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ASPIRIANT INSIGHTS

FIRST QUARTER 2024 INSIGHT

Investing Outlook

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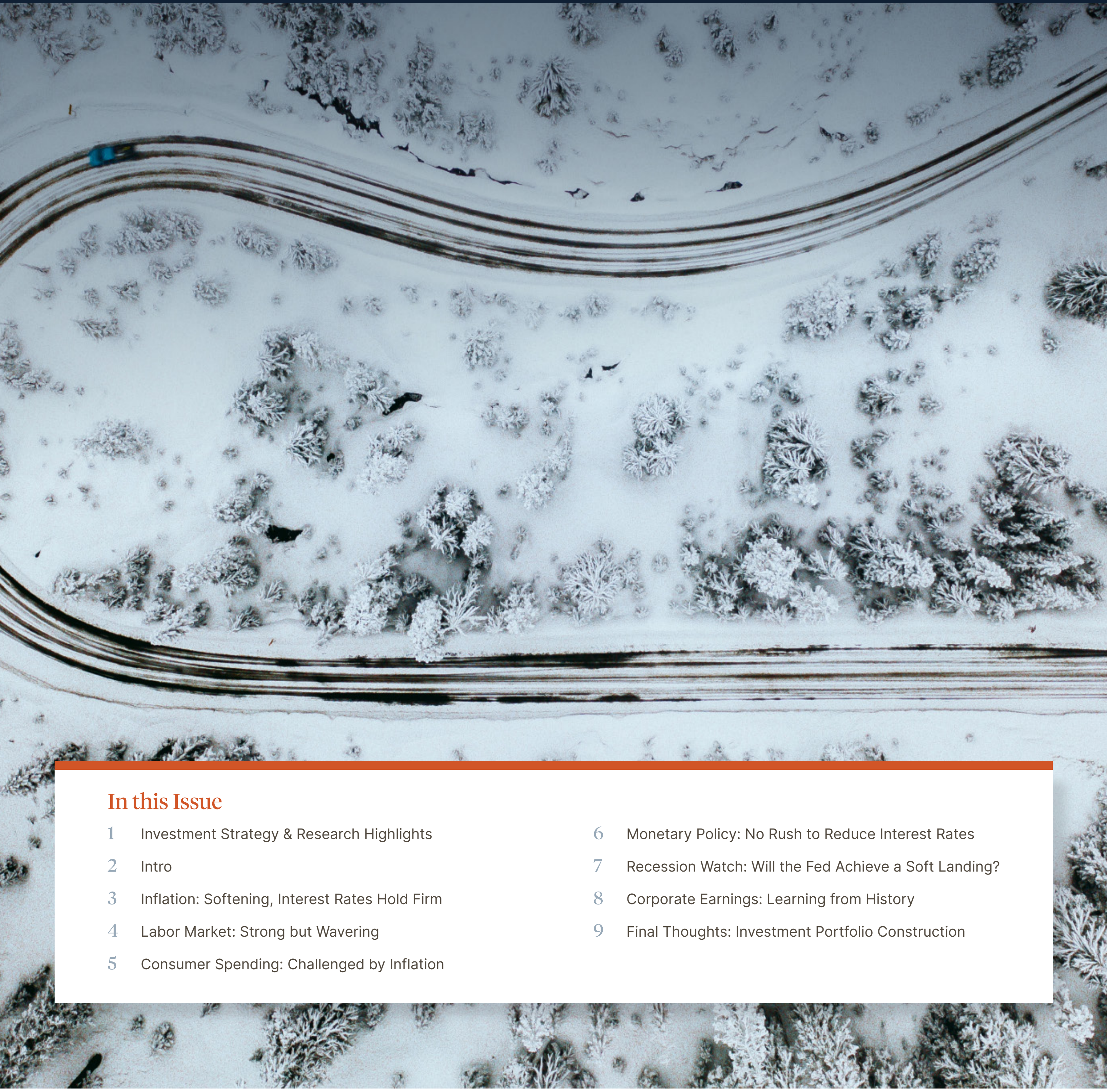


In this Issue

Investment Strategy & Research Highlights

- In the dynamic environment of financial markets, the fluctuating nature of the S&P 500 reflects investors' shifting sentiments from optimism to caution and back again over the past two calendar years.
- Higher interest rates are impacting individual and business spending plans, which has the knock-on effect of increased credit utilization, including buy-now/pay-later services and loan defaults as debt burdens weigh on the economy.
- While they've been resilient so far, consumers may not be able to sustain their spending habits, which may impact corporate earnings and further impact the labor market.
- Today's environment reminds us of the importance of having a balanced, data-driven and systematic approach to portfolio construction and investing.

Intro

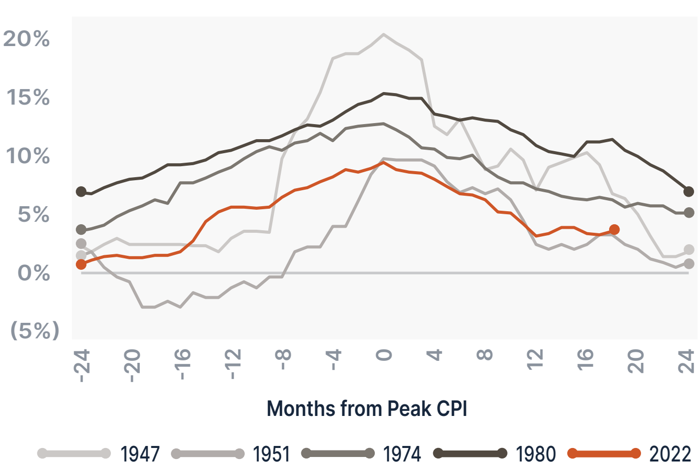
The S&P 500 experienced dramatic swings from an all-time high in December 2021 to a 25% drop in 2022, only to slightly recover by 2023, signaling investor sentiment whipsawing between greed and fear. The market's focus has notably shifted toward AI-driven stocks, particularly the "Magnificent Seven," driving disproportionate and concentrated gains among certain sectors. Higher interest rates have tampered inflation but strained wages, savings and spending, leading to increased consumer credit use and stifled business activity. Despite this, the strong labor market suggests a potential soft landing is possible, though recession risks linger as evidenced by leading indicators. This uneven performance, alongside the broader market's underperformance, calls for careful consideration beyond headline-driven optimism. With the Federal Reserve (the Fed) prepared for future interventions and fixed income becoming more attractive, the investment landscape is evolving, emphasizing the need for strategic portfolio adjustments amid prevailing uncertainties and market dynamics.

Inflation: Softening, Interest Rates Hold Firm

Given the central role inflation plays in the Fed's decision to adjust interest rates, we found it informative to review the history of past inflationary periods. The four gray lines on **Figure 1** display previous inflationary cycles that reached their peaks in 1947, 1951, 1974 and 1980. The orange line represents the current inflationary cycle, which reached its peak in 2022. The "zero" months on the bottom axis are vertically aligned with the peaks of each inflationary period. The arc of the current inflationary cycle resembles those of the previous cycles, with each taking plus or minus 24 months to reach their respective peaks and then another plus or minus 24 months to settle back near their pre-cycle levels. The chart covers a total of 48 months for each cycle.

FIGURE 1

U.S. CPI



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

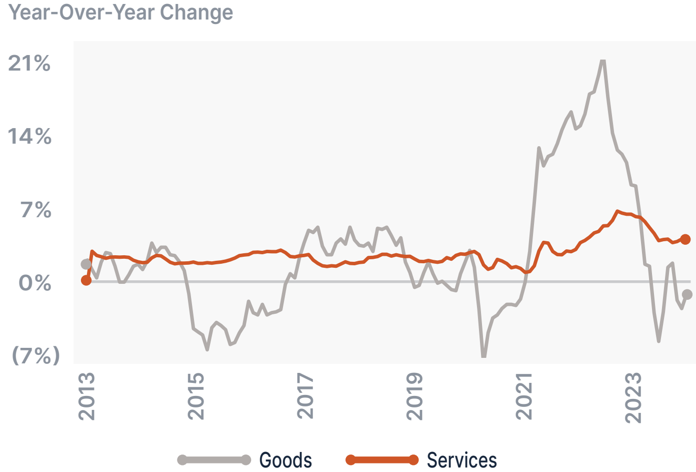
The current cycle (again, the orange line) entered its 48-month period when inflation was just 0.6%. Thus far, it's about 43 months into its cycle with inflation currently running at about 3.4% after peaking at 9.1% in June 2022. With about five months left of its 48 months, we believe inflation will likely continue to soften toward the Fed's 2% target. However, if the labor market remains tight, causing services inflation to remain elevated, the Fed could continue to be patient before cutting interest rates.

With regards to services inflation, **Figure 2** compares the level of inflation for goods to the level of inflation for services. Over the past decade, goods inflation (the gray line) has oscillated around plus or minus 0%, with the brief spike caused when many consumers were stuck at home during the pandemic and bought virtually everything they could find online. Services inflation (the orange line) has been significantly more stable over the decade. While it has also cooled, it could remain elevated if the employment market remains strong. In February 2013, services inflation was running at 3.0% and now it is running at about 4.1%. It's still about 1.1% higher than when it entered this cycle and its persistence could have an impact on market pricing.

FIGURE 2

Inflation
Goods vs. Services

Year-Over-Year Change



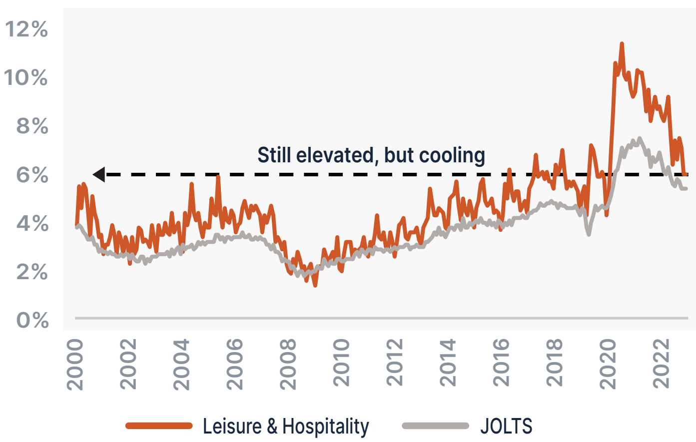
Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

Labor Market: Strong but Wavering

In general, job prospects and employment are still strong but conditions have wavered a bit in recent months. **Figure 3** illustrates the [Job Openings and Labor Turnover Survey (JOLTS)](#) over the last 20 years. The overall measure is the light gray line, and just the leisure and hospitality industries are represented by the orange line. Both follow a similar pattern with more dramatic swings for the leisure and hospitality industries. Job openings soared in 2021 as the economy flourished amidst record fiscal and monetary stimulus. In the ensuing months, supply chains stabilized and idled labor returned to work, causing job openings to fall and now approach pre-pandemic levels. Also, job openings to the number of unemployed now sit at 1.6 times, down from a high of 2.0 times.

FIGURE 3

Job Opening Rate (JOLTS)



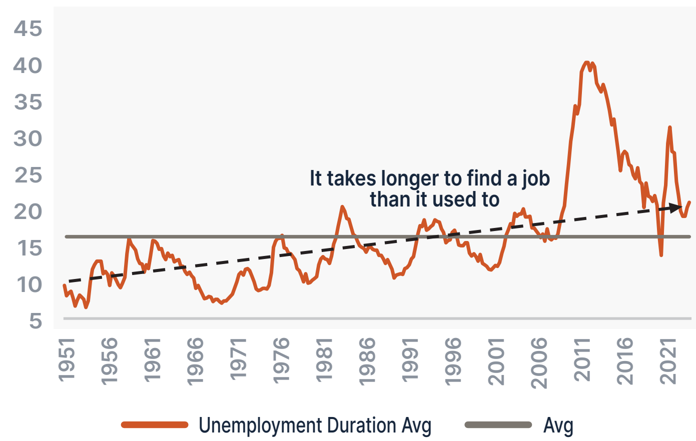
Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations. The monthly Job Openings and Labor Turnover Survey (JOLTS) measures the total number of workers that were hired, quit, laid off or otherwise separated from employment.

Figure 4 shows the average duration, in weeks, of those that are unemployed. This measure has been trending higher over the last several decades, measuring eight to ten weeks in the 1950s to 16 to 18 weeks in the 1980s. As of December 2023, the average duration of unemployment is now north of 21 weeks, well above the 14 weeks in September of 2020 and in line with its reading in early 2020 or before the onset of the pandemic.

The quits rate is the number of people of quitting their jobs as a percent of the those employed and that too is also normalizing, dropping from a high of 3% in November of 2021 to 2.2% in November 2023, which is slightly below its early 2020 level. Collectively, these datasets signal a potential shift in labor negotiating leverage from the job seekers to job providers and could further impact consumer spending in the future.

FIGURE 4

U.S. Unemployment Duration Average Seasonally Adjusted in Weeks



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

> "Collectively, these datasets signal a potential shift in labor negotiating leverage from the job seekers to job providers and could further impact consumer spending in the future."

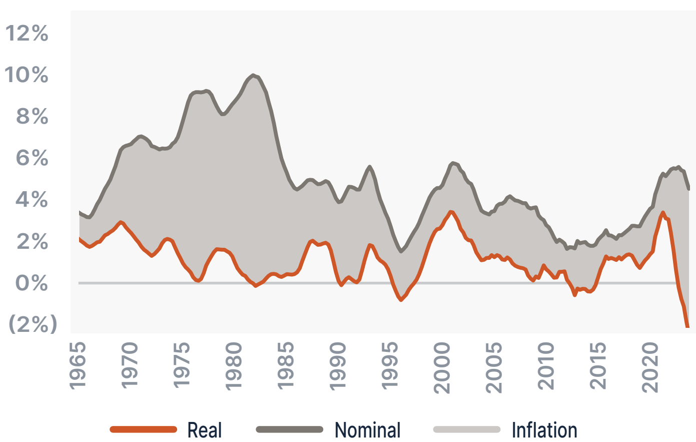
Consumer Spending: Challenged by Inflation

While labor market conditions are near or approaching their pre-pandemic levels and many people remain employed, consumers are still challenged by the lingering inflationary effects of the last three years. Figure 5 shows a three-year rolling average of nominal compensation per hour in the gray line and inflation-adjusted or real compensation per hour in the orange line, with the difference between the two lines, the shaded gray area, representing inflation. As you can see, nominal compensation per hour increased by greater than 5% in 2021 through the start of 2023. Those gains were the strongest compensation increases in over 20 years. However, those compensation advances were more than offset by higher prices. You can see real compensation per hour fell from 1% to 1.5% pre-pandemic to -2.4% by the third quarter of 2023, making the worst change in real compensation per hour in 60 years.

FIGURE 5

U.S. Compensation per Hour Real vs. Nominal

3-Year Rolling Average

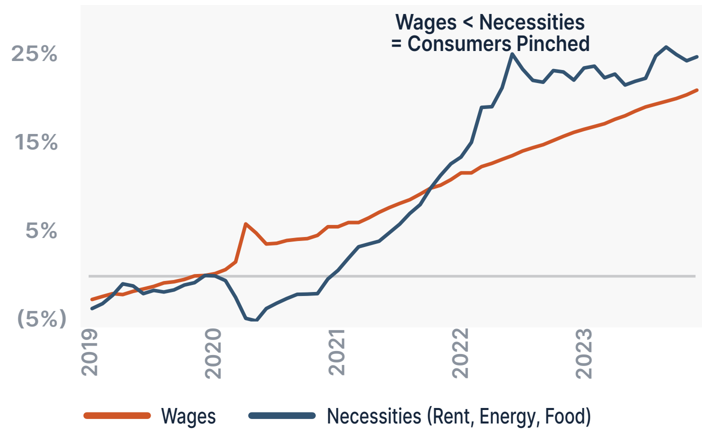


Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

The tangible impact of this dynamic is highlighted in Figure 6, which indexes both nominal wages and the cost of necessities (rent, energy and food) to 2019. Wages, in the orange, are up, on a cumulative basis, 20.8%. And necessities, over that same time period, have increased by 24.5%, for a gap of about 4%.

FIGURE 6

Necessities Costs vs Wages (Indexed to Dec. 2019)



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

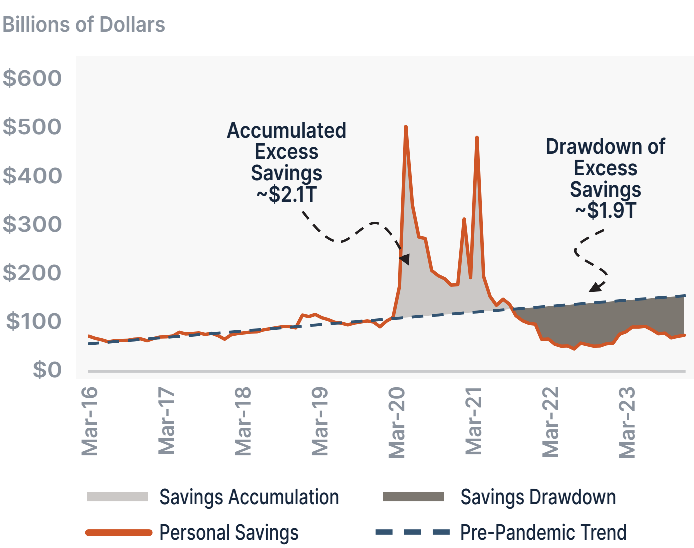
The failure of wages to keep pace with the rise in the cost of essentials is readily apparent in credit card delinquencies, now at a 10-year high. Lower credit quality or subprime auto loans delinquencies are close to a 30 year high.

Furthermore, the increased prevalence of buy now, pay later options supports the notion that spending patterns may not be sustainable. Finally, the savings rate as a percentage of disposable income is about half of what it stood pre-pandemic. In the immediate term, households should get some relief as the wage and inflation picture flips. But that reprieve is coming just as labor and economic conditions may be starting to waver, which may create a whole set of other pressures.

The trend of unsustainable spending maybe further evidenced by consumers tapping into the excess savings they accumulated from COVID-19-related stimulus programs to maintain their spending, as seen in **Figures 7** and **8**. **Figure 7** plots excess savings above or below the pre-pandemic trendline. COVID-related stimulus programs generated excess personal savings of approximately $2.1 trillion (which is the light gray area) above the trendline. However, as those programs came to end, consumers began dipping into the excess savings they had accumulated. At this point, they have spent down approximately $1.9 trillion (which is the dark gray area), leaving only about $200 billion remaining, with a current estimated depletion rate of approximately $75 billion per month. Therefore, the excess savings could be fully depleted in the coming months.

FIGURE 7

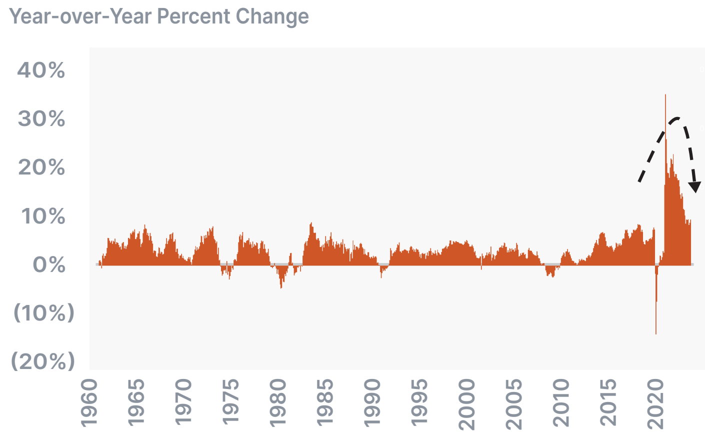
Personal Savings



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Federal Reserve Bank of San Francisco. Please see additional disclosures regarding third-party data and other considerations.

FIGURE 8

Real Consumer Discretionary Spending



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Economic Analysis. Please see additional disclosures regarding third-party data and other considerations.

Figure 8 plots the change in real consumer discretionary spending, which is what matters to companies and shareholders because nominal anything is simply eroded away by inflation. Dating back to 1960, real spending generally bounced around in the mid-single digits – sufficient to generate robust economic growth over 60+ years. COVID-related transfers and shutdowns caused spending to balloon past 20% or roughly three times the historical average.

On the right side, the orange bars have dropped precipitously, with spending back down in the high-single digits and it appears set to continue falling. As it does, the Fed will attempt to ease off the brakes to allow spending to settle back in the mid-single digits. If they can accomplish this, they may indeed orchestrate a soft, or soft-ish, landing, thereby avoiding both a recession and a severe selloff in equities.

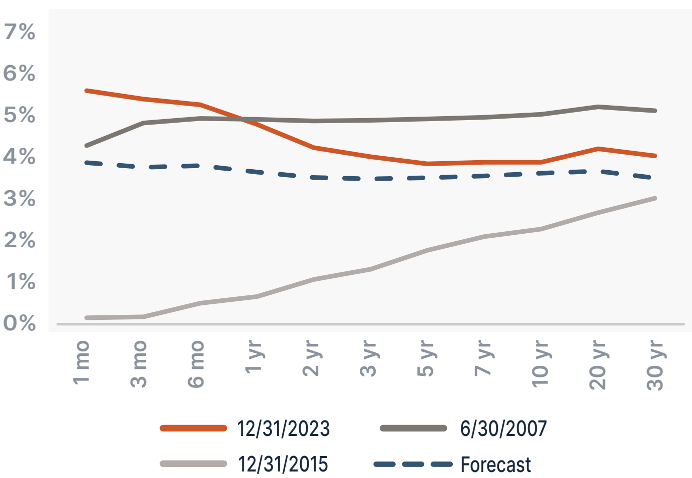
Monetary Policy: No Rush to Reduce Interest Rates

Figure 9 supports our view that the Fed isn't in a rush to dramatically reduce interest rates but we expect a few cuts during 2024, showing that nominal interest rates will likely remain high – or at least meaningfully higher than their level over the past decade or so. The light gray line shows the yield curve during 2015 as an example of borrowing rates over the past decade. With short-term rates near 0% and long-term rates near 3% during several of those years, there was significant incentive to spend and speculate.

The orange line shows the current yield curve, which is much higher and flatter than December 2015 and roughly similar to June 2007, which is the dark gray line from the months just before the Global Financial Crisis (GFC).

FIGURE 9

U.S. Treasuries Yield Curve



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Department of the Treasury. Please see additional disclosures regarding third-party data and other considerations.

High short-term interest rates create an incentive to hold money market funds instead of deposits, which has a ripple effect on banks' ability to lend to consumers and businesses to support growth. The high rates are, in part, the reason why bank financing is harder to come by these days. Likewise, high long-term interest rates dissuade borrowing, spending, growth and investments. Long-term rates are forecast to fall below 4%, barring a significant recession.

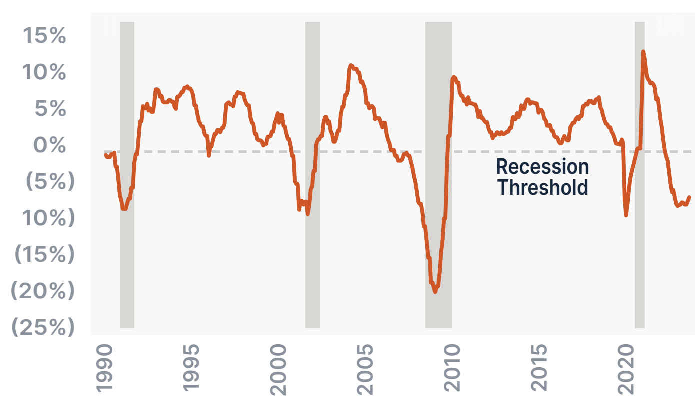
While the Fed's actions to raise rates have slowed the economy and increased market volatility, as we mentioned, it has also allowed them to "reload" its ability to stimulate should trouble arise again in the future.

Recession Watch: Will the Fed Achieve a Soft Landing?

We, like others, analyze a number of data to determine the direction of the economy. Leading Economic indicators (LEI) are one tool often used in that effort. LEI consist of 10 components or measures, such as initial unemployment claims, new orders of manufactured goods, the number of residential building permits issued and consumer expectations of business and economic conditions. They can provide an early indication of turning points in the economy. In the past 40 years or so, as shown in **Figure 10**, there have been five prior occasions when the year-over-year change in the LEI was worse than -5%. In each prior case, a recession occurred as marked by the gray shading in the chart. Throughout 2023, LEI have continued to register a below -5% reading, indicating one sign of potential recession risk in the months ahead.

FIGURE 10

U.S. Conference Board Leading Economic Indicator

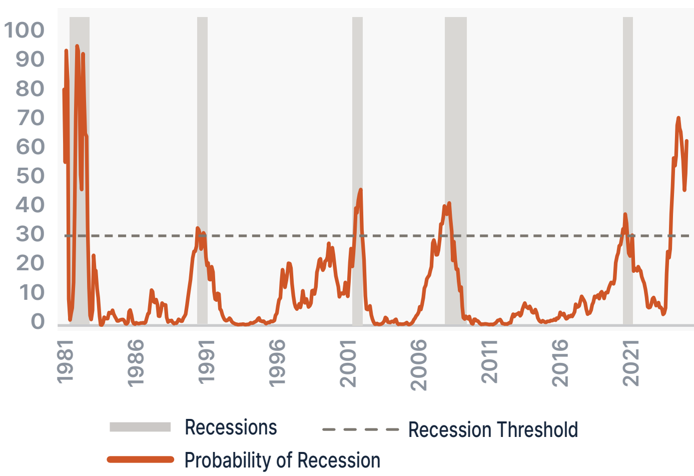


Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Conference Board. Please see additional disclosures regarding third-party data and other considerations.

Another gauge of recession probability is provided by the Federal Reserve Bank of New York and is depicted in Figure 11. They publish a recession probability for the next 12 months based on the difference between the yield of the 10-year Treasury note and the 3-month Treasury bill. Similar to LEI, over the past 40 years or so, there have been five prior instances when the recession probability was higher than 30%. In each case, a recession occurred. Today, the recession probability is at 63%, well above the critical threshold of 30% and among its highest readings since the early 1980s. While inflation has come down and the Fed has more flexibility to act in a softening economy, the odds of a recession have not disappeared and still look to be elevated.

FIGURE 11

Federal Reserve Bank of New York
Recession Probability in 12 Months



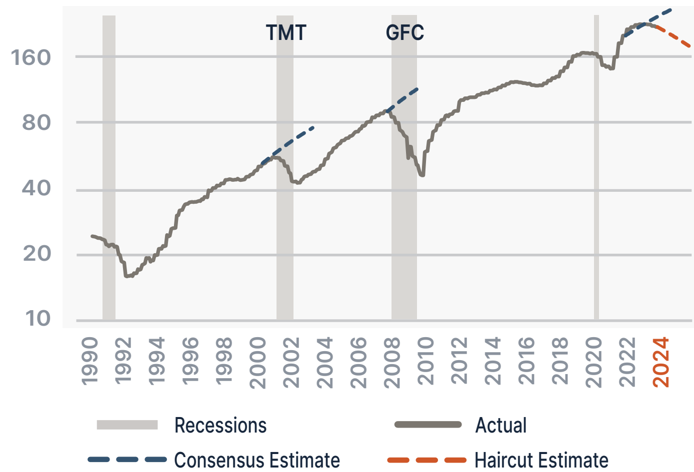
Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Federal Reserve Bank of New York. Please see additional disclosures regarding third-party data and other considerations.

Corporate Earnings: Learning from History

Figure 12 depicts actual earnings of the S&P 500 over the past 30 years, with the dashed blue lines representing consensus earnings estimates of Wall Street analysts at that point in time. A couple of broad observations: earnings tend to have some momentum, moving higher or lower and rarely flatlining or staying static. And second, Wall Street analysts are poor forecasters of corporate earnings as their estimates are usually too optimistic and they rarely, if ever, forecast a recession and a decline in earnings.

FIGURE 12

S&P 500
Actual and Expected Earnings Per Share



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg. S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. Please see additional disclosures regarding third-party data and other considerations.

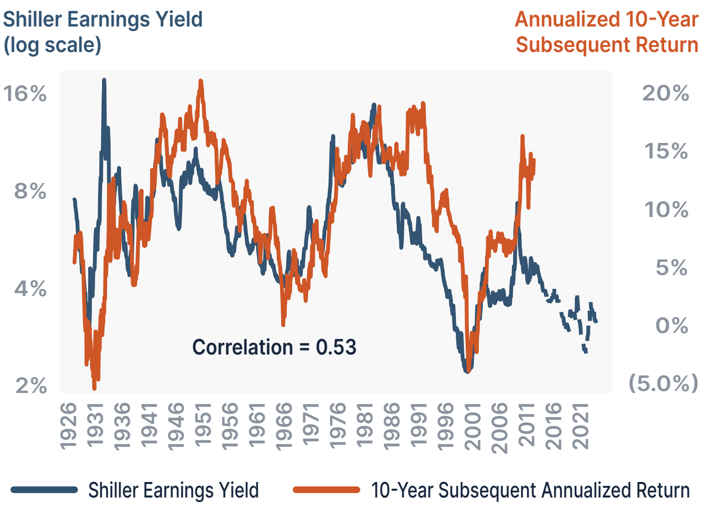
In 2022, S&P 500 earnings were $220 a share. The estimate for 2023, which includes three quarters of actual earnings and just an estimate for the fourth quarter, is right on top of the actual 2022 earnings at $220 a share.

The question then becomes, where do we go from here? Given the relatively minor and brief nature of the pandemic-induced earnings decline, one could argue that the earnings cycle since the GFC, spanning from 2009 to the present, constitutes a single, albeit elongated, cycle, with 2022 and 2023 representing its peaks. Others will argue COVID launched the start of a new earnings cycle and we are in the early part of that next climb higher. The difficulty of the latter statement is that earnings cycles often don't start with near-record profit margins, which is the case today. In fact, profit margins currently are six times higher than their lowest reading in late 2009.

Another way to assess the direction of stocks based on earnings is to look at earnings yield or earnings and subsequent long-term returns. **Figure 13** uses the Shiller or inflation and business cycle earnings yield of the S&P 500. The Shiller earnings yield (blue line) has moved in close parallel to subsequent 10-year annualized returns for the S&P 500 (orange line) for much of the past 100 years. Said differently, when the Shiller earnings yield is low, subsequent 10-year annualized returns for the S&P 500 tend to be low. And when the Shiller earnings yield is high, subsequent 10-year annualized returns tend to be high. This relationship broke down starting in 2009, a time that coincides with a long period of policy cash rates of around zero and negative real rates. The current Shiller earnings yield of 3.2% suggests a coming period of muted long-term returns, particularly if interest rate policy looks more like the pre-GFC era.

FIGURE 13

S&P 500
Shiller Earnings Yield & Subsequent Annualized Returns



Data as of 12/31/23. Source: Aspiriant analysis. Data from Bloomberg, Shiller. S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. Past performance is not indicative of future results. All investments can lose value. The performance and volatility of an investor's portfolio will not be the same as the index. Indices are unmanaged and have no fees. An investment may not be made directly in an index. This information alone is not sufficient and should not be used for the development or implementation of an investment strategy. It should not be construed as investment advice to any party. Please see additional disclosures regarding third-party data and other considerations.

Final Thoughts: Portfolio Construction

Despite the fall in inflation and resilience of economic growth, conditions remain mixed. Unemployment is near a record low but job openings and quits rates, among other datasets, indicate some softening in labor market conditions. Economic growth, as measured by changes in Gross Domestic Product, has averaged about 3% on an annualized basis over the past four quarters. An alternative measure of economic activity, Gross Domestic Income, has been flat or showing no growth at all over those same quarters and LEI has fallen persistently over the past several months. Retail and foodservice spending were up a healthy 5.6% year-over-year in December, as have other measures of consumer spending. At the same time, signs of consumer stress are growing. Credit card delinquencies are at 10-year highs, subprime auto delinquencies are near 30-year highs, savings rates are at half of pre-pandemic levels and more people are using buy now, pay later programs.

> We encourage you to stay focused on the long-term.

The uneven outlook also extends into equity markets. The S&P 500 is trading at peak levels and is expensive relative to history and bond yields. In past months, gains have become increasingly concentrated in Big Tech companies that now make up more than 30% of the index. Crowded positioning and rising valuations will amplify risks if growth of those platforms stumbles, prompted by any number of catalysts. Valuations outside the United States are considerably cheaper but come with higher economic risks given pronounced slowdowns in economies such as Germany and China.

Final Thoughts, cont.

With that backdrop, there are a couple portfolio implications of note. Given the Fed's progress on reducing inflation, there is a higher likelihood today that future shifts in interest rates will be due to changes in economic growth (versus changes in inflation) and returns for bonds and stocks will be less correlated. Also, we have more normalized bond yields and the ability to earn a positive spread to inflation. Together, these changes likely restore the traditionally defensive characteristics of fixed income. In light of that, we favor a lower allocation to diversifiers to fund an increase in fixed income and equities, including U.S. large-cap equities, so overall portfolio risk isn't materially altered. Importantly, we still like some exposure to diversifiers as their cash plus 3% return profile and ability to protect against market volatility and any resurgence in inflation remain attractive properties.

We still have a bias toward international equities but with less emphasis on emerging markets given the structural pressures in China. Defensive equities, with more durable business models and cash flows, are a key holding, especially if economic growth continues to weaken. Finally, and where appropriate, we believe investors should add differentiated strategies in private markets to benefit from market dislocations and long-term secular trends and further broaden portfolio diversification.

We believe we will continue to see volatility, especially in the U.S. stock market, as earnings are revised downward. We will remain patient and disciplined, holding high-quality bonds with attractive yields, risk-dampening alternatives and high-quality stocks at reasonable prices. While the market environment may feel uncertain at times, we encourage you to stay focused on the long-term and take comfort in our approach as we manage risk and optimize opportunities in areas such as international markets and private investments to help clients remain securely on their long-term financial paths.

First quarter 2024 investing outlook and insight provided by:

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COVID is the COVID-19 health pandemic.

GFC is the Global Financial Crisis.

Gross domestic product (GDP) measures the monetary value of final goods and services produced in a country in a given period of time.

IPOs refer to initial public offerings.

Meme stocks describe the shares of companies that are prominently featured on social media and have gained a significant following.

SPACs (special purpose acquisition vehicles) are publicly traded and created for the purpose of acquiring or merging with an existing company.

S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. An investment may not be made directly in an index.

TMT is Technology, media and telecom. Refers to the 2000 stock market crash, due to the overvaluation of stocks and bursting of the dot-com bubble.