2024 Economic Outlook and Portfolio Implications

It feels just like yesterday that we were pouring through stacks of economic research and analysis outlining a good chance of a recession to occur in 2023. As we now know, the recession never materialized, and many aspects of the economy continued to prove strong. The further we get away from the Pandemic, one theme has been consistent the past several years: "extreme volatility" in both markets and economic data. As we prepare for 2024 and beyond, there are hopeful signals that we could be getting closer towards a **"New Normal"** environment as the world accepts the new realities. Throughout the letter below, a common theme will be the expected normalization of several economic variables.

Prior to the Pandemic in 2020, the market environment was characterized by below target inflation, Quantitative Easing (monetary loosening), lower interest rates, and a relatively more Fiscally conservative track. The new regime since has consisted of above target inflation, Quantitative Tightening (monetary tightening), higher interest rates, and significant Fiscal stimulus. Many of the pre-pandemic themes are the reason the overall economy has continued to surprise to the upside despite expectations for a recession. However, as we begin to live with these newer themes, they should ultimately cause both continued volatility but also long-term positive opportunities as investors.

Unfortunately, there are no certainties when it comes to the global economy and the investment markets. Therefore, we feel the best course of action when analyzing the thousands of data points is to create the most probabilistic outcomes. One of the outcomes will always be the potential for a significant recession as markets are unpredictable, but the more important aspect is what probability is assigned to that scenario. Fortunately, we place a very limited probability of a significant recession occurring, but the remaining two scenarios both should receive higher weighted probabilities.

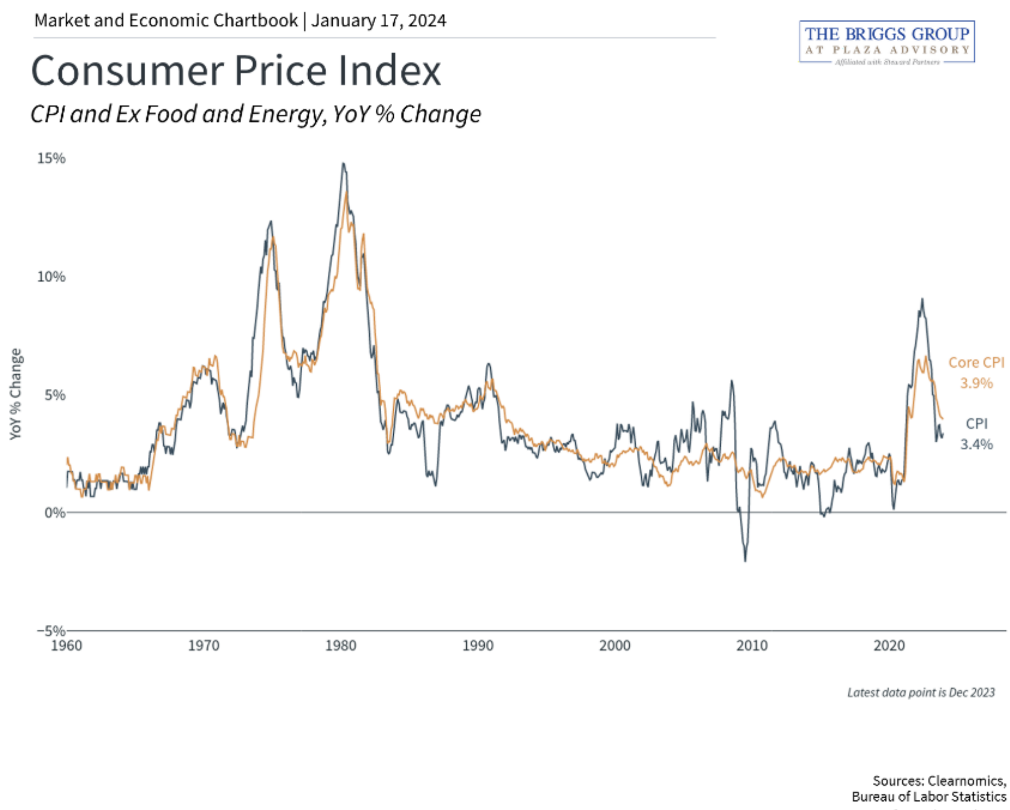
Scenario 1:

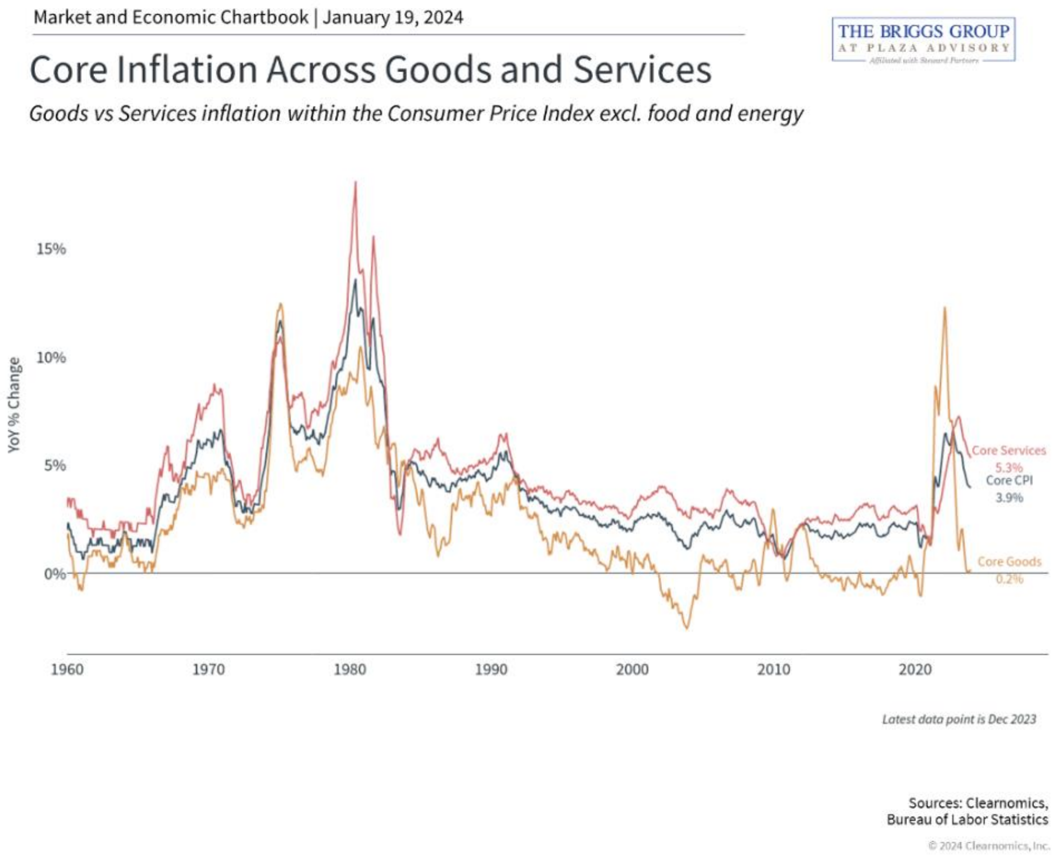
Inflation and therefore growth continue to subside, therefore causing the Federal Reserve to at some point cut interest rates. The rate at which inflation and growth subside is the most important element. If they were to surprise to the downside more than anticipated, it would likely entail some form of a mild recession has begun. Ultimately, this should lead to some short-term downside volatility, but as the Federal Reserve begins to cut it could provide the foundation for long-term positive returns in the equity markets.

- As we now know, many of the forces that led to inflation and stronger than expected growth are looking to have been transitory, such as the Fiscal stimulus and supply side shocks. Much of the disinflation of 2023 has also proven to be transitory as the markets have slowly normalized: improved supply chains and deliveries and somewhat reduced fiscal support.
- The last portion of Disinflation could require an economic slowdown and labor market weakness,[1] which would lead to some form of recession and ultimately Federal Reserve interest rate cuts.

Scenario 2:

Inflation continues to prove stickier than expected, and many of the forces that have allowed growth to stay strong continue. The Federal Reserve could choose to either not cut as soon as expected or even raise rates further if needed. Despite this scenario keeping a recession at bay for now, it could ultimately lay the groundwork for a deeper recession in the future as the economy continues to adjust to higher interest rates and the ramifications.





Below we will lay out the most important areas of the economy that will ultimately determine the direction the economy will take.

Consumer:

The consumer continues to be the most important data point to watch given it makes up 70% of Gross Domestic Product (economic growth). It is the resiliency of the consumer which has thus far delayed the monetary policy tightening transmission.[2] But why has there been so much resiliency is a critical question. As mentioned above, the pre-pandemic era was highlighted by ultra lower interest rates which allowed consumers to strengthen their balance sheets and insulate them from the current higher rate regime. Combine the formerly loose monetary policy with the stimulative fiscal policy, and you have consumers flush with cash and savings.

Again, as we get farther away from the beginning of the pandemic, we are starting to see these trends normalize, as excess savings have dwindled, and higher rates could gradually begin to cause consumers pain the longer they remain.

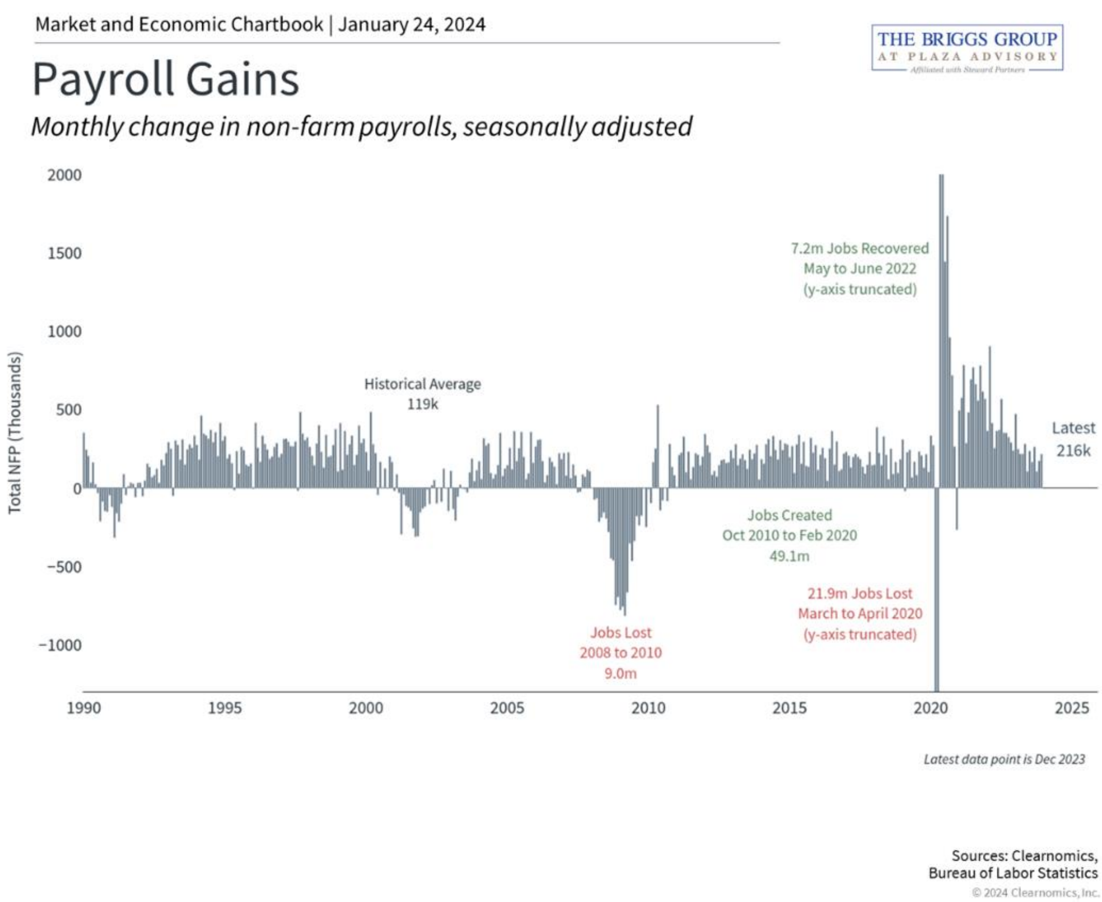
Corporations:

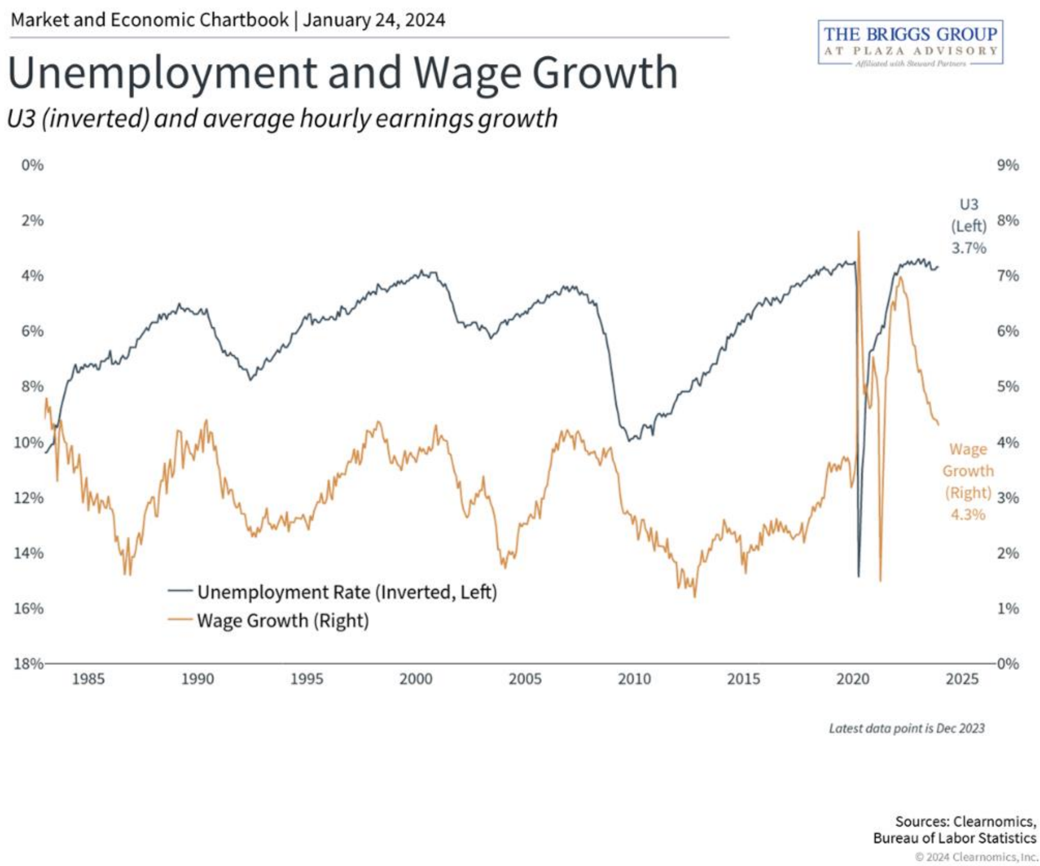
Just as we highlighted above for the consumer, we can basically say the exact same things for corporations. Both before the pandemic and immediately after, corporations were able to strengthen their balance sheets and insulate themselves from today's higher refinancing costs. Even as the Federal Reserve raised rates to 22-year highs, corporate interest payments have dropped to the lowest levels in more than 50 years.[1]

However, as it looks as if we have transitioned into a secularly higher interest rate environment (even if the Federal Reserve begins cutting), higher borrowing costs will impact the average corporation. They will have to adjust how they allocate and spend their capital as profitability will be harder to achieve. More than $3 trillion of U.S. corporate debt is due for repayment over the next five years. Ultimately, it will impact companies differently and most likely hurt smaller size companies, but nonetheless will be require adjustments.[2]

Labor Market:

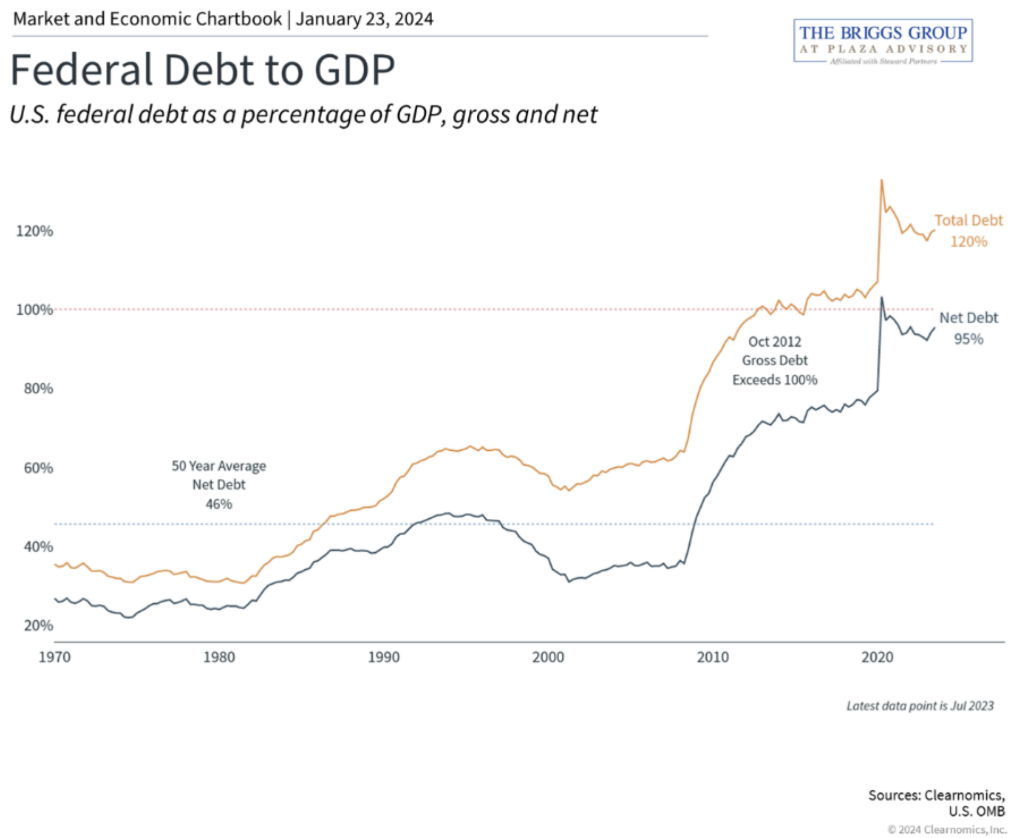
I have made the comment repeatedly in meetings throughout 2023, and the message remains: The labor market will continue to be a key point of focus as it is interrelated to both the Consumer and Inflation. There will continue to be potential tightness in the labor markets as the working age population continues to decline causing upward pressure on wages. However, as of today there are signs of labor market weakness (loosening) as payrolls have weakened, reduced job listings, firms announcing reductions, and fewer people quitting jobs to take on better alternatives.[1] Finally, as part of the scenarios laid out above, if inflation were to surprise to the downside more than expected this could mean layoffs would be to follow helping to cause some form of a recession.





U.S. Government Debt & Spending:

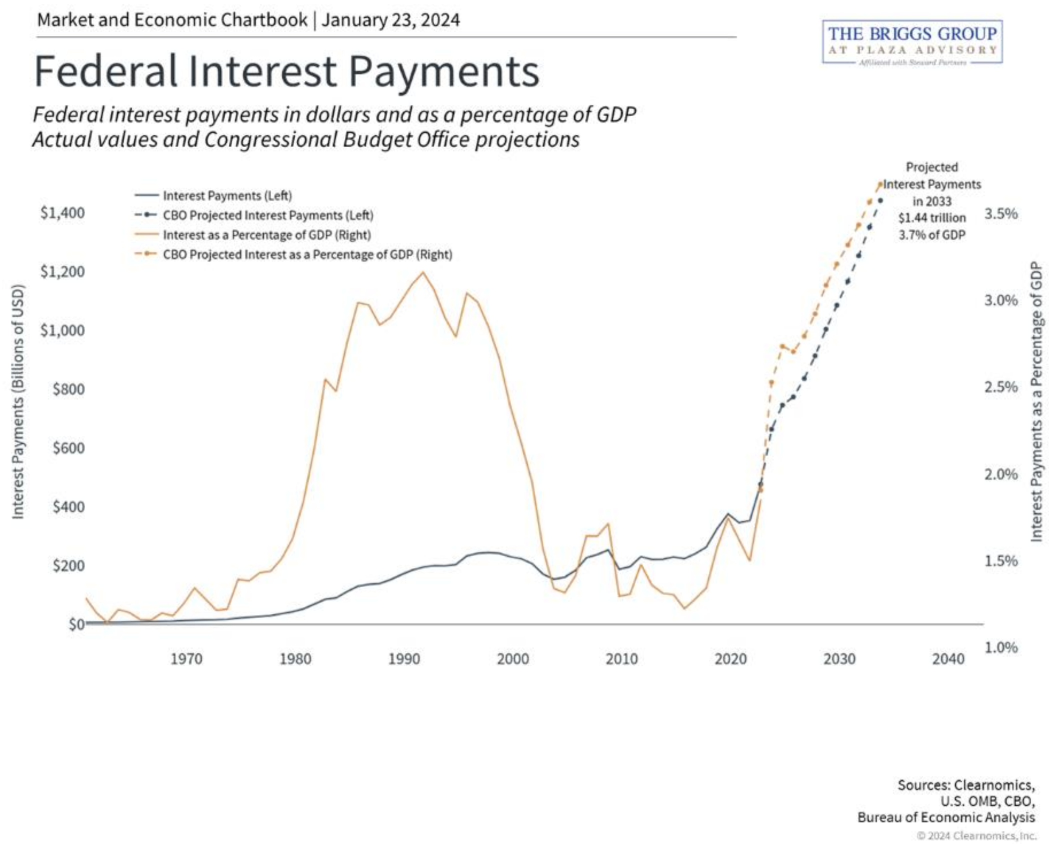
Given the election year, there will and should be continued focus on the levels of government debt and the soaring interest costs. The level of debt already helped to increase pressure on rates during the 3rd quarter of 2023, and at the rate it is going could continue to exert upward pressure. Ultimately, the levels of government debt will continue to play a larger role in how future inflation and interest rates look. Continued spending and increased deficits could keep inflation and therefore rates higher.



Structural Forces/Themes:[2,3]

Ultimately as part of the normalization that should occur, there will be various new themes that highlight the new regime: higher rates, higher inflation, deglobalization, demographics, and fiscal policy and the debt load. On average, these could lead to an ultimately higher rate environment whereas inflation also does not settle as low as pre-pandemic levels.

- Working age population continuing to shrink, potentially leading to less savings and more spending.[2]
- Geopolitical fragmentation:[3] potential cost pressures
- Higher debt loads fiscally:[3] could place additional upward pressure on rates.



Portfolio Implications and Positioning:

Given the scenarios presented above and the potential normalization of the various economic inputs, ultimately, we feel both scenarios can be a long-term positive for investors' portfolios. If we do indeed settle into a higher interest rate and higher inflationary environment, we feel Equities, Fixed Income, and Alternatives all have an important spot in a portfolio.

Equities:

Assuming one or a combination of the scenarios laid out occurs, we would ultimately expect equities to continue to drive portfolio returns long-term. It is just a matter of near-term if we do indeed fall into a mild recession and when and how quickly the Federal Reserve cuts interest rates. Regardless, despite valuations being overly expensive, we believe earnings can continue to drive positive returns going forward. Therefore, we continue to believe a "balanced" approach makes sense between high quality (growth) equities and cyclical (value) equities.

Fixed Income:

Despite the pain in Fixed Income for the past several years up until Q4 of 2023, the starting yields present great opportunities moving forward. As we believe the Federal Reserve is done hiking, we are sitting at the best fixed income rates we have had in well over a decade. Starting yields are a strong predictor of future returns in Fixed Income. We currently view Fixed Income as both a return enhancing asset as well as a volatility buffer if the mild recession were to arise sooner rather than later.

Fixed income market dynamics

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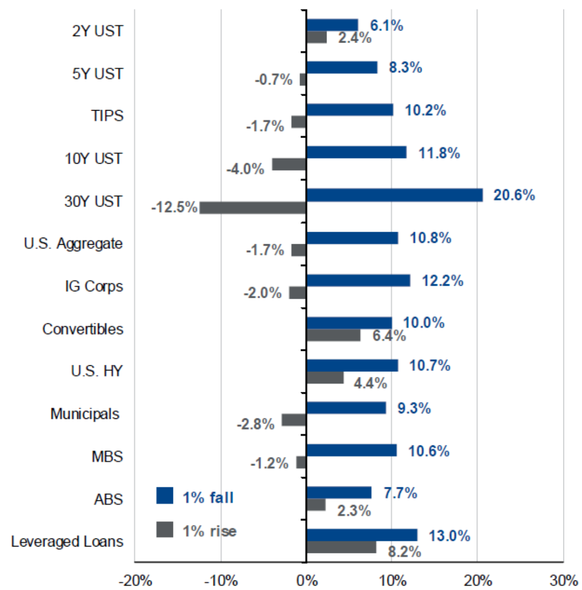
	Yield		Return			
U.S. Treasuries	12/31/2023	12/31/2022	2023	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
2-Year	4.23%	4.41%	3.65%	2 years	0.75	0.00
5-Year	3.84%	3.99%	3.93%	5	0.94	-0.02
TIPS	4.24%	4.38%	3.90%	7.1	0.68	0.32
10-Year	3.88%	3.88%	3.21%	10	1.00	-0.06
30-Year	4.03%	3.97%	1.93%	30	0.93	-0.09
Sector						
U.S. Aggregate	4.53%	4.68%	5.53%	8.5	0.87	0.26
IG Corps	5.06%	5.42%	8.52%	10.8	0.58	0.48
Convertibles	7.88%	7.58%	13.92%	-	-0.10	0.86
U.S. HY	7.59%	8.96%	13.44%	4.9	-0.03	0.72
Municipals	3.22%	3.55%	6.40%	13.3	0.62	0.22
MBS	4.68%	4.71%	5.05%	7.5	0.77	0.24
ABS	5.65%	5.89%	7.05%	3.7	0.01	0.03
Leveraged Loans	10.59%	11.41%	13.17%	2.4	-0.30	0.52

Impact of a 1% rise or fall in interest rates

Total return, assumes a parallel shift in the yield curve

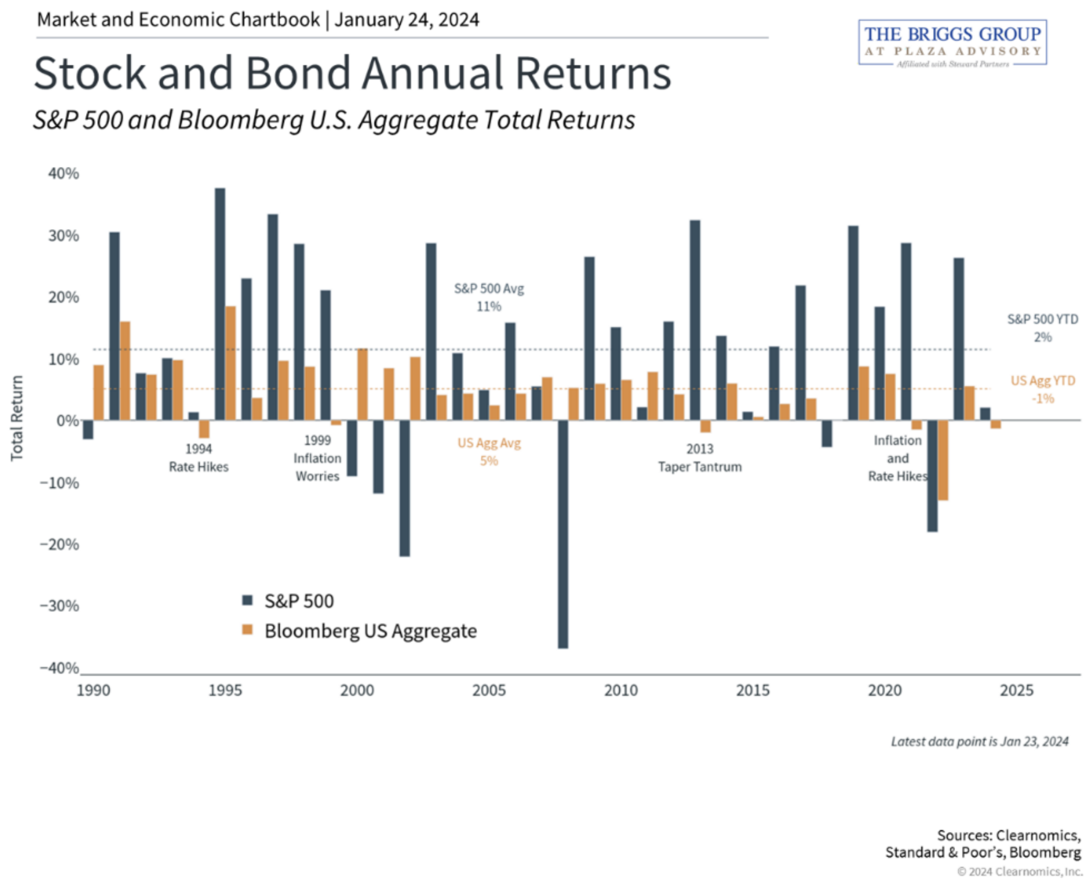


Source: Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg unless otherwise noted and are represented by – U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; ABS: J.P. Morgan ABS Index; IG Corporates: U.S. Corporates; Municipals: Muni Bond; High Yield: Corporate High Yield; Leveraged Loans: J.P. Morgan Leveraged Loan Index; TIPS: Treasury Inflation-Protected Securities; Convertibles: U.S. Convertibles Composite. Convertibles yield is as of most recent month-end and is based on U.S. portion of Bloomberg Global Convertibles Index. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield-to-worst. Correlations are based on 15-years of monthly returns for all sectors. Past performance is not indicative of future results.
Guide to the Markets – U.S. Data are as of December 31, 2023.

J.P.Morgan
ASSET MANAGEMENT

Alternatives:

Given the new secular themes and regime we have seemed to enter, constructing a portfolio with only Equities and Fixed Income could be short-sighted. Now that we have entered a higher rate environment, we believe Equities and Bonds may not exhibit the same negative correlation they did prior to the pandemic. Therefore, Alternative strategies and asset classes can help offset volatility moving forward. These can consist of adding currencies, commodities, and hedged equity strategies.

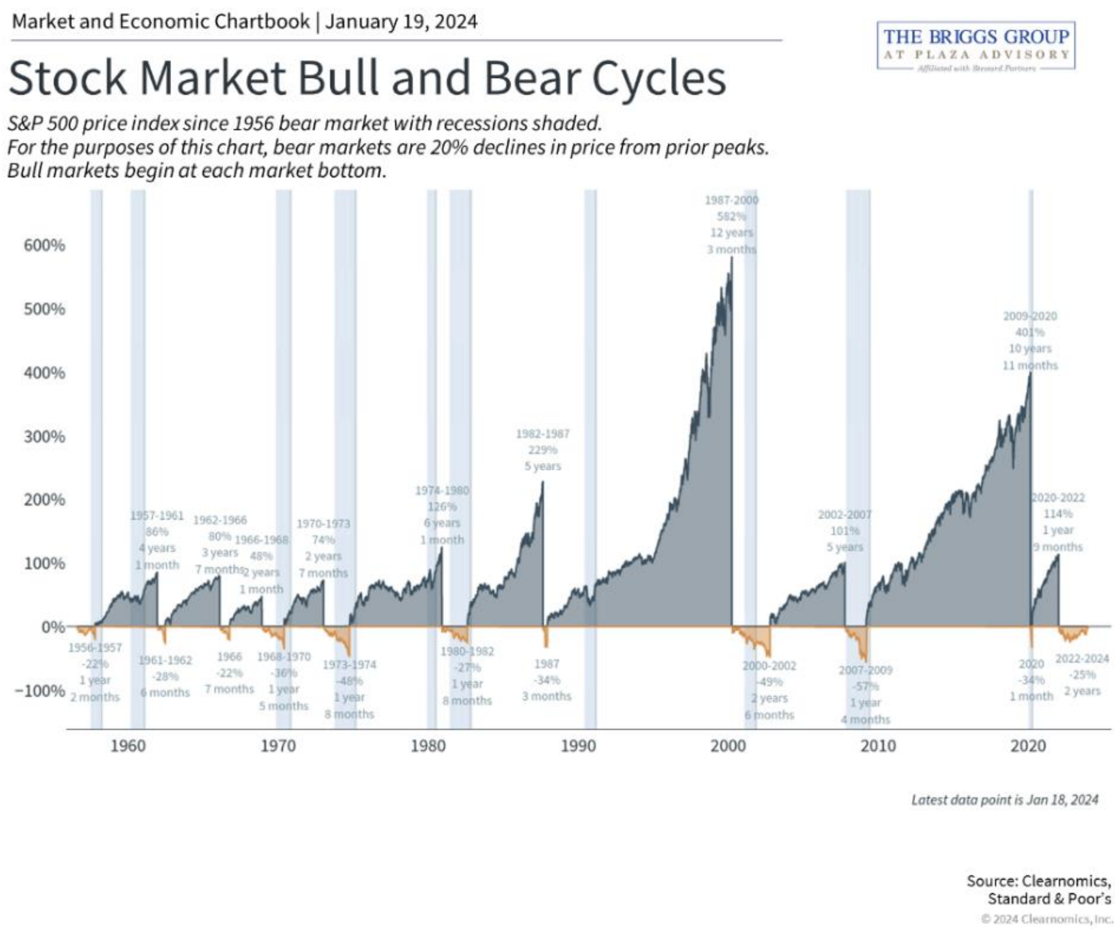


Summary:

In conclusion, as we embark on the journey into 2024, the economic landscape stands at a crossroads, shaped by the echoes of the pandemic and the winds of change in monetary, fiscal, and structural realms. While the specter of volatility looms, there is an optimistic undercurrent, signaling a potential transition to a "New Normal." As investors, our compass must navigate the uncertainties with a nuanced understanding of the consumer's role, corporate resilience, and the intricate dance of inflation and interest rates. The scenarios outlined offer glimpses into possible futures, emphasizing the need for a balanced and adaptive portfolio strategy. In this dynamic environment, equities, fixed income, and alternative assets each play a distinct role in harnessing opportunities and mitigating risks. As we embrace the evolving economic narrative, let us tread carefully, armed with insights and a strategic vision, ready to capitalize on the positive returns that may unfold in the chapters of 2024 and beyond.

Finally, and most importantly, everyone should be thinking about the potential ramifications outlined above and how they impact your personal financial plan and portfolio. As we have expressed and will continue to highlight, focusing on short time horizons can be detrimental to long-term portfolio success. To capture more upside in the markets, it unfortunately requires the potential for greater downside volatility. Another theme we have exhausted this year throughout meetings is the story of the Magnificent Seven (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla). We view the story as a great reminder that despite their strong "recent" performance (2023), that a concentration in such few names also cuts the other way down (2022). Striving to develop sustainable portfolios regardless of the market environment involves utilizing a full array of investments, and not being overly concentrated in any subset of investments that can and have been subject to great volatility.

We look forward to continuing our relationship with our clients' and helping them both navigate the never-ending market volatility, but more importantly their own personal financial journey.



Market and Economic Chartbook | January 17, 2024

Magnificent 7 Performance

Meta, Amazon, Apple, Alphabet, Nvidia, Microsoft, and Tesla. Simple equal-weighted performance versus the S&P 500 and Nasdaq Composite, since 2020

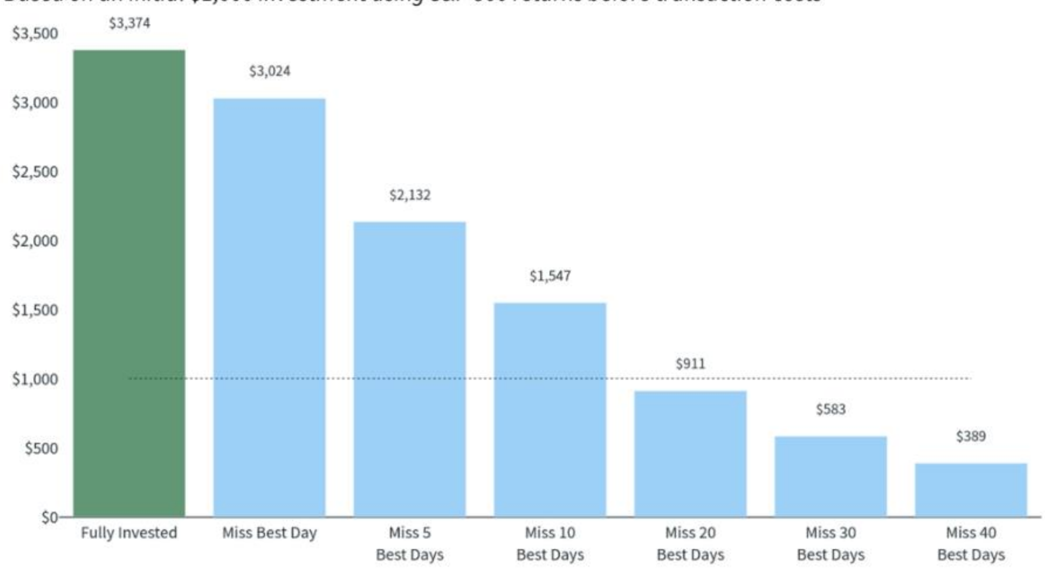
Latest data point is Jan 16, 2024

Sources: Clearnomics, Standard & Poor's, Nasdaq, LSEG

Market and Economic Chartbook | January 19, 2024

Staying Invested: Missing the Best Days

The impact of missing the best market days over the past 25 years
Based on an initial $1,000 investment using S&P 500 returns before transaction costs



Latest data point is Jan 18, 2024

Sources: Clearnomics, Standard & Poor's

Written by:
Andrew Briggs, CFA, CPWA

Director of Portfolio Management

abriggs@plazaadvisors.com
https://briggsgroup.stewardpartners.com/

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Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

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Sources:

[1]Principal Asset Management: Global Asset Allocation Viewpoints Gentle slope, not cliff edge

[2]Vanguard Economic and Market Outlook 2024: A Return to Sound Money

[3]Blackrock 2024 Global Outlook: Grabbing the wheel: putting money to work

[4]JP Morgan Guide to the Markets: 1st Quarter 2024

[5]Clearnomics