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Economic Outlook 2024

Testing Resiliency

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Overview

- Probability for a cyclical economic recession, with accompanying weakened demand, rising unemployment, and moderating inflation, still looks uncomfortably high.

- While recessions often bring their own nasty surprises, current data is still consistent with the unfolding of a milder downturn. Growth is being supported by strong balance sheets, strong underlying structural trends, and the fact that the Fed is the catalyst for the economic slowdown, as opposed to a black swan event such as a pandemic or the collapse of the global banking system.

- Phase one of the inflation slowdown—a sharp decline in the cyclical/transitory components—is now largely over, and we are transitioning to phase two, where the baton of disinflation is passed to the demand side of the economy. Recent inflation data suggests a potential fumble during the handover in the near term, before the Fed achieves its inflation target by year-end.

- Expectations for 100 basis points of rate cuts in 2024 are consistent with a shift away from the Volcker phase of inflation fighting and toward the Greenspan opportunistic phase, where the Fed is likely to drag its heels in matching declines in inflation. Longer-term expectations for only 200 basis points of cuts are inconsistent with the prospect of recession, the Fed's behavior during past easing cycles, and current estimates of the real neutral rate of inflation.

- Greater uncertainty resides at the longer end of the yield curve, due to Treasury Secretary Yellen's unwinding "Operation Twist" in 2024, increased supply issuance, and shifts in demand-side participation.

- Despite some similar analogies with the Magnificent 7 or the internet bubble of the late 1990s, the equity risk premium suggests that investors are being far more cautious than was the case back then.

- While economic weakness is expected, history shows that smaller-cap stock cycles often begin at the economic trough, and this time around valuations on both a relative and absolute basis are historically low and investors are also already discounting a significant amount of bad news.

What's Cyclical and What's Structural?

Almost four years on from the pandemic, the global economy is still wrestling with the repercussions, in terms of the physical and sociological impacts as well as the financial and economic consequences. Seemingly overnight, the crisis caused the kind of behavioral shifts that might normally be expected to take a generation to unfold. Yet the rapidity with which such dramatic changes took place has meant that today we are still coming to grips with which of these post-COVID developments are now structural and which will soon fade.

In terms of structural changes for the corporate sector, many companies are still trying to gauge the right level of headcount and inventory, supply-chain redundancies, and the ongoing implications of work from home.

For investors, the question of structural regime shift versus just a cyclical change is crucial when it comes to assessing expected future returns and the current valuations to accompany them. Probably the two most pertinent of these shifts today is the stickiness of higher interest rates and inflation—a P/E multiple of 15 or 20 times alongside 5%-6% interest rates and 4%-5% inflation is not equal to that with 3% interest rates and 2% inflation.

From a cyclical perspective, at the start of 2023 most economists (ourselves included) were relatively bearish about the economy's prospects for the coming year, believing that a recession was likely in the quarters ahead. The fact that such a downturn has not yet emerged and inflation has continued to decline has been encouraging. In fact, many economists have downgraded their recession probability forecasts significantly for the coming year on the hope that the much-lauded immaculate disinflation/soft landing has already been achieved.

In our view, it is too early to wave the mission accomplished flag just yet, and the probability of recession in the coming 12 months unfortunately remains uncomfortably high.

We believe it is important to acknowledge that this slowdown is being driven by the Fed—meaning it is a known-unknown. This compares to what at the time felt like existential collapses in the banking system, or a shutdown of the global economy due to the spread of a deadly virus, which were very much unknown-unknowns that created massive uncertainty and panic. This is one key reason behind our optimism that any potential recession is still likely to be a much milder one relative to past recessions.

The Cyclical Perspective

If there is one word that personifies 2023, it's "resilient"—a year that can be better described by what didn't happen as opposed to what did.

- There was no recession.
- Energy prices did not shoot to the moon.
- We did not have another deadly pandemic.
- The collapse of several regional banks, including the 16th-largest bank in the country, did not result in a financial market meltdown.
- There was no government shutdown, and the debt ceiling standoff ended with a whimper not a bang.
- China has to date managed to keep the ball rolling, as it continues massive debt deleveraging.
- The current conflicts in Ukraine and Gaza have so far not turned into wider regional conflicts or World War III.

Still Too Soon to Rule Out Recession

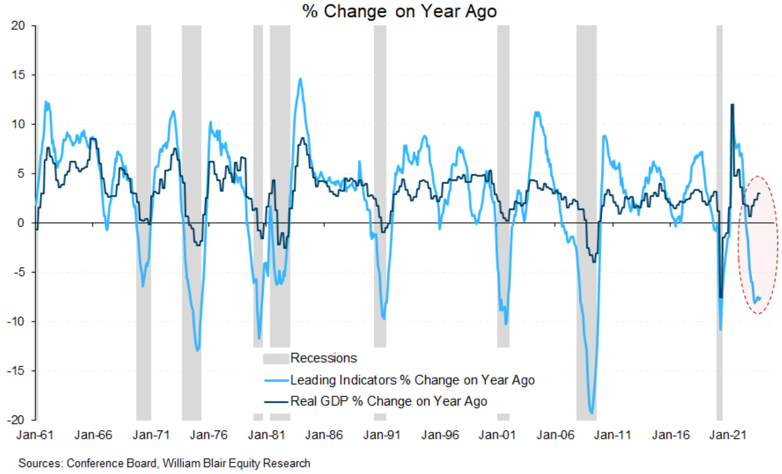
For such good news on the economy to continue and a soft landing/immaculate disinflation to be achieved, one has to believe one of four scenarios:

1. The lags from monetary policy changes are now far shorter than have historically been the case; therefore, the tightening that the Fed has put in place has already been absorbed into the real economy with very little impact.
2. The economy is far less responsive to changes in interest rates than in the past.
3. The lagged effects that remain to be absorbed will continue to have only a moderate impact on growth.
4. If there are still significant further lagged effects, both the Fed and fiscal policy makers will manage to pivot quickly enough to offset any emerging weakness.

After what has been one of the fastest and most aggressive Fed tightening cycles on record—and given the Fed's track record and its willingness to go the extra mile to make sure inflation is squashed—it still seems doubtful to us that the economy will be able to brush off 525 basis points of rate increases with such ease. Rather, just about all of the leading economic indicators of growth continue to point to economic weakness, and the coincident and lagging data are increasingly starting to follow suit.

As shown in exhibit 1, for example, the Conference Board's basket of 10 leading economic indicators (e.g., initial jobless claims, the stock market, credit spreads, yield curve, factory orders, and the money supply) once again are signaling a sharp economic slowdown.

Exhibit 1
Leading Economic Indicators & Real GDP Growth
% Change on Year Ago



The much-discussed Sahm rule is also on the verge of triggering a recession warning (exhibit 2), while the ISM index has now been below the 50% expansion/contraction line for a 13th consecutive month. Since 1948, there has never been a period of more than 10 consecutive months where the ISM index has been below 50 without the economy being in recession (exhibit 3).

Exhibit 2
Unemployment Recession Indicator - "Sahm Rule"
"Recessions occur when 3mth m.a. of the unemployment rate rises by more than 50 bpts above its 12-month low" - Claudia Sahm, Federal Reserve

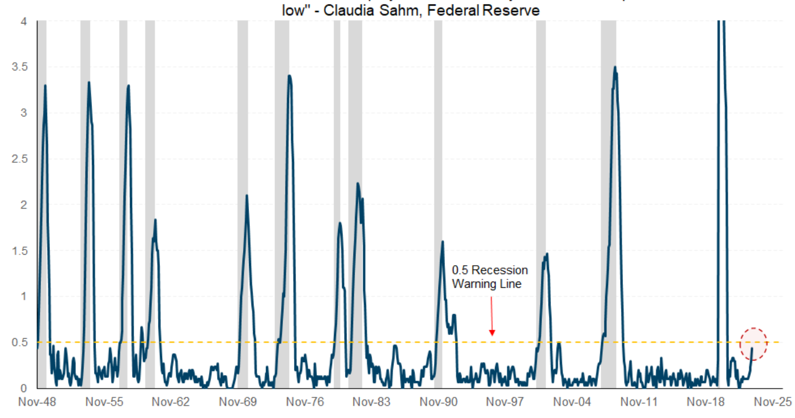
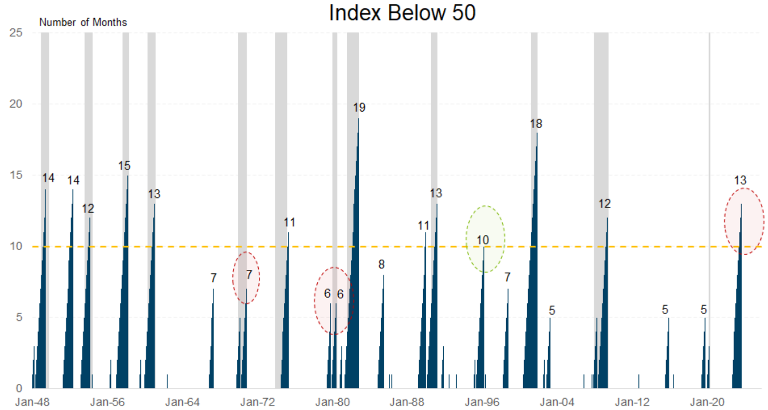


Exhibit 3
ISM Manufacturing Index Cumulative Number of Consecutive Months
Index Below 50

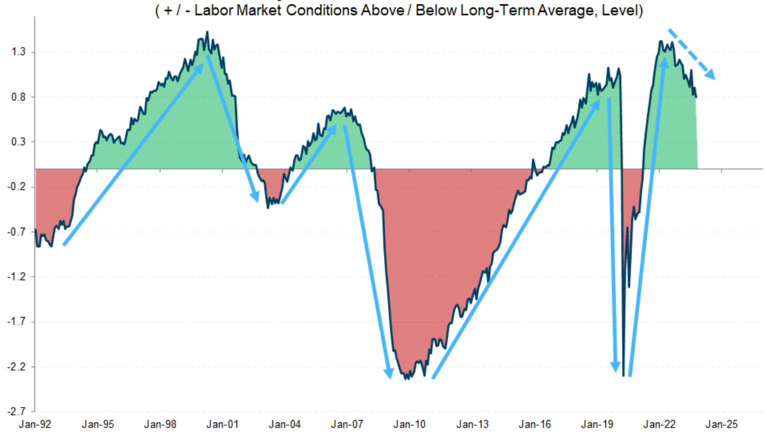


Sources: Institute of Supply Managers, NBER, William Blair Equity Research

Furthermore, while the consumer should remain resilient as long as the labor market remains firm, the capacity to further hoard labor is rapidly diminishing in the face of increased margin pressure from rising net interest costs and reduced pricing power as inflation falls.

Recent employment data show the cycle has already turned and activity has started to slow. For example, the Kansas City Fed's Labor Market Conditions Index, which is an aggregate basket of 24 labor market indicators, is now clearly moderating but has yet to turn outright negative (exhibit 4). The behavior of this basket has also proved to be monotonic, in the sense that there is little volatility and it continues in one direction or the other for extended periods without many false signals.

Exhibit 4
Kansas City Fed Labor Market Conditions Index
(+ / - Labor Market Conditions Above / Below Long-Term Average, Level)



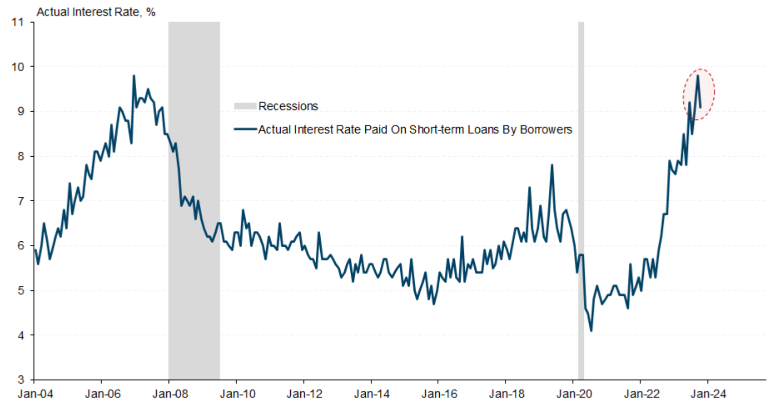
Sources: Kansas City Fed, William Blair Equity Research; Basket index of 24 labor market indicators

Lastly, in addition to slowing in the labor market, many other tailwinds for both the consumer and corporate sectors are either ceasing to provide as much support or turning into outright headwinds.

While most households have the luxury of having refinanced and locked in lower yields for several years during 2020-2021, any new activity faces much higher rates of interest—7.8% mortgage rates, 23% credit card rates, 6.2% BAA corporate bond yields, and 9% noninvestment-grade yields—in addition to facing significant increases in lending standards from the banks themselves. Small businesses, for example, most of which rely on bank loans, have already seen interest costs rise to their highest rates since 2006 (exhibit 5).

Exhibit 5

NFIB Small Business Interest Rates on Loans



Sources: NFIB, William Blair Equity Research

Why Only a Mild Recession?

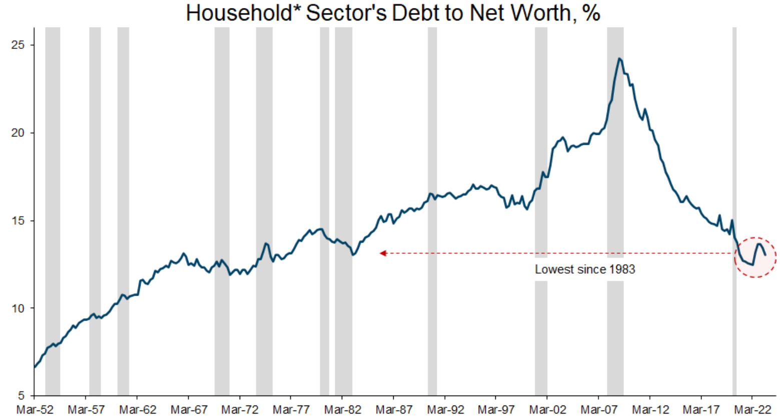
It is important to note that there are at least four key reasons why this time around the odds of a milder recession seem high.

First and quite simply, this slowdown is not being driven by a financial crisis or a pandemic; rather, it is being brought about by a central bank that is raising interest rates to quell inflation. This is important because the process is well telegraphed in advance and there has been ample time for companies and individuals to at least try to mitigate any potential fallout. In this sense, without "something breaking" yet, what is driving this weakness is also very much a known-unknown, where investors and private sector participants can roughly get their arms around the headwinds they are facing. In short, it is not the kind of existential threat to the banking system or to human life that we faced in the previous downturns; there is a clear escape valve to such a crisis via the Fed easing rates.

Second, not all sectors of the economy are impacted by higher interest rates at the same time. Typically, the most interest-rate-sensitive sectors are impacted first, usually housing, autos, and manufacturing. The impact then continues to roll through the economy in a domino-type manner, ending with what is often the relatively less rate-sensitive service sector. Hence, unlike a pandemic or a mega financial crisis where everything collapses at once, the impact this time is likely to be much more muted, with some sectors potentially even exiting the downturn before others even start to fully feel the pinch.

Third, there seems to be a lack of major excesses among the domestic private sector. Households have been steadily deleveraging their balance sheets over the last decade (exhibit 6), and the financial sector has been much more heavily regulated and discerning with regard to credit extension—one only has to look at the returns the banks have been generating to see they have not been overextending themselves on risk.

Exhibit 6
Household* Sector's Debt to Net Worth, %



*This sector also includes domestic hedge funds, private equity funds, and personal trusts.
Sources: Federal Reserve, William Blair Equity Research.

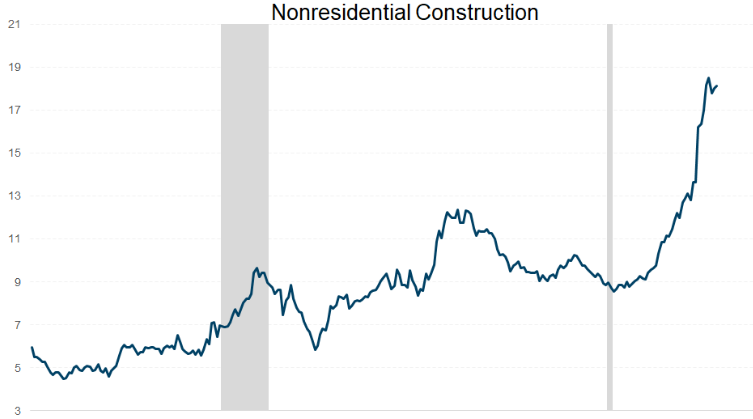
Historically, for a "normal" recession to deteriorate into a major financial crisis, some entity needs to be forced into undertaking deep and painful debt deleveraging. Domestically, the entity that has taken on all the debt since the GFC has been the government sector, and in the process, this has given the private sector the time and space to repair their balance sheets. Internationally, another large area of risk is China, which is still grappling with its own debt deleveraging event.

Fourth, there are a number of structural transformations taking place in the economy that can potentially help limit the fallout from any cyclical slowdown. These include reshoring, a much tighter labor market, and the current mega wave of generative AI and innovation.

Structural Tailwinds Helping to Moderate Cyclical Headwinds

Many of the U.S. companies we have spoken with are certainly keen in theory and increasingly successful in practice to build supply chain redundancies and reshore activity back to the U.S. For example, exhibit 7 shows that the share of manufacturing facilities being built as a percentage of total nonresidential construction has soared in the last three years since the COVID pandemic. This is now at the highest level in at least two decades, and the trend toward reshoring is likely to continue.

Exhibit 7
Construction Spending on Manufacturing Facilities as % of Total Nonresidential Construction

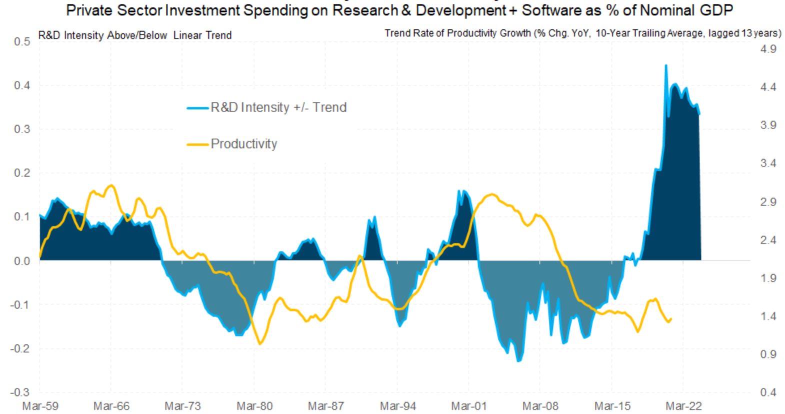


Sources: U.S. Census Bureau, William Blair Equity Research

Similarly, two other areas where we see strong structural support in the face of emerging cyclical weakness are the housing market and business investment. While the housing market continues to struggle in the face of collapsed affordability, this weakness will be underpinned by strong demand from the wave of millennial buyers, coupled with an ongoing shortage of housing stock, which is estimated at 1 million-3 million homes. In comparison to what happened in the early 2000s, this time around there has not been a massive overbuild of single-family homes or mortgages being handed out like sweets on Halloween.

Meanwhile, both the pandemic and the much tighter labor market have laid bare the corporate sector's antiquated capital stock and urgent need for investment. The tighter labor market is changing the labor-to-capital ratio, and for this shift to not adversely impact profit margins, productivity gains need to be achieved. Happily, there seems to be plenty of low-hanging fruit here. Given the historical lack of business fixed investment, the capital stock is the oldest it has been since the early 1960s. There is a strong incentive to invest in order to, at the very least, keep up with the current innovation wave that is in part the result of the very strong above-trend growth in R&D spending that has taken place in recent years, particularly in the technology space (exhibit 8).

Exhibit 8
R&D Intensity vs. Productivity Growth
Private Sector Investment Spending on Research & Development + Software as % of Nominal GDP



Sources: Bureau of Economic Analysis, William Blair Equity Research

Inflation—Near-Term Bumps in the Road, but Still on Course to Meet 2% Target by Year-End

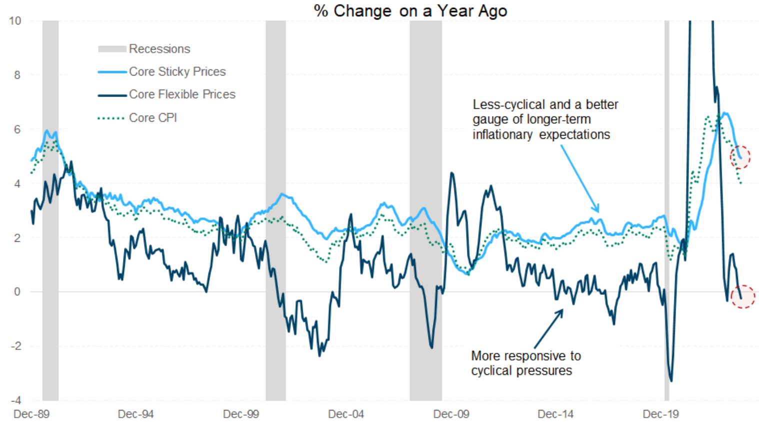
This time last year, economists had expected inflation to fall to 2.5% in the current quarter on both the core and headline readings from 7.1% at the time. While this was right on the direction, it proved overly optimistic in scale, with inflation today reaching 3.2% on the headline rate and still a 4.0% on the core rate, roughly matching our wide 3%-4% expected range at the time. This year we expect to see further progress, with the CPI falling to 2.0% by the end of 2024.

As shown in exhibit 9, most of the heavy lifting of recent disinflation has been achieved via the most cyclical and the most interest-rate-sensitive components of the inflation basket, which have hugely benefited from the reopening of the economy post-COVID. Yet, as the contribution from these components starts to dissipate, it will be necessary to pass the disinflationary baton to the more persistent, stickier inflation components, where more work still needs to be done.

Exhibit 9

Atlanta Fed's Core Sticky vs. Core Flexible Prices

% Change on a Year Ago



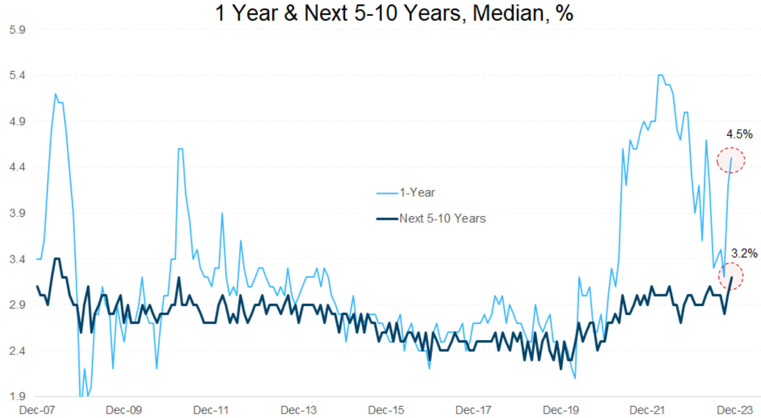
Sources: Atlanta Federal Reserve, BLS, William Blair Equity Research

These stickier components are largely being driven by the demand side of the inflation basket and are predominantly related to services, where prices are being supported by the strong labor market. The risk that the Fed is likely to be most worried about now is a timing mismatch, whereby the strong downward contribution to inflation from the most cyclical sectors lessens, while the stickiest and most persistent components are still slow to fall, causing near-term inflation to stagnate for a few months around current levels.

The recent upward blip in the University of Michigan's 1-year and 5- to 10-year inflationary expectations indices is one reason for caution and will not have gone unnoticed by the Fed (exhibit 10).

Exhibit 10

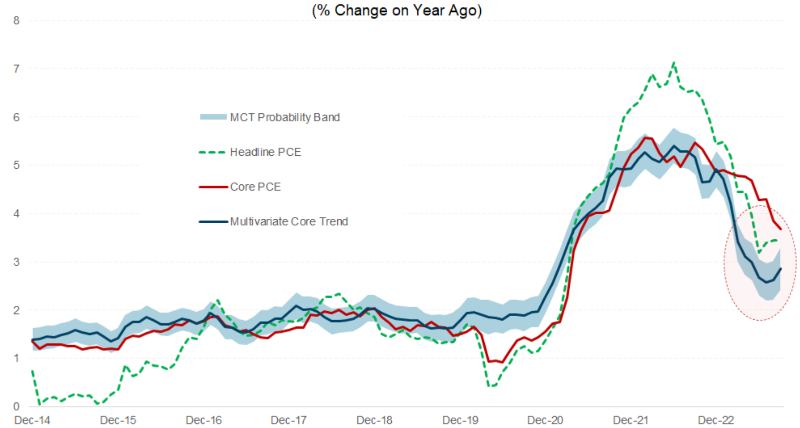
University of Michigan Survey of Inflationary Expectations:
1 Year & Next 5-10 Years, Median, %



Sources: University of Michigan, Bloomberg, William Blair Equity Research

Another key gauge of inflation persistence that has been sending more mixed signals recently is the New York Fed's new multivariate core trend inflation measures (exhibit 11).

Exhibit 11
New York Fed's Multivariate Core Trend of PCE Inflation
(% Change on Year Ago)

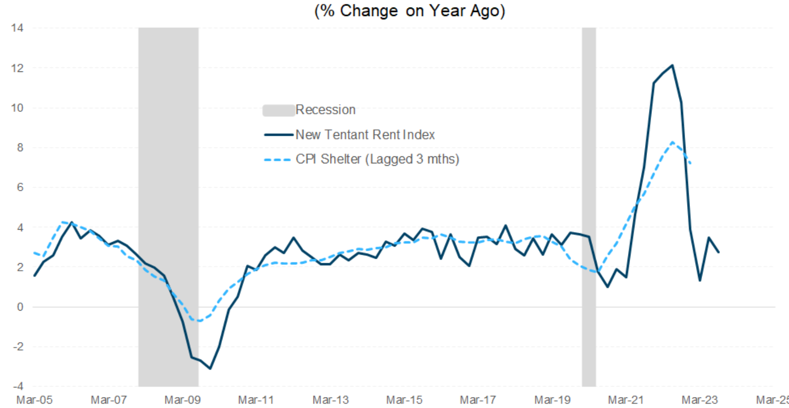


Source: Federal Reserve Bank of New York, Multivariate Core Trend Inflation, https://www.newyorkfed.org/research/policy/mct

This is a newly unveiled inflation gauge that, like its predecessor the Underlying Inflation Gauge, attempts to filter out the more transitory variability in inflation to get to the true underlying core trend rate. The measure shows further progress but, again similar to inflationary expectations, progress seems to have stalled slightly over the last two months and actually turned back up. While these data points are unlikely to cause the Fed to take rates even higher, they will be viewed as evidence of a few small bumps in the road—ones that may give the Fed further pause with regard to getting the easing cycle underway.

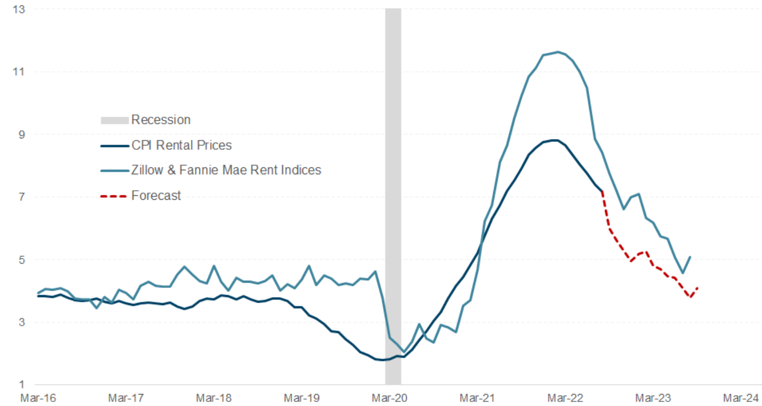
Encouragingly, further progress on inflation through the end of the year still looks likely. It is worth remembering that the largest contributor to these core sticky prices is from shelter, which overwhelmingly reflects the behavior of rental prices. Fortunately, we also know that the BLS's measure of shelter/rent tends to lag other real-world measures of rent such as the Zillow Rent Index or the Bureau of Labor Statistics' New Tenant Rent Index. Both of these measures of rent, which are depicted in exhibits 12 and 13, show that significant further progress should continue into 2024.

Exhibit 12
New Tenant Rent Index vs. CPI Shelter Index
(% Change on Year Ago)



Sources: Bureau of Labor Statistics, William Blair Equity Research

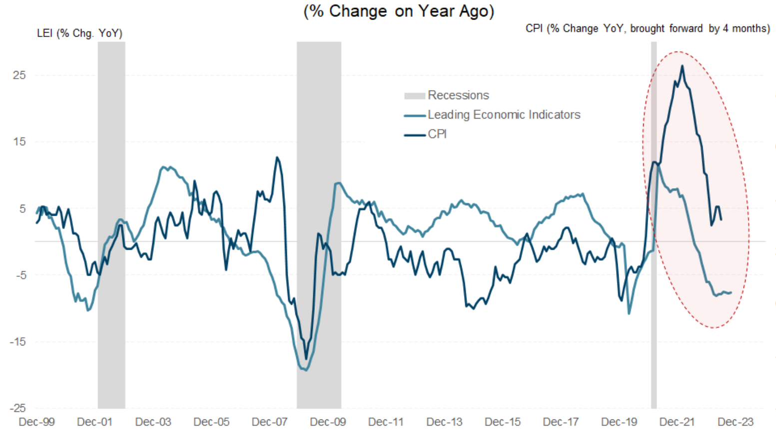
Exhibit 13
CPI Rental Price Index vs. Zillow & Fannie Mae Rent Index
(% Change on Year Ago, CPI Rent Forward 14 months)



Sources: Bureau of Labor Statistics, Zillow, Fannie Mae, Bloomberg, William Blair Equity Research

Ultimately, we are confident that continued weakness in the economy will similarly help support further disinflation (exhibit 14), particularly in light of evidence of returning to a world where the Phillips curve once again seems to have some relevance.

Exhibit 14
Conference Board's Index of Leading Economic Indicators vs. CPI Inflation
(% Change on Year Ago)



Sources: Conference Board, Bureau of Labor Statistics, William Blair Equity Research

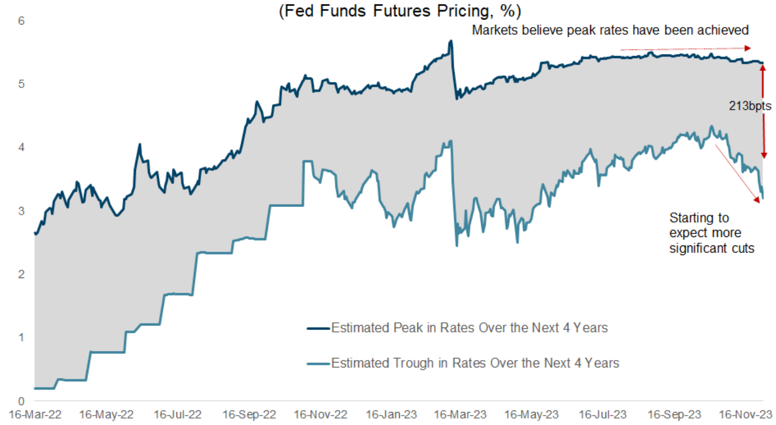
The Short and Long of the Yield Curve

The Futures Market Is Not Pricing in Recession

An examination of futures market data during past economic cycles shows that investors almost always tend to underestimate both the amount of tightening the Fed eventually undertakes in a tightening cycle and the extent of the easing when the Fed starts to cut rates.

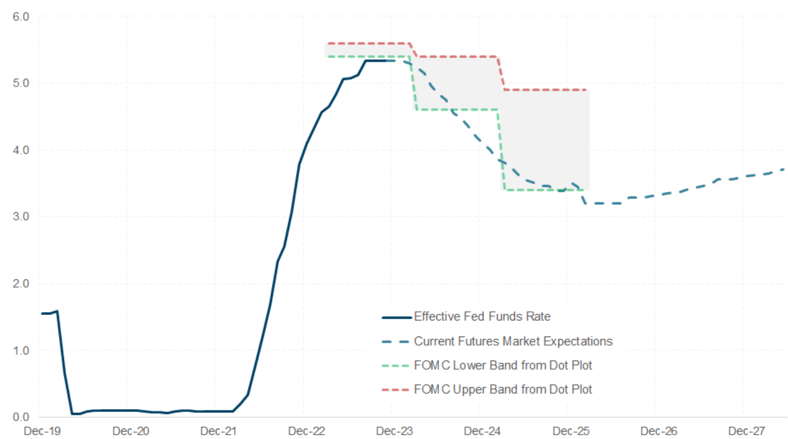
During this cycle, after ratcheting up rate expectations for a peak rate of 2.7% in March 2022, the market now believes rates have peaked at the Fed's target of between 5.25% and 5.5% (exhibit 15). The market also now believes that the Fed will eventually lower rates by 100 basis points in 2024 and a total of 200 basis points by early 2026 (exhibit 16).

Exhibit 15
Progression of Expected Range for Fed Funds Rate in Next 4 Years,
(Fed Funds Futures Pricing, %)



Sources: Bloomberg, William Blair Equity Research

Exhibit 16
Fed Funds Rate, Futures Market Expectations & FOMC Projections, %



Sources: Bloomberg, William Blair Equity Research

While 100 basis points worth of cuts in 2024 may prove to be on the low side, it still seems about right to us, whereas the expected 200 basis points over the entire easing cycle looks very conservative.

Looking back at previous easing cycles, the Fed has historically lowered rates by a median of 375 basis points in the first 12 months from the start of the first easing. Then, over the entire peak-to-trough easing cycle, rates have fallen an average of 550 basis points. It is also worth remembering that in more recent years, these rate cuts were also supplemented with both vast amounts of QE and strong forward guidance.

At the moment, the market is effectively pricing in rate cuts consistent with the soft landing following the 1994 tightening, when the Fed brought down rates by 75 basis points over the first 12 months and 125 basis points over the entire easing cycle.

However, there are two important points worth making here. The first is that rates are now in restrictive territory, in that they are well above what is believed to be r-star, or the real neutral anchor rate of the economy. Hence, even if the Fed wants to achieve a soft landing, it still has to lower rates to be closer to the neutral rate—and also do it ahead of a recession—to actually achieve that immaculate disinflationary soft landing.

While we do not know what that real neutral rate is, current estimates by the Fed peg it at roughly 0.5%-1.0%. Hence, assuming a return to 2% inflation, the nominal neutral rate is roughly 2.5%-3.0%, which is about 250-300 basis points below the current fed funds rate. It would also then need to go even lower in order for policy to actually become accommodative in the event of a recession.

The second point is that as inflation falls, without lowering rates to at least match the decline of inflation, policy is still being passively tightened. Hence, with inflation expected to fall from the current 3.2% headline and 4.0% on the core rate to 2.0%-2.5% over the next year, this once again is consistent with a larger-than-expected decline in the fed funds rate just to keep policy at its current restrictive setting.

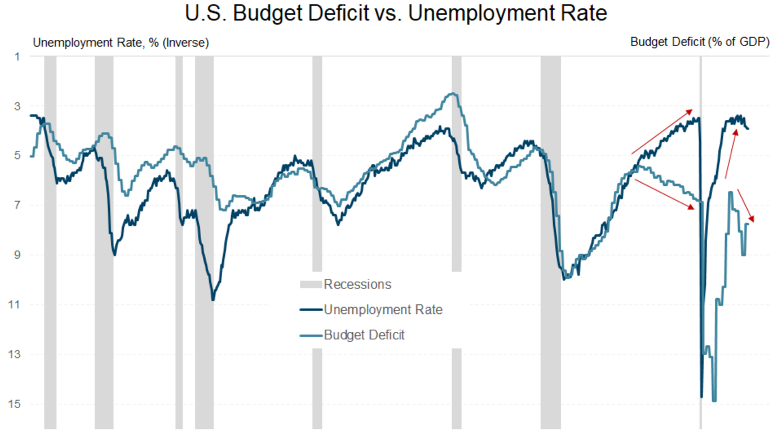
Nevertheless, expectations for 100 basis points of cuts over the coming year make sense in a world where the Fed will move away from the Volcker phase of "keeping at it" to bring down inflation, and into the Greenspan phase of "opportunistic disinflation" to keep it down—i.e., dragging its heels when it comes to lowering rates when hit by disinflationary waves, though also being very quick to lift them again upon signs of higher inflation.

At the Long End, Beware of "Operation Twist Again (Like We Did Last Summer)" and the Liquidity Drain

One potential wildcard in 2024, and something that may put further pressure on the Fed later in the year, could be developments at the longer end of the yield curve.

This year there was a notable increase in market sensitivity to the size of both the current and expected future debt and deficits, as well as who the buyers of this debt will be—a topic investors had previously been quite happy to ignore. Looking into 2024, that sensitivity could continue with bipartisan antipathy toward addressing the issues, especially at a time of near-record-low unemployment and during an election year (exhibit 17).

Exhibit 17
U.S. Budget Deficit vs. Unemployment Rate

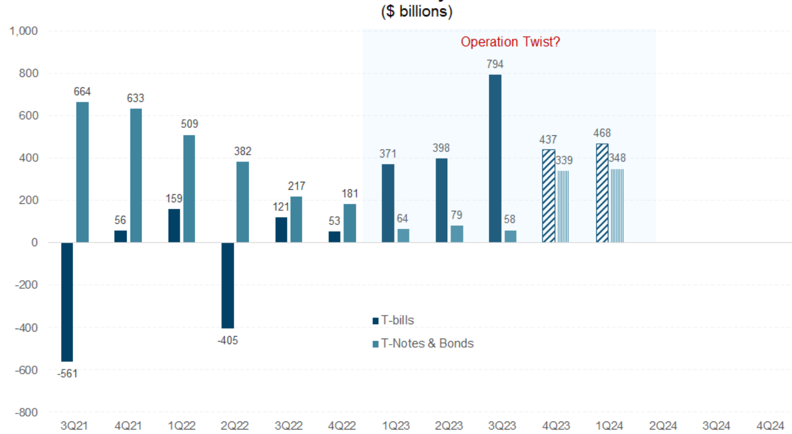


Sources: CBO, BLS, William Blair Equity Research

This sensitivity has increasingly been manifesting itself around the market's new obsession—the release of the Treasury's Quarterly Refunding Announcement (QRA).

In what is increasingly looking like a canny strategic move by former Fed Chair and now Treasury Secretary Janet Yellen to surprise the market, in the latest QRA, Yellen departed from the Treasury's previous guidance on issuance and stated that through the first quarter it will now prioritize greater T-bill issuance over coupon bond issuance. The Treasury will now issue $348 billion in coupon debt, and the remaining 57% ($467.6 billion) will be issued in T-bills, where it had previously guided coupon issuance of $396 billion-$460 billion (exhibit 18).

Exhibit 18
Net New Issuance of Treasury Bills vs. Notes & Bonds
($ billions)



Sources: SIFMA, US Treasury, William Blair Equity Research

It is unusual for the Treasury to diverge so significantly from its previous guidance; what Secretary Yellen was effectively doing was borrowing from the Fed's (and her own at the time) playbook by conducting the Treasury's version of "operation twist"—except this time on the supply side (issuance), instead of the demand side (changes to the Fed's balance sheet).

Yellen had likely become increasingly worried about the growing volatility taking place in recent bond auctions, as well as wanting to kill the momentum of steadily rising bond yields. The move will have also been helpful for her old colleagues back at the Fed because the sharp tightening of financial conditions due to the rise in long-term yields was making officials there increasingly uncomfortable and, if it had continued, could have forced the Fed into lowering short rates sooner than it might have otherwise felt comfortable in doing.

Yellen is also being savvy in issuing more bills at a time when there is still a large demand for them, as assets continue to drain out of the Fed's ON RRP (overnight reverse repo program) and back into money market funds when QT is ongoing.

Looking into 2024, two things are apparent. First, this asset drain from the RRP will likely end in the first quarter of the year, easing some of the demand for T-bills and, importantly, removing what has been a powerful source of liquidity for the market.

Second, it has been unusual for the Treasury to issue so much debt in T-bills, as opposed to coupon debt; the ratio of debt outstanding is roughly 20% bills and 80% notes and bonds. As a result, the Treasury next year will likely have to twist back toward issuing more coupon debt to prevent its aggregate portfolio duration from shrinking too much.

Yellen here is gambling that when the time comes to twist again, inflation will be definitively lower, economic growth will be moderating, and the Fed will have entered its easing cycle, bringing a rising demand for coupon debt. For investors, this process of ending the RRP drawdown and increasing coupon issuance could shrink liquidity and potentially heighten volatility. As a result, they should be wary about this normalization process playing out.

Protection Against Radical Uncertainty—How Much of a Premium?

While getting these structural macro trends right does not by itself guarantee stronger returns, it helps ensure that investors will, at the very least, swim with the tide instead of against it.

In their book *Radical Uncertainty: Decision-Making Beyond the Numbers,* former Bank of England Governor Mervyn King and professor, journalist, and author John Kay—as their title suggests—highlight that while we can attach probabilities to some expected future outcomes, much of what will happen is truly unknowable. We may in fact be doing ourselves an immense disservice by attaching often seemingly complex probabilities to these events in an attempt to pretend otherwise. King and Kay argue that we should simply give in to radical uncertainty, but in so doing adopt mitigating strategies to make ourselves more resilient to the potential for alternative realities and events than what had been expected.

There is perhaps nothing new in the central message of their book, which can be neatly summed up as "don't put all your eggs into one basket"; however, the borrowing behavior that culminated in the GFC, the corporate sector's overly tight supply chains, and a global lack of preparedness around increasingly common major climate events has proved that we often do not heed this simple advice.

Investors tend to understand this maxim more than most, and while they can still get caught up in bouts of fear and euphoria around expected outcomes, most of the time they are relatively effective in choosing strategies to reduce this uncertainty risk and increase their odds of success. From a fundamental perspective, the most common of these strategies entails extensive research (poring over financial accounts, speaking with management teams and investment analysts, engaging in deep channel checks, etc.). Yet even then, other layers of protection need to be added, including: holding appropriate levels of cash, diversifying portfolios, requiring disciplined dividends/buybacks, demanding lower valuations, and sticking to higher-quality companies with strong track records and proven moats; or in some cases, reducing risk by seeking greater control over the assets itself, via seats on boards, more significant share ownership with voting rights, or indeed taking the asset private.

For Treasury bond investors, as was made apparent this past year, this increased risk aversion culminated in a rise in the term premium, which flipped from negative back into positive territory.

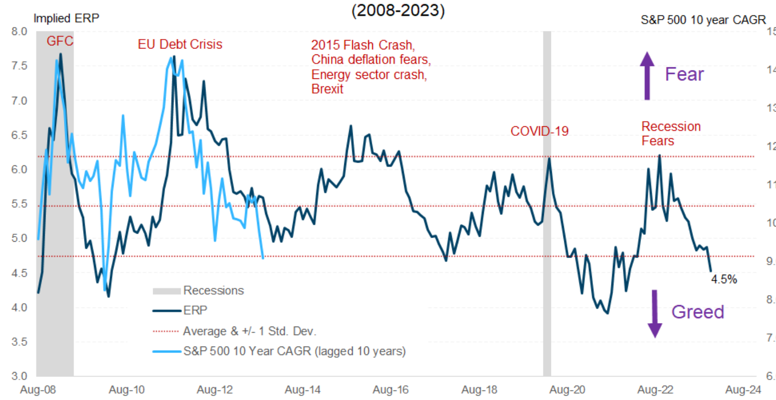
In gauging where we are today on the fear-versus-greed spectrum or how conservative equity investors currently are, one of the best gauges has been the equity risk premium (ERP), or the excess return demanded by investors above the risk-free rate. While there is seemingly no end of versions of this metric, the one we have found the most consistent with actual returns—and the easiest one for all investors to follow—has been NYU Stern's Professor Damodaran's implied ERP.

Exhibits 19 and 20 plot the implied ERP monthly (from 2008) and annually (from 1960) against subsequent 10-year CAGR for the S&P 500. While this should not be viewed as a market timing tool, it is useful in highlighting current sentiment with regard to how much risk investors are willing to accept relative to previous moments in history.

Exhibit 19

Implied Equity Risk Premium vs. S&P 500 10 Year CAGRs Lagged 10 Years

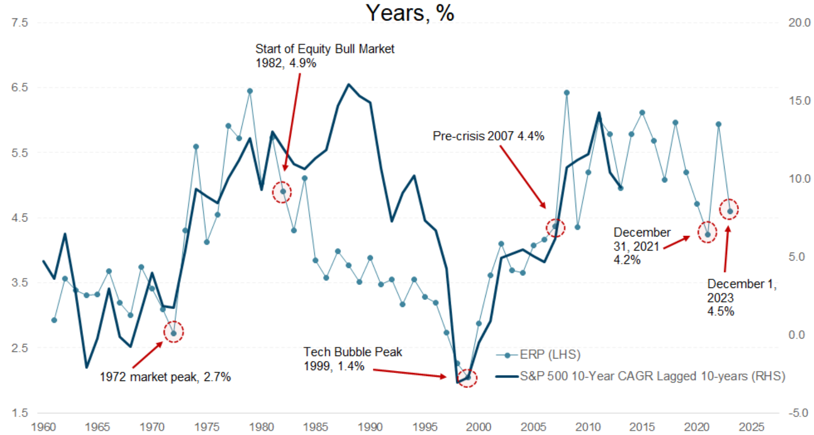
(2008-2023)



Sources: NYU Stern/Professor A. Damodaran, Bloomberg, William Blair Equity Research

Exhibit 20

Implied Equity Risk Premium vs. S&P 500 10-Year CAGR Lagged 10-Years, %



Sources: NYU Stern/Professor A. Damodaran, Bloomberg, William Blair Equity Research

As the exhibits show, the ERP has also demonstrated a remarkable degree of consistency with actual returns over the following decade. The current reading of 4.6% is above the average ERP from 1960 (4.25%), though a little on the low side compared to what has been demanded since the 2008's GFC. On this basis, the ERP today is telling us to expect a still above average return relative to those experienced over the last 60 years, but slightly lower than the average compared to the last 15.

What we also need to take into account here is the influence of the Magnificent 7, whose tremendous weight in the index—a stunning 32%—is having a large distortionary impact. This will necessarily also impact the ERP, and is more visibly showing up in the current aggregate market trailing P/E multiple of 22x for the S&P 500 against a 17x multiple for an equally weighted index, which is the widest gap since at least 2010.

What the ERP is not suggesting heading into 2024 is a significant amount of complacency on the part of equity investors, as was the case during the equity internet bubble days of 1999.

Back then, there was a prevailing argument (made explicit in the book *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market)* that because equities always outperformed over the longer term, no premium was justified, and the market should therefore have been trading at closer to 36,000 on the Dow, as opposed to the prevailing 10,000.

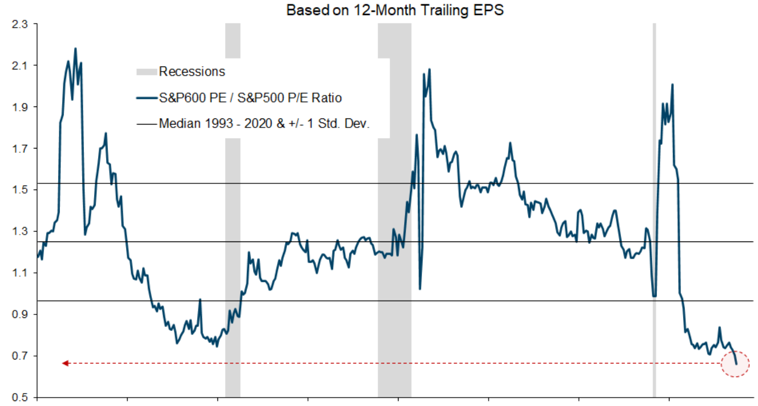
Not surprisingly, with investors demanding a premium of just 1.4% in 1999, returns over the following decade were disappointingly low. Hence, while many investors are making comparisons today between the internet bubble stocks of the late 1990s and the Magnificent 7 stocks of today (AAPL, AMZN, GOOG, NVDA, META, MSFT, and TSLA)—and there are some similarities—the current level of the ERP would suggest that this comparison only runs so far, in that investors are not flying by the seat of their pants as was the case back then.

Quality Smaller-Cap Stocks Get a 2024 Lift

This past year was a difficult one for smaller-cap investors; after a good start to the year, they were knocked off track by the regional bank failures, and then again by the increase in expectations for interest rates to rise more and then stay higher for longer.

Yet, as we laid out in our October *Economics Weekly* on the topic (Where Are We in the Small-Cap Cycle?), at least two factors currently make smaller-cap stocks attractive. The first is that to us these stocks remain as attractively valued as they have ever been on both an absolute and relative basis. The current trailing P/E multiple is just 14.5x relative to the historical average of 25x, which also means it has a very attractive 6.9% earnings yield (exhibit 21). This suggests that —to borrow the value investors' phrase—the margin of safety is now quite high, and much of the bad news has been priced in. And while it will still be difficult to break the monopolistic grip of the dominant large caps, there is certainly room for relative improvement, particularly among the higher-quality smaller-cap stocks.

Exhibit 21
P/E Ratio: S&P600 / S&P500
Based on 12-Month Trailing EPS



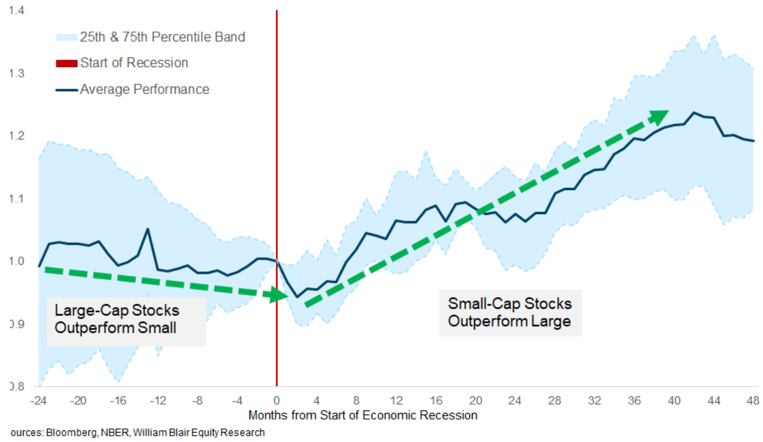
Sources: Bloomberg, William Blair Equity Research

Second, while the smaller-cap stocks often struggle in the later stages of the economic cycle—when interest rates are high and there is less of a surge in domestic growth opportunities—since the 1980s the smaller caps just about always outperform in the early part of the economic downturn and for the following 3-4 years, as they benefit from both a shift to lower interest rates and growth reacceleration (exhibit 22). As a result, these stocks are also looking increasingly attractive from a cyclical perspective as interest rates fall, growth slows, and a new economic cycle emerges.

Exhibit 22

Relative Performance of Russell 2000 vs. S&P 500 Index Around Recessions

(Average Relative Performance for Last 6 Recessions Starting From 1980 to 2023, Indices Rebased to 100 at Start of Recession)



Conclusion

The pandemic took a heavy toll on the global economy, and we are still finding ourselves wrestling with its aftermath several years on. Deciphering exactly which changes are structural and which will soon revert to pre-crisis norms has been challenging—for investors this has been most evident in the debate over high inflation and higher-for-longer interest rates.

Encouragingly, growth proved to be much better than anticipated in 2023. However, while we hope for the best in 2024, this resiliency will increasingly be severely tested as the lagged effects of much higher interest rates continue to bite, resulting in further increases in unemployment and slower growth.

Some comfort might also be taken in the view the downturn will likely be a mild one. In large part, this is because it is a downturn so far being entirely instigated by the Fed. The coming slowdown is very much being driven by the known-unknown of higher interest rates, as opposed to unknown-unknowns associated with existential collapses in the global financial system and a deadly virus, both of which were also situations of radical uncertainty.

With growth tangibly slower and inflation likely to fall further to effectively the 2% target rate, the Fed will be able to start its easing campaign. Consistent with past cycles, financial market participants are likely underestimating the full extent of rate cuts in the next two to three years. The major wild card here will be the behavior of rates at the longer end of the yield curve. This will in large part depend on the degree of the emerging weakness in economic demand, as well as supply-driven dynamics for debt playing out at the Treasury, where there is far less certainty compared to the short end of the curve.

Using the ERP as a gauge of investor sentiment, while investors are moderately bullish relative to the last few years and there are some legitimate comparisons that can be made with the late 1990s, one should also be cautious about pushing that analogy too far. The ERP is telling us that investors are currently demanding a far higher premium than they were during this previous period, and from this perspective expected equity returns over the coming decade still look attractive.

We also continue to believe that with the economic cycle slowing and equity valuations for smaller-cap stocks at extreme lows on both a relative and absolute basis, much of the bad news in this area of the market is likely to have already been priced in. As a result, investors should be thinking about combining a return to fundamental investing with greater active management and increased exposure to higher-quality names at this end of the spectrum, in order to help yield better relative returns over the coming year and beyond.

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DOW JONES: 36245.50
S&P 500: 4569.78
NASDAQ: 14185.50

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Market Perform (Hold)	29	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	0

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