YANKE FINANCIAL

5540 Centerview Dr, Ste 200 | Raleigh, NC 27606
919-306-5811 | Toll-Free: 800-513-2812 | Fax: 919-375-2303
patrick.yanke@yankefinancial.com
www.yankefinancial.com

YANKE FINANCIAL, LLC NEWSLETTER WINTER 2024

Patrick H. Yanke, CFP®
Branch Manager

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Further into the Unknown

Great Diversity of Opinion… Again

As I sit down to write this newsletter, I once again feel the need to point very specifically to the date. As rapidly as things are changing in this environment, much of what I say here could already be old news by the time this is published. Quite honestly, that's one thing plaguing the markets… a rapidly changing environment. Markets tend to like certainty over uncertainty. There isn't much certainty to be found these days. Those with a doom-and-gloom outlook can find economist predictions to meet their outlook… and so can the Pollyannas. We're only going to know for sure in hindsight.

Market Perspective

The U.S. economy saw impressive resilience last year, with the first three quarters showing above trend real GDP growth. Easing inflation and improved prospects for growth have helped fuel optimism for a soft landing. However, a quick look across each sector of the economy tells us that economic momentum in the year ahead is set to be moderate, at best.

We enter 2024 with a similar outlook from the start of 2023. Volatility is a defining feature with higher interest rates and inflation, multiple wars, and recession fears—and let's add a presidential election, too! Inflation may be easing, the Fed may change course, and much of the expected weakness in economic growth may already be reflected in market valuations.

Soft Landing or the Edge of Recession?

Business spending held up better than expected last year despite tighter lending standards, supported by increased spending on intellectual property with greater emphasis on building and integrating artificial intelligence capabilities. Tailwinds from AI spending as well as federal government support for semi-conductor manufacturing should persist in 2024. However, increased caution among lenders and slowing corporate profits could still constrain growth in capital expenditures.

Consumers have remained resilient, supported by a tight labor market and rising real wages. That said, there are some signs of weakness. While revolving credit as a share of disposable income does not look overextended, delinquencies are rising, and younger households are showing signs of increased financial stress. As labor market conditions continue to loosen and lending standards remain tight, consumer spending should grow at a slower pace from here.

The housing market appears to have stabilized, albeit at low levels, as tight housing supply and steadying mortgage rates are signaling that the worst may be behind us. Trade should be a mild drag on the economy as a still-strong dollar and sluggish global growth weigh on exports. Meanwhile, the rate of growth of government spending may slow during this election cycle but there are few calls for fiscal sanity in Congress as the debts continue to mount.

Overall, the U.S. economy should continue to grow at a moderate but slowing pace from here. That said, a slower-moving economy will be increasingly sensitive to shocks. Whether it be the U.S. election, higher policy rates, significant geopolitical tension or something else entirely, the risk of recession in 2024 isn't zero.

Labor Markets

After a red-hot labor market sent wages higher and brought unemployment down from a pandemic peak of 14.7% to a 50-year low of 3.4%, the labor market is now getting back to normal. Unemployment remained at 3.7% in November, despite swift declines in job openings, and has hovered between 3.4% and 4.0% since December 2021. However, cooling labor market conditions are evident in private sector wages, which have moderated from a peak of 5.9% y/y growth in March 2022 to 4.0% in November. While still above its long-term average, wage pressures are receding with quits falling and businesses reeling back hiring efforts in the face of slowing consumer demand. Moreover, while strikes have made headlines in the last year, less than 6% of the private sector workforce is represented by a union, down from over 20% in the 1980s.

On balance, wages shouldn't contribute to higher inflation in the absence of a recession and unemployment could remain stable. U.S. businesses still face structurally slower labor force growth than in prior decades, with Census projections showing the population aged 18-64 will rise only 0.1% in 2024. Tight labor markets could encourage more immigration or further gains in labor force participation, but excess capacity may be limited.

Overall, a combination of subdued job growth and slowing wages should give the Federal Reserve further confidence that inflation is sustainably coming down.

Earnings Growth Slowing

Resilience in the U.S. economy has also been shared by Corporate America with earnings growth surprising on the upside last year. Revenues were the largest contributor to earnings, with consumer strength and pricing power allowing companies to boost sales. Margins, however, have detracted from earnings as companies grappled with higher input and labor costs. Still, companies have been active in defending margins by cutting costs and adopting more efficient digital capabilities, helping margins stage an impressive recovery in the third quarter.

Looking to 2024 and 2025, expectations for double-digit earnings growth seem too optimistic as defending profit margins will become increasingly difficult in an environment of slowing economic growth and waning pricing power. However, high-quality companies with strong balance sheets, ample cash balances and sustainable earnings should perform well relative to the broader index.

Inflation

After inflation reached 50-year highs in 2022, the inflation heatwave met a cold front in 2023. Headline CPI eased to 3.1% y/y in November, well below the 9.1% peak reached in June 2022. While still above the Fed's target, underlying components of inflation provide some confidence the downtrend has room to continue.

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Continued from the front:

Core goods prices trended lower in 2023 as supply chain distortions related to the pandemic and Russia's invasion of Ukraine continued to fade. Meanwhile, the more volatile components, mainly energy and food prices, also provided an important source of disinflation amidst slowing demand. Absent any supply shocks or unexpected surges in demand, these categories should continue their descent in the coming months. Lastly, shelter inflation, which accounts for a third of the CPI bucket, is predictably falling as the rollover in market rents gradually flows through the data.

The remaining problem for inflation, therefore, is core services prices outside of housing, which the Fed has honed in on when referencing persistent inflation. However, as shown on the right-hand side of this slide, inflation in this measure is mostly driven by "transportation services," which includes auto insurance and auto repair costs. Going forward, the rollover in vehicle and auto part prices should feed through to this category and, combined with easing wage pressures and cooling consumer demand, services inflation should fall further in the year ahead.

Overall, inflation made impressive progress towards more normal levels in 2023. While we are not quite back to the Fed's target, 2% inflation by the middle of 2024 is attainable even without a recession. This should give the Fed assurance that inflation is under control as they debate easing policy.

The Fed

The Federal Reserve has hiked rates by a cumulative 5.25% since the beginning of 2022 to combat inflation. However, with inflation steadily trending towards their 2% target and labor market conditions easing, the July rate hike may be the last of this cycle. At their December meeting, the Fed voted to leave the federal funds rate unchanged at a target range of 5.25%-5.50% and strongly hinted that rates are at their cycle peak. Fed Chairman Powell did not push back against easing financial conditions or the idea of rate cuts, as he has done in the past, and forward guidance was decisively dovish.

Specifically, the Fed's "dot plot" suggested that rate cuts may occur faster than initially expected, with the median FOMC member expecting a year-end federal funds rate of 4.6% in 2024, implying three cuts this year. Updates to the Summary of Economic Projections showed lower inflation forecasts for 2023, 2024 and 2025 without material revisions to the growth or employment forecasts. With these revisions, the Fed is acknowledging that inflation is falling faster than expected and appear to be forecasting a soft-landing scenario.

Overall, the Fed is likely at the end of its hiking cycle, which means investors are now more interested in the timing and extent of eventual rate cuts. If the economy remains afloat, the Fed may only deliver minor policy cuts. However, if the U.S. economy enters a recession, the Fed may be forced to cut rates more aggressively to try and stimulate the economy. Either way, it is increasingly likely that rates will move lower in the year ahead, but they may settle at a higher level compared to previous policy easing cycles.

Global Economy

Despite the negative headlines, the global economy proved to be more resilient than expected in 2023, but some countries clearly did better than others. The Eurozone, UK, Canada and China struggled, while the U.S., Japan and emerging markets outside of China were stronger, as evidenced by their composite PMIs remaining above 50 for much of last year.

In China, depressed consumer and business confidence continues to challenge growth, while the full effects of stimulus measures from policymakers have yet to be realized. China's weakness also spilled over to Europe, which is similarly experiencing weak domestic consumption and elevated manufacturer pessimism. Activity is now showing signs of stabilizing, albeit at low levels, and there is hope for a modest reacceleration in Europe as falling inflation boosts real incomes. Elsewhere, India continues to see strong growth, supported by its growing middle class and government support for private businesses and digitalization.

Global growth should be less divergent in 2024, with the US economy slowing down and China's economy stabilizing. However, the key question is how much this gap will close, and whether it is driven by a U.S. slowdown or a pickup in overseas growth.

Fixed-Income Markets

In bond markets, volatility was a defining feature of 2023 as investors grappled with resilient economic data, a hawkish Fed and various technical factors. The yield on the 10-year Treasury climbed by nearly 170 bps from early April to late October, before expectations for a soft landing and an end to tightening helped drive the yield lower by more than 100 bps in less than two months. Even with this move lower, current yields across the fixed income landscape still offer investors much better income and total return opportunities than existed a year ago.

My Greatest Concern

The Federal Government is now borrowing 28 cents for every dollar spent. Interest payments are now 11% of the overall budget… and rising. The worst part is that there is no end in sight where the government slows the rate of debt accumulation—in fact, future projections show it accelerating! As the debt grows (and is financed at higher interest rates) interest payments take over more and more of the Federal budget. At some point, there must be a return to fiscal sanity or the Federal government will be budgeting primarily to pay interest.

When we consider that the very dollars in our pockets are checks written and backed up by the US Treasury, we can appreciate the risk when government finances spiral out of control—every aspect of American life will be affected. We aren't quite there yet… but the trend lines need to change.

Summary

My long-term outlook favors equities over bonds—just don't expect higher than average gains this year. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a rising interest rate environment. Equities are my recommendation for a 10-year outlook. Balance is in favor.

Take the long view with your investment assets and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.
