Choose your own adventure

Assessing investors' economic and market path ahead

Executive summary

- **While the key economic debates facing investors have not changed since last year,** much in the economy has. Investors should take note.
- **Recession is a matter of *when*, not *how*, the cycle plays out.** And though many investors have expressed that this cycle feels slower than others, based on historical Fed hiking cycles we are right on time. Tighter policy is straining many economic sectors already. Profit margins, the consumer sector, and the labor market are next.
- **Regardless of investors' economic view for the year ahead,** the changes already seen support allocation adjustments for the year ahead.

Global Market Strategy

at New York Life Investments

Our team of market strategists connects macroeconomics to asset allocation. Leveraging proprietary research alongside the breadth and depth of the New York Life Investments platform, we provide actionable insight into market-driving events, structural themes, and portfolio construction to empower investment decision-making.

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Introduction

In reading the economic and market outlooks for 2024, investors could be forgiven for feeling “déjà vu all over again.” The very same debates crisscrossing investment outlooks for 2023 — the Fed’s aggressive interest rate hikes, market volatility, concerns about recession — are little changed.

But for the investment landscape, *much* has changed.

The impact of the Fed’s hiking cycle has taken a meaningful toll on interest rate-sensitive, liquidity-sensitive, manufacturing, and services sectors, following the typical path from policy tightening to recession. The factors still going strong — the consumer and the labor market — are historically lagging indicators and tell us very little about the path of the economy ahead.

Investors would also be reasonable to say that this economic cycle feels long. Comments about “the most telegraphed recession” can be heard from every corner of the proverbial marketplace.

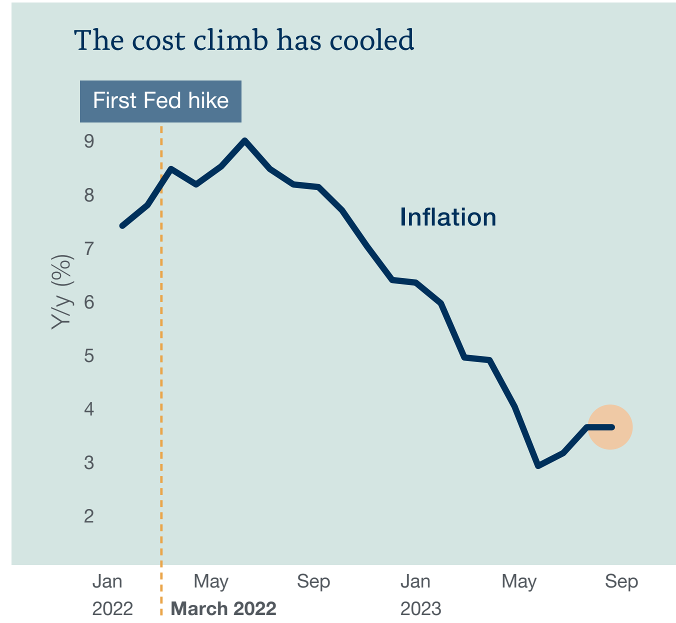
In fact, we’re *right on time*. The Fed is now at the tail end of the most aggressive monetary policy tightening cycle ever. But a faster pace of hikes doesn’t necessarily mean that those impacts are felt more quickly in the economy. Historically, interest rate hikes have taken roughly 12 to 18 months to impact the economy, and 18 to 24 months to impact the labor market. That experience is holding today.

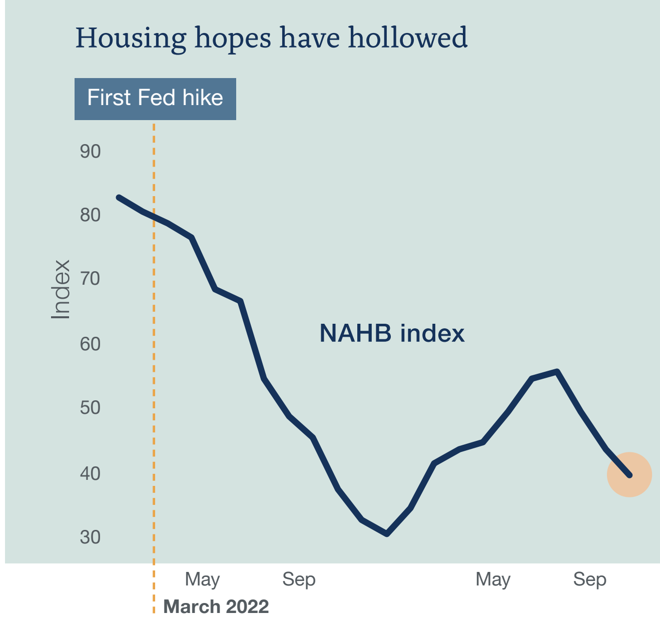
And so the evolution of data makes us feel confident: an economic slowdown is already happening, and a recession is on the way. But alongside our sober economic outlook, we must acknowledge what the past four years have consistently shown us: the market has surprises up its sleeve. It’s nice to be right, but better to be prepared.

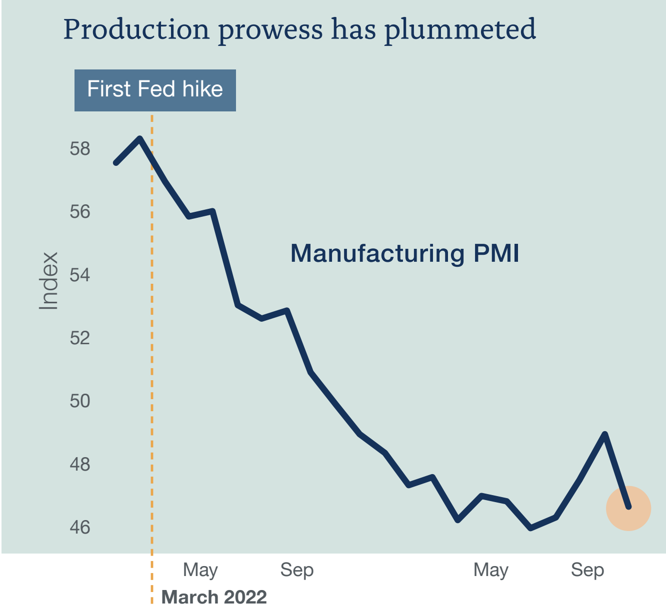
In this piece, we defend our long-held view that recession is inevitable by illustrating where the economy has changed, where it hasn’t, and why that makes us feel confident about where it’s headed. We then share a playbook for our most likely scenario — alongside concrete allocation ideas for key risks.

What has changed?

While the key economic debates facing investors have not changed, much in the economy has. Since the Fed started raising interest rates in March 2022, overall U.S. financing costs have become prohibitively expensive. Most recently, the U.S. 10-year Treasury yield pushed to 15-year highs. These tighter financial conditions have had their intended effect, with inflation cooling meaningfully, though not yet durably. Interest rate-sensitive sectors such as housing and manufacturing have clearly reacted, the first data to falter in the standard pattern of an economic slowdown.



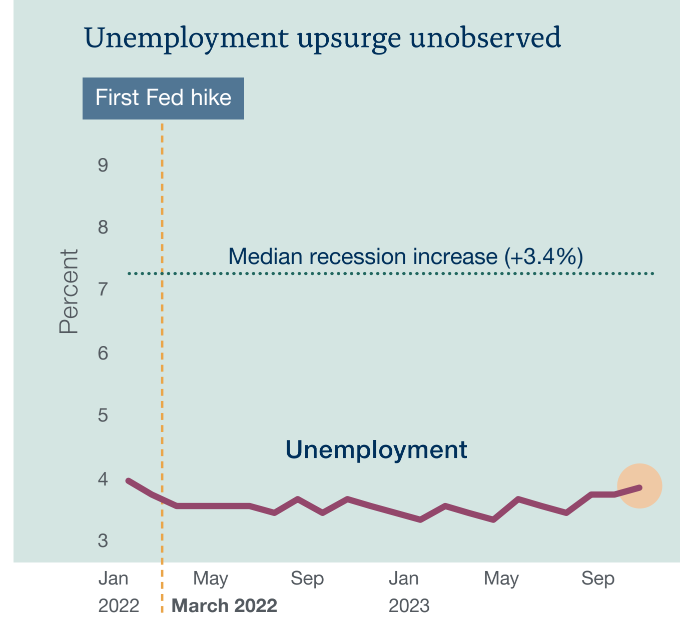


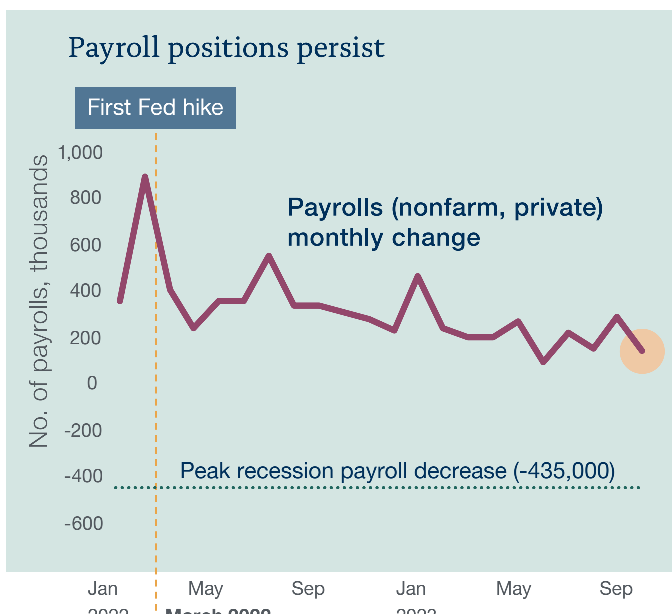


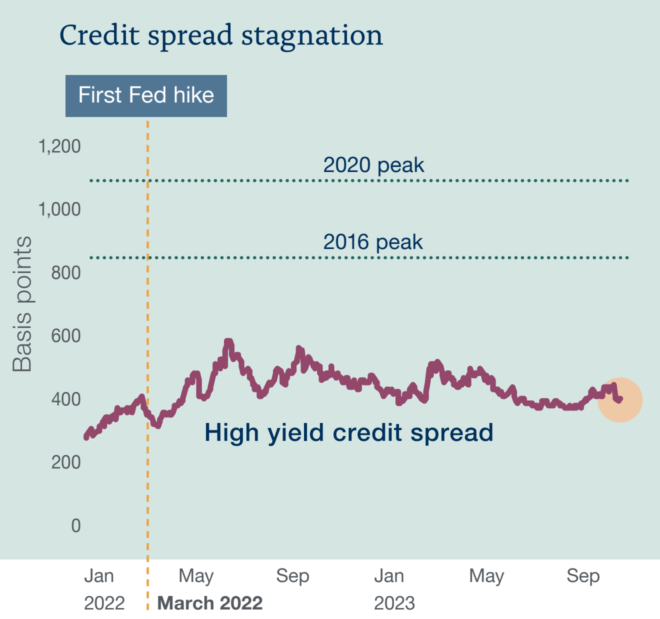
Sources for 10-year yield chart: New York Life Investments, U.S. Department of Treasury, Macrobond, December 2023. **Sources for inflation chart:** New York Life Investments, U.S. Bureau of Labor Statistics (BLS), Macrobond, December 2023. Inflation is represented by the Consumer Price Index. **Sources for NAHB chart:** New York Life Investments, National Association of Home Builders, Macrobond, December 2023. **Sources for PMI chart:** New York Life Investments, Institute for Supply Management (ISM), Macrobond, December 2023. Definitions can be found at the end of this piece.

What hasn't changed?

Proponents of an economic soft landing point to the factors that haven't been as visibly affected by higher interest rates — the labor market and the consumer. Historically speaking, these factors lag monetary policy the most, so it is no surprise the labor market is still tight and corporate profits are flat.







Sources for unemployment chart: New York Life Investments, U.S. Bureau of Labor Statistics (BLS), Macrobond, December 2023. **Sources for payroll chart:** New York Life Investments, U.S. Bureau of Labor Statistics (BLS), Macrobond, December 2023. **Sources for corporate profits chart:** New York Life Investments, U.S. Bureau of Economic Analysis (BEA), Macrobond, December 2023. Corporate profits after tax are presented without inventory valuation adjustments and capital consumption adjustments. **Sources for credit spread chart:** New York Life Investments, Bloomberg, Macrobond, December 2023. High yield spread is represented by the option-adjusted spread (weighted by market value) of the U.S. Dollar High Yield All Cash Bonds sector. Past performance is not a guarantee of future results.

What are we tracking?

There are gaps between where consumer, corporate, and labor market data are today, and where we expect them to be in a recession scenario. In the meantime, what are the signposts? What does the glide into recession look like?

How will we know we're in the final countdown to recession?

Company expectations slow…

- ✓ Negative corporate forward guidance accelerates
- ✓ Earnings expectations downgrades

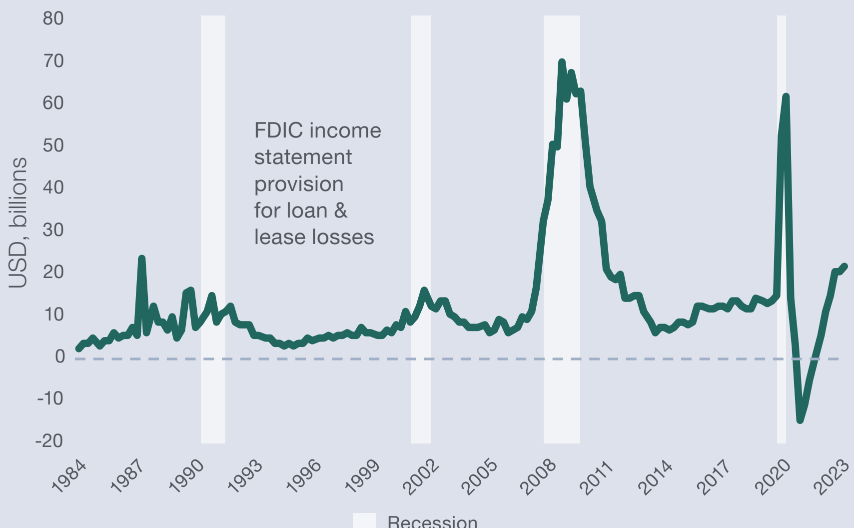
Profit margins fall…

- Loan restructurings increase
- Securitized commercial real estate: special servicing rises
- Banks increase loan loss provisioning
- Beginnings of defaults for smaller, more cyclical companies

Consumers begin to adjust spending on big ticket items…

- New home sales volume falls (existing home sales volume has already fallen)
- Remodeling plans halt
- Auto sales fall (new and used)
- Quits rate decreases (workers not leaving jobs willingly)
- Temporary help payrolls rise

The U.S. banking system is starting to provision more for loan losses, but not yet to recession levels



Sources: New York Life Investments, Federal Deposit Insurance Corporation (FDIC), Macrobond, Bloomberg Finance LP, December 2023. Definitions can be found at the end of this document.

After a full year of revenue pressure, companies are finally seeing their earnings and profit margins decline. Typically, this is accompanied by a stronger corporate and investor awareness that risks are rising and the economy is becoming more fragile. Consumers adjust their spending accordingly until the labor market finally cracks. Equity and credit markets tend to react only when unemployment claims rise and earnings are revised downward—when recession is already upon us.

Consumer confidence is pressured and households make holistic changes to spending…

- Negative substitute companies with lower price points see revenue gains
- Credit cards: balances and delinquency rates rise across age and income groups
- Uninsured unemployment claims rise

Labor market finally cracks…

- Layoffs rampant/seen across industries

The labor market still looks strong, but can deteriorate rapidly

National unemployment, current period of yield curve inversion vs. past six inversions (ex-2019)

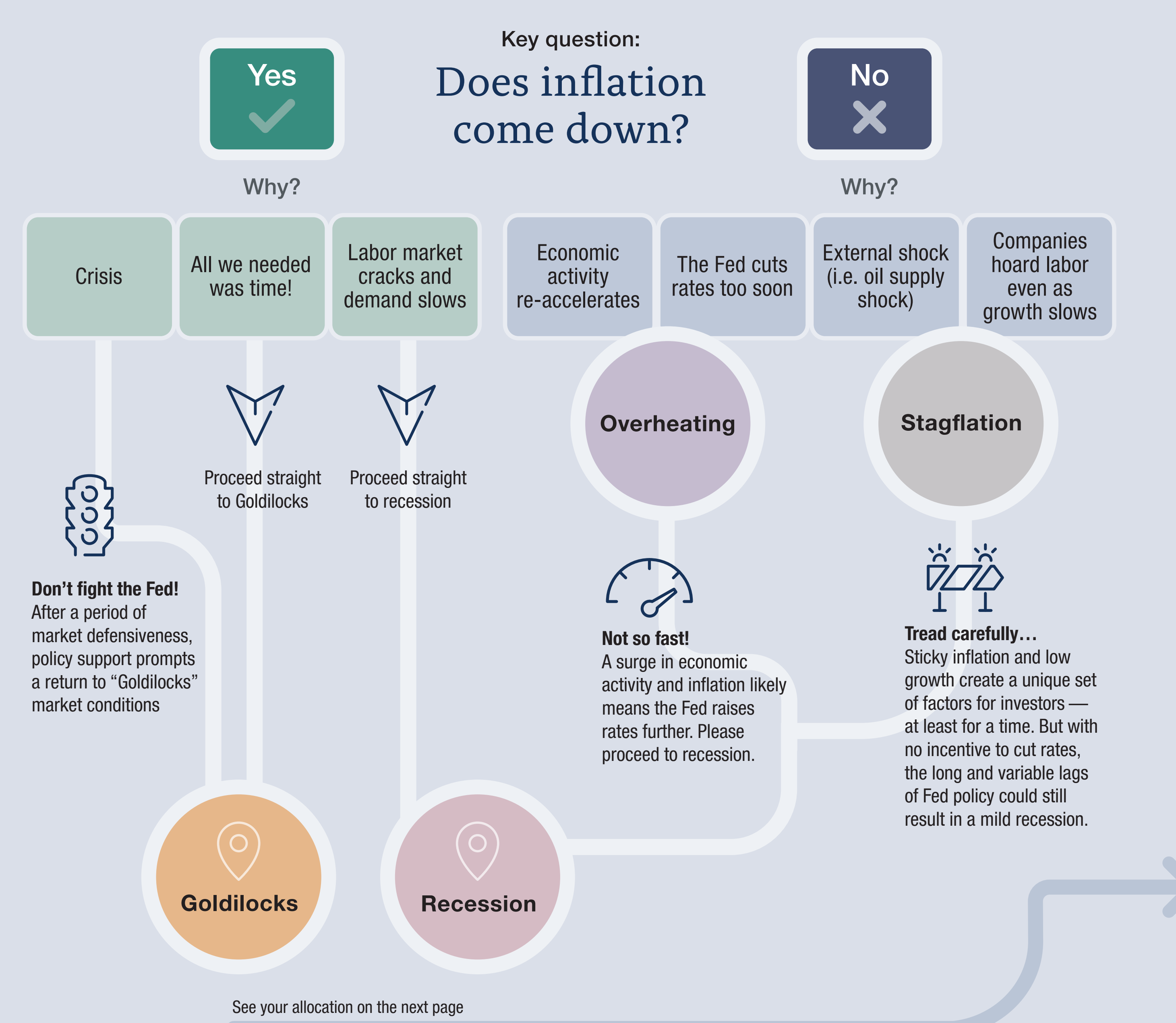
Sources: New York Life Investments, Bureau of Labor Statistics (BLS), Macrobond, December 2023.

What does this mean for asset allocation?

Amid all this data, inflation remains, in our view, the single most important determinant of financial conditions and therefore market behavior ahead. Using this as a starting point, investors can determine the likelihood of success for their many allocation choices.

Our base case perspective — that economic growth will slow in a recession — would bring inflation lower and allow the Fed to cut rates next year. For those assigning a higher likelihood to other outcomes, we provide concrete allocation ideas.

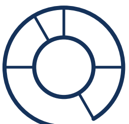
What comes next? Choose your own adventure



2024 scenarios:

	Recession 60% likelihood	Goldilocks 5% likelihood	Overheating 15% likelihood	Stagflation 20% likelihood
Cause	The lagged impact of Fed policy makes the U.S. consumer, small business, corporate, and banking systems even more fragile. Refinancing activity is limited, leaving the economy under the pressure of high interest rates for an extended period. Even if economic activity is resilient at first, market risks—including cost of credit—continue to rise, eventually resulting in a traditional recession.	Pandemic-era government support—including low rates, fiscal stimulus, and balance sheet expansion—keeps businesses and consumers afloat. Today's "higher for longer" rates mean that the economy and inflation slow back to normal pace without recession—but this takes time.	An energy-related or other external shock results in a highly inflationary near-term scenario, forcing central banks to respond with higher interest rates. Global consumers are already weakened by several quarters of higher rates and costs. Tactical investors can benefit from short-term inflationary allocation. Otherwise proceed to "recession."	Excess household and corporate savings, including the hoarding of labor, keep the economy afloat but provide little inflation relief. GDP data is positive, supported by government spending figures, but "felt" economic activity and the job market weaken, particularly for small businesses and those households with less savings and income to keep up.
Fed reaction	Fed can likely cut rates modestly by H2 2024. Market dysfunction may bring a pause of QT.	The bar for Fed cuts in 2024 is high.	Fed may be forced to hike further.	Rates are stable at higher levels.
Allocation: Equity	• Profitable growth across market cap • Large caps • Defensive sectors • Infrastructure equity	• Value • Small caps • Cyclical sectors	• Energy companies • Alternative energy	• Balanced allocation across growth and value equity styles; focused on companies with pricing power • Convertible bonds
Allocation: Fixed income	• Add duration as 10Y and long rates move lower • IG corporate credit	• 10Y moves higher/ stable: wait to add duration • Increase credit allocation: floating rate, HY • Emerging market debt	• Neutral duration; 10Y spikes temporarily • TIPS	• Rates stable • Barbell credit allocation: IG and HY pairing
Allocation: Alternatives	• Hedge funds	• Real estate equity • Private credit	• Commodities • Precious metals • Real estate equity	• Precious metals • Real estate debt
Allocation: Scenario Neutral	• Infrastructure bond • Quality, which looks different in this cycle • Careful credit analysis and security selection			

Opinions of New York Life Investments, December 2023. For illustrative purposes only.



What it means to be “scenario neutral”

2023 proved to investors that sitting it out is not the answer, even when renowned investors and expert economists are calling for an imminent recession. Those who turned strictly toward traditional defensive investing techniques in the past year — overweighting cash, investment grade bonds, and value equities — saw their purchasing power erode in the money market, participated in the greatest Treasury rout in 150 years, and missed out on the spectacular, though temporary, AI-driven equity rally.

Investors face the same conundrum for 2024, and as we have illustrated, macro pressures have only mounted. Outrunning these pressures — and especially inflation — for the sake of capital preservation and appreciation requires taking selective and prudent risks. But how can we go about this when everything feels risky?

We encourage a holistic approach to this question: focus on real returns, and consider how the immediate cycle can be used to rebalance towards longer-term goals.

Real returns. For more than a year, we've said that defensive allocations should look different when inflation is material. In other words: “safe” allocations are not, in fact, safe if they do not preserve capital. Consider real, total returns: to what extent does the income profile of an asset class provide a buffer against price movements?

The money market provides an interesting case in point. Historically, and until very recently, the money market has not outpaced inflation. With the Fed nearing the end of its hiking cycle, we expect it’s time for investors to dip their toes back into bonds. And if the money market doesn’t outpace inflation on average, it may not be “safer” than active high yield credit strategies that are managed with a keen eye on credit risk.

Looking through the cycle. Investors know that standard diversified allocations are constructed to weather all portions of an economic cycle, but what about the next? The structural view can be incorporated at the asset class level by considering the long-term trends at play, from energy rebalancing to digital infrastructure, domestic manufacturing, and access to natural resources. This also extends to investment themes and strategies. For us, these include:

- cross-asset quality;
- active management in more volatile and flows-dependent asset classes (such as municipal bonds, or the smaller potential beneficiaries of AI); and
- allocation to alternative asset classes including private credit, private real estate, and commodities.

Above all, we remind investors that for all the uncertainty and volatility, this time is *not* different.

Definitions

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Loan loss provisions, also known as valuation allowances, are an expense set aside as an allowance for potential uncollected loans and loan payments.

The NAHB/Wells Fargo Housing Market Index is an economic indicator that gauges home builder sentiment in the United States for single-family home sales and expectations for the next six months.

The Manufacturing Purchasing Managers' Index (PMI) from the Institute for Supply Management (ISM) is an indicator of economic health for the manufacturing sector and is based on surveys of private sector companies regarding new orders, inventory levels, production, supplier deliveries, and employment.

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