MJM INVESTMENT ADVISORS, INC.

Fourth Quarter 2024 Investment Outlook

Are You Sure About That?

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.”

– Mark Twain – Humorist

“Doubt is not a pleasant condition, but certainty is absurd.”

– Voltaire – Writer

“Eschewing certainty can keep you out of trouble. I strongly recommend doing so.”

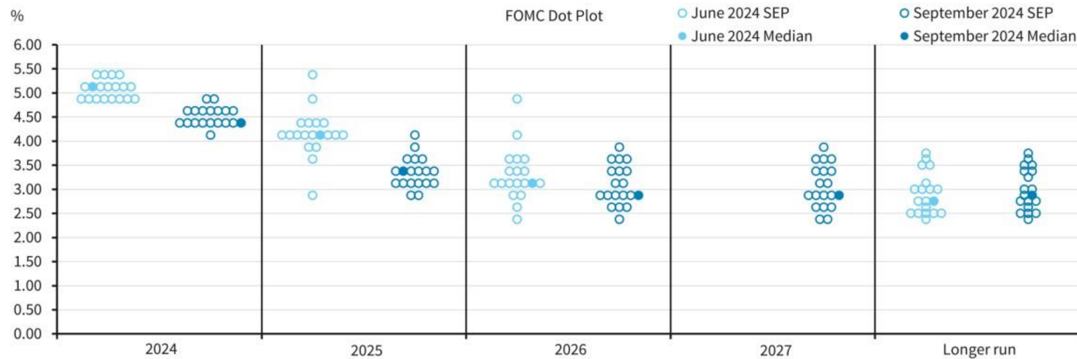
– Howard Marks – Investor and Writer - The Folly Of Certainty memo

Global financial markets had a strong rally during the third quarter with the broad U.S. stock index gaining +6.2%, the broad non-U.S. stock index gaining +8.1%, and the broad U.S. bond index gaining +5.2%. The primary catalyst for the rally was investors gaining more confidence the Fed would start cutting interest rates and expectations for a larger amount of interest rate cuts increased. The rising confidence level of market participants was due to weaker jobs and inflation data over the past several months, which would give the Fed more flexibility to cut interest rates. Before the Fed made its policy decision on September 18th, the market was pricing in 1.00% of interest rate cuts by the end of 2024 and another 1.50% of interest rate cuts during 2025 for a total of 2.50% of interest rate cuts over the next 15 months. If the market’s view is accurate, the Fed Funds rate would decline from the existing target range of 5.25% to 5.50% to a new target range of 2.75% to 3.00% by 12/31/25.

The U.S. Federal Reserve did indeed make a major policy pivot at its September 18th meeting, ending the interest rate hiking cycle it started in March 2022 in response to excessive inflation. The Fed reduced the Fed Funds rate by 0.50% to a new target range of 4.75% to 5.00%. In addition, the Fed updated its quarterly Summary of Economic Projections, aka the “Dot Plots”, and the median forecast was for an additional 0.50% of interest rate cuts for the rest of 2024 and another 1.00% of interest rate cuts in 2025. Including the initial 0.50% cut, the Dot Plots forecast a total of 2.00% of interest rate cuts by the end of 2025. The next chart shows the changes to the interest rate forecasts in the Fed Dot Plots between the June 2024 and September 2024 projections. For each year, the group of dots on the left side represent the June forecast and the dots on the right represent the September forecasts of all 18 Fed members making their individual interest rate forecasts. Each darkened circle represents the median forecast of the 18 Fed members for each time period.

Revisions lower to the FOMC's dot plot

The median participant projects four rate cuts in 2024, four in 2025, two in 2026 and zero in 2027



Source: Federal Reserve, Barclays Research

Note: Light blue dots show June 2024 projections; dark blue dots show September 2024 projections. The medians are shown as filled circles. If two circles are shaded, the average of the two points represents the median. The median is counted from bottom to top and from left to right.

The latest Dot Plots shows a median forecast of 0.50% of additional interest rate cuts by the end of 2024, which would bring the Fed Funds target range down to 4.25% to 4.50% by year end. For 2025, the latest Dot Plots shows the Fed Funds target at just under 3.50%, which means a Fed Funds target range of 3.25% to 3.50%, or another 1.00% of interest rate cuts by the end of 2025. The Secured Overnight Financing Rate (SOFR) is a live proxy of future borrowing rates based off of the Fed Funds rate. The December 2025 SOFR is currently at the same level too, which means the market is currently in agreement with the Fed's latest Dot Plots forecast.

As shown in both the 2024 and 2025 columns, the Fed's September Dot Plots interest rate forecast (the right side group of circles in both columns) declined from the previous Dot Plots in June, meaning the Fed lowered its interest rate forecast for both years compared to three months ago. Lower forward interest rate forecasts have been a positive catalyst for financial markets as a more accommodative Fed, as defined by lower interest rate levels, typically supports higher price/earnings (PE) multiples on stocks. In addition, the recent declining inflation readings supports rising bond prices and thus lower bond yields. In turn, lower bond yields are also supportive of higher stock valuations.

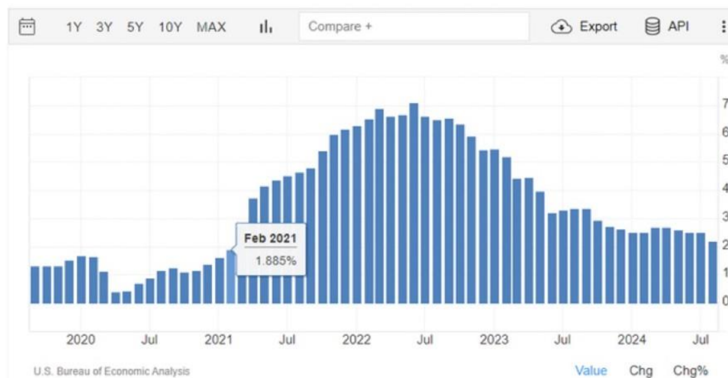
However, even as higher confidence and certainty took hold post the Fed's September meeting, more recently things have changed. The next chart shows a trailing three month chart of the 2-year U.S. Treasury yield. The 2-year U.S. Treasury yield is the maturity most sensitive to interest rate expectations one year out. Three months ago, the 2-year Treasury yield was at 4.50%. However, as summer progressed, the yield started to fall dramatically. A large drop occurred in early August when the July Non-Farm payrolls data was released, which was much weaker than expected. There was also softer inflation and other macro related data and the 2-year yield hit a low of 3.55% during the last week September.

Source: Wall Street Journal Online

Just when the market's conviction level of lower interest rates had peaked, the bond market started to move in the other direction. In early October, bonds began to sell-off and the 2-year U.S. Treasury yield moved back to 4.00% or 0.45% higher than its 3.55% low hit in the last week of September. The reason was the September Non-Farm payrolls released on October 4th was much stronger than expected. In addition, the Consumer Price Index for September released on October 9th was also higher than expected.

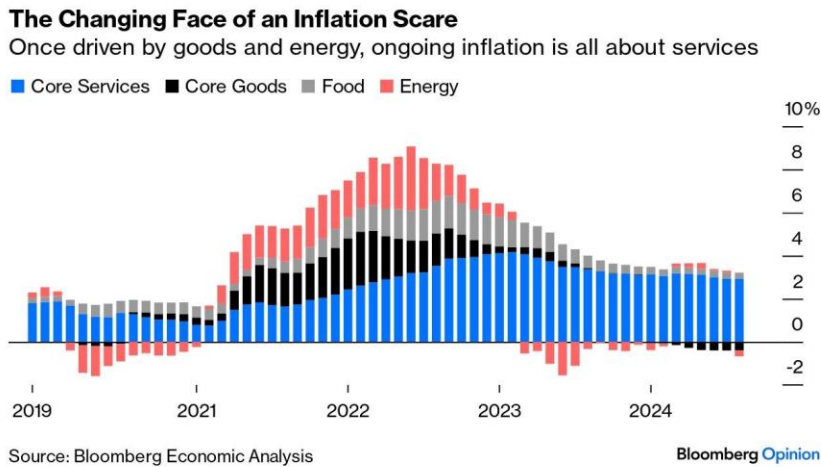
It's important to highlight another major change the Fed made at its September 18th meeting. At his press conference, Chair Powell explained that the jobs market and not inflation was now the Fed's primary focus as it relates to its future monetary policy decisions. This change was brought about by the ongoing decline in inflationary pressures that have increased the Fed's confidence that inflation is headed back towards its 2.0% target. The next chart below shows the Personal Consumption Expenditures (PCE) Index from 2020 to the latest reading in September 2024. The PCE is the Fed's preferred inflation gauge. The large increase in the PCE starting in mid-2021 into 2022 was the reason the Fed began to aggressively hike interest rates from March 2022 through June 2023. The PCE Index peaked near 7% in July 2022 and began to decline from there and is now almost back to the Fed's 2.0% inflation target. As such, the Fed is now more confident that its policy actions have brought inflation back toward its 2.0% target and it can now focus more on its other dual mandate objective of full employment.

PCE Price Index Annual Change in the United States decreased to 2.20 percent in August from 2.50 percent in July of 2024. PCE Price Index Annual Change in the United States averaged 3.30 percent from 1960 until 2024, reaching an all time high of 11.60 percent in March of 1980 and a record low of -1.47 percent in July of 2009. source: U.S. Bureau of Economic Analysis

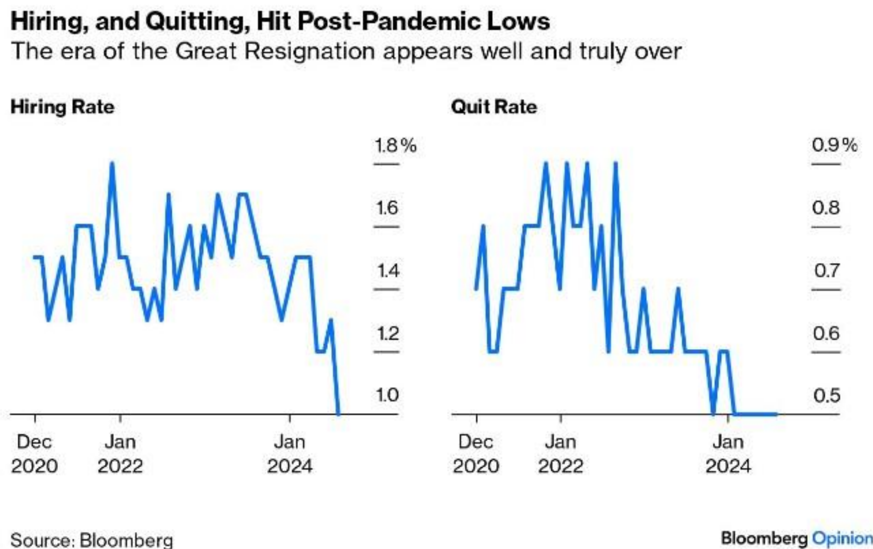


Source: Trading Economics

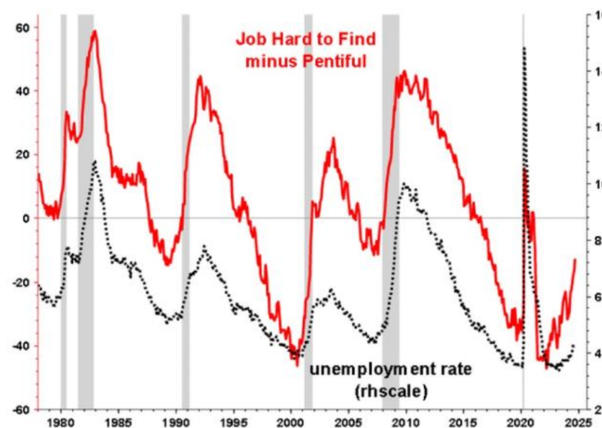
The Fed had to hold interest rates above 5.25% for over year due to persistent and sticky inflation readings. Once the U.S. economy re-opened after Covid-19 hit, higher inflation was mostly due to rising goods inflation brought about by supply chain issues as well as energy inflation from a global demand recovery. It took some time for supply chains to normalize. As shown in the next chart, both goods and energy inflation are now in negative territory (black and red bars) and services inflation (blue bars) is now the dominant source of inflation while the overall inflation level has continued to slowly grind lower.



The Fed holding interest rates above 5.25% for an extended period of time finally had a positive effect in reducing elevated inflation levels but it also started to have a negative impact on the U.S. jobs market. As shown on the left side of the next chart, the hiring rate started to roll over in 2023 and as 2024 progressed it has really decelerated lower. In addition, the quit rate shown on the right has also declined as workers have become more focused on keeping their current jobs instead of looking for another job because job postings have substantially declined.

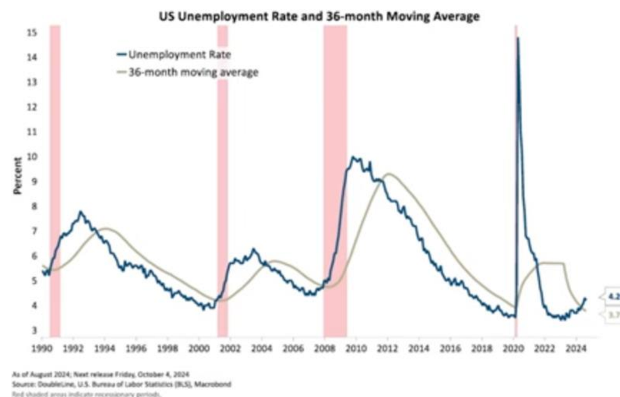


More workers are saying jobs are harder to find as employers have fewer job postings and the unemployed are staying unemployed longer. The median length of time being unemployed has increased to nearly 10 weeks, but this data point usually peaks higher after the end of recession has been declared. The next chart plots the jobs hard to find minus jobs plentiful readings (red line) and compares it to the unemployment rate (black line). The recent surge higher in the red line suggests the unemployment rate should continue heading higher in the months ahead as it has done in prior economic slowdowns or recessions. The unemployment rate increased this cycle from the low of 3.4% to the most recent reading of 4.1%. This unemployment rate is still low compared to historical experience as severe recessions in the U.S. have usually meant an unemployment rate above 8%. It is unlikely to reach that level this time around given the retirement wave of the baby boomers and the under supply of available workers.



Source: The Conference Board

The next chart compares the current unemployment rate (blue line) with the rolling 36-month unemployment rate (grey line). The shaded areas are recession periods. In each of the past four recessions, whenever the current unemployment rate broke above the rolling 36-month unemployment rate, a recession occurred without fail. The current unemployment rate recently moved above the rolling 36-month unemployment rate. While not a 100% certainty, the odds are increasing that the U.S. will enter a recession within the next 12 months. It is important to remember that jobs are a lagging indicator and the job market typically worsens after a recession begins. All of the recent weaker jobs data explains why the Fed is now focusing on the jobs market as it main focus of its policy decisions.

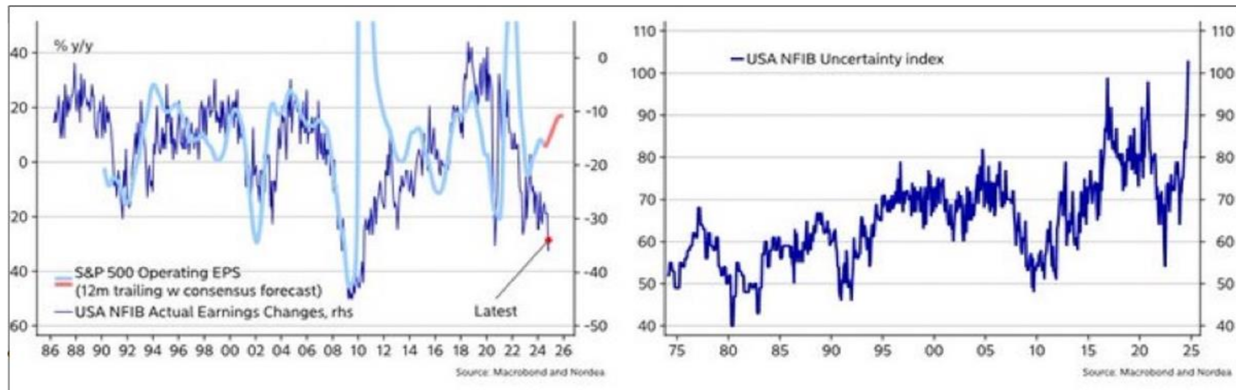


Source: DoubleLine Capital

Just as conviction levels increased about the Fed's ability to cut interest rates because of lower inflation and weaker jobs, the September Non-Farm Payrolls report on October 4th was a surprisingly strong report and threw a curveball at the narrative. Job gains were 254,000, well above consensus expectations of 150,000. In addition, the prior two months were revised higher by +72,000 jobs, the unemployment rate declined to 4.1%, and wage gains were stronger than expected. Granted, the BLS September jobs data doesn't jive with labor data in the most recent ISM readings, ADP report, or Conference Board survey. The 20% gain this year for the broad U.S. stock market is partially due to higher confidence the Fed will aggressively cut interest rates due to a weakening job market so the September jobs report from the BLS was an unexpected surprise. It seems that certainty of a large amount of interest rate cuts through 2025 may now be less certain. The market was expecting a Soft Landing (low growth but no recession) for the U.S. economy but now a No Landing scenario is back on the table. A No Landing economy is one with stronger than expected economic growth and jobs market that would prevent the Fed from cutting interest rates as much as investors have priced in. The strong September jobs report and CPI readings explain the recent rise in bond yields as 0.50% of interest rate cuts have been removed from the forward interest rate cut expectations since the Fed's September policy decision.

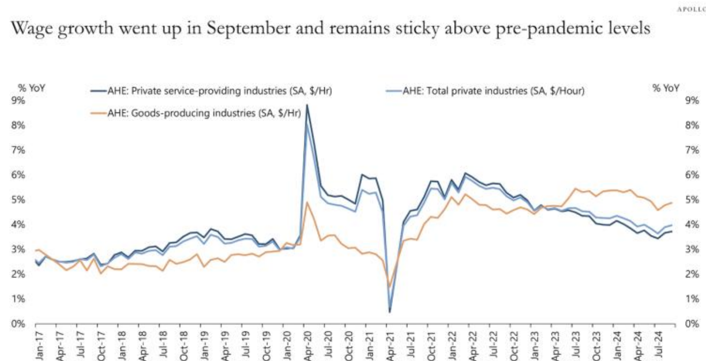
There is a disconnect between the stronger September jobs data reported by the BLS and weaker data coming from small and medium businesses or SMBs. SMBs are the engine of economic growth in the U.S. SMB data is captured in the monthly Institute of Supply Management (ISM) readings of both the manufacturing and services parts of the U.S. economy as well as via a monthly survey conducted by the National Federation of Independent Businesses (NFIB). For the ISM readings, the 50 level is considered the demarcation between growth and contraction. After briefly going above 50 in March 2024, the ISM Manufacturing reading has been below 50 for six straight months and below 50 for 23 of the last 24 months. In effect, the manufacturing economy has been in a low growth or mild recession for quite some time. However, the ISM Services reading, which captures a bigger part of the U.S. economy, has only dipped below 50 three times over the same time period. Overall, when combining these two components of the U.S. economy, the U.S. economy has been in a steady economic growth profile over the past several years. That being said, if the ISM Services reading slips below the 50 level for a period of time then odds of a recession will increase.

In the next chart, the left side compares the earnings of SMBs captured via the NFIB survey and compares it to the operating earnings of large companies captured by the S&P 500 Index (light blue). The red extension line is the forecast of S&P 500 Index operating earnings into 2025 by Wall Street research analysts. As you might expect, the earnings of both SMBs and large companies are tightly correlated over the long term since both are subject to the same U.S. macroeconomic conditions. The major difference would be that some larger companies in the S&P 500 Index having foreign revenues and profits while the vast majority of SMBs only have revenues derived from the U.S. Currently, there is a major divergence as SMBs profits are going lower while S&P 500 operating earnings are higher in 2024 and expected to increase another 15% in 2025. Based on the historical relationship between the two, this type of profits divergence is unlikely to continue and will eventually converge either by SMB profits improving or S&P 500 Index profit expectations being cut for 2025. The right side chart shows the NFIB Uncertainty Index, which soared higher during 2024 and is at its worse level in the survey's history. It is a clear indication that SMBs are under more pressure and their owners are not currently optimistic.



Another important aspect of the U.S. economy that could make it difficult for the Fed to aggressively cut interest rates is wage inflation. The next chart captures three categories of wage growth since 2017. After the Covid-19 related plunge, wage growth took off and went as high as 6% before starting to ease lower during 2023 and 2024. However, September wage gains saw an unexpected turn higher with total industries wage gains back above 4% and goods producing industries back to 5%. Importantly, there are some notable strikes occurring now where the wage demands are very high and emblematic of the demands from labor for higher wages in response to inflation pressures faced by consumers over the past several years. For example, Boeing machinists and aerospace workers are on strike and the company recently made an offer of an immediate 12% wage increase followed by 30% of additional wage increases over the next 4 years. The Boeing union refused to consider it and has been on strike four weeks. The Dock Workers had a brief 3-day strike where port operators had to offer a 62% wage hike offer over a 6-year contract period or a 10+% wage increase per year to temporarily settle the strike. Earlier this year, some airlines had new contracts with pilots that had 40% to 50% cumulative wage increases over the 4-5 year contract term.

These types of wage hike demands are extremely high and are for expiring labor contracts that had been in place well before elevated inflation took hold over the past several years. These new labor deals represent a catch-up of real wages from prior inflation levels combined with getting additional wage increases as protection from future inflation. Ultimately, these wage increases will be passed through in the form of higher prices to consumers over time and are likely to be influential on other upcoming union contract negotiations and even non-union wage demands. It is hard to see how wage growth is going to materially weaken and be a positive benefit to achieving lower inflation rates and ultimately allow the Fed to cut interest rates as much as expected.



Source: BLS, Haver Analytics, Apollo Chief Economist

Summary

Given that the U.S. stock market is trading at a record high, the unemployment rate is low, and GDP growth remains positive, it is a bit of a conundrum that investors deem large interest rate cut expectations a certainty. Mark Twain and other smart observers of human nature throughout history have warned about the risks of being overly certain about anything. The strong stock market gains year to date have been boosted by rising certainty that the Fed will aggressively cut interest rates through the end of 2025. The big question at all times for investors is what is currently priced in and it seems that aggressive interest rate cuts through 2025 are already priced into both stock and bond markets. Two big questions to be answered in the months ahead are whether the jobs markets remains soft and whether inflation data, including wage growth, continues to grind lower. The stock and bond markets seem highly certain of the continuation of favorable data for both such that the Fed can continue on its interest rate cutting path but will this certainty end up being absurd?

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October 11, 2024

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