Outlook, Q4 2024
Traub Capital Management
October 2, 2024

US Economy in Fine Shape

The major tenet of our outlook is based on the US economy, which is very much alive and well. As far back as late 2021, we have held that the US economy was not in recession and that no recession was imminent. We continue to hold that no recession is imminent now.

This "No Recession" view contrasted markedly from most economic forecasts prior to just recently. The mainstream thinking, back as far as 2021, was that recession was just around the corner. But the reality is that since Q2 of 2020 up through the end of 2023, the US GDP rose 5.1% annualized after adjusting for inflation. There are further increases in 2024 and most forecasters are now coming around to the "no recession" view.

Supporting our "no recession" belief are the positive fundamental drivers of the US economy, most notably of which is consumer spending. The rate of change in Personal Consumption Expenditures after adjusting for inflation is shown below in Figure 1 with data from the St. Louis Federal Reserve Bank.

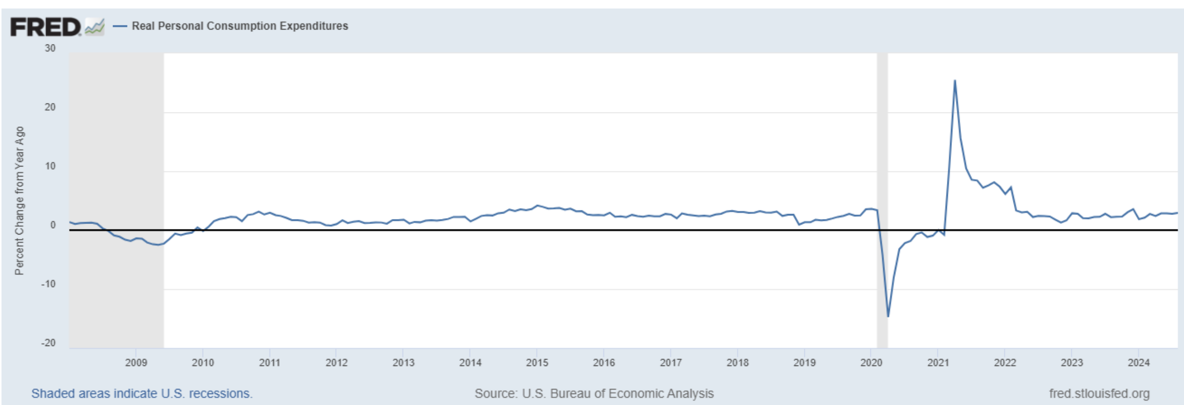

Figure 1

Figure 1: August 2024 Year over Year change in Real Personal Consumption Expenditures of 2.9%

You can see that personal consumption expenditures plummeted during the pandemic. They subsequently rose very dramatically and have since started to level out. Personal consumption is driven by the number of people working coupled to their wages. Both the number of people working as well as their wages (in real terms) have been growing steadily in the last year. These trends in employment and wages should continue.

A second recent trend has been confusing markets since the pandemic. That trend is the inventory cycle. As seen in Figure 2, below, inventory change tends to run within +/- $100 billion. Following the pandemic, however, inventories plummeted, then soared and then plummeted dramatically. Rising inventories amplify the underlying economic conditions, while declining inventories detract.

During the 2020 to 2024 period, most economic forecasts failed to account for the declining inventory factor and mistook it for economic weakness. Inventory change is now stabilizing, and the negative impact of declining inventories should be ameliorated. As a result, mainstream economists are beginning to see the underlying economic strength and have changed their projections of "imminent recession" to the "no recession" view which we have held for a long time. You can see the impact of inventory change graphically in Figure 2.

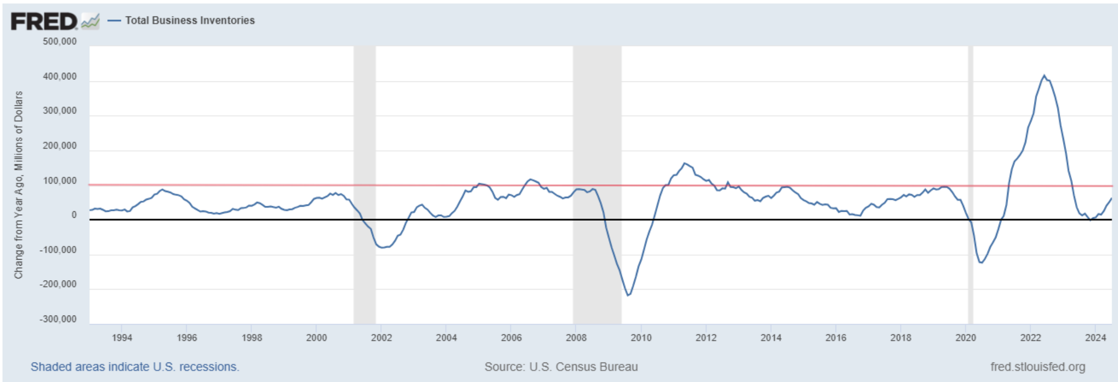

Figure 2

Now that our "No Recession" view, is becoming more mainstream, with it comes the distinct possibility of a near-term, "Market Melt-up". A Market Melt-up is the opposite of a market meltdown, but is not an increase that can be sustained by solid financial data. This is described below also under the section of the same name. First, however, we will see what things look like under a rational scenario.

Most Likely Outlook for Stocks

Conditions for a continued climb in the markets look good. We have discussed inflation a number of times in previous outlooks. There is no question that inflation has declined markedly from nearly 9% just after the pandemic. The overall inflation rate measured by the Consumer Price Index was down to 2.6% in August. By some other measures, inflation is now down to under 2%. With inflation at these levels, the Fed will no longer be applying the brakes to economic growth. The changes at the Fed will also help slow, or perhaps reverse, the recent declines in the number of jobs created. It bodes well for the US economy.

Bear markets are normally associated with recessions and with no recession in the offing, the chances of a bear market are small. Remember that a market correction of 10 to 20% can happen at most anytime but these corrections tend to be over quickly. It is the bear markets, defined as declines of more than 20%, that frequently take a long time to recover from.

Corporate earnings are up. The consensus forecast for the next 12 months is $262 for the S&P 500. Our forecast is $270 – up 10% from 2024 and up a subsequent 11% in 2026. Continued improvements in S&P earnings will also drive the market higher. Our forecast of earnings is a bit higher than the consensus.

Investor confidence is also starting to return with some measures pointing to confidence and some remaining negative. As confidence returns and becomes a widely held view, the market will start to lose the "Wall of Worry" that it loves to climb. But before the peak, FOMO (Fear of Missing Out) may start to color investors' levels of confidence and this would result in the Market Melt-up described below.

Overall, the most likely outlook is to see the S&P up about hundred points by year-end (3%), with further increases in 2025. The "Market Melt-up" scenario described below could drive it substantially higher and quicker, but set it up for a decline later in 2025.

Most Likely Outlook for Bonds

The Federal Reserve lowered the Federal Funds rate by ½ percent at its last meeting. We will most likely see another ¼ point cut by year-end (with some chance of two ¼ point cuts). At the beginning of this year, we thought two cuts would be most likely – a view that was dramatically different from the industry consensus of six cuts in 2024. The rate cuts on Fed Funds will lower the rate on the short-term end of the yield curve. We believe that the need for continued large financing for the Federal government will actually increase yields on the longer end of the curve. By the end of 2025, we expect Fed Funds to be about 3.75%, down more than a full percent from today's rates. We expect the 10-year treasury rate to continue its very recent slow ascent, reaching the low 4%+ range by the end of 2024 and holding at that level through 2025. This is up from today's rate of 3.8%, which is up from a recent low of 3.6% at the beginning of September.

These changes in interest rates will restore the normal positive slope to the yield curve (the curve shows bond yields for different maturities in years). Changes in interest rates will also help improve the overall returns of short-term bonds and decrease the returns of longer-term obligations since bond prices move opposite to the interest rates (when rates go down for a particular maturity date, the value of that bond goes higher and vice-versa). As a result, we have lowered our holdings of long-term obligations, which we expect to see a modest decline and increased holdings of short-term bonds which should benefit from higher values going forward.

Election

Everyone knows that there is an election coming up in November. Every economic outlook has comments on the election as it tends to be a very emotional roller coaster for most investors. We at Traub Capital maintain an independent assessment of the political landscape and our assessment is strictly on a financial, rather than a political basis.

As discussed in the last outlook, control of both houses of Congress is split with the Democrats having 51 members of the Senate (including 4 independents who caucus with the Democrats) while the Republicans hold 49. The Republicans hold a marginally higher number of members of the 435 representatives.

In the Senate, there are 34 seats up for election. Of those, 23 are Democrats and only 11 are Republican. Polls show a very narrow lead for Republican control of the Senate. Polls also show a very narrow lead for Democratic control of the House. Either chamber of Congress could go either way, but with the current composition of Congress and its seat races, the chances for either party holding the presidency AND a meaningful majority of both houses of Congress is virtually nil. There will be no legislative mandate and the probability of either presidential candidate enacting substantial changes in the income tax code is very small, in spite of what is heard on the campaign trail. Markets do not like uncertainty and as soon as the hollering dies down about substantial changes to the tax code, investors will be happier – boding well for the stock markets.

Market Melt-up

This brings us to our last market consideration – "melt-up". Markets climb a wall of worry. They mature on optimism and die on euphoria. Sentiment moving from dour to confident to very optimistic typically ends in irrational investment decisions and higher market values than can be justified.

Our forecast of corporate earnings for 2026 is $301. With the S&P 500 at a level of 6,000 at year-end, which equates to a Price / Earnings ratio of 20.0x forward twelve-month earnings. The ten-year average P/E ratio for forward earnings is 18x. The P/E ratio on forward earnings peaked at 23x when optimism was at its height and just before the pandemic set in.

We would say we are not at any kind of euphoric multiple on earnings. However, as confidence builds, a P/E ratio of 23x could be reached, driving the market to 7,000 and setting it up for a correction late in 2025. This is not our base case, but we view it as a meaningful possibility.

Retirement

One of the most frequent questions we are asked is "Can I Retire" or "When Can I Retire". We can help answer that question as we have very good tools to project your financial situation (including projections of your future income tax liabilities) for many years into the future. You can get yourself into the ballpark quickly, however. That ballpark computation would be to assess what your financial resources will be at age 65 (or later if you plan to retire after 65), not including your house. Then look at your spending and your projected pensions and Social Security earnings. If your pensions and Social Security plus 4% of the financial assets you'll have at age 65 is greater than your present spending, your financial picture is in the ballpark. However, a key consideration is whether your financial assets are in IRAs or 401k's (or equivalent) or in a regular taxable account. Taxes are very important and the IRA/401k's will be taxed upon withdrawal. These are all factors we incorporate when helping clients with their retirement planning.

If you're more interested in being in the right seat & section number within the ballpark, we would be more than happy to take a very detailed look for you at that picture for your individual situation. This detailed analysis will include your projected tax liabilities, which figure heavily into your retirement cash flows and should have a front seat in those calculations.

However, we caution you to look at your retirement through a much broader lens than financial stability. When your working career spans more than 40 years, it is easy to think that you will just stop working cold-turkey, go on a cruise for vacation and be happy for the rest of your life. It often makes sense to ease into retirement and work part-time, especially if that is an option in your position before you are ready to retire. Retirement is much longer than a cruise will last. Even when you finish your cruise and your to-do list, you still will most likely have many, many more years.

We have just finished up a realistic analysis of life expectancies. For a male, now age 65, a life expectancy of 22 years is a good planning horizon. At age 75, that horizon is still 14 years. For women, 25 and 17 years are good planning horizons for ages 65 and 75, respectively.

This is a long time. Your cruise and your to-do list will have long since been complete. Retirement constitutes a change of identity too. If you have been working for forty or more years, you will naturally associate yourself and your purpose with your work. Your financial focus will have been on saving and accumulating financial assets. These change upon retirement.

It is now a new personal identity and perfecting the art of subtraction, decumulating assets and withdrawal planning - which is difficult at first (tapping into your investment assets).

Christine Benz is a noted columnist for Morningstar and regularly writes about retirement considerations. She has recently written a thoughtful book on the subject entitled. "How to Retire". You might be able to pick up a copy at the library, or for $18, you can purchase one on Amazon. We are also happy to send a copy to clients at no charge. It will help you make all the considerations needed for retirement and help make sure yours is a happy one.

Conclusion

The stock market has been on a very good run since the end of the pandemic. Our forecast of "no recession" has given us the foundation to continue to hold at least our "normal" positions in equities the last few years and keep the returns on your portfolios strong. We are expecting the overall upward trend to continue through the 5.1 of the year and well into 2025. In the Q1, 2025 outlook, we will go into considerably more detail on the 2025 projections.

In the meantime, if you are considering retirement remember there are a lot more considerations in addition to your financial position. We can make an assessment of that position, but give some thought to the rest of the picture to give you the best chance of a comfortable position.