Episode 77

Fireside: 10 for ’24—Ten big ideas for 2024

Chief U.S. Economist Lara Rhame joins Andrew Korz to forecast the key macro and market trends for investors in 2024 and review last year’s predictions.

Andrew Korz (00:04):

Welcome to FireSide, a podcast by FS Investments. I'm Andrew Korz, a part of the research team here at FS Investments, and I'm here today with Lara Rhame, our Chief U.S. Economist for the last episode of 2023. Today we'll be discussing what is my favorite of all the pieces you've put out Lara, the 10 for ’24, where you provide us your 10 big ideas for next year. We'll also take a look back and grade our 10 for ’23. Lara, thank you for being with me and happy holidays.

Lara Rhame (00:31):

Happy holidays.

Andrew Korz (00:33):

So let's set the stage real quick here. 2023 was a bit of a forecaster's nightmare. Consensus economic view coming into the year was for a mild recession. Instead, we got GDP growth that will likely be in excess of 3% for the year. The leading indicators that have reliably signaled where the economy is going in the past, such as the inverted yield curve and pessimistic consumer confidence, have been dead wrong this cycle. Interest rates have been incredibly volatile, reacting harshly to shifting market expectations for Fed policy. And looking forward to next year, the economic foundation appears solid, but there are plenty of risks from inflation to the lagged impact of higher rates to geopolitics and a presidential election. The equity market, which enjoyed an incredible year on the back of the magnificent seven now carries a PE ratio near 20 times heading into ’24. Lara, 2023 was certainly not a boring year and given the cross currents I just laid out, I doubt 2024 will be either. So let's start with a brief look back at your 2023 calls and let me just say I think it's admirable that you put out a report card at the end of every year.

Lara Rhame (01:40):

Thank you. Instead of just burying it and pretending like it never happened.

Andrew Korz (01:44):

It would be easy to do that, but you stand your ground and...

Lara Rhame (01:48):

I try to be honest, both good and bad.

Andrew Korz (01:52):

Accountability is important.

Lara Rhame (01:52):

Yeah, there you go. So, hey, I'll take my hard knocks first and point out where I was the most wrong. Because I was one of the many economists who were looking ahead to this year thinking we might have a mild recession. And the reason for that's not too difficult to understand. We had the Fed raising rates, the most aggressive rate hike cycle since the 1980s, and I've been doing this a long time. When I see them raising rates, I would argue 75 basis point clip per meeting is kind of raising rates with your eyes shut. And when I saw the regional bank failures and March, to me that was really like, “here we go.” Our economy wants to grow. And that is so, I always keep that in the back of my mind when forecasting, something has to really happen to make it contract.

(02:38):

And to me, Fed rate hikes, some financial market incident, were kind of the typical blueprint of that. I have never been more happy to be wrong. Nobody ever roots for a recession. So, I think what to your point has been extraordinary is the tailwinds being so strong and growth. Obviously, we don't have fourth quarter GDP yet, but 2023 will probably come in around 3%, even higher. And that is just a really strong pace of growth. So not only were we all wrong, we didn't have a recession, we had blowout really what I would call growth and economy firing on all cylinders. So that was where I was wrong. I think where I was right was on the inflation side. A year ago, our expectation was that this year we would end inflation at 3.5% on the CPI. Well headlines, CPI is 3.1%. This is in November, and core CPI is 4%. So, I feel like that is on target.

Andrew Korz (03:43):

To give you even more credit, the Fed's preferred measure, the core PCE, is it 3.5 right now?

Lara Rhame (03:48):

Right. Yeah. There you go. Thank you. Thank you. So, I think the disinflationary process has made a lot of progress, but I think it's still far too early to declare victory. And that was something that we got really, really right. So there's my look back.

Andrew Korz (04:04):

Yeah, well, I was looking at your report card and the first two grades were A and F, so that's a nice place to start a podcast I think. But you mentioned sort of declaring victory or mission accomplished or however you want to put it. I think some people would argue, and we're recording this here on December 18th, I think some people would argue that that is sort of what the Fed did at last week's FOMC meeting and markets, as they do. Certainly took Fed chair Powell's comments and ran with them. And we're now pricing in something like six or six and a half rate cuts in 2024. And I think as we head into next year looking ahead, this inflation growth policy sort of moving target is still front and center. So I do want to dig into your views for each leg of that stool. Where does inflation go? Are we too sanguine on the path for inflation down to 2%? I think on the equity market side, the equity market is saying we're basically going back to two with very little or no pain to the growth or labor side. And what does that all mean for the Fed's policy? Are they going to be able to cut as much next year...

Lara Rhame (05:14):

As markets think?

Andrew Korz (05:15):

Yeah, as markets think and certainly given your inflation outlook. So tell me how you're thinking about that sort of relationship right now.

Lara Rhame (05:20):

So, digging into the 10 for '24, I think number one, the most crowded trade that is happening now, it's not like being long, the magnificent seven, it's being long a soft landing. I think everybody in the markets now seems to have embraced this view. So my own forecast is for growth to be one and a half percent next year, that's half as strong as this year. It's not a weak growth outcome by any stretch, but it is, let's call that a soft landing. And here I want to stress still, a lot of uncertainty around that. We could very well have a quarter of negative growth. We could still get some downside surprise, and we could also conversely still see this very robust rate of growth. I think we continue to underestimate the tailwinds from the excess savings and the pandemic policies. So let's assume the soft landing is our backdrop, and that's number one, sort of laying out the growth piece of that.

(06:27):

I think number two really digs into the inflation side because to your point, I feel like the market right now really is seeing the inflation picture with rose colored glasses. And the last, let's just take the last CPI report that we got. We still are not seeing rents come down as fast as everybody has been expecting the fed. And I feel like this is where they often make this mistake. They hyper-focused on a piece of data and then that may not work out in the way that they want. And what they have focused in on is this super core measure. I keep thinking of Austin power as like magma. It's like love the hot. Yeah, it's like this super core and this services excluding shelter and that has not been well-behaved over the last several months. It's actually really accelerated. So all that's to say on the good side, we are seeing the deflation.

(07:27):

I think that makes a lot of sense given right sizing of inventories and the fact that we're not buying the houses, so we're not buying the durable goods that we buy when we buy a house, but the services side is a much larger part of our economy. And when I see people saying, oh, inflation's well controlled excluding rents, that to me is absurd. That's like saying the gas is expensive, we'll just exclude the cost of a car. It's kind of the number one ticket item that everybody spends their money on. So the inflation picture to me is more troubling. Hey, it's a lot better now than it was this time last year. And I think going forward to me it's going to be a process of convincing markets that the Fed just does not have as much latitude to aggressively cut interest rates as is currently priced in.

Andrew Korz (08:20):

Yeah, no, I think that's well said. And for me, I mean the interesting thing will be sort of underlying this idea coming from the Fed that they can sort of reduce rates outside of recession is really this idea that as inflation comes down and you leave the policy rate the same, you're unintentionally letting policy get tighter because real rates are implicitly going up. The interesting thing I think will be the Fed knows these lags in the rental inflation data of course, and there's still some of that to come through in 2024. What'll be interesting is sure the official inflation numbers might look pretty benign next year, but to the extent that you still have nominal consumer spending rising at this rapid rate, you have wage growth that's between four and 5%. A lot of these numbers are still not consistent with a long-term, 2% inflation data. So it'll be very interesting to see how the Fed navigates this if the official inflation data cooperates. But a lot of the other things that would maybe sort of pertain to future inflation expectations, we've

Lara Rhame (09:25):

Talked about this through the wage side. I mean, I don't have a page on this, but it is definitely a piece of the inflation picture and wages continue to be persistently higher. And let's face it, the

unemployment rate went right back down to 3.7%. It's not exactly a loose labor market. It's still pretty tight. Yeah.

Andrew Korz (09:44):

So one thing I want to jump to, Laura, is your third point here in your 10 for 24, I think you have this pretty shocking chart showing rate cuts over history and how little context we have for non-res recessionary rate cuts. So walk me through how you think that changes things for markets and for economists

Lara Rhame (10:03):

That's really important and I hope that as you're listening to this, you're able to just take a quick look at that graph because this to me is really critical. We look back since the eighties, we have virtually no, we only have a single example when we were in a non-res recessionary rate cut environment. Typically when the Fed is cutting rates, it's because we're having a recession or about to have a recession. The data is slowing markedly, the fed takes the elevator down, I call it. They really are cutting rates incredibly rapidly and they're really moving fast. A couple of times that it was a non-res recessionary scenario. That was also, for example, the financial crisis around the long-term capital management failure. They cut three times or the beginning of 2019 when we had markets really selling off sharply in high yield markets in distress. But just a plain old, everything's fine, no urgency to cut rates, no recession, soft landing scenario.

(11:06):

We have one example in that one example. The fed funds rate was started at six. They cut three times over the course of eight months and they left rates there. And in fact, the next move after that was a 25 basis point rate hike. I am not saying that this is necessarily my forecast. I think it's important to recognize that the kind of long run rate decline that markets have immediately priced in on the back of this idea that we're going to have rate cuts to me really only applies when you're having a recession. If we take it for granted that we're going to have this soft landing, I think rate cuts become much more surgical. I credit you're the one used that phrase, I love it. I call it the nip and tuck, and I think they start in the second half of the year.

(11:59):

Everyone is now on the back of fed chair. Powell's very dovish comments, pulling forward those expectations a lot. The market's already seeing rate cuts in March. I think I also do not expect these rate cuts to be on autopilot or programmatic. I think they're going to have to be more sort of data dependent. And I really take to heart the fact that following the financial crisis, the Fed was their dot plots were signaling they were going to raise rates. Markets were pricing that into the Fed funds yield curve and yet meeting after meeting after meeting the time wasn't quite right and they kept pushing it off and it took them years to get to that point. We may just be seeing a situation and we've seen it a lot where the market has just gotten overly exuberant around rate cuts. It's hard to imagine, but this time last year, markets were pricing in rate cuts by the end of 2023. So we had 40 basis points of rate cuts priced in for 2023 last year. Markets absolutely can and often do get ahead of themselves. My forecast is for a much of surgical rate cut scenario next year in the second half of the

Andrew Korz (13:10):

Year. And I mean you think about interest rate volatility, which has really been the defining feature of the past, call it year and a half, two years of markets, and judging by what you just said to the extent we don't have a recession, this outlook for rate cuts seems primed to continue to change and shift as the data.

Lara Rhame (13:29):

I think it'll continue to keep the market off balance because we've just seen the tail wagging the dog. We've seen the interest rate complex be the key driver for equities, and I think this last month has been no different. Yeah.

Andrew Korz (13:44):

Okay. So I want to jump to point number six. In your magnum opus here,

Lara Rhame (13:52):

This is an upsetting graph.

Andrew Korz (13:53):

It is it, yeah. So I think one thing that we've all been surprised about and has led to a lot of the economic resilience we've talked about over the past two years is the lack of interest rate sensitivity in the US economy, right? And much of that is because households and companies spent much of the past decade extending the maturity of the liabilities. That's smart, smart than you do, which was very smart. And I would say the government is the only one who didn't do that. And the result has really been that while rate hikes have slowed the flow of activity, if you look at home buying or you look at m and a activity, the impact to sort of the stock of debt just hasn't been there because you've got these long-term fixed rate maturities. And again, the one leg of the stool that really hasn't done a very good job of that is the government.

(14:38):

And of course, as time goes on, you get incrementally more debt that will need to be refinanced. And I think one thing to really watch in 2024 is you do have this uptick in maturities starting in 2024, and then it gets progressively worse over 2025 and 2026. Of course markets are forward-looking beasts, they see that. Just looking at your chart here in 2024, the s and p 500 has about 8% of its total debt coming due, which doesn't seem like a lot, but it's close to 600 billion in the commercial real estate market. We have over 500 billion worth of debt maturing.

Lara Rhame (15:13):

High yield market too is in there.

Andrew Korz (15:15):

The high yield market and loan market have escalating maturities. The treasury would scoff at those poultry numbers,

Lara Rhame (15:20):

Right? Because here you're looking at the treasury and they have got nine and a half trillion, trillion dollars. A

Andrew Korz (15:27):

Third of the total treasury stock has to be rolled

Lara Rhame (15:29):

Next year. Yeah, it is. That is just a staggering number. And only three years ago that number was $5 trillion. So it speaks to the fact that next year is going to be a year where we're all going to start to learn the dynamics of these debt auctions. I don't think that it's a coincidence that

earlier this year when the tenure hit 5%, we had a couple of rough longer term tenure, 30 year treasury auctions where uptake wasn't quite as good as the treasury had hoped for. And they made announcements that they were changing that mix and maturing, rolling more at shorter term rates. And suddenly you had the 10 year rally somewhat and come down. Obviously there were other factors involved there, but at the margin you can't roll the US economies, treasury debt at three month increments. You have to keep some of that longer term issuance going.

(16:28):

And the fed's quantitative tightening is still in process. They made that clear. They are stepping back slowly as the largest purchaser. Global central banks, they're still in the mix, but I think their reserves are more sort of one in one out. They're rolling their debt but they're not absorbing new debt. And you put it all together and you are just going to have a situation where LL sql, long-term interest rates are going to be higher. And I think for that reason, my forecast on the tenure, it's to really maintain the same band that we had last year. We had three and a half to five was code the band of 2023. I absolutely think that could continue in 2024. And I think that that is something that markets do not price in. And this dynamic has not been appreciated,

Andrew Korz (17:17):

Especially to the extent that we don't get a recession. There's no reason to believe that that range can't hold

Lara Rhame (17:21):

Well. And I think this is something that you mentioned off the top, Andrew, the inverted yield curve being such a strong sign of recession, if you buy the Goldilocks soft landing outcome, eventually that yield curve will need to move out of inversion. And I just don't see that happening without long-term interest rates rising. Again, normally in a recession it happens because short-term interest rates get slammed down very sharply. But in this instance, it's more likely to have to be both some of these surgical rate cuts and long-term rates drifting up. And I think that is probably one of the places where I'm off consensus.

Andrew Korz (18:07):

And then on the private side, I mean again, you've got escalating maturities in investment grade, corporate bonds and high yield in leveraged loans and commercial real estate. And so you've got this swell of demand for financing coming at you. And then on the other side, you've got banks that have clearly said in their surveys that they're restrained. There's still risks of deposit outflows given some of the dynamics in their funding rates. And

Lara Rhame (18:34):

Lemme jump back in and also say that the inverted yield curve puts implicit pressure on the banking system. And when I hear about this debt maturing, it's slightly higher interest rates and it's also speaks to some of the headwinds that the economy's going to face next year because business spending has been very robust. We've written a lot about the secular uptrend in business investment, but when interest rates rise and the interest burden increases for companies, they start to need to make a few tough decisions. I think we're still broadly positive on investment in general, but that gets a little more friction when you're facing some of those higher interest rates. And I think, hey, if we end at 2025 with a few rate cuts and long-term interest rates higher, a more normal looking yield curve, the banks will be thrilled. I mean, there are a grumpy bunch going into this coming year with the yield curve today still deeply inverted.

Andrew Korz (19:34):

Yeah, absolutely. And then final point on that, on the equity side, I mean we've talked about the margin expansion over the past decade, roughly half of it has been comprised of just interest rates going down and interest expense going down. So I think even as rates have come down over the past month or two, we still have rates that are well elevated relative to pre covid norms. So to the extent that rates stay here, again, you're going to have this stock of debt recycling itself into higher interest burdens going forward. And look, the reality is we do have this magnificent seven that just, it's a cash guzzling machine. It's capital light business models. So some of these firms may not be as impacted, but the reality is interest expense is going to hit companies bottom lines eventually.

Lara Rhame (20:23):

Well, this is where I'm going to ask you my point number nine is one that we've discussed a lot together, which is the concentration in equity markets being at the highest in 50 years and the extraordinary nature of this runup, what do you see for next year? Let's talk about it together.

Andrew Korz (20:44):

Yeah, I think the complexion of how people are going to view the 2023 stock market has changed a bit over the past, call it month, month and a half for much of the year. The story was very obvious. It's what I just mentioned, the magnificent seven. These seven giant tech names were really the only thing driving the market higher. You had the AI narrative, obviously you had depressed valuations coming into the year and you had admittedly just incredible fundamentals at a lot of these companies. So I think as rates have come down over the past couple months, that's changed a bit. Yes, the magnificent seven is still at more than a hundred percent year to date. It's incredible. That hasn't changed. And I have a stat that of all of the market cap that's been added to global stocks, all global stocks this year, half of that has been from seven companies, 5 trillion added

Lara Rhame (21:30):

In wealth, $5 trillion. That's just

Andrew Korz (21:32):

Unbelievable. Incredible. But more recently, as rates have come down, you've gotten some support from the more cyclical parts in the market and now you've got not just a market that's expensive because of seven companies, but you've got a market that's expensive. Full stop. One thing I did coming into this podcast, I broke out all the sub industries in the US market. There's about 60 of them. I looked at their valuations relative to their own history, their PE ratios. And if you take all the industries where valuations are in the top quartile of its history, that is about 67% of the US market cap. So two thirds of the US market cap is valued in its top quartile. This is not just seven companies anymore. It's the majority of the market. If you look back two months ago, that number was only 46% less than half. So things have changed a lot

Lara Rhame (22:23):

Rates. Broader participation. Broader

Andrew Korz (22:24):

Participation in high valuations. Absolutely. What this tells me is that a scenario in which inflation comes all the way back down to 2% with a minimal hit to growth or the labor market is pretty much fully priced in here. That's

Lara Rhame (22:37):

What we've been hearing for a long time. Now it's price for perfection.

Andrew Korz (22:40):

I just don't know if that was true. If you looked at sort of the s and p 500 x magnificent seven, it was for a while there priced below where it was pre covid. We

Lara Rhame (22:50):

Can look back back. I like the first three months of the year was really

Andrew Korz (22:53):

Lagging

Lara Rhame (22:54):

Significantly.

Andrew Korz (22:54):

Absolutely. And really, if we're sort of looking at things on what's the starting point going into the new year, I think that starting point has gotten a lot worse. Obviously people have reaped the gains and it doesn't matter whether gains come in 2023 or 2024, but as we look into next year, that starting point is just really challenging. The VIX is at 12, that's the lowest it's been before. So again, as we look into next year, I think you'll need a new catalyst and maybe you'll get one, but the reality remains that the market is priced at almost 20 times forward earnings. So the bar is just really high for returns from here, and I think it's very unlikely. This is what we show on the right hand chart on the equity slide here. It's very unlikely to get the same tailwind on the fundamental side from the Magnificent seven specifically because you look at this, I mean, you had 60% free cashflow growth from those seven companies. There's no wonder they're up a hundred percent.

Lara Rhame (23:46):

Yeah, yeah, yeah, sure. Next

Andrew Korz (23:48):

Year the outlook is not nearly as good.

Lara Rhame (23:50):

I think you hit an important point there. It's not that we're expecting some terrible deterioration of fundamentals. Are the conditions going to be ripe for these multiples? And that is where I think interest rates really matter a lot more than people expect. Yeah,

Andrew Korz (24:06):

I think that's right. That's

Lara Rhame (24:07):

Right. Alright, let me finish this off. Please do with the last, my number 10, which I wrote because this is a question that I've been getting all the time from many investors, from their clients. This was the question, if I can get 5% in a cd, why would I do anything else? That was the question. And you can answer this question through the lens of the economy, through the lens of investing equities risk. I think here's something that I'll start us off on the economic side. That's a smart question to ask. Let's just level us up there. Very logical. It's a very logical

question because you should be holding more cash if cash is yielding 5%, then when cash was yielding zero. I mean, that just makes all the sense in the world. I think we have to recognize that even though five percent's the highest you got out of CD in 20 years with inflation today at 4%, that 5% isn't as much as you think it is.

(25:11):

It's only a hundred basis points of real return. So that's point number one. This narrative of persistently higher inflation means that this CD is not going to get you as much return as you expect as you think. And I think one thing that we're learning from the Fed, this 5% is also likely a high watermark going forward. It's going to less of a return. I think it's also important to recognize that if you burrowed in at 5% this past year, you missed a lot. You missed a lot of returns, you miss growth and you miss out on income. And I think it's the income piece that I also want to really focus on because you look at leveraged loans this year up, what, 12% high yield, up 13%. You look at private credit, which is yielding 12%. There is an important allocation story here because when you divide, what we try to do for our clients, the growth, the income, the diversification, none of those are satisfied by just money completely in that cd.

(26:25):

Which again, I understand why that seems like an easy, there should be an easy answer of yes and why I strongly push back against that. I think finally recognizing that diversification has been such a problem with stocks and bonds and that we still are seeing a very high correlation between those two. Back in the day, if you were just earning 5%, but equities were going up a lot, that 5% on the fixed income side seems like it would be pretty good today. I think totally piggybacking off of your conclusion, today's a tough entry point for equities and that's why you need to rethink this allocation and look for growth somewhere outside of this extremely expensive publicly traded market.

Andrew Korz (27:15):

And I think what makes cashflow attractive, I mean, A, you're not taking any duration risk, so you're not really subject to the incredible swings and long run rates that we've seen. And number two, you're getting exposure to the short end of the yield curve, which is the most attractive part of the yield curve right now. So you can get both of those things in other parts of the market though. You can get it in loans, you can get it in private credit, different areas of private credit. So I think to your point, I mean, you can sort of take all those advantages that you're getting from investing in cash and you can move up the risk spectrum a little bit and get more return.

Lara Rhame (27:51):

Which makes a lot of sense if you buy into the non-recessionary backdrop. I mean, I think that's really a key point because the fundamentals of the U.S. economy continue to look solid, even if growth is likely going to be slower in the coming year than it was last year. Yeah.

Andrew Korz (28:06):

Alright. Well, Lara, I think we'll leave it there.

Lara Rhame (28:08):

Thank you.

Andrew Korz (28:09):

Thank you so much for coming by and taking an honest look back at your 2023 calls and giving us your forecast for 2024.

Lara Rhame (28:16):

Well, I hope everyone takes a look at this. We'll certainly be back next year to have this same conversation all over.

Andrew Korz (28:21):

We will be back. Absolutely. Happy holidays everybody.

Lara Rhame (28:23):

Happy holidays.

Lara Rhame (28:27):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by the investment research team. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.