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Independent Investment Strategy

Five Keys For Investment Success In 2024 And Beyond

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Top Takeaways

- The last decade does not provide a good investment framework for the future.
- Interest rates will be higher for longer.
- Lower U.S. equity returns are inevitable.
- Don't ignore opportunities outside the U.S.
- The 60/40 portfolio is still relevant.

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Don’t Think Last Decade Was The Norm

- The hangover from the bursting of the housing and credit bubble in 2008-2009 was intense and lasting.
- Households spent most of the 2010s fixing their balance sheets and reducing debt, a reversal of prior decades.
- As a result, consumer spending growth was much weaker over the decade, especially in the first half.
- Subpar consumer spending growth also helped suppress inflation.
- It wasn’t “secular stagnation” as some said, it was a deleveraging cycle. This former headwind has ended.

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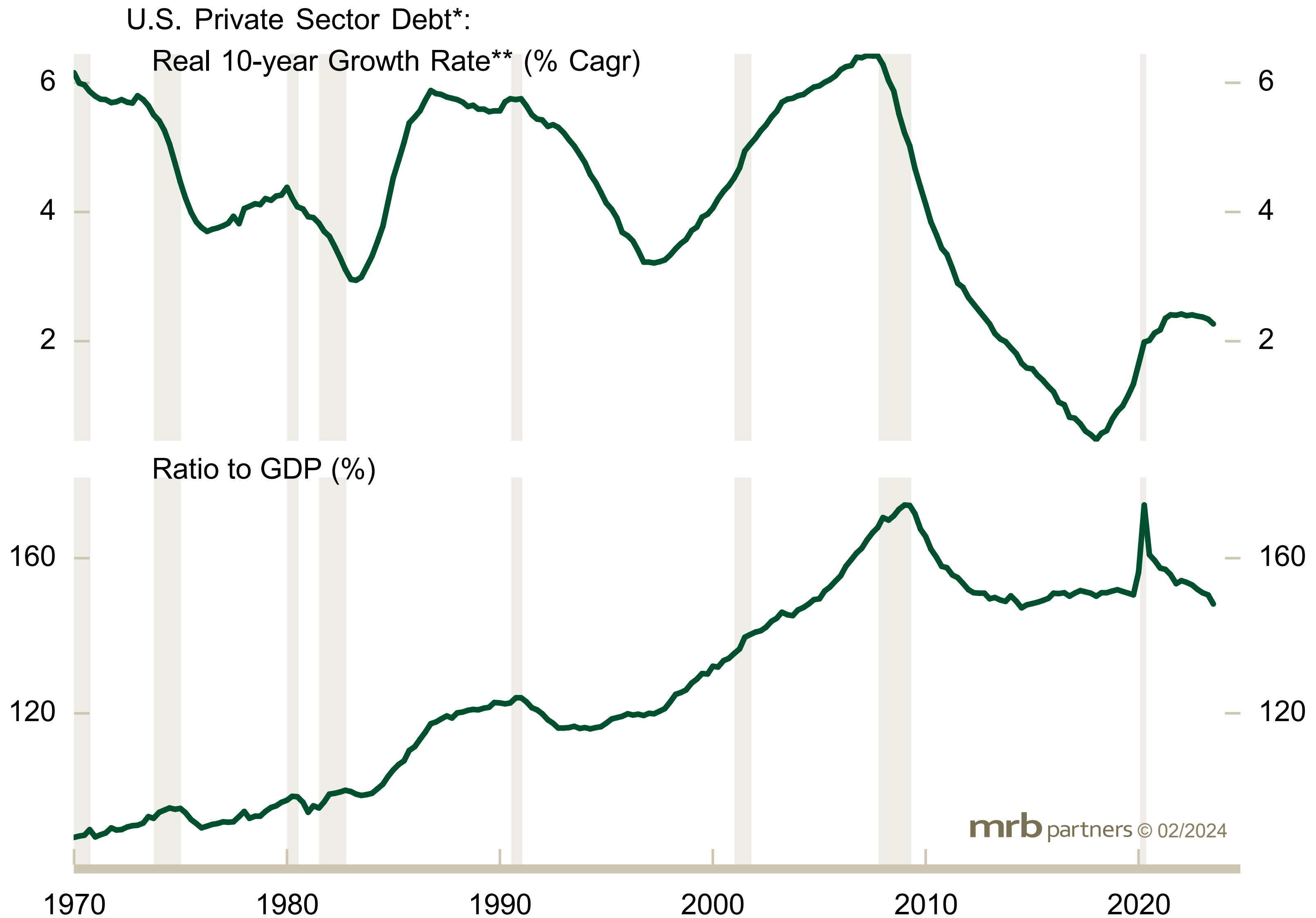
The 2000s Debt Binge Was Followed By A Bust



* Household and business sectors; source: Federal Reserve

** 10-year compound annual growth rate; sources: Federal Reserve and Bureau of Economic Analysis

Note: Shaded for NBER-designated U.S. recessions

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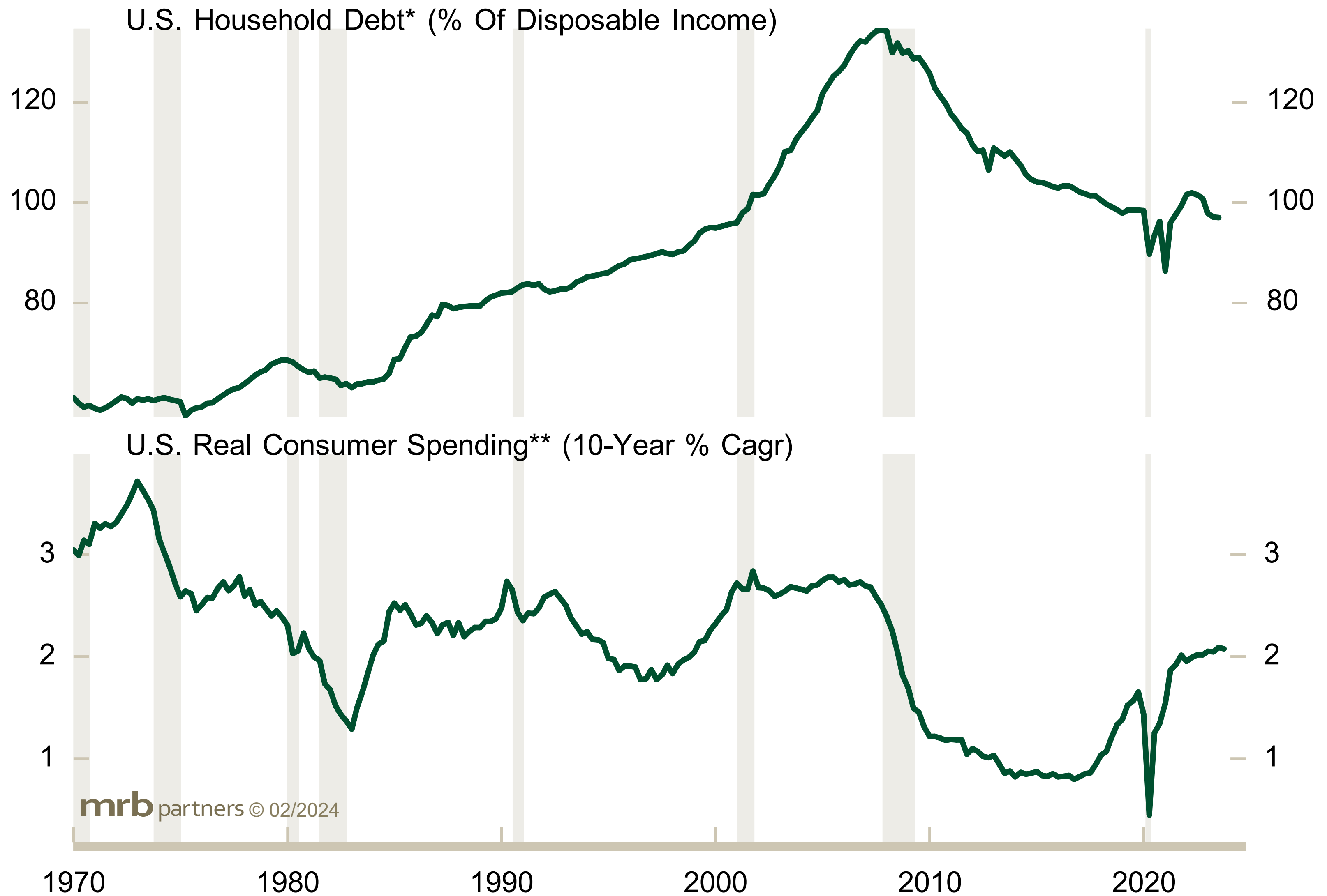
Consumers Are Normalizing After Last Decade's Deleveraging



* Sources: Federal Reserve and Bureau of Economic Analysis
** 10-year compound annual growth rate; source: Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

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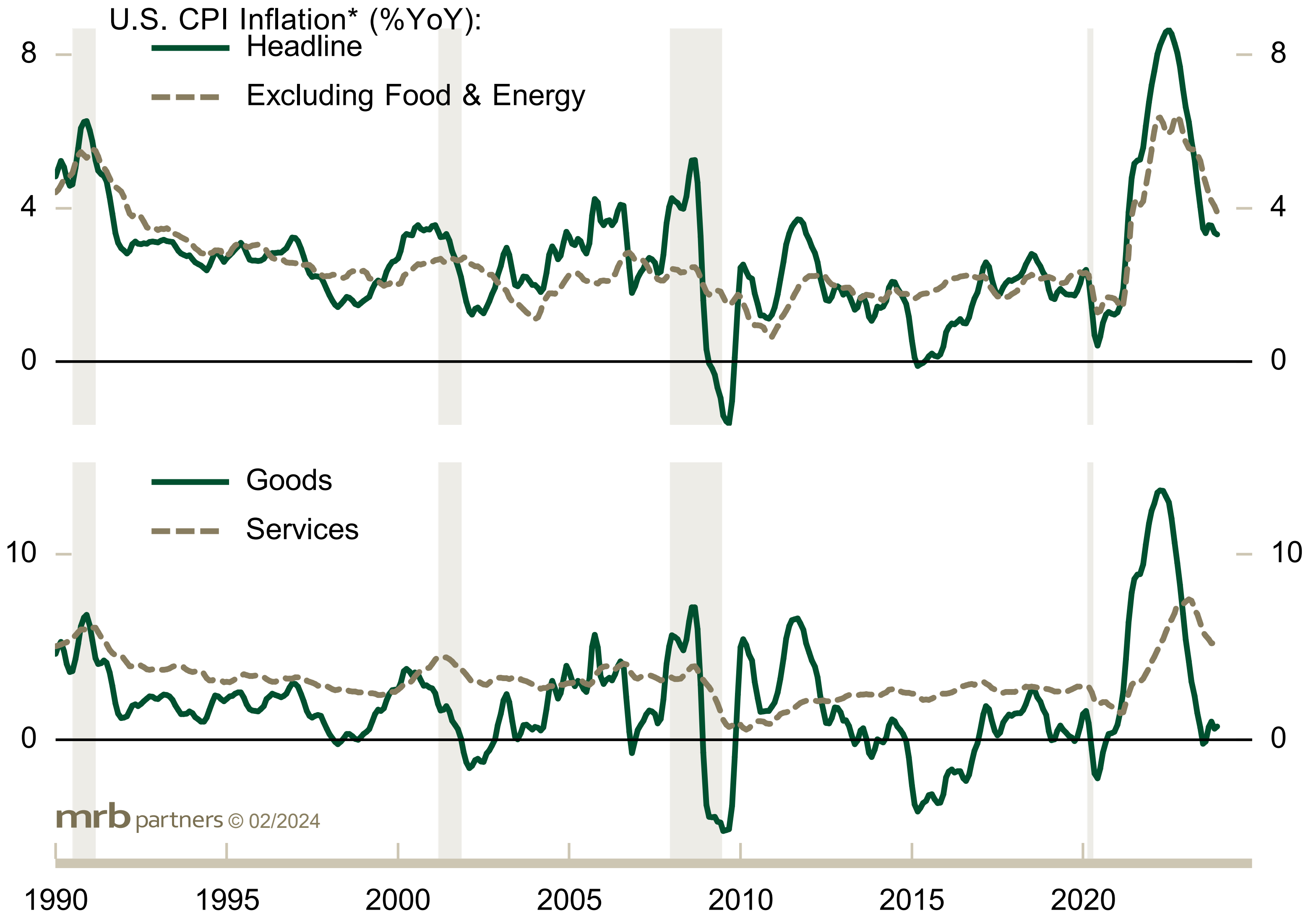
Inflation Has Retreated, But The Battle Is Not Yet Won



* Smoothed; source: Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

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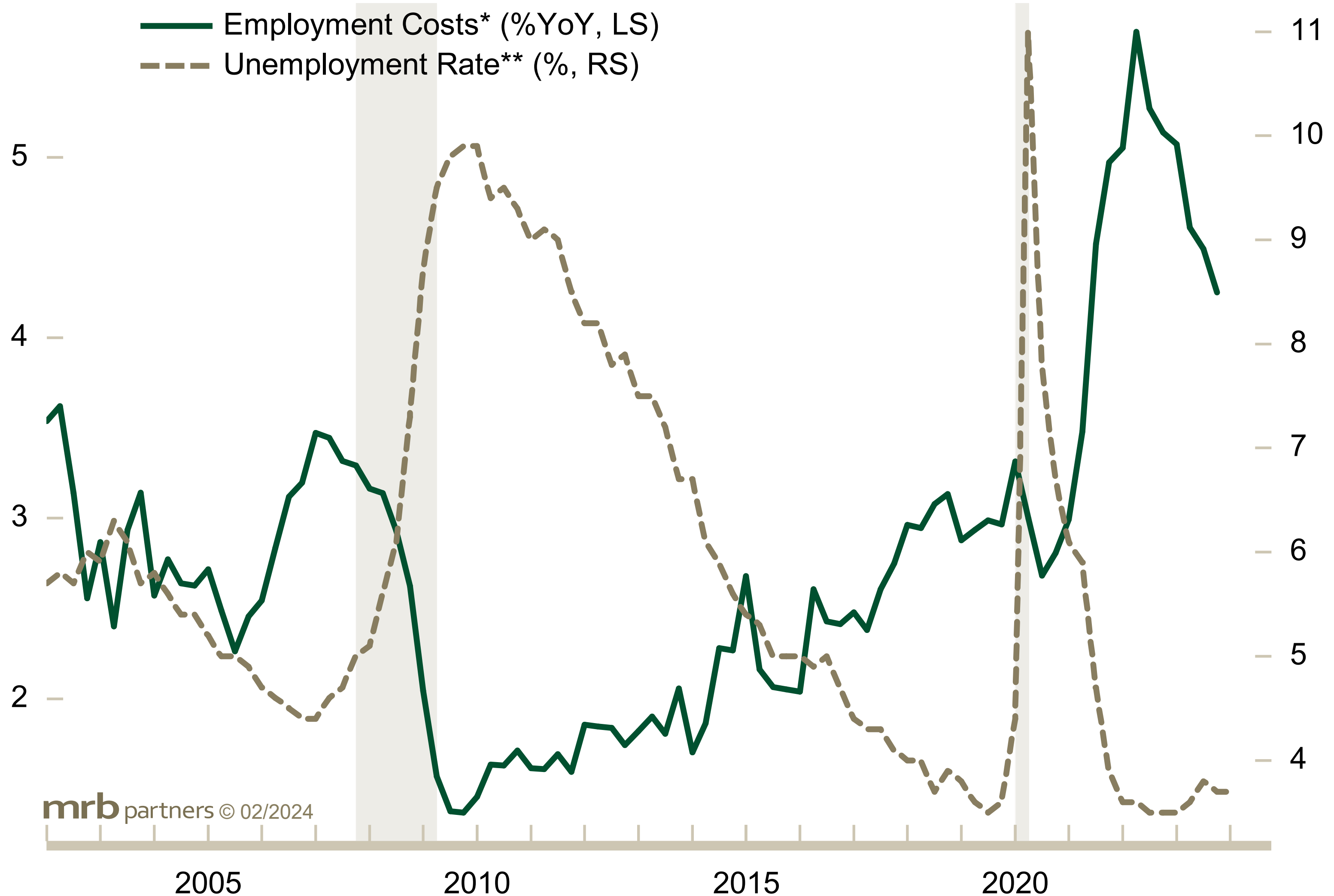
A Tight Job Market = Persistent Wage Pressure



* Employment cost index for private sector wages and salaries; source: Bureau of Labor Statistics
** Source: Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

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This Is A Different Economic And Investment Climate

- Economic growth will be stronger this decade than last.
- Inflationary pressures and risks will be greater.
    - No or less economic slack (unemployment rate is very low).
    - De-globalization is inflationary.
    - Large fiscal deficit/debt easier to manage politically with higher inflation.
    - Populism and redistribution pressures raise inflation risks.
- Accordingly, interest rates will be higher on average.

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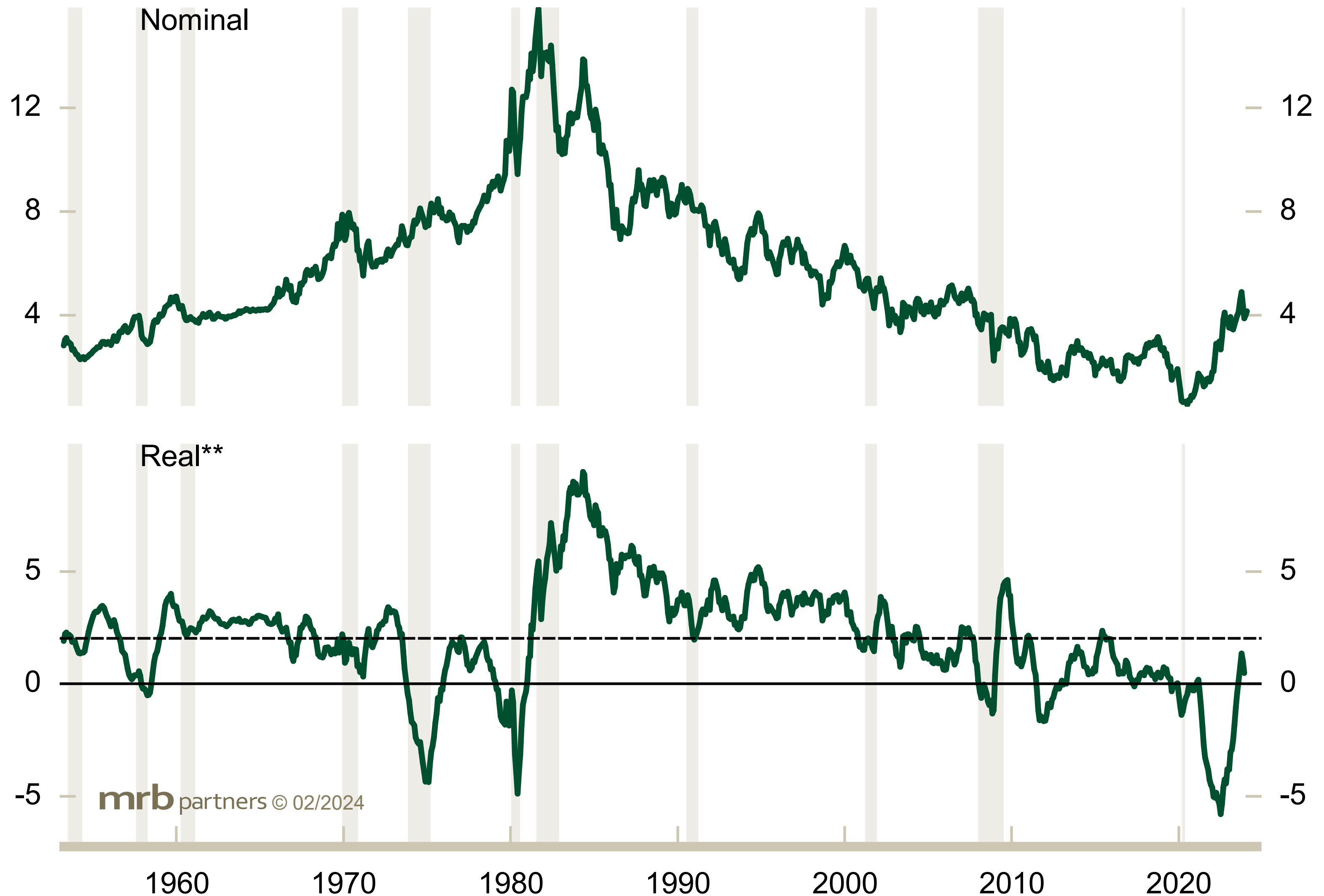
Don’t Expect A Return To The Low Yields Of Last Decade



* Source: Federal Reserve
**Nominal yield minus 6-month average of CPI annual inflation rate; source: Bureau of Labor Statistics
Note: --- in panel 2 is period mean; shaded for NBER-designated U.S. recessions

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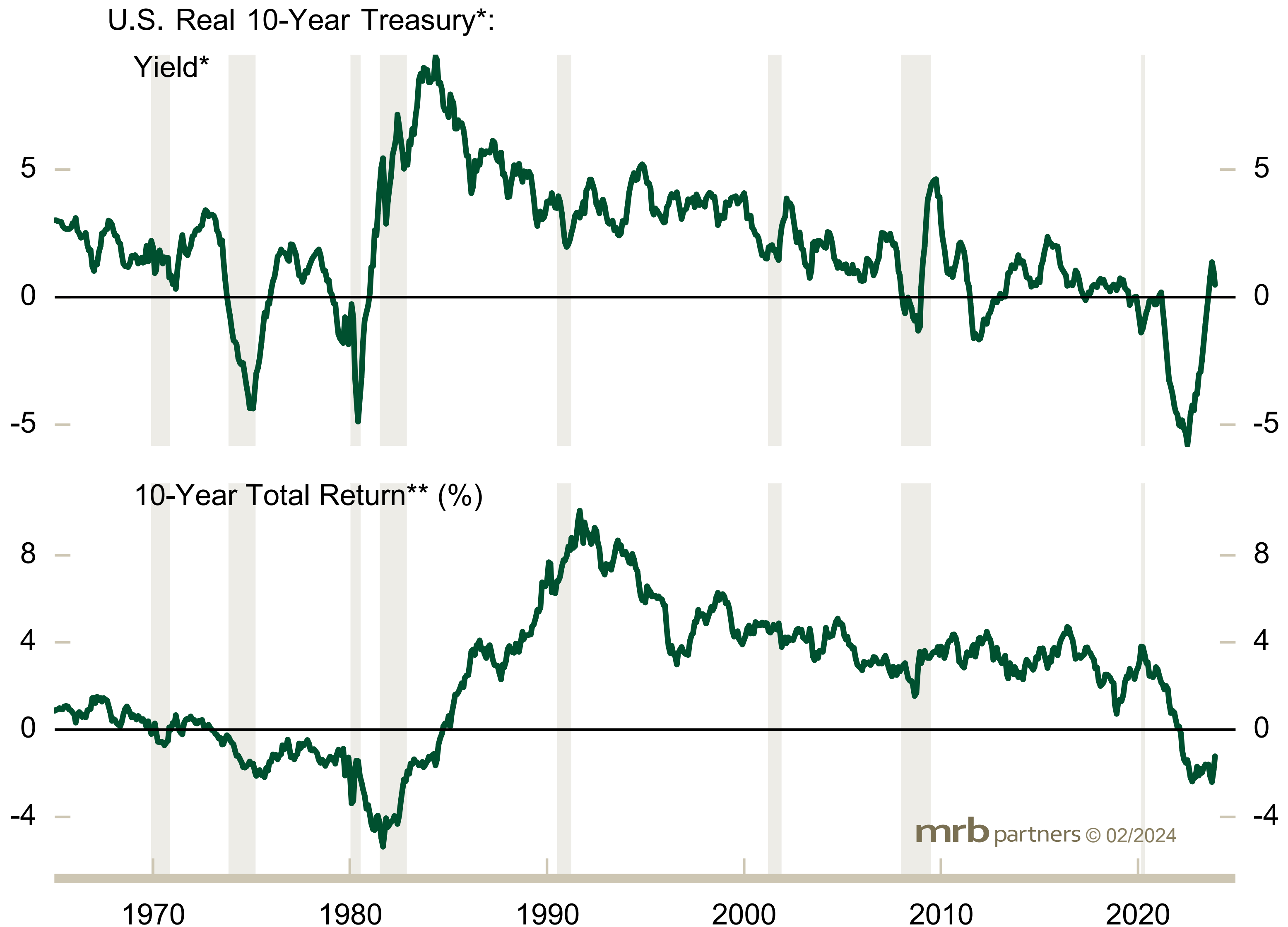
Higher Real Yields Today = Higher Real Returns In The Future



* Nominal yield minus 6-month average of CPI inflation rate; source: Federal Reserve, Bureau of Labor Statistics

** Compound annual return

Note: Shaded for NBER-designated U.S. recessions

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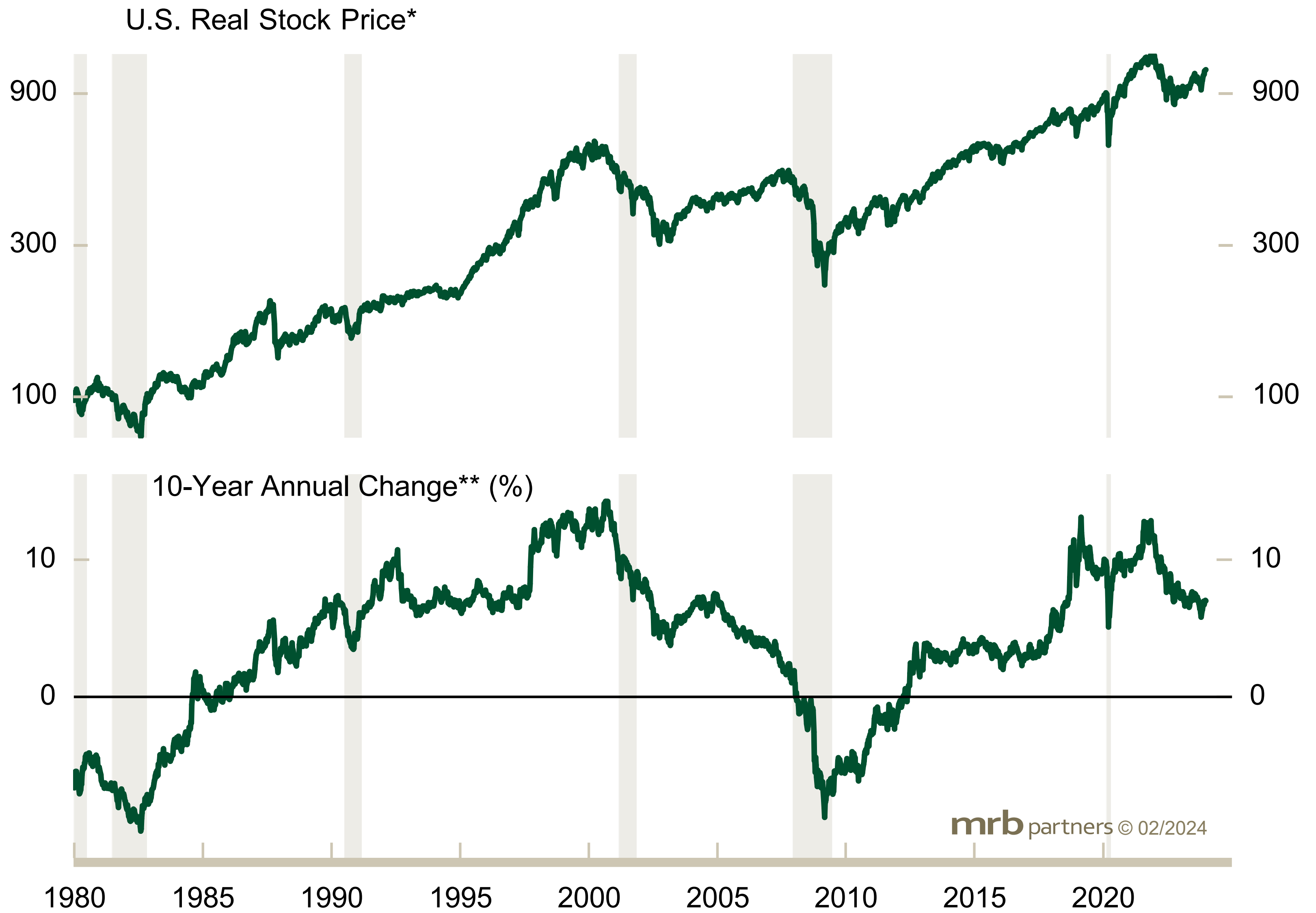
Lower U.S. Equity Returns Loom



* Deflated by CPI; rebased; sources: MSCI and Bureau of Labor Statistics

** 10-year compound annual growth rate

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Several Tailwinds For Stocks Will Fade Or Reverse

- **De-Globalization:** Companies will find it tougher to shift production overseas to cut costs and to open new markets.
- **Labor Income:** Corporate profits are historically elevated relative to labor income, with pressure for change.
- **Corporate Taxes:** The corporate tax rate has fallen steadily in recent decades, but there is limited scope for it to fall further.
- **Technology Earnings:** Profitability and growth in the tech and tech-related sectors is extraordinarily high and will be difficult to sustain.

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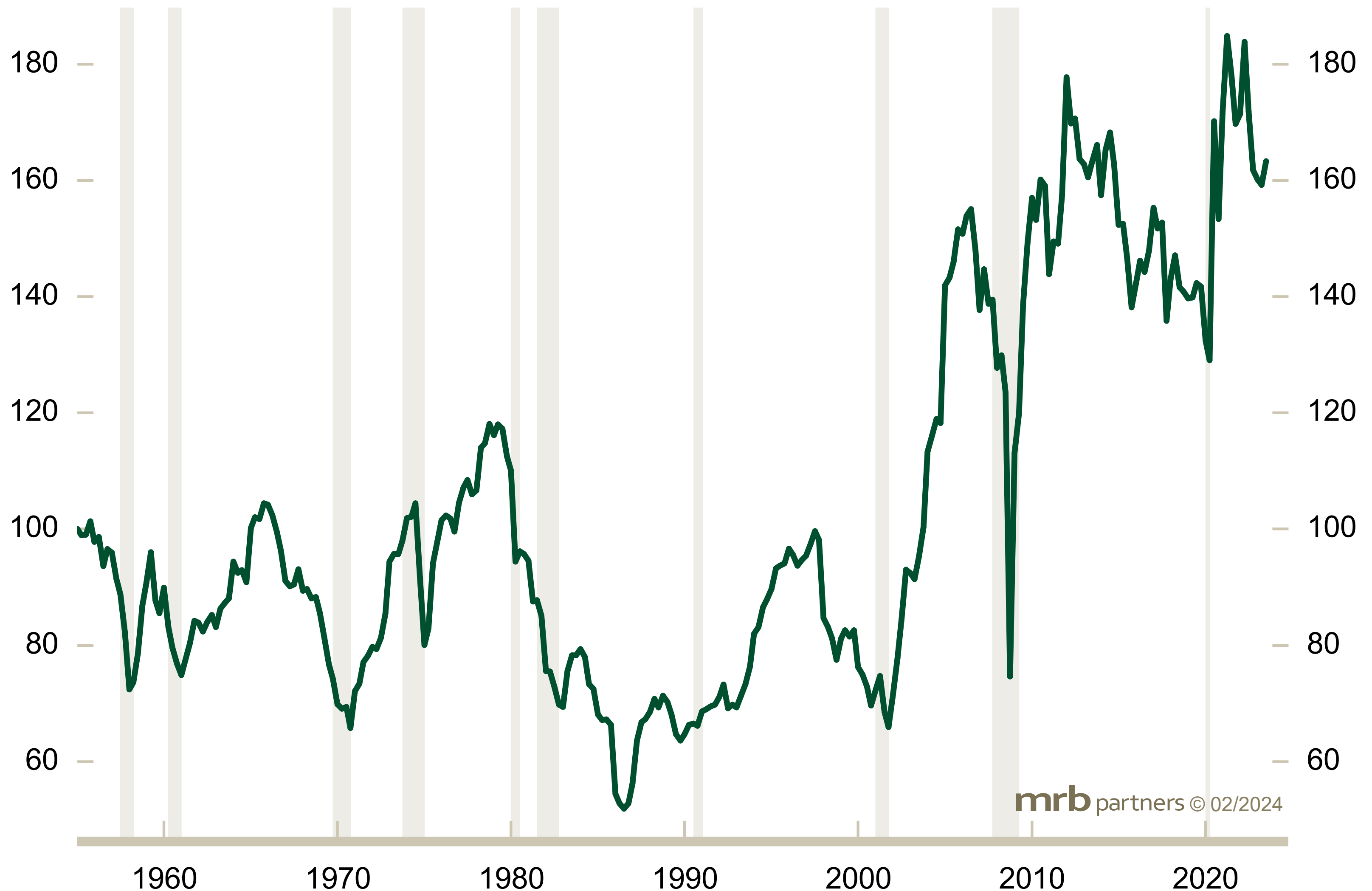
Profits Have Risen Dramatically Relative To Labor Income



* Corporate profits after tax divided by employee compensation; rebased; source: Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

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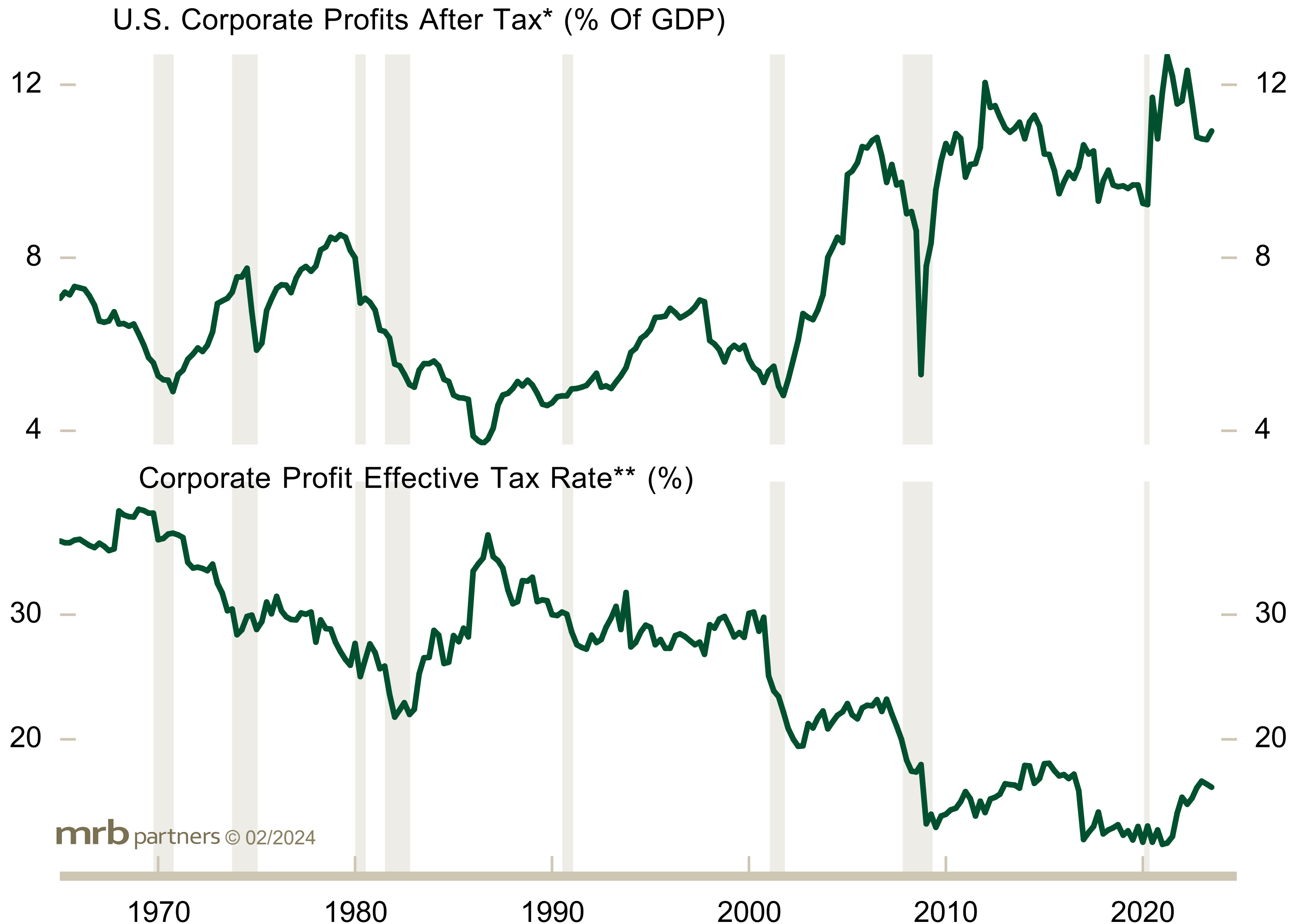
Little Scope For Lower Taxes To Boost Corporate Profitability



* Source: Bureau of Economic Analysis
** Source: Tax Policy Center
Note: Shaded for NBER-designated U.S. recessions

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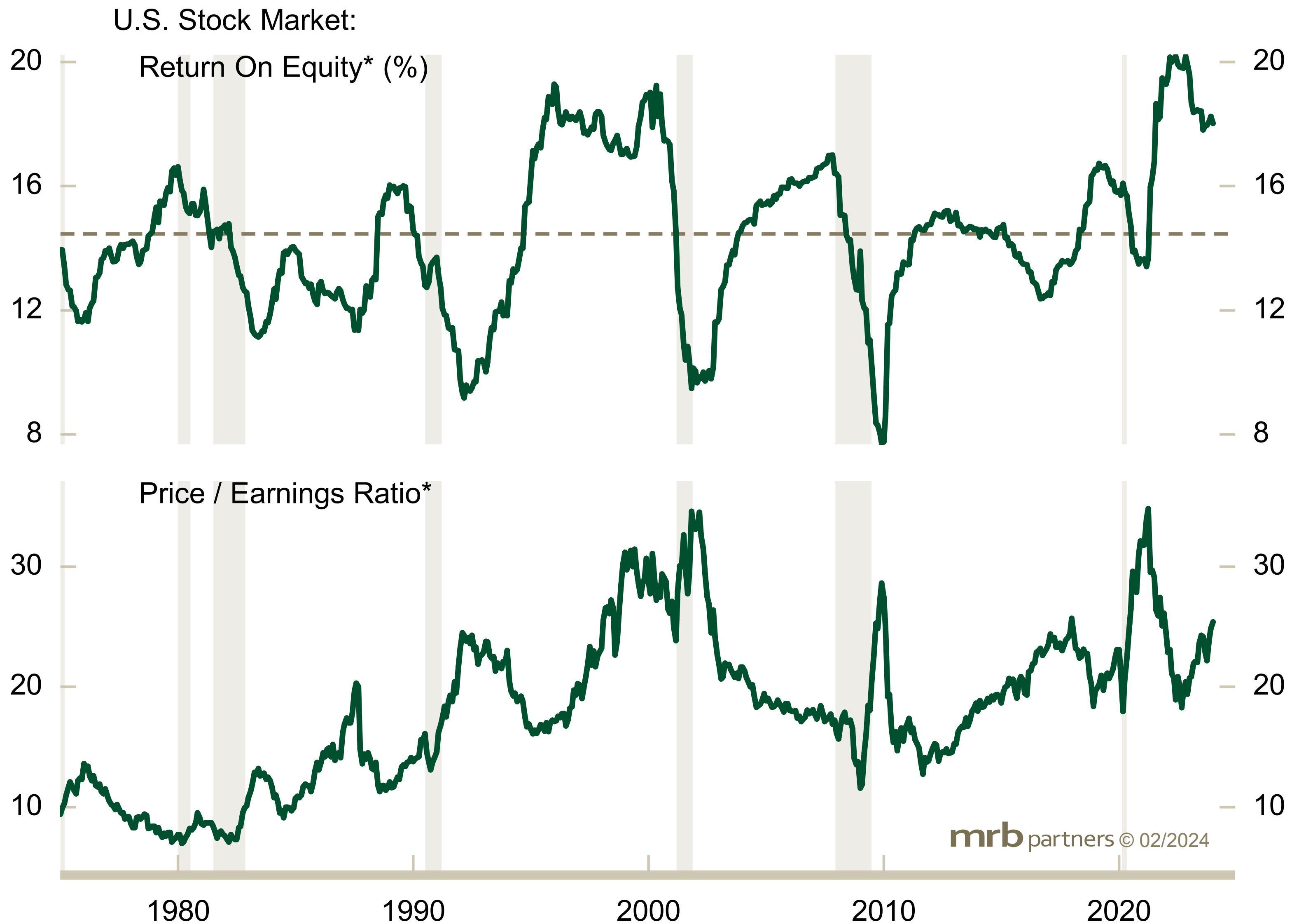
Elevated Profitability & Valuation Are Headwinds For Prospective Equity Returns



* Source: MSCI
Note: --- in panel 1 is period average

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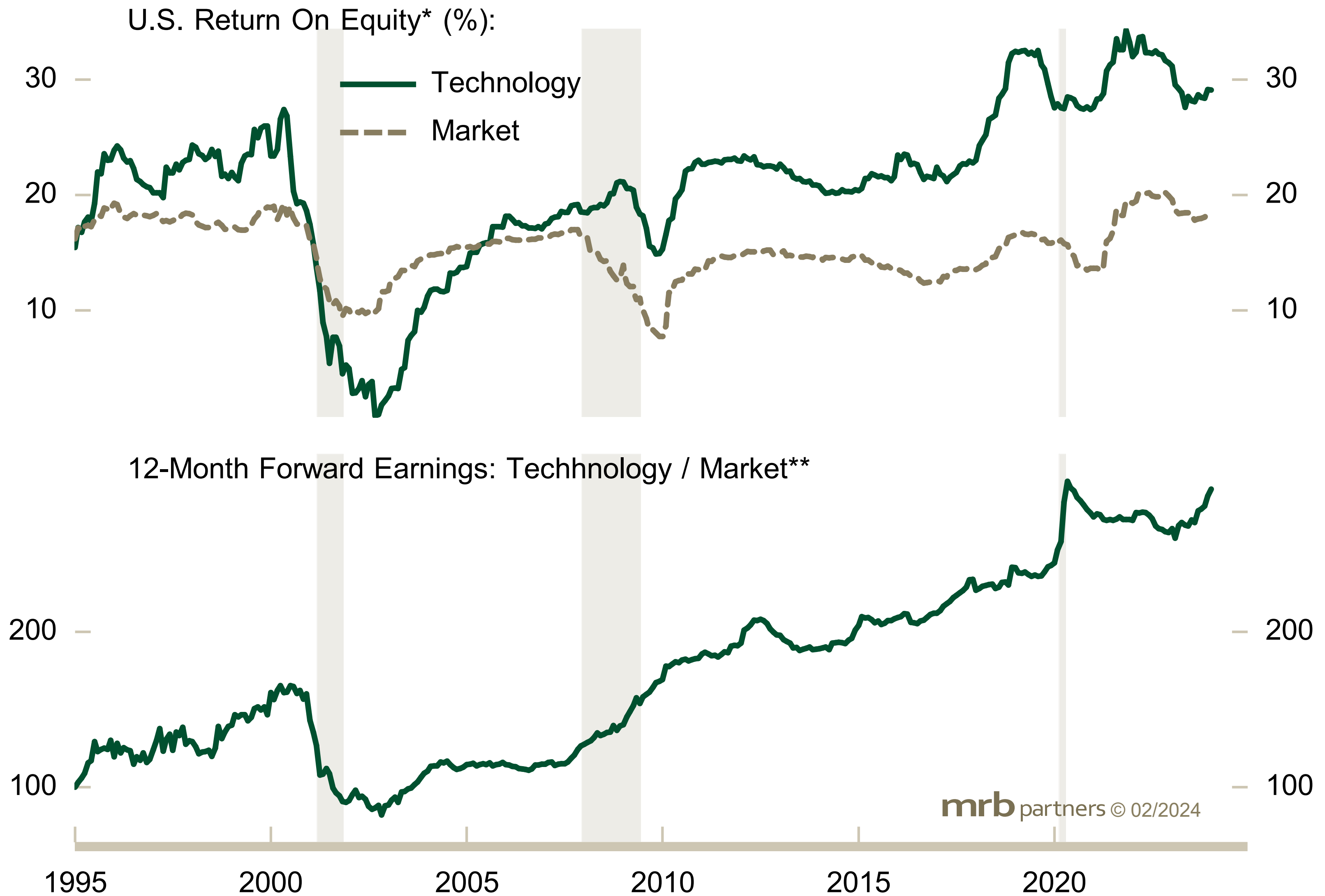
Technology Profitability Is Extraordinarily High



* Source: MSCI

** Rebased; source: MSCI

Note: Shaded for NBER-designated U.S. recessions

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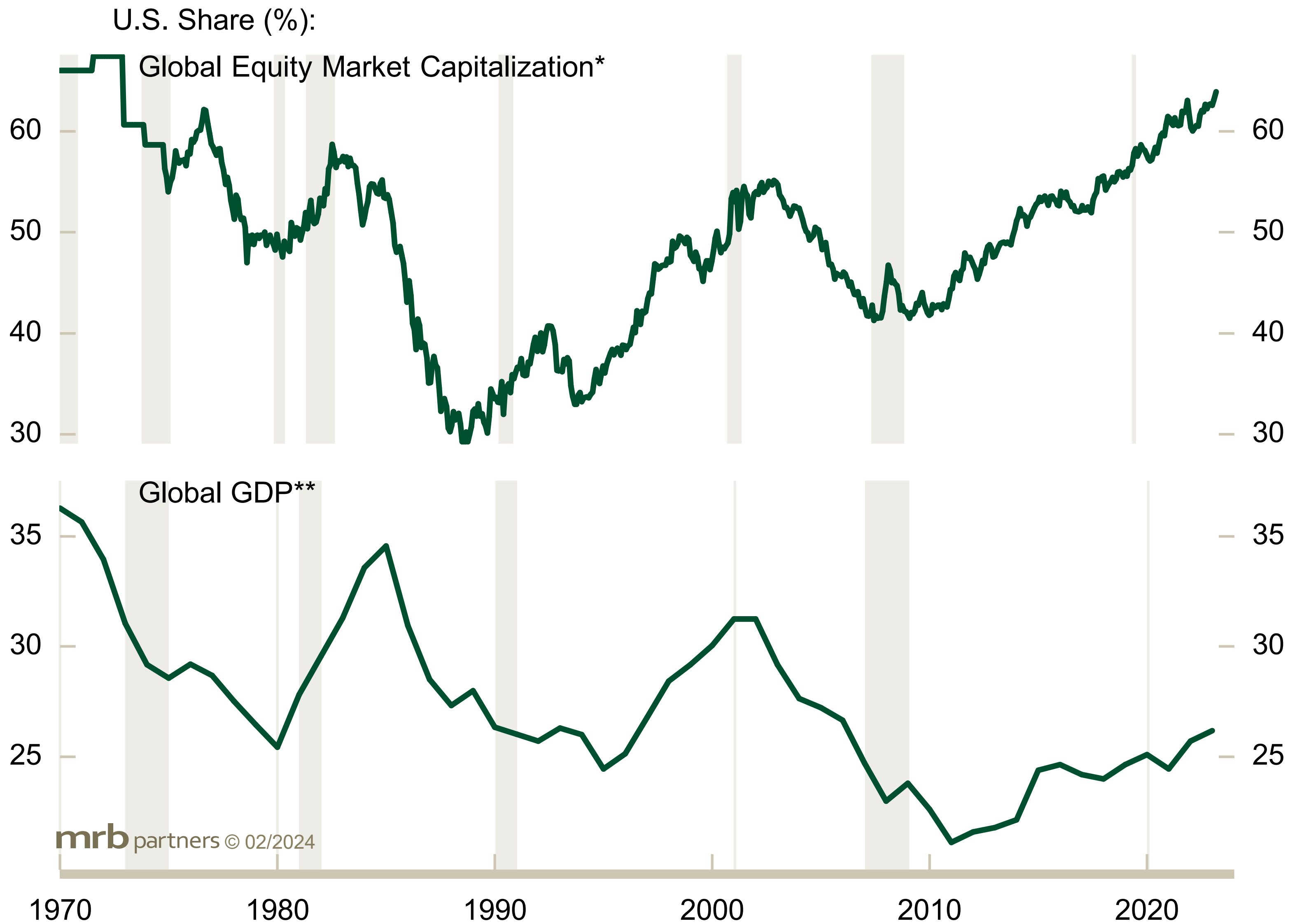
Adverse Reversion Toward Mean For U.S. Stocks Looms



* Source: MSCI
** World Bank and IMF

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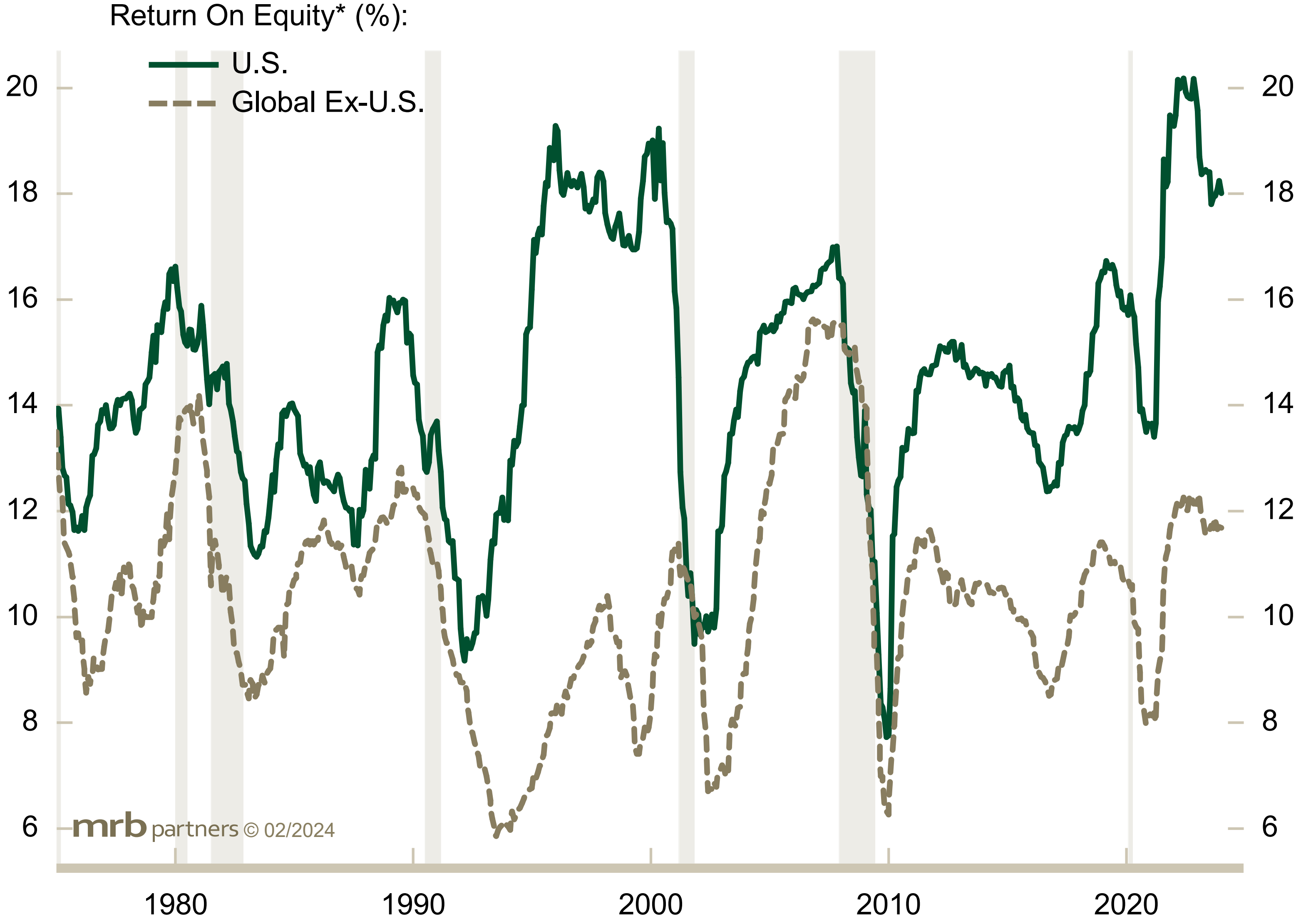
U.S. Relative Profitability Advantage Is Unsustainable



* Source: MSCI
Note: Shaded for NBER-designated U.S. recessions

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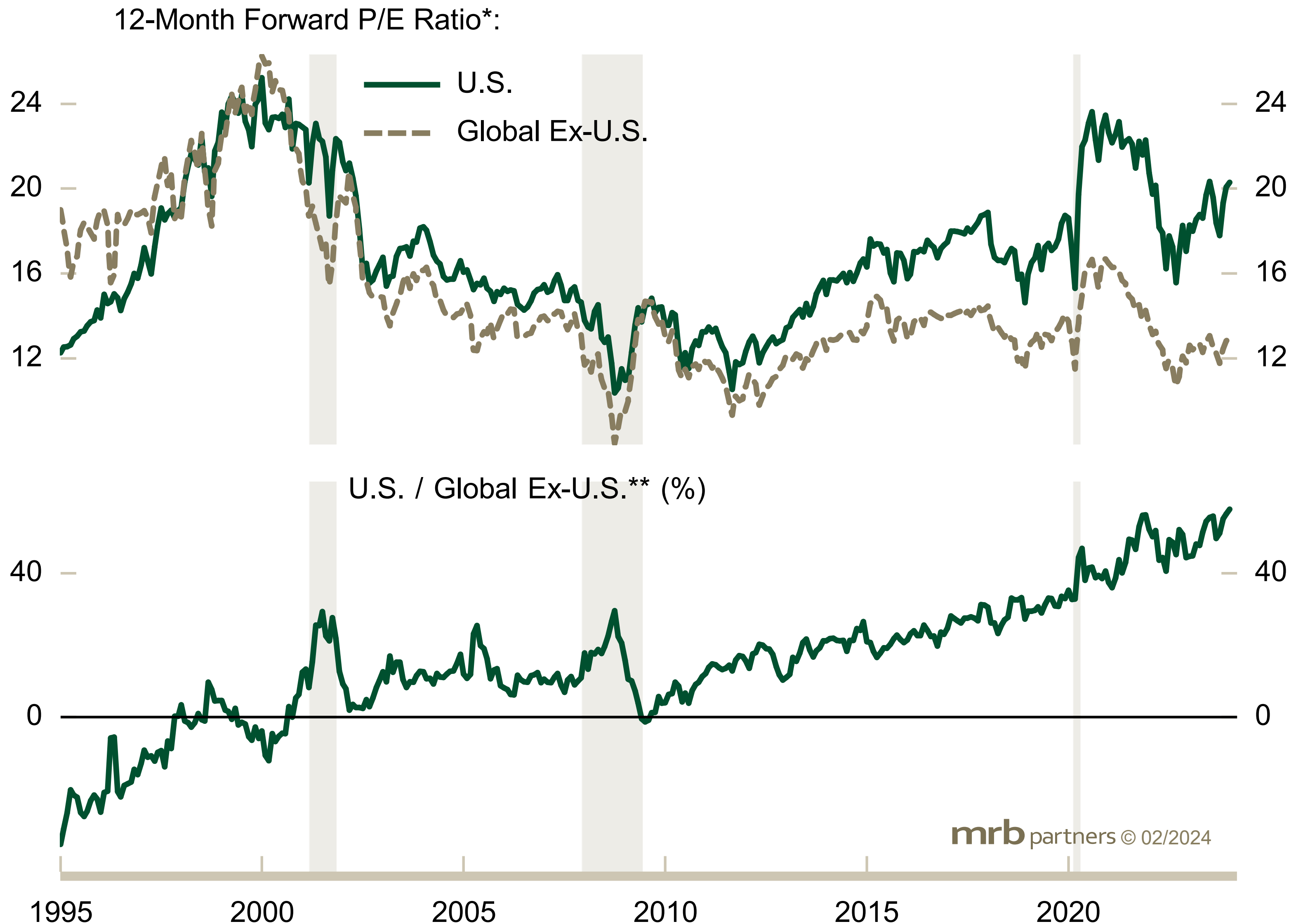
U.S. Equity Valuation Premium Is At A Record High



* Source: MSCI
** Percent premium (+) or discount (-)
Note: Shaded for NBER-designated U.S. recessions

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Don’t Ignore Opportunities Outside The U.S.

- The U.S. has had a great run, but various tailwinds are fading.
- China is out of favor, but pessimism is overdone. It will remain hugely important to the global economy and capital markets.
- The euro area had a tough 2010s following the prior bubble, and geopolitics has been a drag for the past two years, but it is poised to grow, with cheap stocks and a cheap currency.
- Japan is grappling with equity market reforms, and the yen is super cheap.
- Emerging markets ex-China are a diverse mish-mash, but there are select growth opportunities (India, Indonesia, Mexico, Brazil, etc).

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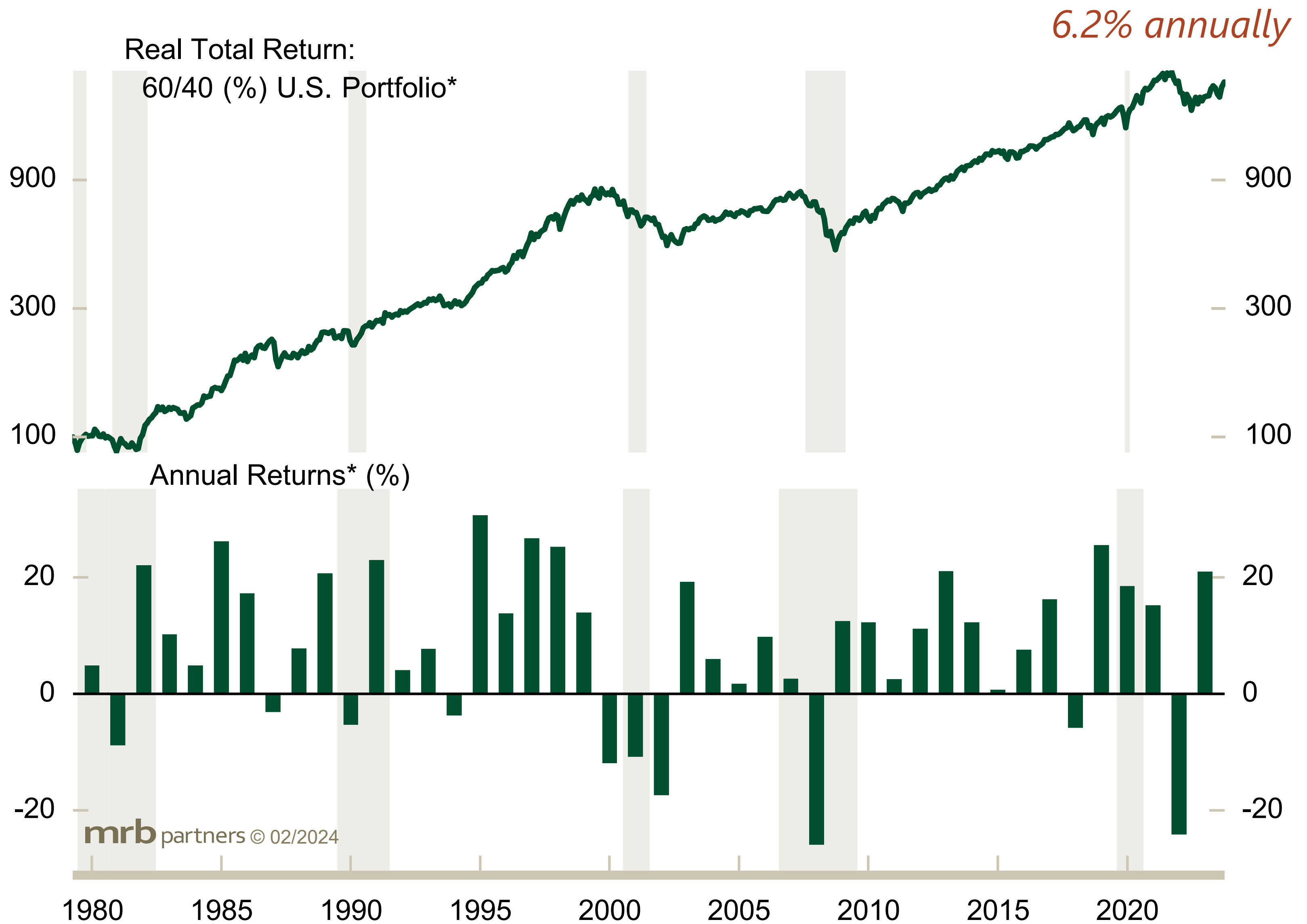
The 60/40 Portfolio Has Produced Solid, Reliable Returns



* 60% U.S. equities, 40% U.S. 10-year government bonds; local currency; sources: MSCI and MRB calculations
Note: Portfolio is deflated by U.S. CPI; shaded for NBER-designated U.S. recessions

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The 60/40 Portfolio Is Not Dead

- The 60/40 portfolio (60% stocks and 40% bonds) performed dismally in 2022, but that was an historic rarity driven by high inflation and rising interest rates.
- With interest rates having largely normalized, bond/stock correlations should be negative; i.e. bonds will be a diversifier for stocks.
- For most investors, alternative investments, whether private equity, private credit, real estate, commodities or others, are complementary to, not replacements for, portfolios built off an equity-bond foundation.

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This Year's Market Outlook: Brief Thoughts

- Another year of decent growth in the U.S. economy.
- But inflation will be stickier than the consensus expects.
- The Fed will not cut rates as much as discounted by investors.
- Thus, bond yields will be higher later this year.
- U.S. stocks are already expensive, and earnings elevated, thus limiting upside from current levels.
- The economy and Fed policy rather than the election will drive markets, but the latter is a clear negative risk factor.

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Conclusions

- The investment framework that was successful over the 2010s and since the early-1980s is no longer appropriate. A more tactical approach will be required.
- The low inflation, low interest rate era of most of the past 40 years will not prevail in the coming years.
- Inflation and interest rates will be higher for longer compared with recent decades.
- Several U.S. equity market tailwinds have faded, implying lower returns in the future.
- The U.S. dominates global equities but don't overlook opportunities elsewhere.
- Investors have more options to choose from today, but the 60/40 portfolio still has benefits from a return, diversification and understability standpoint.

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