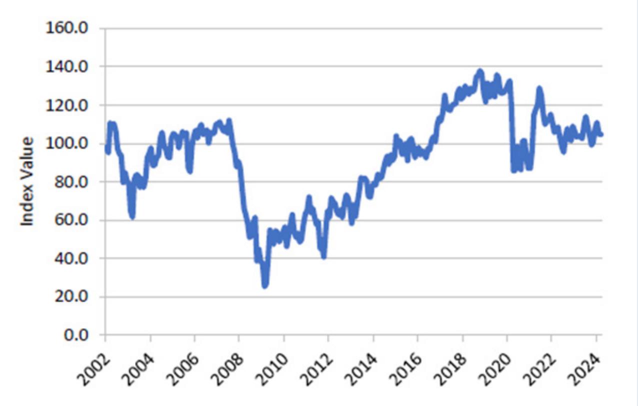
Chart 6: U.S. Household Debt Service Ratio



(Source: Janney ISG, US Census Bureau)

A final look at the consumer is via the lens of soft data, namely readings on confidence. The old saying "Watch what they do, not what they say" is certainly apropos. Surveys of consumers' attitudes have rebounded (shown in Chart 7) but remain well below those of 2019, the last full year of the historically lengthy economic expansion, when employment and income growth were not dissimilar to where they are today. Spending measures, such as retail sales and consumer-facing company reports, generally illustrate households are opening their wallets even as queries around spending plans on major durable items, including cars, appliances, and homes, infer a somber attitude. It is difficult to square the behavior with the sentiment, but a convergence of the two in the wrong direction could precipitate an economic slowdown with some consequences.

Chart 7: Conference Board Consumer Confidence



(Source: Janney ISG, Conference Board)

RISKS

The outcome of the Presidential election poses concerns that organic uncertainty from fiscal profligacy, tax law changes, trade wars, and foreign policy could be amplified. In addition, any escalation of the wars in Eastern Europe or the Middle East that devolves into broader conflicts involving the U.S. or NATO military directly, or carries a material, protracted economic impact, could impart a meaningful derating in risk assets.

CONCLUSION

The economy's sure footing may be tested later this year as inflation-restricting monetary policy, a softening labor market, diluted savings balances, and demand that household resources supported by jobs and their security, endure. We expect favorable economic conditions to persist through 2024. However, we sympathize with the view that the turn of the year may bring a different economic climate than the one we leave this year. As such, while it is premature to call a need for caution, we remain alert to changes in any of the consumer-related data points that would have view-altering repercussions.

INVESTMENT IMPLICATIONS

The Federal Reserve is poised to take a dovish turn before year-end or soon thereafter and lower interest rates as inflation subsides. The question is whether the economy can withstand the current monetary policy set to combat inflation without suffering the consequences of weakening the labor market to the point of causing a recession. History is stingy with examples of the Federal Reserve manipulating rates with enough precision to stamp out inflation while averting one. Given the underlying strength in the economy being exhibited today, the verdict on its effort may not be determined until next year.

- **Global Equity Markets** — U.S. equities should have an upward bias commensurate with projected earnings estimates being met. Valuation could be an encumberment so profits will be the predominant driver of prices. Volatility may increase in the months leading to the election unless the polling settles the ambiguity earlier than November.

  Foreign markets are generally geared more toward heavy industry and thus more cyclical in nature. If global activity turns up as central banks begin reducing rates, having successfully quelled inflation, then international equities, particularly emerging markets, offer appeal. Markets such as Europe, Japan, India, and Mexico are favored.

- **Sectors** — The tech and tech-related companies found in Technology, Communications, and Consumer Discretionary should continue to draw investor interest. Also, Industrials, Utilities, and Materials benefit from fiscal spending directed at reshoring industries and domestic semiconductor development. Energy, for its idiosyncratic issues of deliberate supply constraints and possible shipping distortions, is a favored cyclical sector along with secular themes such as defense companies, cybersecurity, artificial intelligence, genomics, and robotics.

- **Commodities** — Industrial metals, such as copper and uranium, should benefit from fiscal expenditures on infrastructure, decarbonization, and electrification, both here and abroad. Used as a hedge in a diversified portfolio, precious metals, namely gold, may be employed in part to address the risk of a geopolitical or economic shock.

VARIOUS ECONOMIC SCENARIOS AND PROBABLE OUTCOMES

Our prognostication for the U.S. stock market's path forward includes three potential outcomes from various economic scenarios, assigning a probability to each. In preview, we remain bullish; however, we think that sentiment may be tested in the coming months, potentially requiring us to shift toward a more cautious posture before the end of this year.

Scenario 1: Mission Accomplished

Inflation recedes, allowing the Federal Reserve to pivot from its restrictive monetary setting. With rate cuts on the horizon, the moderation in economic activity fuels the bullish narrative of a recession-avoiding outcome. The job market remains reasonably strong, underpinning consumption and business activity remains expansive. Corporate earnings estimates, which once appeared optimistic for 2024 and 2025, are far more plausible, girding investors' risk appetites. Bond yields are benign, given fewer spike-inducing variables. Stocks advance on rising animal spirits and maintain a 20x forward multiple looking out to 2025 estimates, which drives the S&P 500 to 5,600.

Probability: 60%

Scenario 2: Range Rover

Stocks traverse some rough terrain as inflation fails to subside sufficiently to allow the Federal Reserve to release the monetary brake. Consumers finally begin to show signs of spending fatigue as the effect of tightening lending standards, high interest rates, and a less certain labor market outlook conspire to shutter confidence levels. Businesses take their cue from a slipping pattern of consumption and begin to shed workers and mothball hiring plans. The economy may avert a recession over the balance of 2024, but its compromised state raises the risk of one in 2025. The S&P 500 encounters some setbacks and falls in advance of the election but rallies into year-end to reach 5,400.

Probability: 30%

Scenario 3: Recession Looms

Decelerating inflation does allow the Federal Reserve to ease its restrictive policy, but it is not enough to mitigate the economic weakness that has already infiltrated the landscape. The self-feeding cycle of consumers pulling back on spending, thereby thwarting demand, which then serves to encourage the business community to shed employees, causes households to retrench even more. A recession ensues in early 2025, but stocks, which are prone to lose value in anticipation of a typical loss in earnings, experience a sharp decline. The S&P reaches 4,800 before a durable bottom is found, then rebounds, but the peak for the year is not exceeded.

Probability: 10%

BOTTOM LINE: ENSEMBLE FORECAST

Our weightings lean into a favorable outcome. In fact, simple math demonstrates that we assigned a 90% probability to an outcome at a price level for the S&P 500 index that is around or higher than where it stands at the time of this writing. However, we are not so dogmatic as to ignore signs that our bearish scenario is usurping the rationale for holding a more sanguine view.

FIXED INCOME & INTEREST RATES

GUY LEBAS, CFA®
Chief Fixed Income Strategist

Director of Custom Fixed Income Solutions, Janney Capital Management

Guy LeBas is responsible for providing direction to the firm's clients on the macroeconomic, interest rate, and bond market investing climate.

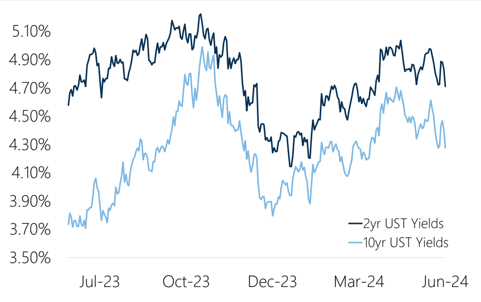
Guy authors bond market periodicals which provide relative value recommendations across the fixed income spectrum. Bloomberg named him the most-accurate forecaster of the Treasuries market in 2015 and previously recognized him as a "Bloomberg Best" for his work in bond market forecasting.

Prior to joining Janney in 2006, Guy served as Interest Rate Risk Manager for U.S. Trust's bank asset and liability portfolios, a role in which he oversaw risk and return on an $11 billion balance sheet. He received his education from Swarthmore College and is a CFA Charterholder.

In 2023, the U.S. bond markets faced a more complex landscape than at any point in memory.

Six months ago, Janney Investment Strategy Group highlighted the complex landscape faced by U.S. bond markets, with an end to the Federal Reserve's tightening cycle amid potentially persistent economic growth. Moreover, we argued that the influence of momentum-based trading strategies will continue to produce unusually large monthly swings in interest rates. Heading into the year, market pricing was completely inconsistent with our fundamental outlook, and staking a (bearish) position on interest rates was relatively easy. Today, not so much.

Chart 8: Interest Rates Towards High End of 12-Month Range



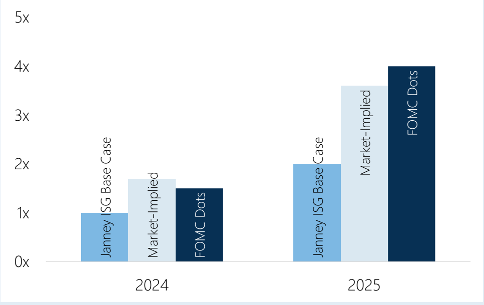
(Source: Janney ISG; Bloomberg)

Our fundamental economic outlook remains a "tail" of two outcomes, with little room in the middle. The left tail scenario involves a typical late-cycle economic slowdown, perhaps even a mild recession, as consumer spending stagnates and fiscal stimulus fades. In this downside case, we expect the Federal Reserve (Fed) to cut interest rates one to at most two times in 2024, followed by several additional cuts in 2025. In this tail scenario, longer-term interest rates will likely drift somewhat lower, with the 10-year Treasury yield ending 2024 near 4.00% and the 2-year Treasury yield falling to 3.75%.

An alternative and arguably more probably right-tail scenario is that the U.S. experiences an extended period of real economic growth and even acceleration as demand remains strong and inflation comes off the boil. This scenario—admittedly an optimistic take—would permit the Fed to execute a "mid-course correction" of three rate cuts beginning in 4Q 2024 and extending into mid-2025. In many ways, this outlook is similar to the 1995 experience in which a few cuts into slowing inflation on top of big technological leaps, helped power economic expansion for another five years. In this right-tail scenario, longer-term interest rates will likely chop around current levels, with the 10-year Treasury yield ending 2024 at 4.50% and the 2-year Treasury yield falling to 4.40%.

Our Outlook 2024 rate call was easy last December because pricing was absurdly skewed towards lower rates (markets were pricing in six Fed cuts!). Indeed, interest rates rose across much of the yield curve since that point, and pricing for Fed rate cuts swung substantially. Today, pricing is consistent with the midpoint of our fundamental economic views. As of June 12, markets anticipate two rate cuts in the second half of 2024 and a third in 1Q 2025. Treasury yields, with the 10-year at 4.30% and 2-year at 4.70%, are meanwhile too close to the midpoint of our outlook to stake an aggressive long or short position.

Chart 9: Janney ISG Rate Cut Expectations Are Now Close to Market Pricing

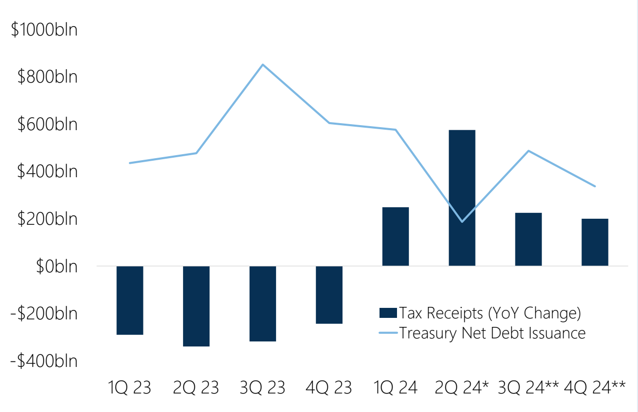


(Source: Janney ISG; CME; Federal Reserve Board a/o June FOMC Meeting)

With pricing close to the fundamental outlook, short-term supply and demand technicals are arguably more significant. The influence of momentum-based traders like Commodity Trading Advisors (CTAs) has generated large swings in Treasury yields this year. We estimate that CTAs are moderately net short duration, and all else equal, they will be net buyers through summer. Pensions are also actively reallocating fixed-income gains to equities. Insurer Voya Financial, Inc. recently noted that private sector pension funding is roughly 108%, while pension fixed income allocations have barely moved, hinting at more buying to come.

While CTAs and pensions should be a strong source of demand, the main source of supply is the U.S. Treasury itself. Federal tax receipts rose in 2024, but there is still an estimated $586 billion of net cash the Treasury needs to raise in 3Q (down from last year, but still hefty). Notably, in weeks when the Treasury Department is auctioning off a substantial amount of debt, we have seen interest rates rise. Treasury issuance does not always matter for the level of interest rates, but it does seem to be a swing factor at present. In general, we like a strategy of fading extremes by buying 10-year yields over 4.60% and selling them below 4.00%.

Chart 10: Tax Receipts Are Slowing Issuance Growth, But Supply Still Big Factor

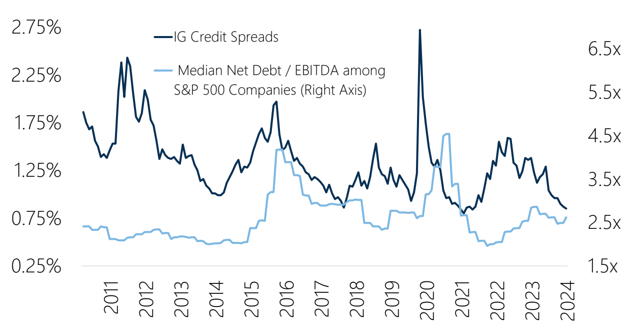


(Source: Janney ISG; US Treasury Dept; SIFMA; *Actual & Pro-forma; **Estimated)

Given this two-tailed backdrop and the market technicals driving large moves in Treasury yields, we advocate using real yields to guide fixed-income positioning. Real yields, which measure the after-inflation return on a bond, have been a useful tool for timing fixed-income allocations. When real yields are high, forward returns on bonds tend to be attractive. Today, real yields on 10-year Treasury Inflation Protected Securities (TIPS) are around 2%, which is historically an attractive level. Our ISG real yields model, which explains 67% of the variation in 12-month forward returns for the Aggregate Bond Market Index, currently projects 4.8% returns for the coming year. While no model is perfect, both current real yield levels and modeled forward returns suggest adding duration to bond portfolios.

Within the credit environment, both Investment Grade (IG) and High Yield (HY) are quite expensive in an historical context. IG spreads are in their 8th percentile, and HY in their 10th percentile of history. Moreover, spreads are trading directionally with rates, meaning that credit is exaggerating the volatility in interest rates and presenting a portfolio construction challenge. At the same time, corporate profits are on a clear uptrend, and corporate debt issuance is declining. In sum, credit pricing is expensive, but credit fundamentals are strong. While we see no evident near-term downside in credit, there are better opportunities elsewhere.

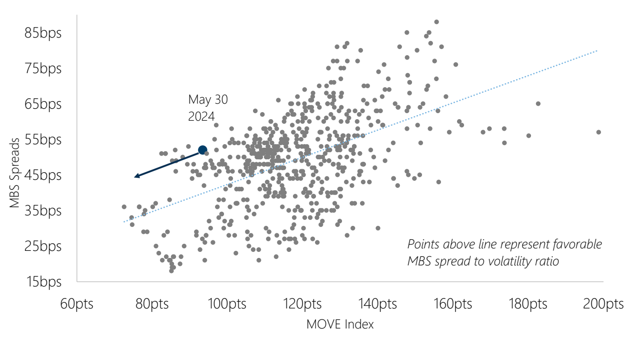
Chart 11: Credit Spreads Are Right, but Corporate Fundamentals Healthy



(Source: Source: Janney ISG; Bloomberg; Standard & Poors)

In our view, the best of those opportunities reside in volatility-sensitive bonds such as agency mortgage-backed securities (MBS) and callable agencies. Since bond market volatility surged amidst the Fed's rate hikes in 2023-2024, prices on callable securities, like MBS, have remained depressed relative to other sectors. With the Fed likely to follow a more predictable trajectory, volatility should decline over time. Since MBS are among the most sensitive sectors to changes in volatility, they stand to outperform in this scenario. Valuations for MBS are slightly cheaper with historical norms, which, in comparison to credit, makes them better avenues for capital than IG credit. These comments apply to the sector and individual MBS may have characteristics that make them more or less favorable than this overall opinion.

Chart 12: MBS Spreads are Favorable Relative to Volatility



(Source: Janney ISG; Bloomberg)

CONCLUSIONS

To summarize, today's interest rate markets are fairly priced relative to our two-tailed economic outlook. Technicals with CTAs and pension demand facing off against Treasury Department supply will create some short-term trading trends, which we would suggest fading at the extremes. Longer term, our real yields modeling suggests forward returns are likely healthy. Finally, while IG and HY credit are relatively expensive, we like opportunities in bonds that benefit from falling volatility, such as MBS.

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Overweight: Janney ISG expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return.

Marketweight: Janney ISG expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return.

Underweight: Janney ISG expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return.

Benchmarks

Asset Classes: Janney ISG ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclays U.S. Aggregate Bond Market Index" as a benchmark.

Treasuries: Janney ISG ratings employ the "Barclays U.S. Treasury Index" as a benchmark.

Agencies: Janney ISG ratings employ the "Barclays U.S. Agency Index" as a benchmark.

Mortgages: Janney ISG ratings employ the "Barclays U.S. MBS Index" as a benchmark.

Investment Grade Credit: Janney ISG ratings employ the "Barclays U.S. Credit Index" as a benchmark.

High Yield Credit: Janney ISG ratings employ the "Barclays U.S. Corporate High Yield Index" as a benchmark.

Municipals: Janney ISG ratings employ the "Barclays Municipal Bond Index" as a benchmark.

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