The 2024 Outlook:

Slow-Bicycle Economy

SUMMARY OF EXPECTATIONS

THE ECONOMY

ECONOMIC GROWTH

We expect the U.S. economy to continue growing into 2024, but its momentum has been slowing, and ***slowing momentum will put the economy at increased risk of recession***. As the growth rate continues to moderate or slow, the economy will become increasingly susceptible to shocks such as a domestic financial crisis or a major geopolitical event that saps confidence.

Just as riding a bike too slowly makes it difficult to stay in balance, slowing economic growth will increase the risk of a downturn in the economy.

RECESSION RISK

Reflecting the risks inherent in a slower-growing economy, ***we believe the economy is slightly more likely to slip into a recession in 2024 than it is to avoid one***. Nevertheless, if a recession does transpire, we believe it will be relatively mild and short-lived.

INFLATION & MONETARY POLICY

In any case, slowing demand growth and the Federal Reserve's aggressive interest rate hikes since early 2022 ***will probably lead to further moderation in consumer price inflation***. That should allow the Fed to avoid or at least minimize any further rate hikes, but we expect policymakers to try to keep rates high for an extended period to make sure inflation pressures are eliminated.

ELECTIONS

The U.S. presidential election in November 2024 could have a big impact on key asset classes. At this point, it appears to be a close race between President Biden and former President Trump, but there is an elevated chance that some third-party candidate or candidates could join the race.

The elevated political uncertainty ***could keep investors cautious***. In contrast, if one candidate appears to break from the pack, or if the election is thrown into the House of Representatives, risk assets could be pushed sharply higher or lower than in our base case.

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SUMMARY OF EXPECTATIONS (cont.)

MARKET OUTLOOK

FIXED INCOME

As investors come to accept the Fed's "higher for longer" stance toward interest rates, ***we think intermediate- and longer-term U.S. Treasury obligations will be susceptible to selling pressure in 2024, pushing the yield on the benchmark 10-year Treasury note to 4.90% or more***.

- The spreads between investment-grade corporate obligations and Treasuries have recently been unusually low, in part reflecting the way many firms refinanced and termed out their debt when interest rates were ultra-low during the coronavirus pandemic. Spreads could remain tight, but if a recession does materialize, we would still expect them to widen to take account of the increased credit risk.
- Similarly, the spread between below-investment-grade corporates and Treasuries is also low, but it would likely widen even more dramatically if economic growth falters.

U.S. EQUITIES

For U.S. large capitalization equities, ***we forecast that the S&P 500 price index will be between 4,060 and 5,090 at the end of 2024, with a single point forecast of 4,580***.

- The rise in the U.S. stock market in 2023 was heavily concentrated among just a few large cap growth stocks. Stocks with smaller capitalizations lagged, making them better values now. We therefore think small cap stocks will outperform in 2024.
- Similarly, value stocks lagged in 2023, likely setting them up to outperform in 2024.

FOREIGN EQUITIES

We continue to believe that the performance of foreign equities will largely depend on the value of the dollar. ***Continued strength in the greenback in 2024 is likely to be a headwind for foreign equities***, although prudent investors will still want some exposure to the asset class for diversification and as a hedge against any unexpected dollar weakening.

COMMODITIES

Finally, we expect gold and precious metals to be supported in 2024 by a range of factors, including the end of the Fed's interest rate hikes, safe-haven buying amid today's increased geopolitical tensions, and strong buying by central banks.

Broader commodities would face headwinds if a recession materializes, but they could snap back by year's end if any such downturn ends up being short and mild, as we expect.

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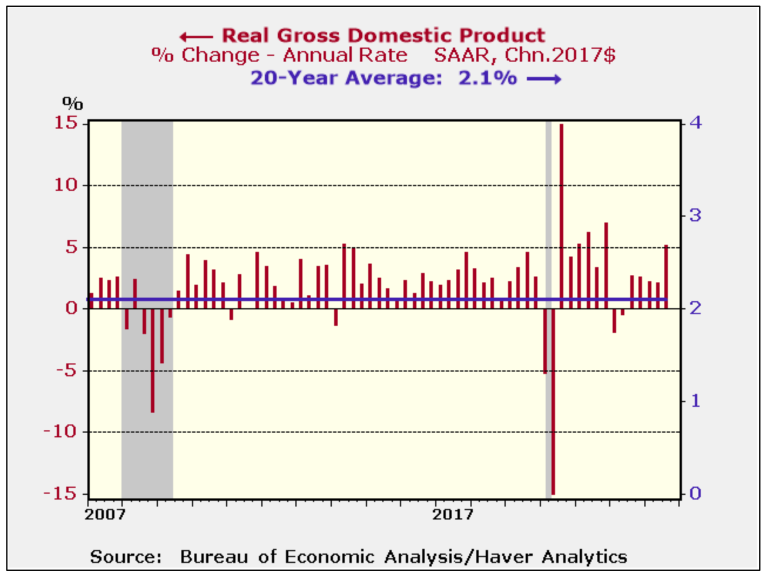
THE ECONOMY

At Confluence, our *Outlook* reports always begin with a key question: Will the United States be in recession in the upcoming year? In this section, we first delve into that question in great detail. Later in this section, we explore the outlook for inflation and monetary policy.

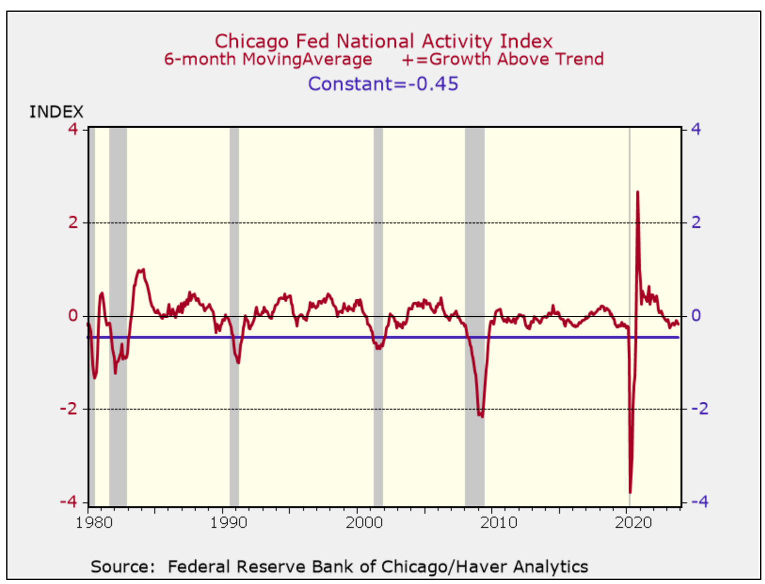
GROWTH OR RECESSION?

Today, key coincident indicators continue to suggest the economy isn't quite in recession yet. Nevertheless, the indicators do show weakening momentum. That's important because, as the title of this *Outlook* suggests, slow or slowing activity puts the economy at greater risk of slipping into recession. Just as riding a bicycle too slowly makes it easier to tip over, weak growth makes the economy susceptible to shocks, such as a domestic financial crisis or a major geopolitical event that undermines confidence. Key forward-looking indicators are also flashing signs of slowing.

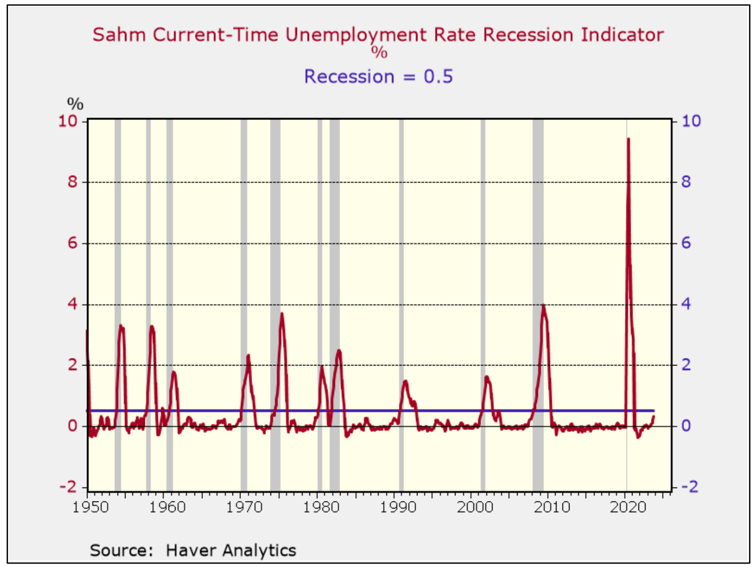
Quarterly GDP Report. The main gauge of economic activity is the Commerce Department's quarterly report on gross domestic product (GDP). After stripping out seasonal variations and price changes, GDP in the third quarter of 2023 expanded at an annualized rate of 5.2%, far above the average annual growth rate of 2.1% over the last couple of decades. Nevertheless, the extraordinarily strong growth rate in the third quarter was widely seen as a one-off fluke, driven largely by companies accumulating inventories. Prior to that, GDP had grown at about the long-term average rate for four straight quarters. A close look at those figures shows GDP growth was slowing slightly in each of those quarters. That's a far cry from the heady growth rates back in 2021. Considering headwinds such as recent high inflation and elevated interest rates, it's not hard to imagine a period of subpar growth in the coming quarters.



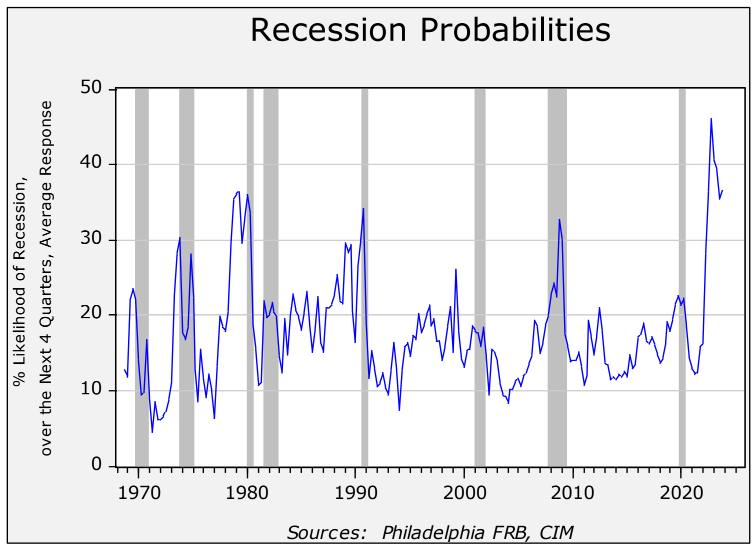
Chicago FRB National Activity Index. Of course, one shortcoming of the GDP report is that it comes out with a long-time lag. The initial estimate is published about one month after the end of a quarter, and it's subject to regular revisions in each of the following two months. For a more granular, nearly real-time measure of activity, one of our favorite indicators is the Chicago Federal Reserve's National Activity Index. The CFNAI encompasses dozens of frequent data series that provide a more current measure of production. It is designed so that readings of 0.0 represent the economy growing at its long-term trend rate. Our analysis shows that when the six-month moving average of the CFNAI declines below -0.45, the economy is typically falling into recession. As shown in the chart, the six-month average of the CFNAI currently remains above that standard. Indeed, it has even rebounded a bit in recent months. All the same, the chart clearly shows that the CFNAI has been trending downward over the last year or so. We take that as a clear sign that the economy has lost significant momentum recently.



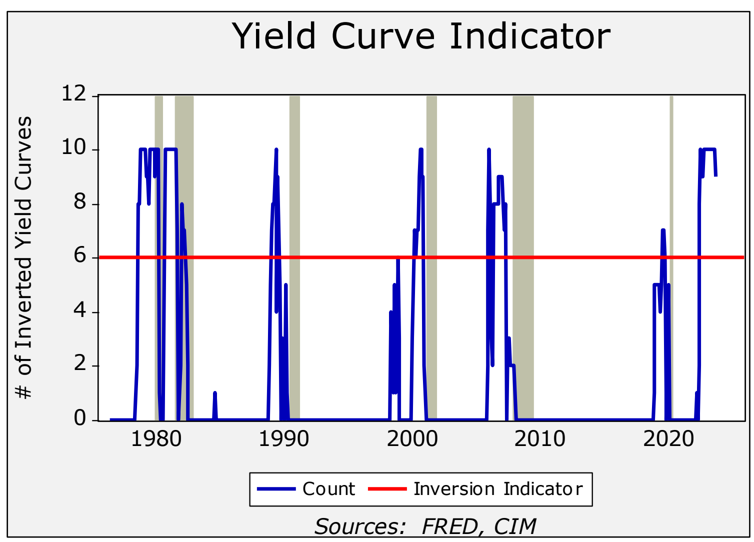
Sahm Unemployment-Based Recession Indicator. Another coincident indicator that is becoming increasingly popular was developed by former Fed economist Claudia Sahm. Based on historical data, this indicator says the economy is likely in recession when the unemployment rate is 0.5 percentage points or more above its minimum over the preceding 12 months (all calculated on a rolling three-month basis). The Sahm Indicator still hasn't hit the recessionary level of 0.5. However, consistent with the CFNAI discussed above, it has certainly been moving toward recession levels in recent quarters. Taken together, these two indicators provide an important yellow flag for U.S. economic growth and suggest the U.S. economic bicycle really is slowing down.



Philadelphia FRB Recession Probabilities Survey. Economists are often criticized for their inability to accurately predict recessions and for their frequent disagreements. Despite that, when enough economists think a recession is on the way, it can signal an impending downturn. Since 1968, the Philadelphia Fed has conducted a regular survey of economists regarding their outlook for economic growth, consumer price inflation, interest rates, and the like. One key question asks the economists to give their probability of a recession over the next 12 months. As shown in this second chart, the average probability of recession hit a record high in 2022. The probability has come down recently, but it remains historically high, pointing to an unusually strong consensus that a recession is coming.



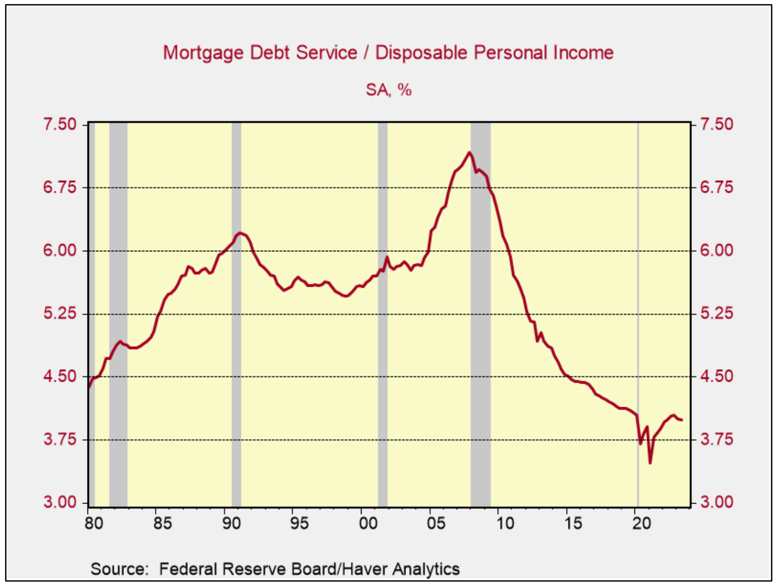
The Yield Curve. Of course, the leading indicator of recession with the most storied reputation for reliability is the yield curve, defined as the progression of yields on U.S. Treasury obligations from shorter maturities to longer maturities. The yield curve is normally upward sloping, i.e., yields on longer-maturity obligations are usually higher than yields on shorter-duration obligations. Prior to a recession, the yield curve has historically inverted, i.e., short-duration yields have risen above long-duration yields. The problem is that there are many ways to measure the yield curve. For example, you could look at the difference between the 10-year yield versus the two-year yield, or perhaps the 10-year yield versus the three-month yield. To address this issue, we've developed an indicator that tracks 10 different yield curves. Historically, recessions have occurred nine to 25 months after six or more of our yield curves have inverted. As depicted in this third chart, 10 yield curves were inverted for an extended period over the last year, adding to the caution we feel just from the slowdown in economic growth.



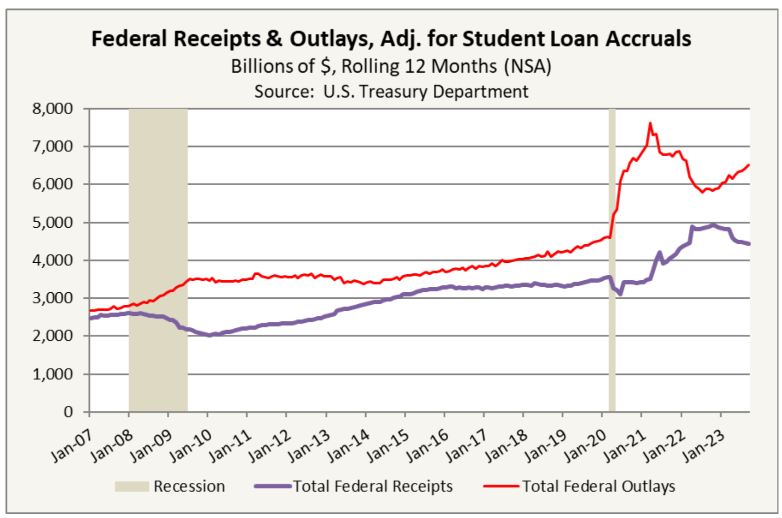
WHY HASN'T THE RECESSION HIT YET?

Regular readers of our *Outlook* will note that we titled last year's edition as "The 2023 Outlook: A Recession Year." After all, a recession is exactly what was expected given the previous year's jump in consumer prices, the Fed's aggressive interest rate hikes, the gradual run-off in pandemic relief spending, and the drop in stock prices through most of 2022. However, it doesn't appear that the recession has hit. We think that can be explained by several factors, all of which have some bearing on whether a recession will hit in 2024 and how deep or long such a recession might be.

The economy today is more resilient to rising interest rates. We believe that one key phenomenon that pushed out a recession was corporate and household debt refinancing when interest rates fell to historic lows during the pandemic. Many companies were able to replace higher-rate obligations with new, low-rate ones that don't mature until 2025, 2026, or later. These companies, therefore, haven't been hurt by today's high interest rates. They might even be benefiting if they have big cash balances that are now earning high yields. Similarly, many homeowners bought or refinanced a home during the pandemic, with the vast majority choosing fixed-rate mortgages that don't have to be refinanced anytime soon. Of course, those homeowners are now reluctant to sell their homes, drying up inventory and driving up prices, but their insulation from Fed rate hikes has probably been a net benefit for the economy. Some student-loan borrowers may have also refinanced, locked in low interest rates, and termed out their debt.



Federal fiscal stimulus has come earlier than usual. If pandemic-era refinancing has been the gift that keeps on giving for the economy, federal fiscal stimulus has also probably played a role. Historically, it wasn't uncommon for the economy to first slip into recession and start boosting unemployment well before Congress belatedly reacted with stimulus measures such as tax cuts or spending increases. The political process can work slowly, and legislation can take months to work its way through both chambers before being signed into law by the president. Past fiscal stimulus, therefore, often hit the economy too late, when it was already coming out of recession. This time, however, several important pandemic-relief programs were still pumping money into the economy or subsidizing activities until recently. The federal government also passed several pieces of spending legislation independent of the pandemic in 2021 and 2022, and those programs began to infuse cash into the economy in 2023. Driven in part by worsening geopolitical tensions as the post-Cold War era of relative peace and globalization gives way to the new era of U.S.-China rivalry, those new laws include the Infrastructure and Jobs Act of 2021, the CHIPS and Science Act of 2022, the Inflation Reduction Act of 2023, and ongoing increases in defense spending. The outlays and tax breaks in these laws will be deployed over the coming several years, but even the modest amounts being spent to date are probably helping to buoy activity.



Some consumers still have excess cash balances from the pandemic. Our analysis indicates that many consumers are still holding more cash savings than they typically did prior to the pandemic. That's especially true among higher-income households, while lower-income households, as a whole, have now spent down their excess savings. The excess savings that remain provide extra cash for consumption or investment purposes, helping to sustain consumer demand. Importantly, a lot of these high cash balances are likely invested in money market funds or other instruments that are now kicking out meaningful amounts of interest income, which, of course, some consumers are likely spending.

Labor shortages are boosting wages, especially for those with a high propensity to spend. Finally, we think the economy has been profoundly changed by the mass retirement of baby boomers and the loss of some other groups of workers during the pandemic. Prior to the pandemic, an unexpectedly large number of boomers were sticking around in their jobs. Those jobs were often relatively high-level and well-paid, leaving fewer opportunities for younger, less-skilled workers. When legions of boomers finally retired, many labor market logjams finally broke, allowing middle- and lower-paid workers the chance to move up and get a raise. For those that moved up from the lower, entry-level jobs, employers couldn't easily find replacements. That's been a boon to prime-age workers, boosting their participation in the labor force, driving up their wages, and encouraging them to spend.

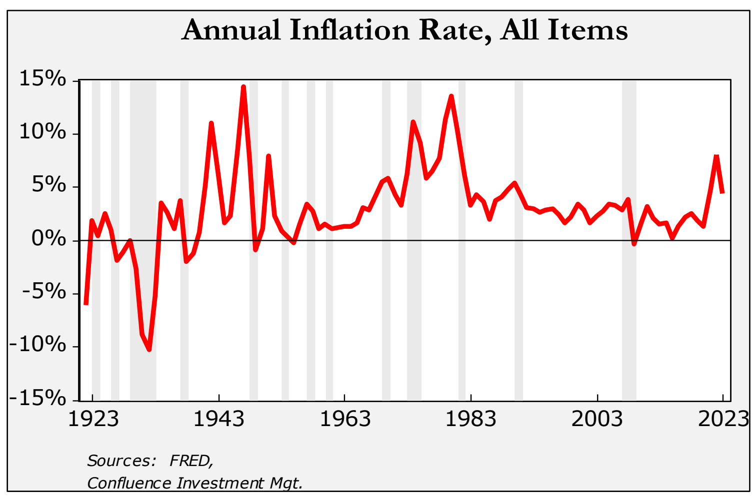
IS A RECESSION STILL COMING?

Despite the factors that have been delaying a recession, we remain concerned about the economy's apparent downshifting to more moderate or even slow growth. As discussed above, weakening activity will produce an economy in which there may not be enough momentum to sustain growth if there is an unexpected shock, such as a domestic financial crisis or a geopolitical event, that saps confidence. To express this concern, we believe the downside risks to the economy now modestly outweigh the upside risks. Against the current global and domestic background, we assess that the U.S. economy is slightly more likely to slip into recession in 2024 than it is to avoid a recession. Because of the supportive factors mentioned above, we continue to believe that any recession in 2024 would probably be relatively mild and short-lived, even if policymakers refrain from loosening monetary or fiscal policy in response.

WHAT ABOUT INFLATION AND MONETARY POLICY?

In our view, U.S. inflation is likely to keep moderating in the near term, with year-over-year price growth slipping to below 2%. However, prices will be at risk of rebounding in 2024, so we expect the Fed to try to hold interest rates near today's high levels.

The U.S. inflation rate is on track to fall almost by half from the previous year, its fastest retreat during an expansion since the outbreak of the Korean War. Paralleling that period, the Fed has navigated a confluence of pent-up consumer demand, surging fiscal spending, and the delicate transition from crisis management to inflation containment. The Fed now enjoys greater independence from the Treasury compared to the 1950s, and it has seized this opportunity to try to re-establish its reputation as the inflation watchdog and government spending counterweight.

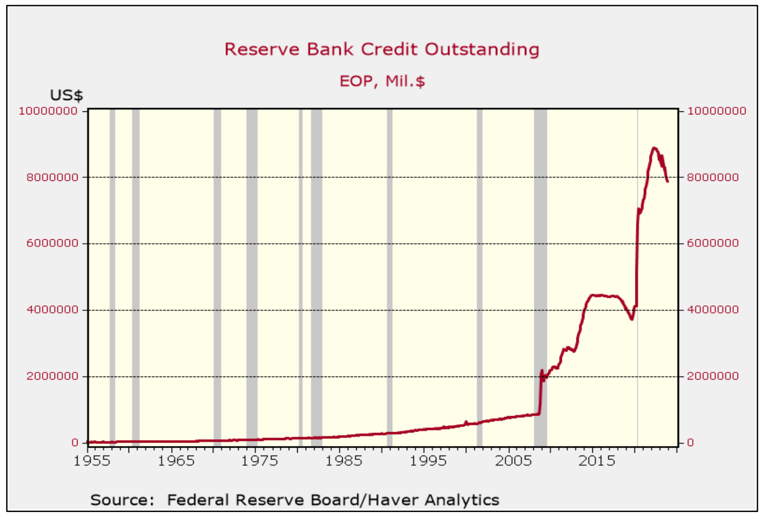


A Bit of History: Monetary Policy and Fed Independence After World War II. Prior to the Korean War, the Fed was still grappling with the lingering effects of years of expansionary monetary policy implemented during World War II. This policy stance involved maintaining prolonged low interest rates and expanding the Fed's balance sheet to support the government's war efforts. During this period, the Fed engaged in yield curve control, keeping short-term interest rates below 0.5%, while capping long-term bond yields at 2.5%. This intervention, while favorable for government borrowing costs, laid the groundwork for future inflationary pressures. To prevent prices from getting out of control, wage and price controls were imposed on the economy.

While wage and price controls temporarily suppressed inflation, their removal ignited a forceful inflationary surge. This resurgence was exacerbated by pent-up consumer demand stemming from wartime rationing, the slow conversion of manufacturing from war production to civilian goods, and an abundance of liquidity. As a result, inflation soared, reaching a peak of 19.7% in June 1947. Although a gradual increase in interest rates and a recession helped alleviate some of the price pressures, inflation resurfaced in the lead-up to the Korean War as consumers rushed to stock up on goods in anticipation of renewed price controls.

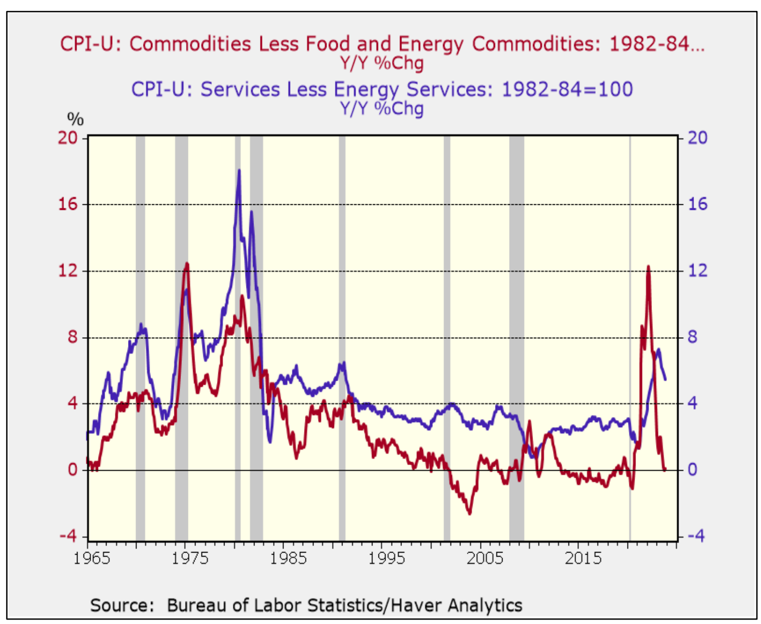
Growing concerns over the resurgence of inflation sparked a clash between the Fed Board and the Truman administration. Fed policymakers were hesitant to continue with accommodative monetary policy in the face of rising inflation. Despite Truman's displeasure with the Fed's stance, the administration ultimately yielded, paving the way for the end of yield curve control and an informal agreement that established central bank independence, now known as the Treasury-Fed Accord.

The Fed's Challenge Today: Persistent Price Pressures. Decades later, Fed Chair Powell now confronts a similar dilemma. In the aftermath of the financial crisis and the pandemic, the Fed has employed expansionary monetary policies to shield the economy from the adverse effects of these events. This has involved keeping short-term interest rates low by managing the federal funds rate and suppressing yields on long-term securities through asset purchases. However, this intervention has had unintended consequences, allowing governments and households to borrow at exceptionally low rates, exacerbating asset bubbles, widening fiscal deficits, and making the economy less responsive to the Fed's monetary policy tools.



Amid the Fed's accommodative monetary stance to foster economic recovery, concerns have emerged over the potential exploitation of this lax policy by government officials. The uneasiness stems from the implementation of unfunded tax cuts, stimulus checks, and other fiscal expansionary measures. Moreover, the emergency lending facilities introduced by the central bank have drawn criticism for setting a precedent for lending to businesses and municipalities, further reaffirming fears that the central bank is unduly collaborating with the government on fiscal objectives and compromising its independence.

In the face of spiraling inflation and growing criticism of his perceived complacency, Powell embarked on the most aggressive cycle of interest rate hikes since Paul Volcker's groundbreaking tightening campaign in the 1980s. The Fed has raised interest rates 525 bps in under two years. For comparison, that was more than double the previous hiking cycle which lasted for three years. This sharp rise in interest rates along with base effect changes and supply chain improvements have played a crucial role in curbing inflation. While the progress has been welcome, there are worries that the Fed may still struggle to get inflation down to its 2% target.



While commodity prices have largely stabilized at pre-pandemic levels, service prices have stubbornly persisted above their historical trend, serving as the main driver of inflationary pressures. This persistence can be attributed to the ongoing influence of shelter prices and elevated wages. While both factors have shown some moderation in the past six months, they are likely to hinder inflation's return to the 2% target. On the one hand, shelter prices remain elevated due to a shortage of available inventories as homeowners, having locked in low mortgage rates, are reluctant to sell unless they receive a premium. On the other hand, elevated wages persist as a consequence of a persistently tight labor market, forcing businesses to bid up wages to retain and attract workers.

A severe recession could potentially help alleviate the remaining inflationary pressures, but it is not our primary expectation. We anticipate a moderation in economic growth or perhaps a mild recession in 2024, but not a deep contraction. Absent the immediate threat of a recession, the Fed has demonstrated that it is willing to inject liquidity into the market,[1] effectively curbing the risk of contagion from any repo market disruptions and safeguarding the broader financial system. Moreover, rising borrowing costs and the relatively low mortgage payments enjoyed by homeowners have reduced their incentive to take on new debt, rendering them less sensitive to interest rate changes.

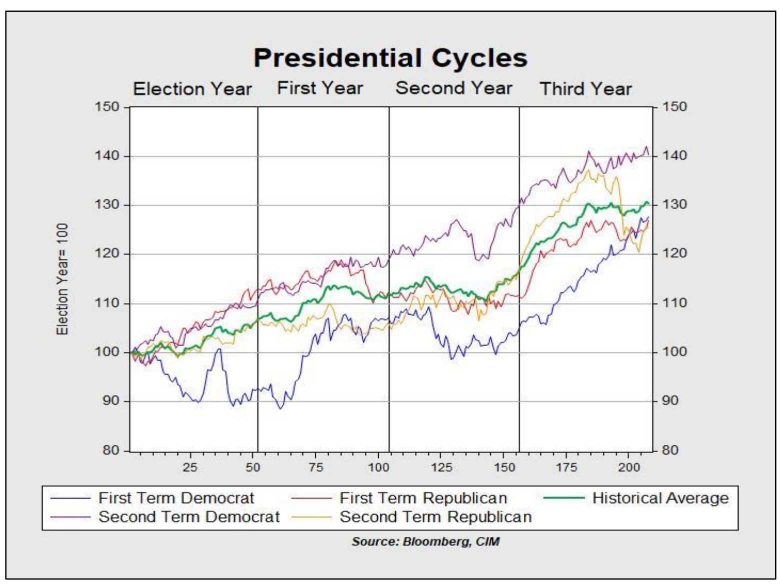
Price pressures are unlikely to resurge to their pandemic-era peaks, and price volatility will likely prevent inflation from sustainably subsiding below 2%. In addition to the persistent influence of a tighter labor market and a housing shortage, goods prices are likely to experience significant swings as global supply chains are reconfigured in response to escalating trade tensions. Although we don't anticipate this to pose an immediate challenge in the coming year, it is a potential concern for the future. Over the next decade, we anticipate annual inflation to potentially range between 3% and 4% as firms and consumers navigate the challenges of rising supply chain uncertainty.

The Result: Interest Rates to Stay Higher for Longer. To navigate this evolving economic landscape, Fed policymakers may need to assert their commitment to price stability once again, even if it means defying market expectations. Despite Fed officials consistently reiterating their unwavering stance against policy easing, market participants continue to anticipate an interest rate cut of 100 basis points, as reflected in fed futures contracts. While investor optimism may be understandable, particularly in the face of a potential economic downturn, it overlooks the underlying challenges. The persistent pressures of rising inflation and an unsustainable budget deficit will likely necessitate the maintenance of higher interest rates for a prolonged period. And so, although we think that further rate hikes are unlikely, we think the policy rate will likely remain higher than market expectations in 2024.

THE ELECTIONS

Next year's U.S. presidential election will likely be a rematch of the 2020 contest, but a dark horse candidate could emerge from either party to shake things up. Polls show that former President Donald Trump is the frontrunner for the Republican nomination in 2024, while the Democratic Party has not entertained any substantial challenger to incumbent President Joe Biden. However, despite not officially launching a bid, California Governor Gavin Newsom (D-CA) has raised his profile after his debate with second-place Republican candidate Ron DeSantis, suggesting he could emerge as a candidate if Biden decides not to run. Additionally, there is a reasonable chance of a third-party candidate as some outside candidates may be looking to play spoiler.

How Has the Stock Market Historically Performed in Election Years? This chart shows the Friday closing price for the S&P 500, indexed to each four-year presidential cycle, dating back to 1928. Equity markets tend to underperform in election years, returning an average of 4.9% compared to the long-term average of 8.4%. Historically, markets have performed best during the second term of a Democratic presidency and the first term of a Republican presidency. Meanwhile, first-term Democratic administrations have seen the worst equity performance.



[1] *As evidenced by the Fed's response to the banking crisis in the spring of 2023.*

How Potential Winners Could Affect the Stock Market. Based on the framework above, a Biden presidency is likely the best outcome for markets as he will likely be unable to pass major legislation. In general, second terms for incumbents tend to be policy constrained, whereas the major lift in policy typically occurs in the first term. A Republican newcomer would also be welcomed as conservative candidates typically use their political capital to pass market-friendly legislation. Among the Republicans who have never been president, Ron DeSantis is currently favored in the polls, with Nikki Haley and Vivek Ramaswamy trailing. Trump could be described as a first- or second-term candidate, depending on your perspective.

If Trump wins the 2024 presidential election, he will become the second president in U.S. history to serve non-consecutive terms. The strong stock market performance during his first term, in which the S&P 500 rallied 11% per year, may boost investor confidence. However, his presidency would also likely face increased opposition from his political rivals, who would use previous strategies to prevent him from pushing through his agenda, including his probable goal of extending his tax cuts. As a result, it is a toss-up as to whether markets will respond favorably if he is reelected. In other words, there is the temptation to view a second Trump term as a replay of the first term; however, this position could be a mistake. Recent comments from the former president suggest he will be more populist in his second term, which may mean less focus on tax cuts and more focus on reforming the operation of government.

The Potential for a Third-Party Candidate. As mentioned, third-party candidates could disrupt the 2024 presidential election. Environmental lawyer and vaccine critic Robert F. Kennedy Jr. has declared that he will run as an independent. Voter polls suggest his candidacy could hurt the Republican nominee as his following includes many people who are sympathetic to political outsiders. Meanwhile, a new bipartisan political party called No Labels is expected to challenge President Biden's chances of re-election. The leading candidates for the party’s nomination are West Virginia Senator Joe Manchin and former Maryland Governor Larry Hogan. The last third-party candidate to actually capture electoral votes was George Wallace in 1968. Thus, political analysts tend to view third party candidates as “spoilers.” Nevertheless, given the fractious nature of our political environment, it isn’t out of the question that some extra-party candidate could capture a state or two. Considering the narrow path to re-election, such an outcome could be disruptive.

The Potential for a House Election. Due to the lackluster enthusiasm for the 2024 presidential election, there is a significant risk that no candidate will win the requisite 270 electoral college votes. If this happens, the House of Representatives will elect the president, and the Senate will elect the vice president. In the House, each state delegation gets one vote, regardless of the number of congressional districts it has. A majority of states (26) are needed to win. This system favors Republicans as Democrats are disadvantaged in state delegations due to the number of conservative states.

No matter who wins the presidency, a major concern will be what to do with the remainder of spending from the Inflation Reduction Act. Much of the spending is set to come between 2024 and 2026. Trump has already vowed to cut some of the spending. As a result, next year will be a test as to how much the country has bought into President Biden’s agenda. With the deficit in focus, the bill's popularity may affect whether the planned spending is realized. That’s especially the case since the Trump tax cuts are set to expire in 2025.

Given the prospect of a close race between the presumptive Republican and Democratic candidates, coupled with viable third-party challengers, the market is likely to exhibit greater caution compared to previous election cycles. The lingering uncertainty over future policy may cause voters to delay their participation until a clear winner emerges. However, if a frontrunner establishes a commanding lead — as polls suggest for Trump — the market could experience an early breakout. Trump has previously indicated that a second term would entail tax cuts and policies that prioritize fossil fuels over clean energy initiatives.

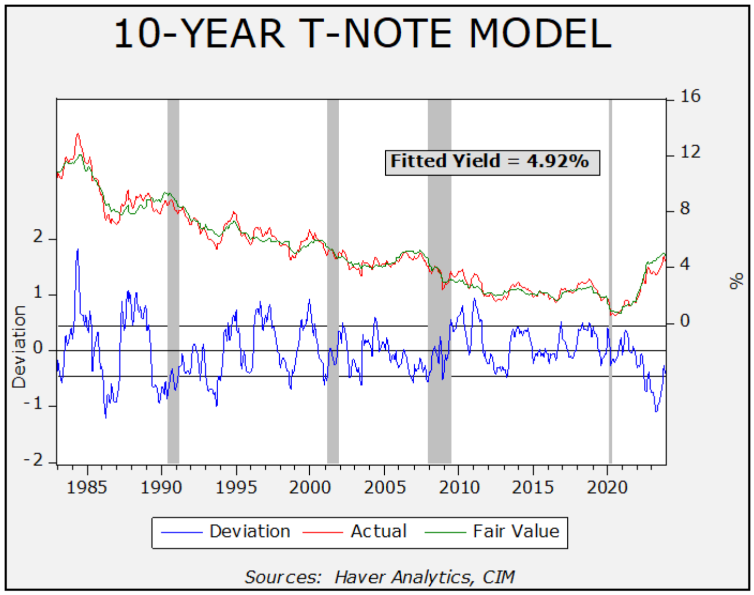
FINANCIAL AND COMMODITY MARKET OUTLOOK

Whichever way the economy and elections play out in 2024, we think investors in the new year will increasingly accept that the financial markets have changed now that the post-Cold War era has given way to an era of East-West rivalry, with its fractured trade and investment flows, higher inflation and interest rates, and the greater potential for instability. In the new world of U.S.-China rivalry, we expect that reduced inflows of foreign capital, higher inflation, and bigger government fiscal deficits will erode the value of fixed income assets, keeping interest rates higher than investors have seen in more than three decades. The change will become more obvious in 2024 if the Fed keeps interest rates high and bond yields don't fall dramatically even if the economy slips into recession. Continued elevated inflation and interest rates are also likely to weigh on stock valuations through much of the year, although prospects are good for a late-year rally if election uncertainties dissipate. We also see the potential for commodity values to rally late in the year if any recession proves to be short and mild.

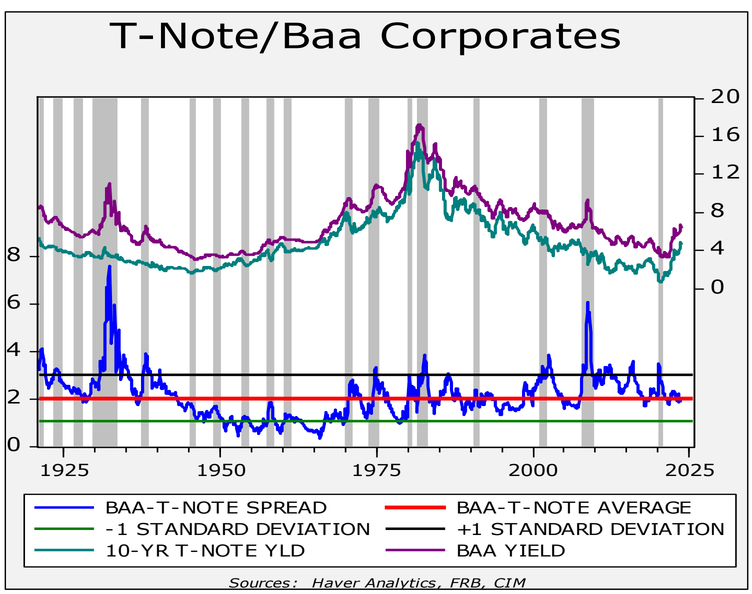
FIXED INCOME

What is the "proper" interest rate on cash? What is the "correct" yield on longer-term bonds? Over the last 30 years (essentially the post-Cold War period of peace and globalization), the Fed's benchmark fed funds interest rate averaged 2.45%, while CPI inflation averaged 2.50%. Using round figures and subtracting inflation from the fed funds rate, we might therefore conclude that the "real" risk-free interest rate should average about 0.0% over the long term. However, if we use 50-year averages to capture some of the Cold War period of geopolitical tension and high inflation, the same exercise points to an average real interest rate of about 1.0%. In other words, it would be reasonable to expect real risk-free interest rates to average between 0.0% and 1.0% over time. If we perform a similar comparison of 10-year Treasury note yields versus the fed funds rate, we could say that the average time premium for the 10-year Treasury is about 1.5%. In other words, the expected real yield on the 10-year Treasury note is probably 1.5% to 2.5% over time. Now, let's see what our analysis tells us about fixed income assets specifically in 2024:

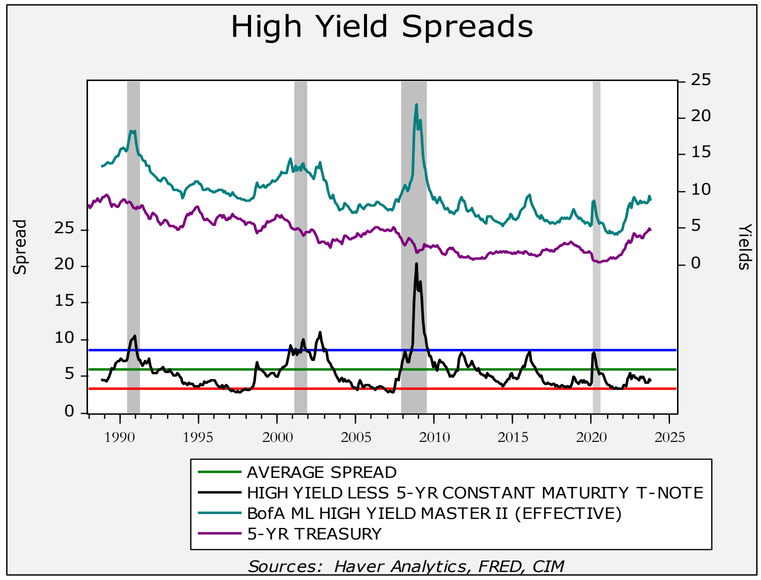
Treasuries. If we're right about the inflationary impact of future geopolitical tensions, global economic fracturing, labor shortages, excessive government spending, and the like, then it's reasonable to expect CPI inflation in the coming decade or more to average something in the range of 3.5%, rather than the 2.5% average of the last three decades. That would imply that the yield on the 10-year Treasury note would lay between 5.0% and 6.0%. Indeed, our broad, multi-factor model currently suggests the fair-value yield on the 10-year Treasury would be about 4.9%. As investors continue to buy into the Fed's "higher for longer" expectation for interest rates, and as they give up on their hopes of outright interest rate cuts in the near term, longer-term yields may move upward toward the expected long-term range. That would be especially the case if the Fed responds to any economic slowdown or crisis by leaning on pandemic-style asset-purchase programs rather than rate cuts. In other words, with only a moderate likelihood of a shallow recession, bond values are likely to depreciate modestly in 2024, nudging yields upward rather than downward.



Investment-Grade Corporates. The yield on investment-grade corporate obligations compared with 10-year Treasury yields remains unusually low, suggesting corporates are richly priced. Given the risk that slowing economic growth will allow the economy to slip into recession more easily, we think these corporates are at greater risk of price declines (and yield increases) than investors might realize. As discussed above, many companies have termed out their debt, insulating them from the need to refinance in any 2024 recession. Nevertheless, as shown in the second chart, corporate yields and spreads typically jump in a recession, and we would expect that in a 2024 recession as well.



High-Yield Corporates. The extra yield provided by below-investment-grade "junk" bonds remains significantly lower than average. In fact, except for a brief period at the beginning of the pandemic, high-yield spreads have been historically tight for much of the last decade. Currently, the narrow high-yield spreads likely reflect the way that many companies termed out their debt when interest rates reached ultra-low levels during the pandemic. As with large, investment-grade firms, many companies with below-investment-grade debt won't face refinancing pressures in 2024. Nevertheless, if the slowing economy produces a recession in 2024, many investors are likely to dump their below-investment-grade debt which would drive down prices and push up their spreads again, as typically happens in a recession.

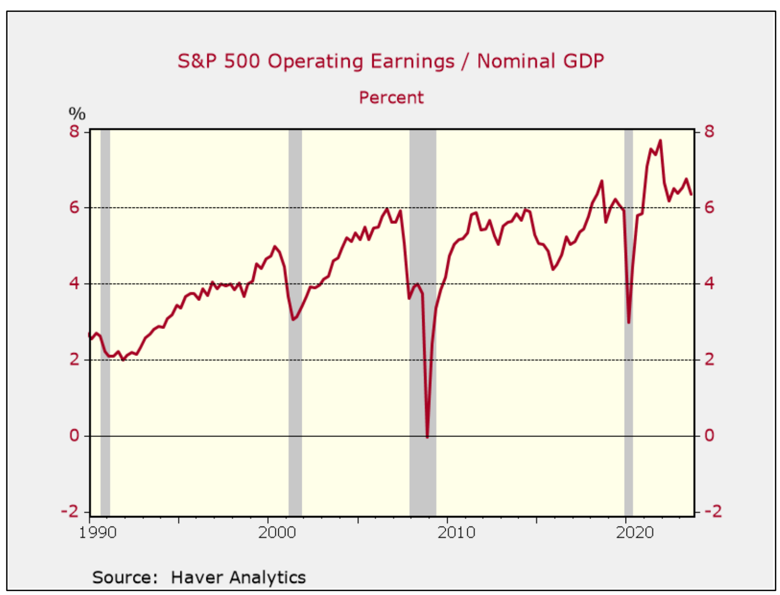


U.S. EQUITIES

For insight into where U.S. stock prices will go in the coming year, we begin with an estimate of corporate profits and then apply a price/earnings (P/E) ratio to project a year-end figure for the S&P 500 stock price index, which tracks stocks with large market capitalizations. Finally, we try to gauge the relative outperformance or underperformance of large cap stocks versus small cap stocks and "value" stocks versus "growth" stocks. ***As we discuss below, we currently forecast that the S&P 500 price index will end 2024 between 4,060 and 5,090, with a single point estimate of 4,580, up only slightly from today's levels.***

S&P 500/Large Cap Stocks. Given our forecast for a slowing economy and likely mild recession in 2024, we are currently expecting a decline in corporate profits. Our forecast for S&P 500 profits in 2024 is $206.57 per share, down approximately 5.0% from the $217.46 currently estimated for 2023.

Our earnings-per-share estimate for 2024 derives, in part, from our forecast of S&P 500 profits as a share of GDP, shown in this chart. One word of caution in interpreting the chart is that S&P 500 margins tended to range from 2% to 3% of GDP in the last few decades of the Cold War (from 1965 to 1990). Since then, however, margins have not only been elevated, but they've been trending upward, with extreme volatility around recessions. If we are correct that the post-Cold War era of relative peace and globalization is now over, it would not be unreasonable for margins to enter a period of secular decline. That may not occur in any recession that takes hold during 2024, but it could show up as a weak margin recovery after the recession. This process of margin compression will likely be gradual, and so it may not be a major issue in 2024, but by the second half of the decade it will become a serious concern.



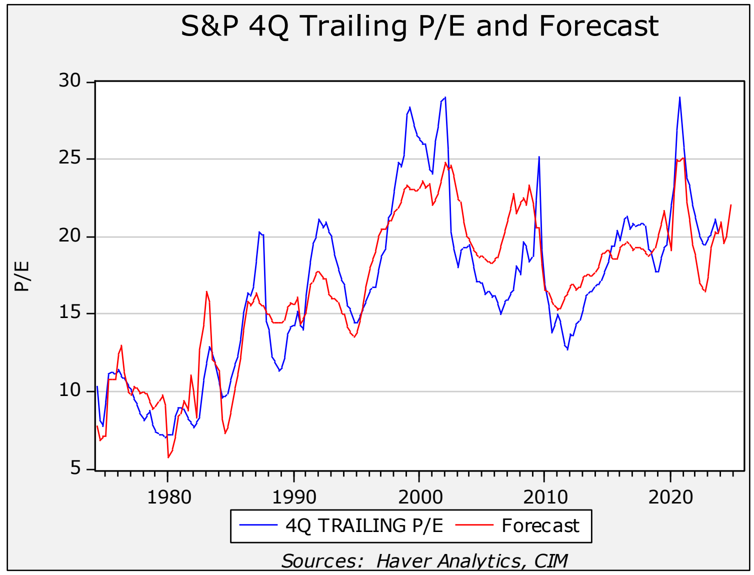
The next step in developing our S&P 500 forecast is to apply a P/E ratio to our earnings estimate. Our P/E model uses annual CPI inflation, the five-year standard deviation of CPI inflation, the annual growth in the M2 money supply, the size of the fiscal deficit, 10-year Treasury note yields, total retail money market fund balances, and a binary variable for recession. The model currently suggests the P/E multiple will come under pressure in 2024 before rebounding to 22.16 at year's end.

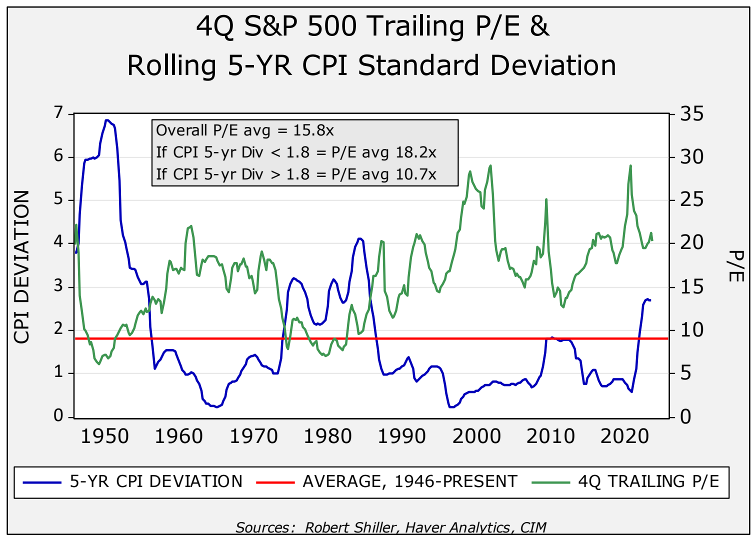
If our P/E forecast isn't spot-on, today's global economic outlook probably means that it is more likely to come in lower than anticipated.

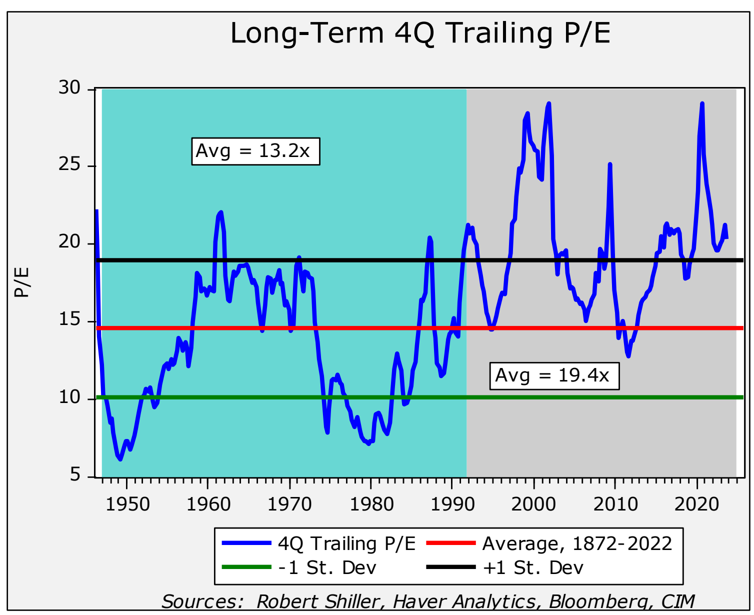
As shown in the second chart on this page, the P/E multiple on the S&P 500 has averaged 15.8x in the years since 1950. Overlaying the multiple is the five-year rolling standard deviation of annual CPI inflation. As is clear from the chart, there is an inverse relationship between the two: When inflation volatility is less than 1.8%, the multiple averages 18.2x, but when inflation volatility is greater than 1.8%, the multiple averages just 10.7x. Since we believe today's deglobalization will steepen the global supply curve, inflation volatility is likely to increase, pushing down average P/E multiples. However, for 2024, the expected decline in inflation will also lead to lower inflation volatility. Our forecast for the multiple reflects this expected decline in inflation volatility.

Moreover, the experience of the Cold War and its aftermath suggest that the increased geopolitical tensions associated with the U.S.-China rivalry will weigh on confidence, reduce efficiency, and increase inflation, putting further downward pressure on multiples. As shown in this third chart, the P/E on the S&P 500 tended to fluctuate around its long-term average during the Cold War. However, since the end of the Cold War, the multiple has rarely fallen below the average and instead has risen to unusually elevated levels. As U.S.-China tensions worsen into something similar to a cold war, it would be reasonable to assume multiple compression in the coming years.

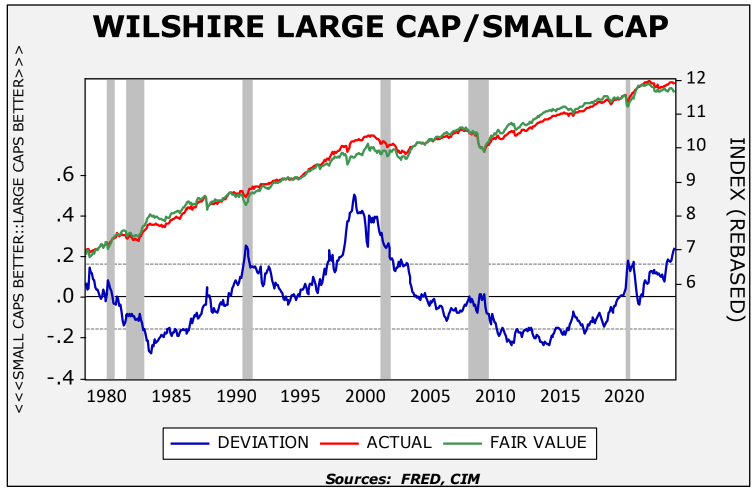
Putting it all together, we multiply our S&P 500 earnings forecast of $206.57 per share by our P/E forecast of 22.16 to estimate that the S&P 500 will end the year at about 4,580, up less than 1.0% from today's level. Our P/E model has a standard error of 2.5x, so we can say that the S&P 500 is likely to end the year in a range between 4,060 and 5,090.



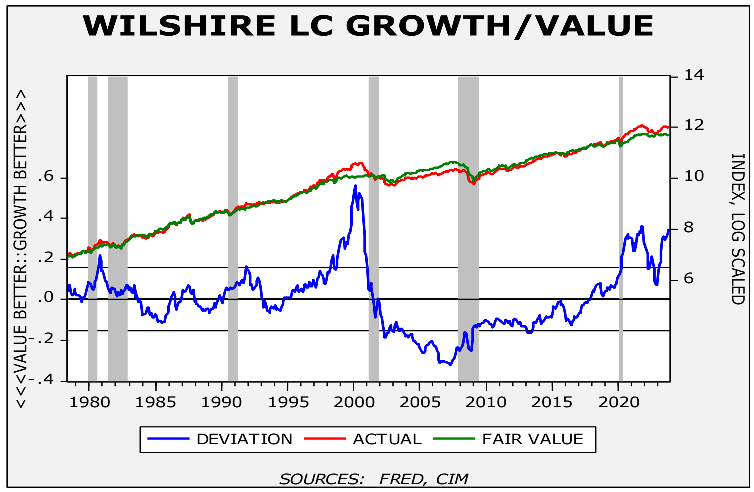




Small Cap vs. Large Cap Stocks. Over the last couple of years, the U.S. stock market has been extremely narrow, in the sense that the indexes weighted by market cap have been driven almost entirely by just a dozen or so stocks. Specifically, the large capitalization stock indexes have been driven by a limited number of large cap technology stocks active in the artificial intelligence sector that has investors so excited. The outperformance in those stocks has left small capitalization stocks languishing. As shown in this first chart, the underperformance in small cap stocks has been extraordinary. Therefore, going into 2024, we think the relative value of medium and small cap stocks is far more attractive than that of large cap equities.



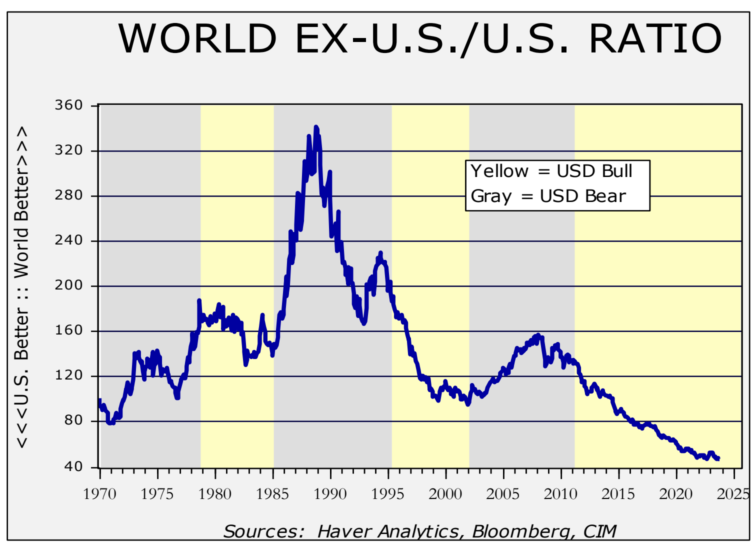
Value vs. Growth Stocks. Similarly, the recent outperformance of growth stocks and the lagging performance of value stocks tells us that value-style stocks are probably a better value and are likely poised to "catch up" at some point. Besides, as the economy begins to show more signs of potential recession and the Fed further demonstrates its intention to keep interest rates "higher for longer," it would be reasonable to expect investors to recognize the attractive pricing, higher average dividend payout, and lower volatility of value stocks.



FOREIGN EQUITIES

Although the longstanding outperformance of U.S. stocks versus foreign stocks has left foreign valuations relatively low, that doesn't necessarily point to a near-term rebound in international equities. Our research indicates that foreign stock performance is heavily influenced by the value of the U.S. dollar. When the greenback is appreciating, foreign stocks typically struggle, and vice versa.

Moreover, our most recent research has shown that the dollar's value is largely determined by the ebb and flow of international capital flows as the U.S. moves through innovation and capital investment cycles. When the U.S. develops and commercializes an important new technology, such as artificial intelligence (AI), it often touches off waves of domestic investment, and the associated inflow of capital from abroad buoys the greenback. As the technology matures and begins to diffuse into the global economy, foreign capital follows it, taking away support for the dollar. ***Given that we appear to be in the very early stages of the AI boom, we think the dollar could remain richly valued in the near term, even though it is already trading at historically high levels versus key currencies.*** In our view, the continuing AI boom could keep the dollar richly valued in 2024 even if the Fed holds interest rates steady or cuts them while foreign central banks keep raising theirs.



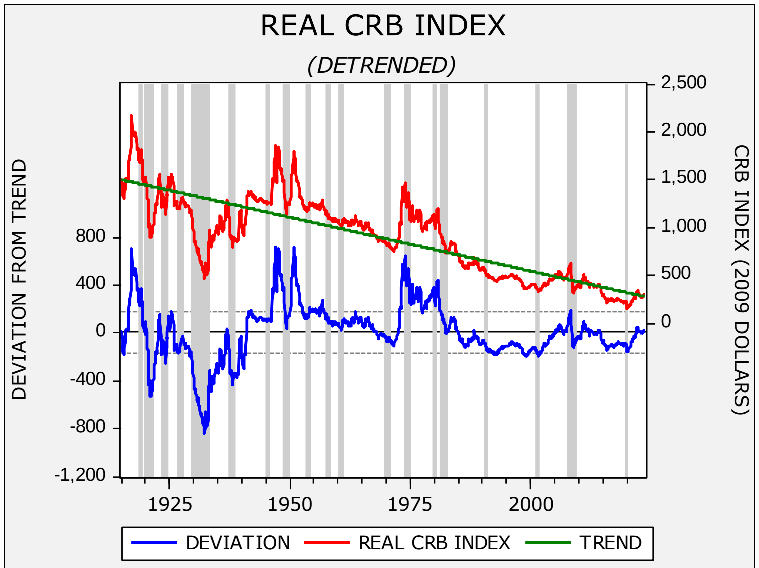
Taking these points into consideration, as the chart on the previous page shows, foreign stocks have dramatically underperformed U.S. equities in recent years. Nevertheless, although there isn't an obvious catalyst to drive foreign stocks higher, for strategic, long-term investors, some allocation to overseas equities is recommended.

TO SUM UP OUR EQUITY OUTLOOK

Although we are looking for a mostly flat year for the overall S&P 500, as we note, lower capitalization stocks, value stocks, and foreign stocks have all "sat out" the recent rally seen in the S&P 500 and the NASDAQ. Thus, we think there is ample opportunity for equities in the areas of the market that didn't participate in the 2023 rally. This position is generally reflected in our Asset Allocation portfolios.

ALTERNATIVE INVESTMENTS

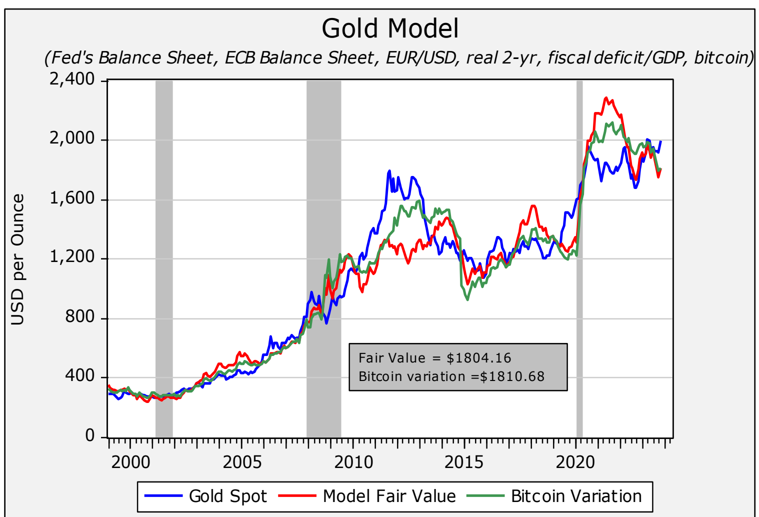
Finally, what can we say about the prospects for gold and precious metals, mineral commodities, and other natural resources in 2024? First, we note that over the very long term, commodity prices typically fail to keep up with the rise in general prices. In other words, inflation-adjusted commodity prices tend to decline. That makes sense in a capitalist economy, which gives natural resource companies such strong incentives to find and develop new supplies and increase their productivity in bringing those supplies to market. Capitalism also provides strong incentives for buyers to become efficient in their use of commodities. Nevertheless, as shown in this chart, commodity prices often surge in times of elevated geopolitical tensions, as the world is seeing now with the intensifying U.S.-China rivalry. We think these geopolitical forces, especially the potential for the China/Russia bloc to weaponize their commodity supplies, will help support commodity prices generally now and into the future.



Sources: Haver Analytics, BLS, CIM

But what is the outlook for particular classes of commodities in 2024 alone?

Gold and Precious Metals. Today's geopolitical backdrop is especially supportive for gold and other precious metals. Not only are some investors looking to precious metals as a hedge against geopolitical conflict, but many central banks have increased their buying after the U.S. and Europe responded to Russia's invasion of Ukraine in 2022 by freezing the Kremlin's U.S. dollar holdings. Nevertheless, precious metals have also faced competition as more investors buy cryptocurrencies on the belief that they will be a hedge against geopolitics and inflation. Finally, the Fed's aggressive interest rate hikes over the last year and a half, coupled with falling inflation, have left "real" interest rates at their highest levels since the Great Financial Crisis of 2008. Historically, high real interest rates have been negative for gold and other precious metal prices. Given that the Fed seems dead set on keeping interest rates high for an extended period,



Sources: Haver Analytics, FRED, CIM

even as inflation retreats, we think high real interest rates will still tend to limit further gains for gold and other precious metals in 2024. Indeed, our gold model currently suggests pricing for the yellow metal could retreat more than 10% in

2024. This bearish outlook is somewhat tempered by the aforementioned central bank buying. Central bankers are usually price insensitive. In other words, if a policy decision is made to add an asset class to foreign reserves, it's usually not driven by prices. After all, central banks were sellers of gold when prices were languishing around $200 per ounce. Why are central banks interested in gold? The reason is due, in part, to concerns about the reliability of U.S. Treasuries as a reserve asset. The ability of the U.S. and Europe to effectively freeze Russia's foreign reserves has increased the demand for other reserve assets such as gold. Thus, a retreat in 2024 is possible for gold, but we would not be surprised if it performs better than our model suggests.

Other Commodities. Slowing economic growth and the risk of an outright recession would tend to temporarily sap commodity demand and hold down prices. Nevertheless, as stated earlier, we continue to believe that any economic downturn would most likely be relatively short and shallow. Any negative impact from the election campaign should also dissipate by the fourth quarter, potentially boosting commodity prices along with stock prices. Once the economy comes out of any recession, we believe the support from geopolitical tensions could reassert itself. Moreover, petroleum and natural gas supplies remain constricted because of tepid investment over the last half-decade or more. As economic growth and commodity demand strengthen again, the lack of supply will likely come to the fore and boost energy prices, in particular.

AUTHORS

Patrick Fearon-Hernandez, CFA
Chief Market Strategist

Thomas Wash, CBE
Associate Market Strategist

Bill O'Grady
Advisory Director – Market Strategy

Mark Keller, CFA
Chief Investment Officer

ABOUT CONFLUENCE INVESTMENT MANAGEMENT LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.