JOHNSON FINANCIAL GROUP®

Economic & Market Outlook

2024 Year Forecast

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2024 Economic and Market Outlook

2023 turned out to be a much better year for the economy and markets than expected thanks to a fourth quarter rally triggered by a one percentage-point decline in key interest rates. Let's look back to a year ago:

- Most economists had forecasted a recession to begin by mid-year due to high inflation and the torrid pace of interest rate hikes to fight it.
- In turn, companies were expected to struggle with recession leading to declines in earnings and stock prices.
- On the other hand, the outlook for bonds was encouraging considering investors could earn over 4% on their bond portfolio. However, the interest rate outlook was divided given the potential for recession fears to drive rates lower and persistent inflation to push rates higher.

In the end, though, investor caution proved unnecessary. The economy remained resilient, inflation moderated and, in November, the Fed signaled it had likely made its last rate increase for the cycle.

Now, as we look to 2024, expectations have changed considerably. Investors expect economic growth to slow from current levels but avoid a recession, and inflation is expected to continue to slow toward the Fed's 2% target. Although the setup for markets is mixed, this year's better economic outlook seems to hold sway with investors, given that securities prices already reflect favorable expectations.

Following is a brief summary of our outlook for stocks, bonds and alternative investments. We will publish a more detailed outlook for each asset class in the coming weeks.

Stocks: Time to rebalance. We expect continued gains should the economy avoid recession. However, we are mindful of downside risk considering elevated valuations with the S&P 500 Index trading near 20 times expected 2024 earnings.

Bonds: We expect another year of gains in 2024 considering yields are currently in the 4-5% range for investment-grade bonds and the Federal Reserve will likely be cutting rates.

Alternatives: We anticipate favorable performance in both absolute terms and relative to stocks and bonds. Potentially lower rates and continued elevated inflation should position alternatives to perform well.

2023 Markets Year in Review

Stocks finished the year with double-digit gains, including a 26% gain for the S&P 500 Index and about a 5% gain for bonds—even though both stocks and bonds were near flat at points during the year **[Figure 1]**.

The U.S. economy is on pace for 2.3% growth in 2023, and the unemployment rate remains low at 3.7%. A resilient consumer, supported by continued job gains and 4.3% wage growth and higher than expected government spending contributed to the positive surprise.

Stocks began the year with an 8% rally, bouncing back from dismal 2022 returns. However, gains evaporated rather quickly in the wake of the collapse of several regional banks in March. The Federal Reserve stepped in to provide support, which eased concerns as the year progressed with limited contagion to other banks.

Figure 1

Annual Return by Asset Type

as of December 31, 2023

FIXED INCOME	LAST 5 YEARS	2023	THREE MONTHS
Bloomberg U.S. Aggregate Intermediate	1.1%	5.2%	5.5%
Bank of America Merrill Lynch Municipals 1-12 Yr	1.9%	4.5%	5.2%
U.S. EQUITY			
S&P 500	15.7%	26.3%	11.7%
Russell 1000 Growth	19.5%	42.7%	14.2%
Russell 1000 Value	10.9%	11.5%	9.5%
Russell 2000 (small-cap)	10.0%	16.9%	14.0%
INTERNATIONAL EQUITY			
MSCI ACWI Ex U.S. (international)	7.1%	15.6%	9.8%
MSCI EAFE (developed)	8.2%	18.2%	10.4%
MSCI EM (emerging markets)	3.7%	9.8%	7.9%
COMMODITY/CURRENCY			
Bloomberg Commodity	7.2%	-7.9%	-4.6%
U.S. Dollar Index	1.1%	-2.1%	-4.6%

Source: Morningstar Direct

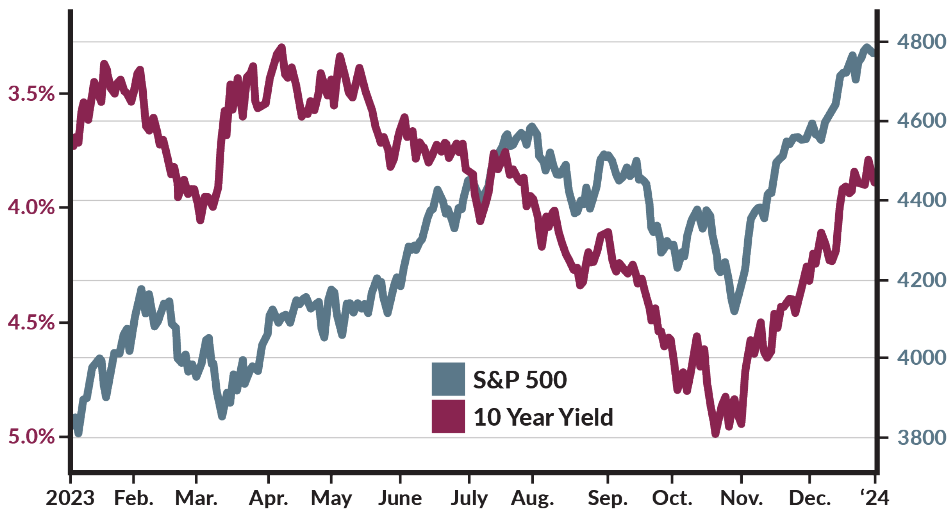
Stocks and bonds struggled mid-year as recession, inflation and higher rate uncertainties continued. With bank lending and recession worries top of mind, an uptick in inflation in August and September, including oil prices climbing to near $100 per barrel, forced the Fed to continue on its inflation-fighting path with another rate hike. The Fed ended up increasing the Fed Funds Rate by a total of one percentage point during the year to 5.5%.

The 10-Year US Treasury Bond yield peaked near 5% in October. Stock prices moved in a tight correlation with interest rates for most of the year, with the mid-year surge in rates pushing stocks lower. As illustrated in the chart below, the price of the S&P 500 and the rate on the US 10 Year Treasury Bond moved in a tight correlation for most of the year **[Figure 2]**.

With sentiment negative, markets were poised to move on any positive news. Inflation slowed in October and November. At the same time, oil prices retreated, while job gains continued and the U.S. economy grew at a robust 5% rate during the third quarter. Stock price momentum received a boost in November when the Federal Reserve signaled that its rate-hike campaign was likely over. Recession anxiety turned into FOMO (Fear of Missing Out) as investors scrambled to buy stocks (as lower interest rates suggest a lower probability of recession) and bonds (to lock in yields given the potential for rates to come down).

Figure 2

S&P 500 Index vs U.S. 10 Year Treasury Bond Yield



Source: Bloomberg

What to Expect in 2024

If the gains in 2023 were due to better than feared outcomes, we expect returns in 2024 to be determined by delivering on the current optimism.

We expect economic growth to slow in the coming quarters, with recession risk remaining elevated, as the lagged impact of higher interest rates and inflation work through the economy and the offsetting impact of fiscal spending runs its course. Growth in the labor market is one important variable we are watching given the high correlation with economic growth. Payroll growth has been a positive surprise in the rebound since the pandemic, but the pace of growth has been steadily declining over the past three years, and we expect further slowing in 2024 **[Figure 3]**.

While we may once again avoid recession, a rapid reacceleration in growth seems to be a low probability outcome. Although momentum is expected to slow, the drop in interest rates and slowing inflation, such as the drop in oil prices to near $70 per barrel, are supports to the growth outlook.

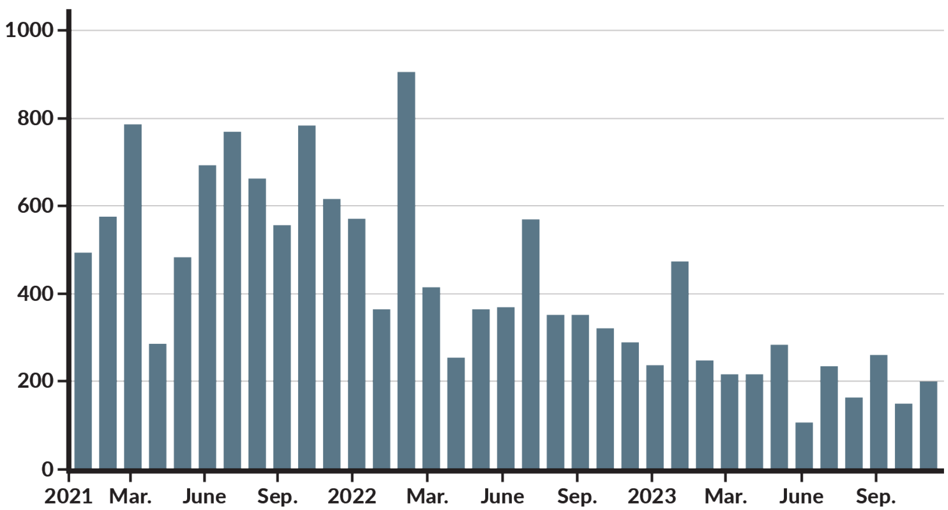
As real-time indicators of future expectations, stock and bond prices have reacted to anticipated lower interest rates. Steady and declining interest rates support the outlook for bond prices. Intermediate bonds yield more than 4%, providing a good backdrop for returns in the coming years. Stock valuations tend to benefit from lower interest rates as well, but this adjustment may already be reflected in prices with valuations near 20x forward earnings, compared to 17x to start the year. Stable or declining interest rates and inflation may also reduce the high correlation between stocks and bonds during the past two years. Lower correlation may serve to reduce portfolio volatility relative to recent years.

While we may once again avoid recession, ***a rapid reacceleration in growth seems to be a low probability outcome.***

Figure 3

Total Nonfarm Payrolls

MoM Net Change



Source: Bloomberg

In addition to offering unique sources of income and returns, we continue to be attracted to the diversification benefits that alternative investments provide, especially if the pace of inflation increases.

Of course, even if conditions support the current optimism, there's potential for geopolitical turmoil negatively affect results. Market risk from geopolitical factors remains high as countries turn inward in the wake of slower global growth and changing demographics. Election uncertainty will also be present in 2024 with elections in the U.S., Taiwan and India. Using history as a guide, the fourth year of the U.S. Presidential cycle is good for stocks although returns tend to be back-end loaded as uncertainty declines.

Portfolio Strategy

In recent decades, investors and savers were increasingly forced to accept one of two undesirable trade-offs:

- Lower returns while maintaining portfolio allocations; or
- More risk while pursuing returns consistent with historical expectations.

Investors who remained fully invested have ultimately been rewarded by the market's generally consistently positive performance, but there have been significant drawdowns along the way. Although old habits can be challenging to break, a new year is a good time to reconsider the status quo.

After more than a decade in which investors earned very little holding bonds, the Fed rate-hiking cycle has fixed-income investors excited once again. Improved returns from fixed-income portfolios represent a significant transition for investors, which is demonstrated in the following graphic **[Figure 4]**.

Though not intended to represent a specific portfolio, the bar graphs depict the allocation to various asset classes that would have produced a 7.5% return while minimizing volatility. From 1995 to 2022, investors were required to include larger amounts of risky assets and shouldered ever-increasing investment risk to target a 7.5% return. Thankfully, the latest forecasted returns represent a significant break from this long-term trend, enabling investors to pursue a desired level of return with larger allocations to lower risk assets like bonds.

The change warrants a reassessment of risk allocations for investors, and we're encouraging clients to evaluate their asset allocations in relation to their financial needs and return objectives. In short, many investors may be able to attain their financial goals with a more significant allocation to bonds.

In comparison, the substantial rally in equities during 2023 has diminished their expected returns. Equity markets begin 2024 with elevated valuations and earnings expected to increase 11-12% in 2024 and 2025. This optimism suggests that risk is to the downside should valuations normalize or companies fail to deliver on earnings. We're positioning portfolios with a bias toward quality and have increased portfolio efficiency through larger index representation, where it makes sense.

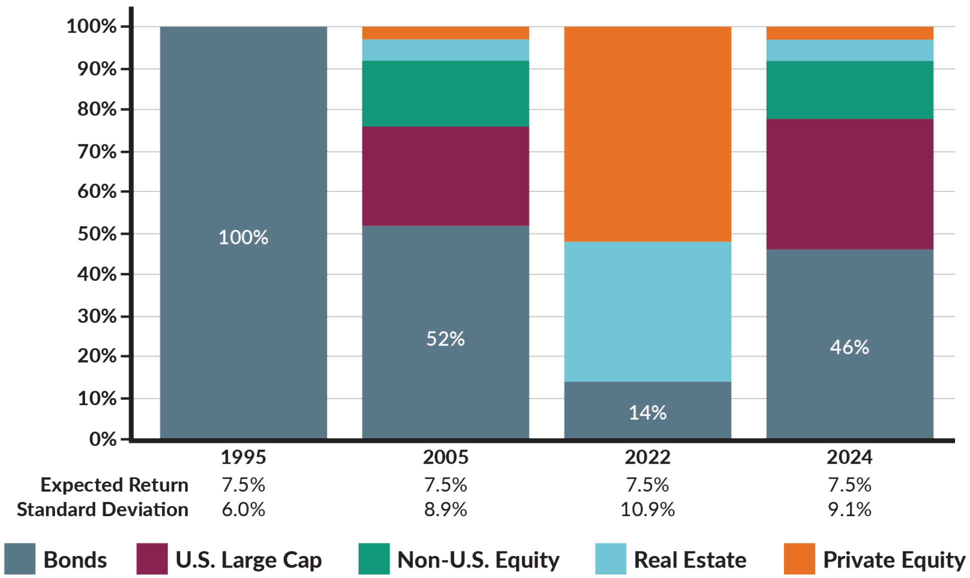
Notably, these factors continues to suggest a role for alternative investments in portfolios. No single asset class or investment is a silver bullet. We're positioning portfolios to benefit from the collective diversification and unique return sources introduced by investing in asset classes such as infrastructure, private debt, and real estate. We're maintaining a balanced allocation across alternative assets and monitoring developments within real estate and private debt.

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. Over the coming weeks, we'll share more specific outlooks for stocks, bonds and alternative investments. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. **Thank you for your partnership and trust in Johnson Financial Group.**

Figure 4

Portfolio Allocation with 7.5% Return Goal



Source: BlackRock