2024 Outlook / 2023 Review

Our newsletter this year is going to look a little different. As we gathered materials, we read a few very good articles from Raymond James that warranted passing along. Attached you will find; “2024 Preview: Market Performance in a Presidential Election Year” by Ed Mills, “Ready, Set, Lock in Rates” by Tracey Manzi, and “Respect the Trend But Curb Your Enthusiasm for Stocks Next Year” by Talley Leger. These are all very pertinent and effectively answer a lot of the questions we are getting as we head into 2024.

We also felt like we needed to highlight a few quotes from Larry Adam, CIO at Raymond James, that really stood out:

“Markets are salivating over the possibility of as many as six interest rate cuts in 2024, but we believe that is overly optimistic; we favor three or four.”

Takeaway: Whether it is three rate cuts or six, rates are highly likely to be coming down. Our fixed rate securities like CDs, bonds, and fixed annuities have already started to decrease their rates in preparation. We are still believers in the “Buy High” (rates) strategy we laid out in the Mid-Year 2023 letter.

“That’s because a lot of the good news has already been priced into the market, including expectations for a soft landing, Fed rate cuts and easing inflation. The proof in the pudding is that the P/E multiple is trading near the upper end of its 20-year range.”

“Our expectation is that earnings growth will be only 2% to $225 for 2024. History (i.e., election years, Fed easing cycle, etc.) suggests our less spicy expectations for the S&P 500 - to 4850 by year end 2024 – make more sense.”

Takeaway: As of 01/22/2024, the S&P 500 is already at 4850… We’re not much on “crystal ball” stock market predictions, however, it is worth noting that this is the lowest growth prediction from a mainstream firm that we can remember.

We recently launched our new website www.lalancemckellar.com. All of the articles listed above can be found there, as well as an archive of our past letters. Please go visit, save to your favorites, and let us know if you have some feedback. We look forward to working through this year with you.

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Product Spotlight

* **Buffered ETFs** – Sometimes called Target Return ETFs, allow participation in the capped upside potential of an index while offering some loss protection through a buffer. Over a longer period of time the stock market has trended upward. There are times of volatility and Buffered ETFs look to smooth out that ride. As part of our allocation for you, don't be surprised if you hear us discuss this investment option.

Points of Interest

* **What is the Rule of 72** – Many times we are tasked with teaching a younger generation the power of compounding. The Rule of 72 gives a simple estimate. Divide the number 72 by your expected investment return. The answer provides the estimate for you to double your funds.

* **Tech Sector Versus the Rest** – While the S&P 500 is at record levels, the tech sector is the only of 11 sectors that can say the same. The 10 other sectors are trading an average of 15% below their all-time highs. In January of 2022, the market rally was much wider spread with 7 of the 11 sectors joining tech in all-time highs. (Source WSJ)

* **Performance After a 20% Year** – Since 1928, the S&P 500's average annual performance after a 20% yearly gain was 6.7% with positive returns 68% of the time. (Source: Bespoke)

* **Election Year Performance** – Since 1932, the S&P 500's average return during an election year was 6.2% versus 9.6% during non-election years. (Source: J.P. Morgan Asset Management)

YTD Change as of 12/31/23

S&P 500	+24.23% YTD 12/31/23 (Raymond James Market Summary)
NASDAQ	+43.42% YTD 12/31/23 (Raymond James Market Summary)
DJIA	+13.7% YTD 12/31/23 (Raymond James Market Summary)
Russell 2000	+15.09% YTD 12/31/23 (Raymond James Market Summary)
Global Dow	+17.62% YTD 12/31/23 (Raymond James Market Summary)
6 month Brokered CD Rate	5% as of 01/29/24 (Raymond James Trading Platform)
10-Year Treasuries	3.86% as of 12/31/23 (Raymond James Market Summary)

The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The Global Dow is an equally weighted stock index. It is composed of the stocks of 150 top companies from around the world as selected by Dow Jones editors and based on the companies' long history of success and popularity among investors. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow", is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal. The NASDAQ Composite Index is an unmanaged index of securities traded on the NASDAQ system. The Russell 2000 index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks. It is a market-cap weighted index. CDs are insured by the FDIC and offer a fixed rate of return, whereas the return and principal value of investment securities fluctuate with changes in market conditions. Diversification and asset allocation do not ensure a profit or protect against a loss. Guarantees are based on the claims paying ability of the issuing company. Raymond James Financial Services, Inc. does not provide advice on tax, legal or mortgage issues. These matters should be discussed with the appropriate professional.

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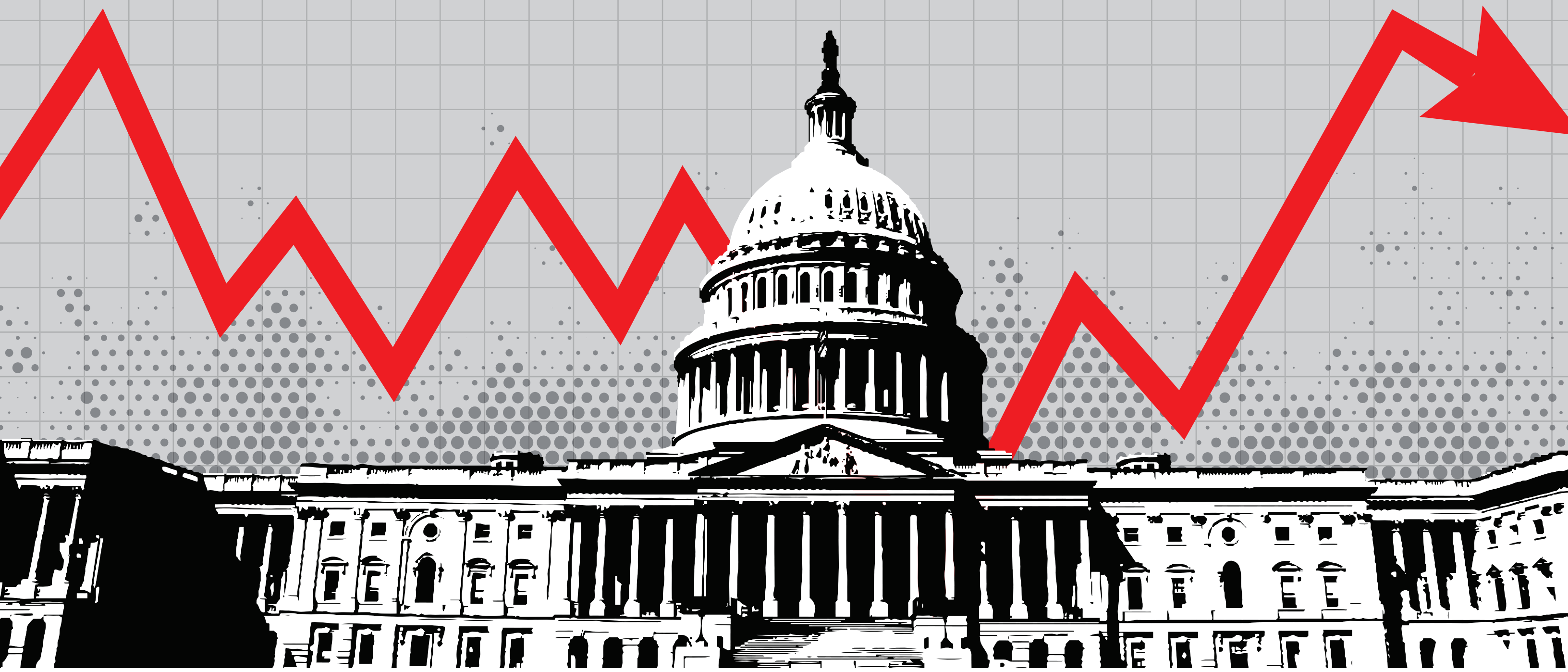


2024 Preview: Market Performance in a Presidential Election Year

Ed Mills, *Managing Director, Washington Policy Analyst,* Equity Research

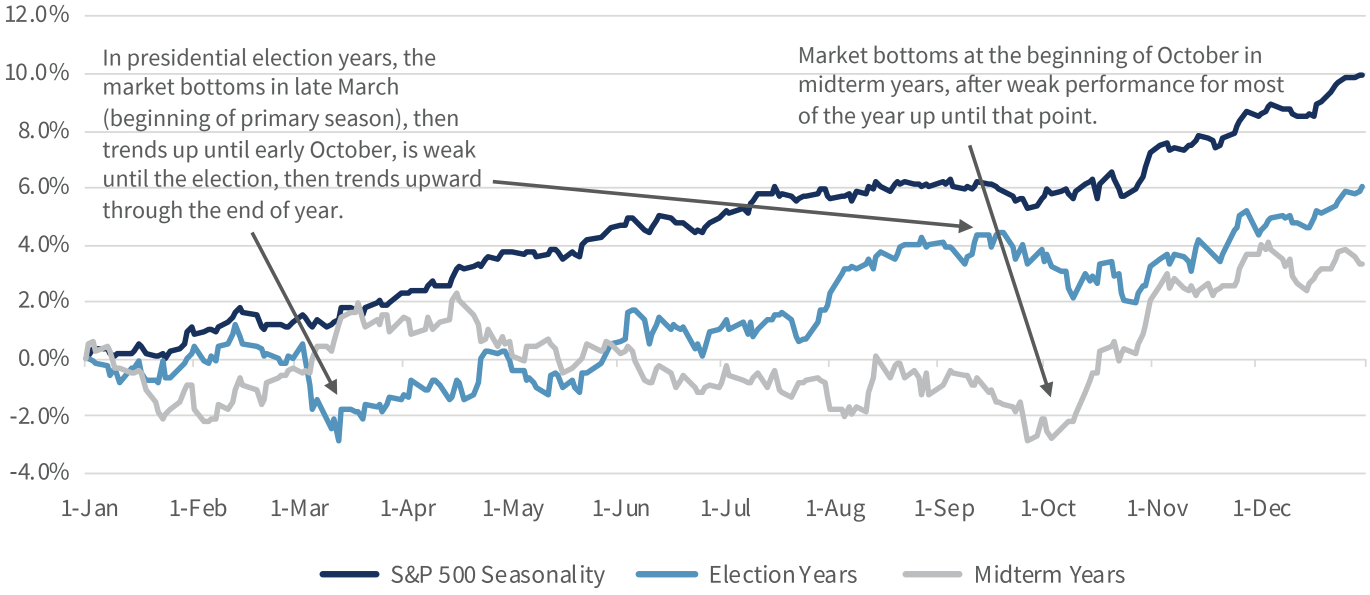
Presidential election years usher in considerable uncertainty. While the most likely scenario remains a rematch of the 2020 election, there seems to be a nagging feeling that something could happen to reset the race and produce an unexpected outcome. This uncertainty, the potential for surprise and the polarized nature of the political environment may cause investors to be cautious in the upcoming election year. Adding to this uncertainty is lingering geopolitical risk, concerns over the trajectory of the debt and deficit, recession risk, and unresolved government funding decisions. From a market perspective, we would not be surprised to see 2024 track traditional presidential election years, where there are pockets of weakness during periods of the greatest uncertainty, but a market rebound and renewed strength as we receive clarity on key issues. In this article, we will provide our outlook for the 2024 elections and provide an update on other key issues that DC will tackle in 2024, with impacts for the US fiscal picture and geopolitical risk.

HOW COULD THE ELECTORAL CALENDAR IMPACT MARKET PERFORMANCE?

The state of play for the 2024 race will remain fluid ahead of Election Day, but a 2020 presidential rematch remains the most likely situation at this stage of the race. However, many unanswered questions remain in the months ahead, with implications for market sentiment at various turning points. Overall, election years have historically seen the second lowest market returns of the presidential term cycle, with an average monthly return of 0.54%. However, markets quickly play catch-up after election year uncertainty is resolved, averaging a monthly return of 1.28% during the year after the election. Midterm election years are the weakest point for markets in a presidential term, historically seeing average monthly returns of 0.3% regardless of the party in control of the White House.

As we enter January, we would highlight to investors that the beginning of election years (January-March) historically sees negative market returns as the primary process—and associated political volatility—hits its peak, with average monthly returns of -0.44%. The primary cycle will kick off on January 15 in Iowa for Republicans and the first ‘official’

S&P 500 Seasonality (Avg. Since 1980) vs. Election & Midterm Years



Source: Bloomberg as of 12/15/2023

primary will be on February 3 in South Carolina for Democrats. Two key measures of strength for an incumbent president are his favorability ratings and the right track/wrong track trajectory of the country. In each of these measures, there are warning signs for President Biden and we will be watching to see if this provides an opening for weaker than expected primary election results for Biden. Biden has two long-shot candidates running against him, but anything less than 75-80% support will set off renewed alarm bells for his campaign.

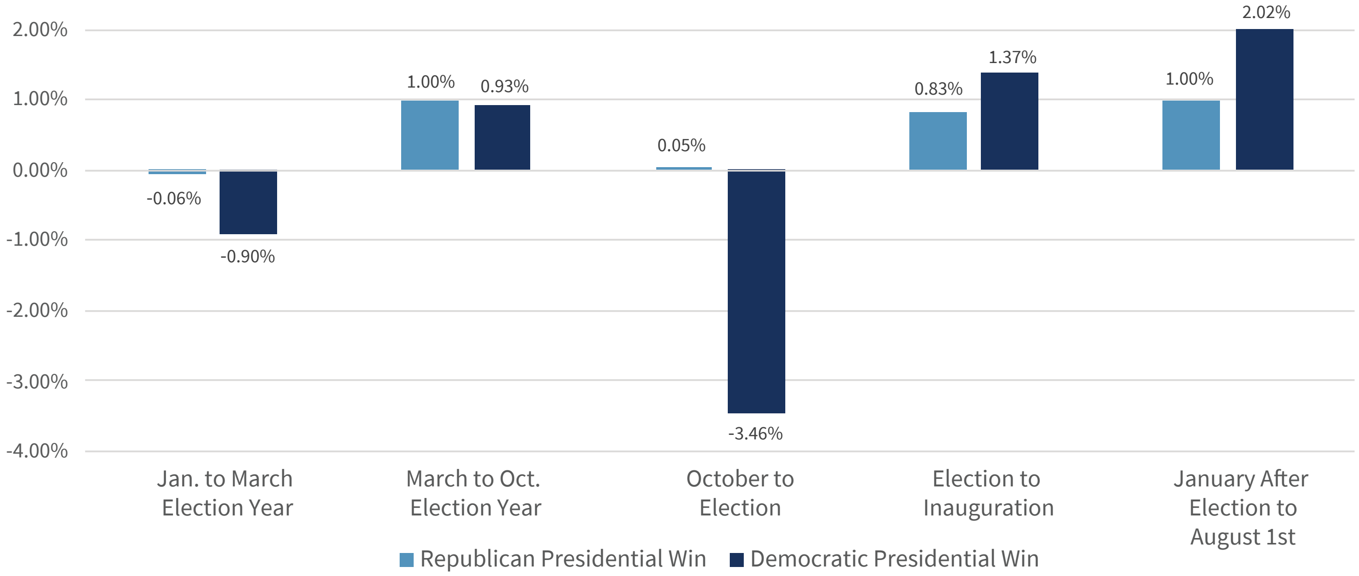
As Republican voters head to the primaries, Trump's continued strong polling numbers suggest his likely nomination to the Republican presidential ticket, but his legal challenges remain a significant wildcard ahead of the primary process. If there is a surprise in the Republican primaries, we would need to see voters coalesce around a clear alternative to former President Trump, picking up momentum in the early states. Should Trump emerge as the Republican nominee, a key debate for the general election will be how much of the election is a referendum on Biden versus Trump, as Trump has similar unfavorable ratings to Biden.

> We would caution investors to avoid using the election as too much of a catalyst for investment decisions.

KEY ELECTORAL INFLECTION POINTS FOR THE MARKET: MARCH, OCTOBER-NOVEMBER

March remains an important inflection point in the electoral calendar, with 34 primary elections, including 16 states holding their primaries on Super Tuesday. The end of the month will provide important clarity on who the prospective nominees might be, with more than half of both parties' delegates awarded ahead of the Republican convention in July and Democratic convention in August. Given this clarity, the period between March and October during an election year historically has seen positive returns (0.97% average monthly returns). Any remaining uncertainty over nominees should be resolved at the nominating conventions—July 15-18 for Republicans and August 19-22 for Democrats. Beyond first quarter volatility, the most significant downside risk is seen in the immediate run up to the election (October through Election Day), with an average monthly return of -1.27%.

Average Monthly Returns With A Republican vs. Democratic Presidential Victory Since 1980

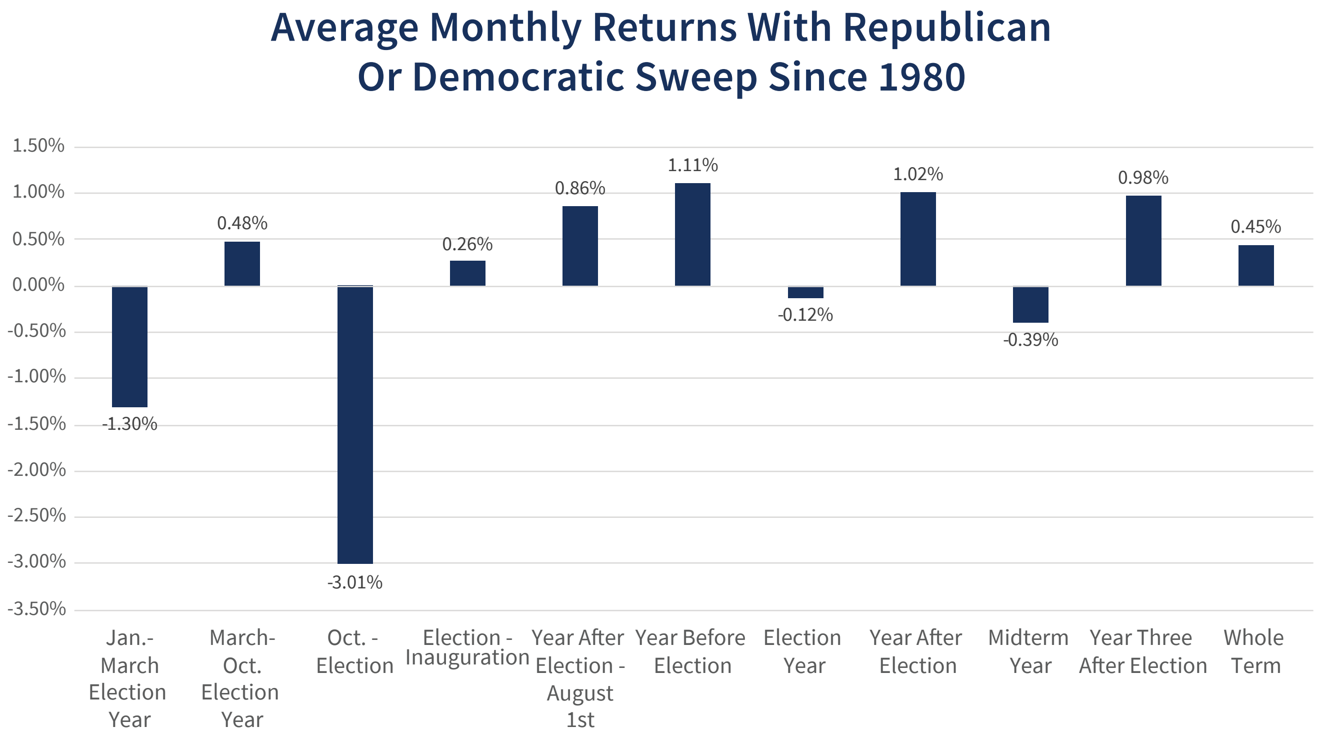


Source: Bloomberg as of 12/15/2023

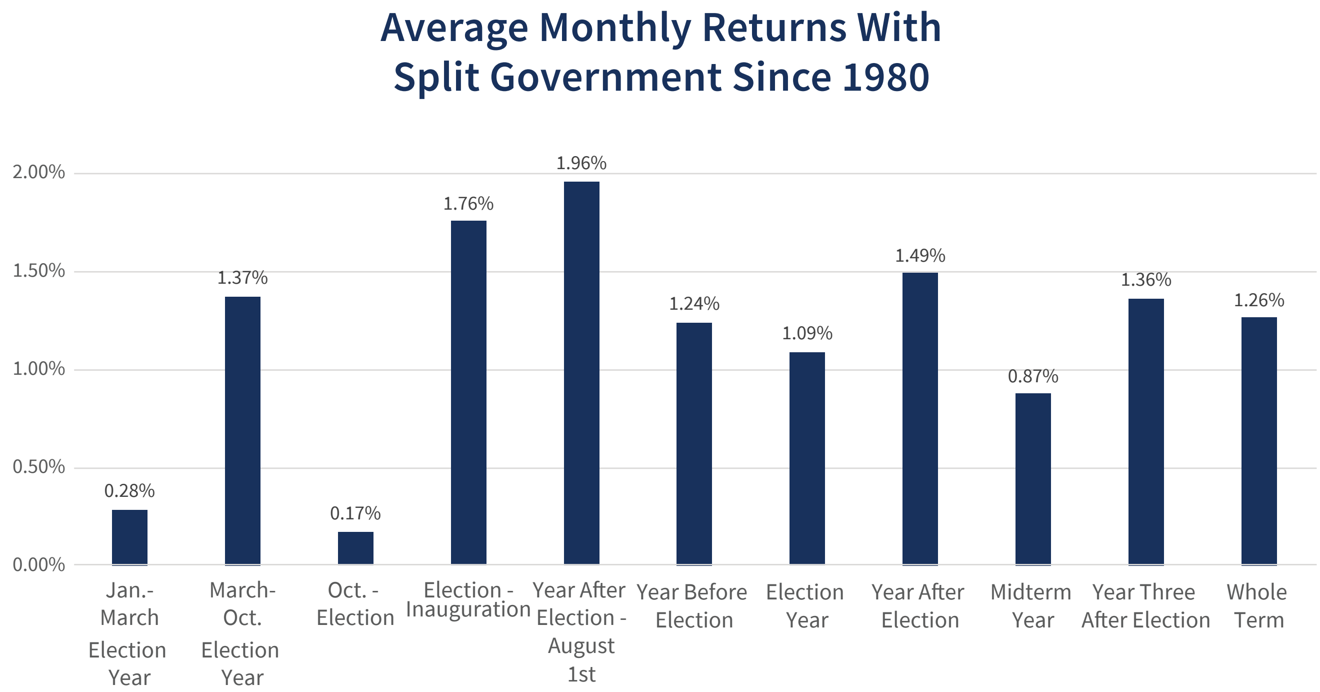
While the race is likely to remain close until the polls open on November 5, historically we have seen more market weakness in the run up to a Democratic presidential victory versus a Republican presidential victory, but these numbers are a bit skewed by the impact of the global financial crisis in 2008 preceding President Obama's victory. Despite this pre-election volatility, markets tend to quickly play catch-up and see an outsized market return. If Democrats retain the White House, we expect to see a greater positive rotation in the first 100 days of a Democratic presidency compared to a GOP victory— on average, markets rise 1.75% monthly the year following a Democratic presidential win, compared to 0.88% for Republicans. Given this historical correction, we would caution investors to avoid using the election as too much of a catalyst for investment decisions.

Control of the House and Senate will also be up for grabs next November and we would highlight to investors that expectations of a partisan sweep in either direction tend to drive more volatility, seeing -3.01% average monthly returns in the pre-election period. In contrast, expectations of a divided government set the conditions for calmer waters, seeing positive average monthly returns both ahead of the election (0.17%) and in the years after. The race for Congressional control will similarly remain fluid up to election day, but the retirement of Senator Joe Manchin (D-WV) will compound an already challenging map for Senate Democrats, while a slow-to-restart fundraising operation under new House Speaker Mike Johnson (R-LA) could limit the flow of funds to vulnerable House Republicans in key swing districts.

> “Expectations of a divided government set the conditions for calmer waters, seeing positive average monthly returns both ahead of the election (0.17%) and in the years after.”



Source: Bloomberg as of 12/15/2023



Source: Bloomberg as of 12/15/2023

WHAT ELSE DOES DC NEED TO ACHIEVE IN 2024?

Aside from electing a president and a new Congress, DC will enter 2024 with an important to-do list, including government funding and responding to a changing global security environment. A first-mover for investors to watch will be the government funding debate, with new deadlines set for January 19 for four of the twelve appropriations bills and February 2 for the remaining eight bills. Temporary government shutdowns and triggers of 1% across-the-board spending cuts remain possible, which could add to market volatility in the first quarter. While near-term economic concerns have been raised about a potential slump in near-term fiscal support given the spending cut discussions, we would point to the implementation of major infrastructure legislation (including the bipartisan infrastructure law and the Inflation Reduction Act) which will continue to be deployed and have significant macroeconomic impacts.

Geopolitics will be another priority for DC to address throughout 2024, with parallel wars in Ukraine and in Israel/Gaza alongside ongoing Indo-Pacific security concerns likely to shape key legislative, political and regulatory outcomes throughout the year. Amid heightened concerns around fiscal spending and under the leadership of new House Speaker Mike Johnson, additional military aid for Ukraine will continue to come under close scrutiny in the halls of Congress. The pairing of funding for Ukraine and Israel with border security provisions will continue as another first-mover theme once Congress returns. Despite the political process likely slowing down the passage of the supplementary defense funding bill, we continue to expect to see a long-term setup that supports higher defense spending given national security's reemergence as a core legislative and regulatory theme in DC.

Finally, the US/China relationship will also remain in focus in 2024 as DC and Beijing try to restabilize the bilateral relationship through strengthened channels of communication. Reactions to further national security initiatives (such as expanded restrictions on the export of advanced technology) can generate new geopolitical risk for investors to monitor, but will also serve as a test of the new guardrails placed on escalation risk by the renewed bilateral contacts. A hawkish tilt in Congress (compared to the White House) can drive additional market-impactful policy actions out of DC that place further restrictions on China-related economic activities.

> Expect to see a long-term setup supporting higher defense spending given national security's reemergence as a core legislative and regulatory theme in DC.

KEY TAKEAWAYS:

- While the most likely scenario remains a rematch of the 2020 election, there seems to be a nagging feeling that something could happen to reset the race and produce an unexpected outcome.
- We would not be surprised to see 2024 track traditional presidential election years, where there are pockets of weakness during periods of the greatest uncertainty, but a market rebound and renewed strength as we receive clarity on key issues.
- The race for Congressional control will remain fluid until election day with Senator Manchin's retirement compounding an already challenging Senate map for the Democrats and slow to restart fundraising operations potentially limiting the flow of funds to vulnerable House Republicans in key swing districts.
- DC will have an important to-do list in 2024, including government funding and responding to a changing global security environment.
- The US/China relationship will also remain a key focus.

Ready, Set, Lock in Rates

Tracey Manzi, CFA, *Senior Investment Strategist,* Investment Strategy

2023 proved to be another challenging year for the bond markets. Stronger-than-expected growth, concerns about the US government's fiscal outlook and the Fed's pledge to keep interest rates higher for longer drove yields (particularly longer-dated maturities) to levels not seen in decades. After the 10-year Treasury yield climbed above the psychologically important 5.0% level in October 2023, yields headed sharply lower in the final months of the year. While interest rates are well off their recent peaks, yields still stand near their highest levels in nearly 15 years. And with a Fed easing cycle coming into view in 2024, we think yields will trend lower in the months ahead. Although, the journey to lower interest rates is unlikely to proceed in a straight line.

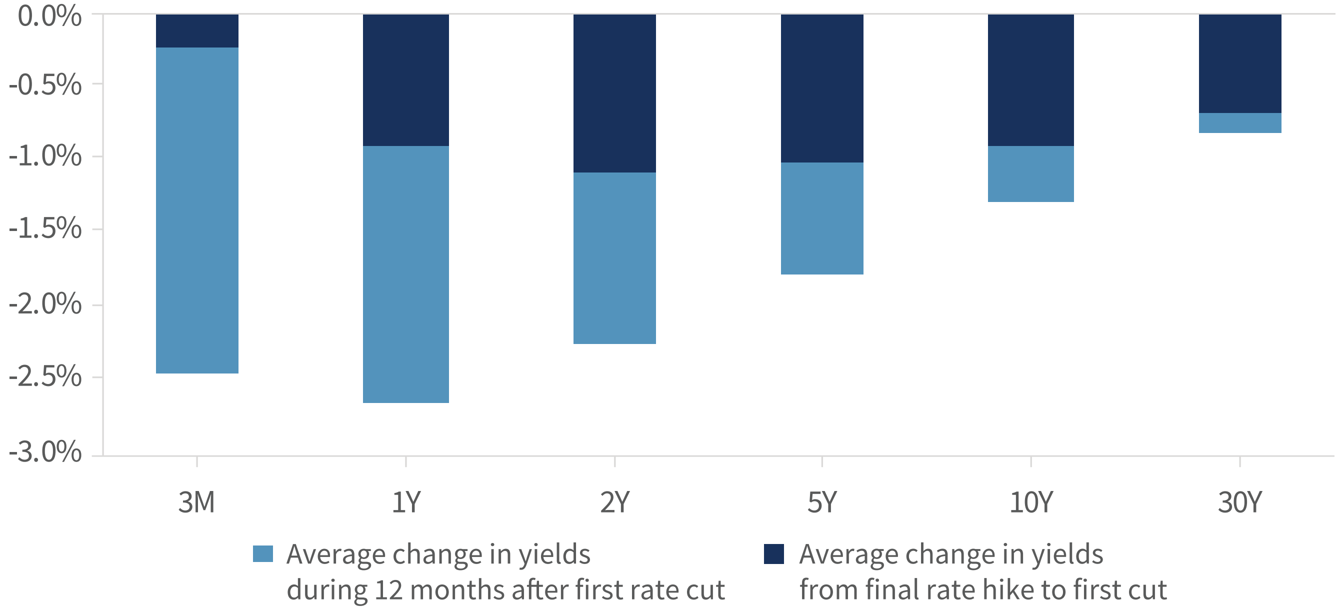
Bonds have historically delivered strong, positive returns when Fed policy is transitioning into an easing cycle. This should be welcome news for fixed income investors who have endured significant volatility and two back to back years of losses. But, as challenging as the last few years have been, there is a silver lining for investors—and that is, the great rate reset has restored yields to more normal levels. And, with yields now at their highest levels in decades, investors can once again reap the benefits of owning bonds. These include an attractive source of income, reasonable yield cushion to offset adverse movements in interest rates or spreads, potential capital appreciation and diversification from equities. These factors were missing when yields were artificially suppressed in the years following the Great Financial Crisis.

> While interest rates are well off their recent peaks, yields still stand at their highest level in nearly 15 years.

MACRO OUTLOOK SUPPORTS OUR CALL FOR LOWER BOND YIELDS

Despite calls for a recession in 2023, the economy remained remarkably resilient. While the long-awaited slowdown has been delayed, we still believe that a recession is coming as the tailwinds that supported growth are fading. Fed policy is restrictive. The long and variable lags of monetary policy are still working their way through the economy and are expected to become a bigger drag on growth as we progress through 2024. The fiscal impulse that supported consumption has ended. Job growth is stalling. And the disinflationary trend that

Yield Changes Leading Into and One Year After First Rate Cut



Source: FactSet as of 12/15/2023

started over a year ago is becoming more entrenched. The bond market has already sniffed out slower growth and sustained disinflation, driving 10-year Treasury yields from a peak of ~5.0% to 3.90%. The market is also pricing in nearly five 25 basis point rate cuts by year-end 2024. While the market may be overly optimistic about what the Fed will deliver in 2024, we do believe that policy rates are headed lower given our expectation for a mild recession next year.

What is up for debate is the pace and magnitude of the Fed's expected rate cuts in the upcoming easing cycle. Policymakers will likely err on the side of caution in lowering interest rates as concerns about a renewed spike in inflation or a re-acceleration in growth could derail their progress to date. However, if a sharper than expected slowdown materializes or inflation decelerates at a more rapid clip (not our base case), Fed officials have plenty of room to lower rates to cushion the downturn. Given the economy's resilience to the Fed's aggressive rate hikes and the unusual nature of this cycle, volatility is likely to remain elevated as the economy normalizes.

Therefore, the tug-of-war between the market's expectation for rates cuts and the Fed's forward guidance is likely to persist. But ultimately, we do believe that the direction for policy rates and Treasury yields will be lower.

BONDS PERFORM WELL LEADING INTO AN EASING CYCLE

Bonds have historically performed well leading into an easing cycle. In fact, once the Fed delivers its final rate hike, yields begin to move lower as the market starts to anticipate the next easing cycle. In the last six cycles, the period between the Fed's last rate hike and the first rate cut (i.e., the 'pause') averaged around seven months. Applying this average to the current cycle suggests that the Fed could kick off its next easing cycle as early as the first quarter of 2024—which coincidentally aligns with the timing of the first rate cut according to the fed funds futures contracts. While caution is warranted when looking at averages, as every cycle is different, it is worth noting that on average, 2-year and 10-year Treasury yields have declined ~100 basis points during the pause period. Yields fell even further once the Fed started cutting rates. More importantly, high quality bonds delivered strong, positive returns after the Fed's tightening cycle ended. We think the next cycle will deliver similar results.

> Given our outlook for slower growth, more disinflation and a Fed pivot in 2024, we believe Treasury yields still have room to move lower.

Cooling inflation pressures, slowing job growth and the end of the Fed's tightening cycle have driven Treasury yields sharply lower in the final months of 2023. The recent decline in 10-year Treasury yields has simply been a retracement of the upside growth surprises and Treasury supply concerns that drove yields higher earlier in the year. In fact, yields are essentially back at the levels that prevailed when the Fed delivered its last rate hike of this cycle (i.e., July 2023). Given our outlook for slower growth, more disinflation and less restrictive Fed policy in 2024, we believe yields still have room to move lower—perhaps not back to the crisis-induced lows reached during the pandemic, but lower than current levels. While the decline in shorter-maturity yields will remain constrained by Fed policy rates, particularly with policymakers reluctant to ease aggressively with inflation still above the 2.0% target, longer maturities will be more responsive to the slowing growth/inflation dynamics. Absent a more aggressive Fed, the yield curve, as represented by the 2-year to 10-year spread, is likely to remain modestly inverted. But over time the yield curve should return to a more normal, positive slope.

YIELDS HAVE NOT BEEN THIS ATTRACTIVE IN DECADES

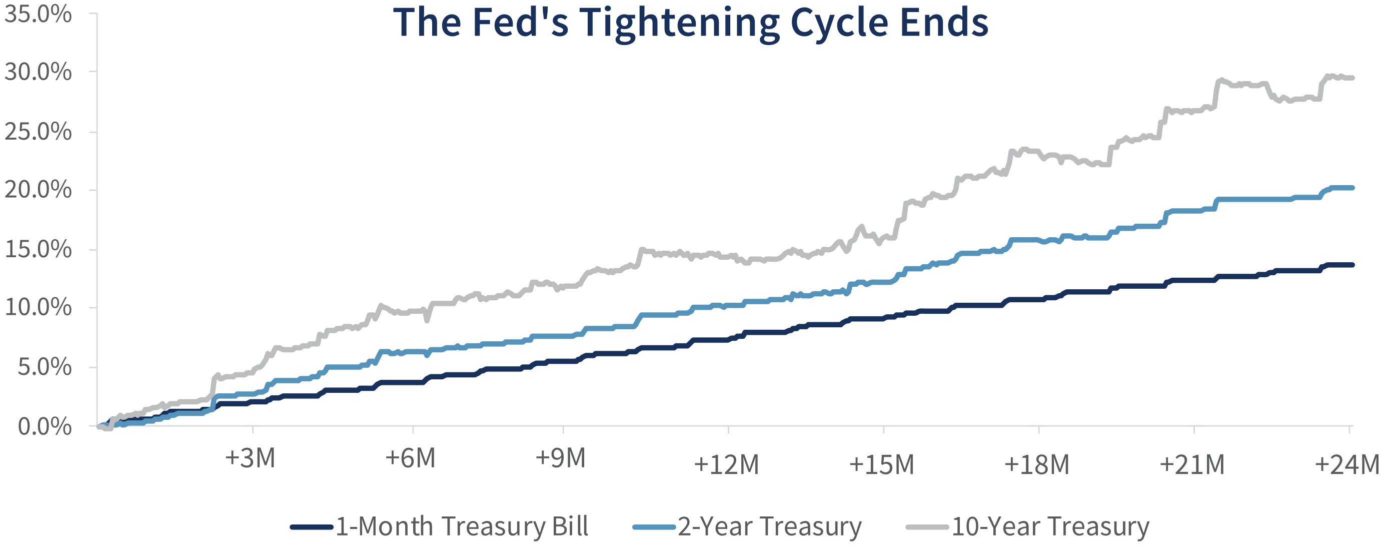
The inflation surge following the pandemic has shifted the investment landscape. After a decade or more of extraordinarily low bond yields, interest rates have risen to levels not seen in decades. While the process of getting here has been painful, there is a silver lining for investors—and that is, the income is back in fixed income. This is important because the starting level of yields has historically been one of the best predictors of future returns.

> “After a decade or more of extraordinarily low bond yields, interest rates have risen to levels not seen in decades.”

And with yields hovering near a 15-year high, bond returns should be much better than they have been in the past.

While the majority of a bond’s return potential comes from the income component, the opportunity to capture some capital appreciation from a move lower in bond yields is an added bonus for investors. And with a Fed easing cycle coming into focus, we think it would be prudent for investors to consider taking on some additional duration risk and locking in these higher yields while they are still available. This is especially true for investors who have been riding out the storm in cash or cash-equivalents earning competitive yields of 5.0% or higher. While cash yields are attractive today, the allure will quickly fade once the Fed starts cutting rates. In fact, history has shown that cash and cash-equivalents underperform intermediate and longer-maturity bonds by a significant margin after the Fed delivers its last rate hike.

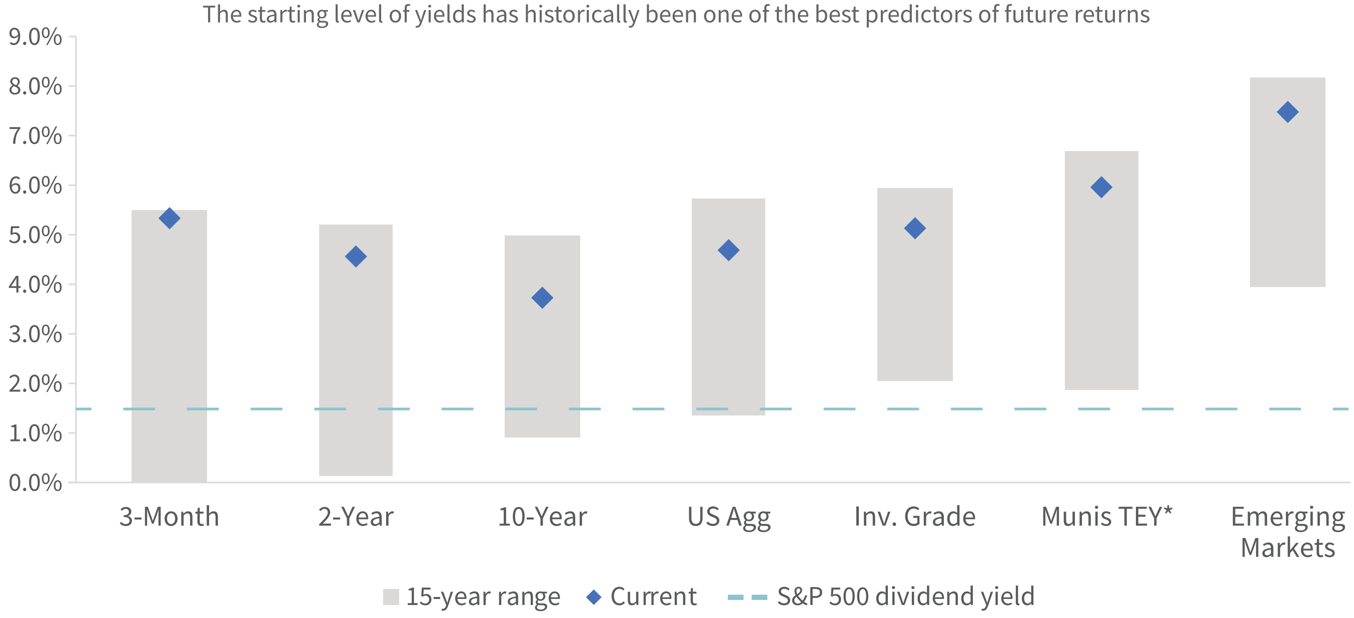
Duration Outperforms After The Fed's Tightening Cycle Ends



Source: FactSet as of 12/15/2023

Yield Opportunities Across All Fixed Income Sectors

The starting level of yields has historically been one of the best predictors of future returns



Source: FactSet as of 12/15/2023

* Tax-Equivalent Yield (TEY) is calculated using a top 40.8% tax bracket.

LOOKING FORWARD

Our optimism about bonds is driven by the high starting level of yields. While this was true in 2023, it is even truer in 2024. With yields across the fixed income spectrum near their highest levels in nearly 15 years, bonds have not looked this attractive on an absolute basis or relative to equities for a long time. Fixed income has the ability to generate mid-single digit returns or greater in 2024. As growth and inflation momentum slows, we look for lower yields and steeper curves in the months ahead. Given our outlook for a mild recession, we favor the higher-quality sectors of the bond market, which include Treasurys, investment-grade corporates and municipal bonds. While high yield bonds offer enticing yields, we remain cautious on the sector given deteriorating fundamentals (i.e., rising defaults, higher bankruptcies, falling interest coverage ratios) and tight credit spreads.

KEY TAKEAWAYS:

- Stronger-than-expected growth, concerns about the US government's fiscal outlook and the Federal Reserve's (Fed) pledge to keep interest rates higher for longer drove yields to levels not seen in decades.
- Bonds now offer an attractive source of income, reasonable yield cushion to offset adverse movements in interest rates or spreads, potential capital appreciation and diversification from equities.
- Bonds have historically performed well leading into an easing cycle.
- We believe that fixed income has the ability to generate mid-single digit returns or greater in 2024.

Respect the Trend But Curb Your Enthusiasm for Stocks Next Year

Talley Léger, *Senior Equity Strategist,* Investment Strategy

US large-capitalization stocks have enjoyed a whopping increase of 23% in 2023 fueled by a Fed policy pause since July, powerful rally in bonds, lower discount rate, softer energy prices, cooler inflation and a weaker US dollar.

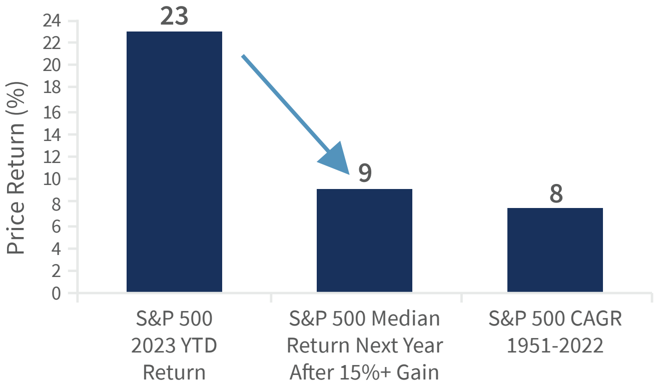
After 15%+ annual gains, however, subsequent calendar year returns on the S&P 500 have decelerated 93% of the time, based on records dating back to 1950. Specifically, the median S&P 500 price return in the year after a 15%+ gain was 9%, consistent with the long-term average return of 8% (read: reversion to the mean). Simply put, we don't need a recession to expect a single-digit gain in stocks next year.

STOCKS ARE OVERBOUGHT AND VULNERABLE TO A PULLBACK IN EARLY 2024

That said, RJ Economics sees a mild recession as the most probable outcome in 2024. The average peak-to-trough decline in stocks heading into recessions has been 30% since the 1950s and we're talking about a mild recession, not the average experience. From our lens, a recessionary drawdown in the low double-digits—a bit worse than a garden-variety correction—would be a reasonable expectation, meaning the S&P 500 could see the low 4,000s again before ending the year on a positive note.

(Not) Great Expectations

Absent a recession, it's reasonable to expect equity returns to moderate after a 20% year



Source: FactSet, RJ Investment Strategy : YTD = Year to date. CAGR = Compound annual growth rate. As of 12/15/2023

WHAT ARE THE RISKS?

We believe it would require another big increase in energy prices, meaningfully higher bond yields, surging inflation and renewed interest rate hikes from the Fed (all of which seem increasingly unlikely now) to push stocks below their October 2022 lows. Indeed, it appears that we lack the negative forces necessary to recenter outcomes around such an extremely bearish case at this stage.

Consistent with our price target of 4,850 in 2024, a subpar 5-6% advance was the typical outcome for stocks in recessions since the inception of the S&P 500, which usually witnessed an initial selloff before staging a recovery rally. Similarly, the absence of fear amongst investors and proverbial blood in the streets curbs our enthusiasm for equity returns, especially in the first half of next year. However, a growth scare and related risk-shedding event could inject some much-needed panic back into the marketplace, thereby boosting our excitement for stocks later in 2024.

OUTLOOK FOR EARNINGS AND VALUATIONS

In the face of a potential business cycle contraction next year, bottom-up analyst consensus expectations of $243 or 14% year-over-year (YoY) growth for S&P 500 four-quarter operating earnings per share (EPS) seem aggressive to us. That said, a mild yet broad-based recession in 2024 doesn't necessarily mean a catastrophe for the fundamental outlook. Our economists forecast an average annual pace of 4% for nominal gross domestic product (GDP) growth—an intuitive, albeit slowing driver of companies' top lines—which projects a modest 3% YoY growth rate for S&P 500 four-quarter sales per share (SPS) next year. Given the -23% peak-to-trough compression in net profit margins from the fourth quarter of 2021 to the first quarter of 2023—which is in line with the typical recessionary adjustment—as well as ongoing company expense management and hiring discipline, the Investment Strategy Committee assumes a flat margin of 11.6% to arrive at $225 or 2-3% YoY growth for S&P 500 four-quarter operating EPS in 2024.

> Ongoing tailwinds in the form of softer oil prices, cooler headline inflation, melting bond yields and enthusiasm about the beginning of Fed interest rate cuts should continue to support a similarly lofty multiple of earnings next year.

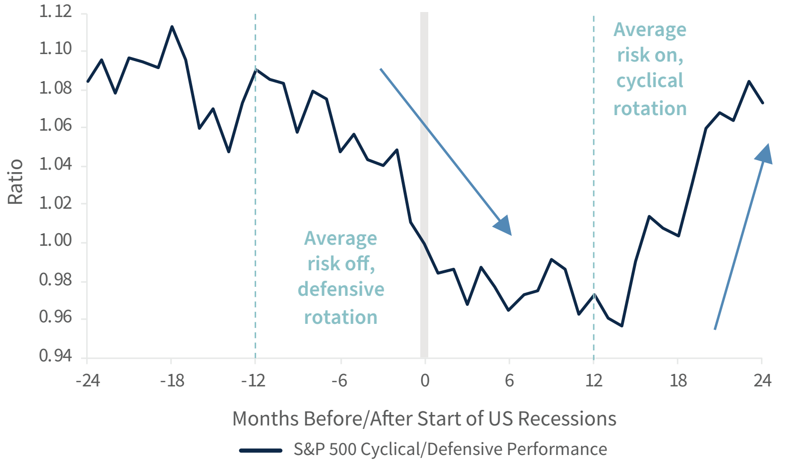
Meanwhile, the current S&P 500 trailing four-quarter operating price-to-earnings (P/E) ratio of 21.5x is above its long-term average, yet still below +1 standard deviation away from its mean. In other words, US large-cap valuations are elevated, but not unusually so. In our view, ongoing tailwinds in the form of softer oil prices, cooler headline inflation, melting bond yields and enthusiasm about the beginning of Fed interest rate cuts should continue to support a similarly lofty multiple of earnings next year.

SECTOR, SECTOR ON THE WALL, WHO'S THE FAIREST OF THEM ALL?

We foresee a defensive rotation into the lagging Health Care and Consumer Staples sectors, largely owing to their resilience to the business cycle, valuation discounts and positive earnings outlooks. In a reacceleration or recovery type of scenario, we expect the early-cycle, rate-sensitive Consumer Discretionary sector to continue doing well. Also, the economy-sensitive Financial and Industrial sectors should benefit from the favorable combination of valuation discounts plus positive catalysts in the form of rebounding earnings growth later next year.

First Half 2024: Defensive Rotation, Second Half 2024: Risk-On Recovery Trade

We foresee a defensive rotation next year, followed by a risk-on recovery trade heading into 2025



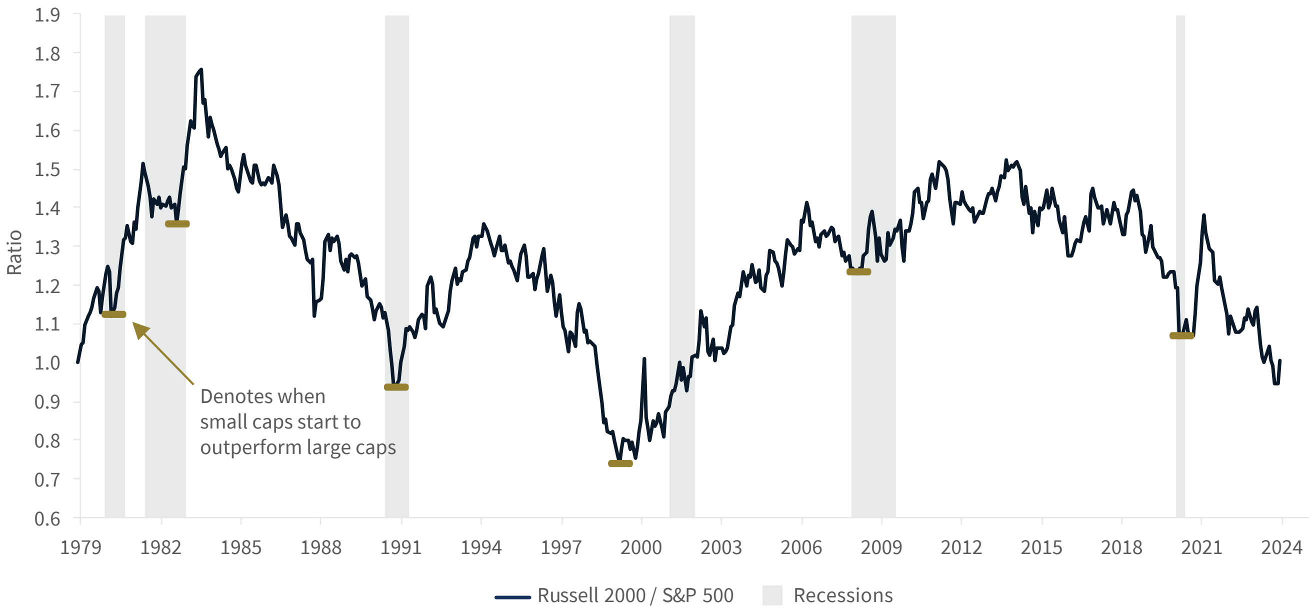
CYCLICALS	DEFENSIVES
Consumer Discretionary	Consumer Staples
Energy	Health Care
Financials	Communication
Industrials	Utilities
Technology	
Materials	

Source: FactSet, RJ Investment Strategy, as of 12/15/2023

Real Estate sector not included in table due to lack of data. Real Estate became its own GICS sector in 2016.

Small Caps in The Big Picture

Persistent small-cap outperformance likely awaits the end of the current business cycle



Denotes when small caps start to outperform large caps

Source: FactSet, S&P Global, RJ Investment Strategy, as of 12/15/2023

SMALL CAP, BIG PICTURE

In our view, compelling valuation opportunities exist for investors in small-cap stocks. After a decade of underperformance, naturally, the small-cap P/E ratio has become extremely cheap relative to that of large caps and history. The last time small caps were this undervalued, they outperformed for many years to come.

While valuations aren't timing tools, we're starting to see catalysts for unlocking the potential reward embedded in smaller stock prices.

First, a less inverted yield curve today and a Fed that has stopped raising rates suggest better times ahead and good news for higher-beta segments of the stock market. In the past, small caps have outperformed large caps when the yield curve was steepening.

Second, the Fed's Senior Loan Officer Opinion Survey indicates that fewer banks are tightening credit conditions for small firms seeking commercial and industrial loans. That's good news for the small-cap arena, where banks are a more important source of financing. Credit is the lifeline to smaller firms, and crucial for keeping their growth 'promise' to investors.

While a convincing turn in industrial output and broader economic rebound would likely give small caps a much-needed boost relative to large caps, we worry about missing the turn in the size cycle. After all, median total returns on the Russell 2000 were positive and outpaced those of the S&P 500 by 3% in recessions, meaning small caps tend to front-run business cycle recoveries. The bottom line is we're much less concerned about another 5-10% down in small caps than we are about capturing the next 20% up.

KEY TAKEAWAYS:

- Despite an economic soft patch, a mid-single-digit return could lift the S&P 500 to 4,850 next year.
- A mild recession should produce below-consensus earnings of $225 or 2-3% YoY growth in 2024, whereas cooling inflation and falling interest rates may support a lofty multiple of 21.5x earnings.
- We expect the deeply oversold Health Care and Consumer Staples sectors to benefit from earnings rebounds beginning in early '24. The pro-cyclical Consumer Discretionary, Financial and Industrial sectors should lead a risk-on recovery trade later in the year.
- Lagging small-capitalization stocks are extremely cheap relative to their larger brethren, but a business cycle contraction and ensuing recovery could be agents of change.

Disclosure

All expressions of opinion reflect the judgment of the authors and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

Investing in small- and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

US government bonds and Treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. US government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Treasury bills are certificates reflecting short-term obligations of the US government.

While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities.

The Russell 2000 Index is a small-cap US stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The MSCI China A Index measures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. The MSCI Pacific Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. The MSCI Europe index is a European equity index which tracks the return of stocks within 15 European developed markets.

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2024 tax rates, schedules, and contribution limits

Income tax

	If taxable income is over	But not over	The tax is	Of the amount over
Married/Filing jointly and qualifying widow(er)s	$0	$23,200	$0 + 10%	$0
	$23,200	$94,300	$2,320 + 12%	$23,200
	$94,300	$201,050	$10,852 + 22%	$94,300
	$201,050	$383,900	$34,337 + 24%	$201,050
	$383,900	$487,450	$78,221 +32%	$383,900
	$487,450	$731,200	$111,357 + 35%	$487,450
	$731,200		$196,669.50 + 37%	$731,200
Single	$0	$11,600	$0 + 10%	$0
	$11,600	$47,150	$1,160 + 12%	$11,600
	$47,150	$100,525	$5,426 + 22%	$47,150
	$100,525	$191,950	$17,168.50 + 24%	$100,525
	$191,950	$243,725	$39,110.50 + 32%	$191,950
	$243,725	$609,350	$55,678.50 + 35%	$243,725
	$609,350		$183,647.25 + 37%	$609,350
Estates and trusts	$0	$3,100	$0 + 10%	$0
	$3,100	$11,150	$310 + 24%	$3,100
	$11,150	$15,200	$2,242 + 35%	$11,150
	$15,200		$3,659.50 + 37%	$15,200

Tax on corporations and other businesses

- 21% tax rate applied on C-corporation income
- Taxpayers may generally deduct up to 20% of the qualified business income (QBI) of S corporations, partnerships, and sole proprietorships (reduced by net capital gain and qualified dividends), subject to limitations:
  - — Deduction generally not available for a Specified Service Trade or Business (SSTB) if taxable income exceeds $241,950 (single) or $483,900 (married/filing jointly); the deduction is subject to a phaseout unless taxable income is at or below $191,950 (single) or $383,900 (married/filing jointly)
  - — If taxable income exceeds $241,950 (single) or $483,900 (married/filing jointly), the deduction is limited to the lesser of: (a) 20% of QBI or (b) the greater of (i) 50% of W-2 wages paid by each business or (ii) 25% of W-2 wages paid by each business plus 2.5% of the unadjusted basis of qualified property; wage and qualified property limitations are not applicable to taxable incomes at or below $191,950 (single) or $383,900 (married/filing jointly) and are fully phased in once taxable income exceeds $241,950 (single) or $483,900 (married/filing jointly)

Employer retirement plans

Maximum elective deferral to retirement plans, e.g., 401(k), 403(b)	$23,000
Catch-up contribution limit for 401(k), 403(b), and certain 457 plans	$7,500
Maximum elective deferral to SIMPLE plans	$16,000
Catch-up contribution limit for SIMPLE plans	$3,500
Maximum elective deferral to 457 plans of government and tax-exempt employers	$23,000
Limit on annual additions to defined contribution plans	$69,000
Annual compensation threshold requiring SEP contribution	$750
Limit on annual additions to SEP plans	$69,000
Maximum annual compensation taken into account for contributions	$345,000
Annual benefit limit under defined benefit plans	$275,000
Limitation used in definition of highly compensated employee	$155,000
Health flexible spending account maximum salary reduction contribution	$3,200

Sources: IRS and Social Security Administration updates 2024.

Not FDIC insured | May lose value | No bank guarantee

Tax on capital gains and qualified dividends

Income Single	Married/Filing jointly/Qualifying widow(er)	Tax rate
$0–$47,025	$0–$94,050	0%
Over $47,025 but not over $518,900	Over $94,050 but not over $583,750	15%
Over $518,900	Over $583,750	20%

Additional 3.8% federal net investment income (NII) tax applies to individuals on the lesser of NII or modified AGI in excess of $200,000 (single) or $250,000 (married/filing jointly and qualifying widow(er)s). Also applies to any trust or estate on the lesser of undistributed NII or AGI in excess of the dollar amount at which the estate/trust pays income taxes at the highest rate ($15,200).

Kiddie tax*

Child's unearned income above $2,600 is generally subject to taxation at the parent's marginal tax rate; unearned income above $1,300 but not more than $2,600 is taxed at the child's tax rate.

* Applies if either parent of the child is alive at the close of the taxable year, the child does not file a joint return for the taxable year, and the child either (a) has not attained age 18 by close of the year, (b) has attained age 18 before the close of the year, but the child's earned income represents not more than one half of support needs and the child has not attained age 19 by the close of the year, or (c) the child is a full-time student who has not attained age 24 as of the close of the year and the child's earned income represents not more than one half of support needs.

Preferential rates on long-term capital gains and qualified dividends are applicable; 3.8% federal NII tax is imposed separately on each child if modified AGI exceeds threshold amounts stated above.

Child tax credit

- $2,000 per "qualifying child" (who has not attained age 17 during the year); phased out as modified AGI exceeds $400,000 (married/filing jointly) or $200,000 (all other); $1,700 per child is refundable
- $500 nonrefundable credit for qualified dependents other than qualifying children (with some modified AGI phaseouts)

Standard deductions

	Annual	Additional age 65+ or blind
Married/Filing jointly and qualifying widow(er)s	$29,200	$1,550
Single	$14,600	$1,950

Health savings accounts contribution limits

Individual	$4,150
Family	$8,300

Catch-up contribution: Taxpayers who are 55 or older in 2024 may contribute an additional $1,000, or a total of $5,150 for individuals and $9,300 for families.

Deduction for mortgage interest

- Deduction on interest for qualifying mortgages up to $750,000 ($375,000 if married/filing separately); homes under agreement before 12/15/17 for purchase prior to 1/1/18 (provided purchase occurred by 4/1/18) grandfathered under previous $1,000,000 ($500,000 if married/filing separately) limits
- Interest on home equity lines of credit (HELOC) deductible in certain cases where proceeds are utilized to acquire or improve a residence

Deduction for state and local taxes

Individuals may deduct state and local income (or sales) taxes and real and personal property taxes up to $10,000 ($5,000 if married filing separately) in the aggregate.

Maximum Qualified Long-Term-Care insurance premiums eligible for deduction

Age 40 or less	Age >40, ≤50	Age >50, ≤60	Age >60, ≤70	Age over 70
$470	$880	$1,760	$4,710	$5,880

Traditional IRAs

Maximum annual contribution

- Lesser of compensation or $7,000
- Up to $7,000 contribution can also be made for nonworking spouse
- Catch-up contributions (age 50 and over): $1,000

Traditional IRA deductibility table

Filing status	Covered by employer's retirement plan	Modified AGI 2023	Modified AGI 2024	Deductibility
Single	No Yes Yes Yes	Any amount $73,000 or less $73,001–$82,999 $83,000 or more	Any amount $77,000 or less $77,001–$86,999 $87,000 or more	Full Full Partial None
Married/ Jointly	Neither spouse covered	Any amount	Any amount	Full
Married/ Jointly	Both spouses covered	$116,000 or less $116,001–$135,999 $136,000 or more	$123,000 or less $123,001–$142,999 $143,000 or more	Full Partial None
Married/ Jointly	Yes, but spouse is not covered	$116,000 or less $116,001–$135,999 $136,000 or more	$123,000 or less $123,001–$142,999 $143,000 or more	Full Partial None
Married/ Jointly	No, but spouse is covered	$218,000 or less $218,001–$227,999 $228,000 or more	$230,000 or less $230,001–$239,999 $240,000 or more	Full Partial None

Roth IRAs

Maximum annual contribution

- Lesser of compensation or $7,000
- Up to $7,000 contribution can also be made for nonworking spouse
- Catch-up contributions (age 50 and over): $1,000

Contribution eligibility

Modified AGI is less than $146,000 (single) or $230,000 (married/filing jointly); phaseouts apply if modified AGI is $146,000–$160,999 (single) or $230,000–$239,999 (married/filing jointly).

Deductibility

Contributions to Roth IRAs are not deductible.

Conversion eligibility

There is no income restriction on eligibility for a Roth IRA conversion.

Base amount of modified AGI causing Social Security benefits to be taxable

	Up to 50% taxable	Up to 85% taxable
Married/Filing jointly	$32,001–$44,000	> $44,000
Single	$25,001–$34,000	> $34,000

Maximum earnings before Social Security benefits are reduced

Under full retirement age ($1 withheld for every $2 above limit)	$22,320
Full retirement age and over	No limit*

* Interim annual limit of $59,520 applies for whole months prior to attaining full retirement age during year individual reaches full retirement age ($1 withheld for every $3 above limit).

Maximum compensation subject to FICA taxes

OASDI (Social Security) maximum	$168,600
HI (Medicare) maximum	No limit

OASDI and HI tax rate: 12.4% OASDI and 2.9% HI (15.3% combined) for self-employed; 6.2% and 1.45% (7.65% combined) for employees. An additional 0.9% HI tax imposed on individuals with wages or self-employment income in excess of $200,000 (single and qualifying widow(er)s) or $250,000 (married/ filing jointly).

Death/gifts occurring in 2024*

(subtract applicable credit from calculated tax)

If gift/gross estate is over	But not over	The tax is	Of the amount over
$0	$10,000	$0 + 18%	$0
$10,000	$20,000	$1,800 + 20%	$10,000
$20,000	$40,000	$3,800 + 22%	$20,000
$40,000	$60,000	$8,200 + 24%	$40,000
$60,000	$80,000	$13,000 + 26%	$60,000
$80,000	$100,000	$18,200 + 28%	$80,000
$100,000	$150,000	$23,800 + 30%	$100,000
$150,000	$250,000	$38,800 + 32%	$150,000
$250,000	$500,000	$70,800 + 34%	$250,000
$500,000	$750,000	$155,800 + 37%	$500,000
$750,000	$1,000,000	$248,300 + 39%	$750,000
$1,000,000		$345,800 + 40%	$1,000,000

* Annual gift tax exclusion: individual, $18,000; married electing split gifts, $36,000.

Combined lifetime gift tax and gross estate tax exemption: $13,610,000.

GST tax exemption: $13,610,000.

Higher education tax credits

Modified AGI phaseouts for American Opportunity Tax Credit

Married/Filing jointly	$160,001–$179,999
Others	$80,001–$89,999

Modified AGI phaseouts for Lifetime Learning Credit

Married/Filing jointly	$160,001–$179,999
Single	$80,001–$89,999

AMT exemptions

Single	$85,700
Married/Filing jointly and qualifying widow(er)s	$133,300

Phases out beginning with alternative minimum taxable income over $1,218,700 (married/filing jointly and qualifying widow(er)s) or $609,350 (single filers); AMT ordinary income rate increases from 26% to 28% for alternative minimum taxable income over $232,600 (single; married/filing jointly; and qualifying widow(er)s).

This information is general in nature and is not meant as tax or legal advice. Tax laws are subject to change. Please consult your legal or tax advisor.

Putnam Retail Management

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