

# HAROLD DAVIDSON & ASSOCIATES, INC.

INVESTMENT COUNSELORS

## ECONOMIC OUTLOOK & INVESTMENT PERSPECTIVE

FIRST QUARTER, 2024

### THE ECONOMY: THE U.S. ECONOMY SHOULD DECLINE MODESTLY IN 2024 BUT AVOID A RECESSION.

While economic conditions are expected to decline modestly, real GDP growth and the pace of job gains are expected to remain positive, pointing to a soft landing for the economy and avoiding a shallow recession. Key to this projection is the Federal Reserve hint at their December meeting that they are likely to reverse the policy of raising the Federal Funds Rate, and that interest rate increases (seven times over an eighteen month period) are done. In 2024, the Federal Reserve indicated they would likely lower interest rates three times, which would probably result in the current 5.25% Federal Funds rate declining to 4.5%. It is the opinion of Harold Davidson & Associates, Inc. (HDA), that the Federal Reserve will be more aggressive on the downside and bring the Federal Funds rates down to 4% by year end 2024. The Federal Reserve also intends to continue its policy of quantitative tightening, letting its massive holdings of Treasuries and mortgage-backed assets dwindle over time.

The key difference for most Americans in 2024 will be the moderation in inflation. The consumer price index, which spiked to 9.1% in June 2022, has fallen to 3.4% in December 2023. It is expected to decline to close to 2%, the Federal Reserve target, by year end 2024, or soon thereafter. The two dynamics of robust employment and falling inflation should result in notable gains in real disposable income for American households. HDA forecasts Gross Domestic Product (GDP) growth of 2.5% in 2023 and 1.5% in 2024.

The labor market is predicted to cool somewhat after proving to be stronger than expected in 2023. The unemployment rate should tick up to 4.2% from the current 3.7% rate at the beginning of 2024.

Consumer spending is likely to contract. The remarkably resilient consumer sector was the story of 2023. While overall finances have been in good shape, excess liquidity is shrinking and access to credit has become more expensive as banks are becoming more cautious in making consumer loans.

A development that offers promise is productivity has recently picked up with manufacturing advancing at a 4% rate for the past six months. Companies have invested heavily in new manufacturing capacity, as well as in new technologies such as robotics and artificial intelligence.

What about the housing market? Many homeowners are locked in at low interest rates and are unwilling to sell due to higher interest rate for new home purchases, resulting in demand continuing to outpace supply. Housing stock remains near historic lows, especially entry level housing. Also, affordability issues continue to deteriorate. Millennials entering their prime home-buying years, wage growth, and financial wealth are tailwinds that will sustain housing demand in 2024. Mortgage rates are projected to decline to 6% by year end from the 8% peak reached last year.

The Institute for Supply Management (ISM) in the December report was optimistic about overall business prospects in manufacturing, seeing accelerated growth in the second half of 2024. When looking at the retail sales forecast for 2024, expectations by the National Federation of Retailers is for similar growth to 2023 over 2022, which is 3% to 5%. Likely increases in unemployment may result in this estimate being modestly optimistic.

New automobile sales for 2023 were expected to be just under 15.5 million vehicles, a significant increase of 12.8% from 2022, when just 13.7 million vehicles were sold. Supply problems are no longer an issue, as dealers are now discounting some of their available inventory. New vehicle sales for 2024 are projected to increase between 1% to 4% to 15.6 million to 16.1 million vehicles.

Expected weak global economic growth should slow oil demand growth in 2024, with the price of West Texas Intermediate Crude averaging approximately \$79 per barrel. Concerns about economies and oil demand, combined with greater than expected non-OPEC supply growth, has depressed oil prices which have also largely shrugged off the OPEC+ supply cuts and the Hamas-Israel war. Additional geopolitical flare-ups, specifically in the Red Sea, could potentially cause greater supply problems and higher prices.

The European Union (EU) lowered its estimate for eurozone economic growth for 2023 to 0.6%, though it is expected the eurozone economy will avoid a recession. The EU warned the Russia-Ukraine and Hamas-Israel wars have increased uncertainty and downside risks. The eurozone economy is projected to rebound modestly in 2024, as inflation eases amid a robust labor market, and could potentially rebound to 2% growth. Both Germany and France contributed to 2023's slowdown in growth.

China's manufacturing activity continued to contract through year-end 2023, indicating weakening momentum in the world's second largest economy despite increased government effort to boost growth. Policy makers are under pressure to tackle a slowdown in the country's debt-stricken property sector.

Geopolitical risks for 2024 include elevated trade tensions with China, ongoing Russia-Ukraine war, Hamas-Israel war, and the U.S. presidential election. This should be an interesting year.

## THE STOCK MARKET: RENEWED OPTIMISM THAT INFLATION IS SUBSIDING FUELED STOCK MARKET GAINS.

The S&P 500 finished off a strong 2023, closing out the year with a 26% increase based on expectations that the Federal Reserve was successful in taming inflation, and the next move in interest rates would be lower. Expectations are that inflation will be brought down without the U.S. experiencing a recession.

Where will the stock market finish in 2024? The S&P 500 Index finished 2023 at 4,769 which is a 21.68 P/E multiple on the consensus 2023 S&P Index earnings estimate of \$220. For 2024, it is widely anticipated the S&P will earn approximately \$240 per share and using the same 21.68 P/E multiple should end the year around 5,200, which is 9% higher than 2023. However, there will be rotational sector opportunities for stock purchase as the year unfolds. It is also anticipated as the Federal Reserve Federal Funds interest rates are decreased, the momentum of stock appreciation will increase.

During the quarter ending December 31, 2023, HDA purchased shares in an insurance company and added to our position in a hospitality company and an infrastructure company. HDA sold our position in a performance ride dynamics manufacturer and completed year-end tax repositioning.

The composition of the assets currently managed by HDA is as follows: cash and cash equivalents - 3%; municipal bonds - 7%; corporate bonds - 8%; bond mutual funds – 2%; equity mutual funds - 12%; common stocks - 54%; and real estate equities -14%.

## THE BOND MARKET: WHILE 2023 WAS A VOLATILE YEAR FOR THE BOND MARKET, MEANINGFUL ANNUAL RETURNS WERE ACHIEVED.

During the fourth quarter the Core Bond index increased 6.6%, which erased the losses from the prior three quarters. The bond market at the end of October reached a low as investor sentiment and confidence declined. However, after inflation data showed significantly slower inflation and the Federal Reserve provided neutral monetary policy guidance, the bond market rallied dramatically and the yield on the 10-year U.S. Treasury ended the year roughly where it started at about 3.9%, and the 2023 annual bond market return equaled a very strong 5.3% annual return.

As a result of recent indicators suggesting economic growth has slowed, job gains have moderated, and the unemployment rate remains low during the fourth quarter. The Federal Open Market Committee (FOMC) stated a target range for the Federal Funds Rate of 5.25% to 5.5%. This is unchanged from the third quarter. The FOMC did reiterate their desire to “achieve maximum employment and inflation at the rate of 2% over the longer run” and will adjust monetary policy as necessary to achieve this objective. It is widely anticipated that during the second half of 2024, if not sooner, the FOMC will become more accommodative and reduce interest rates. Lower interest rates will make our recent fixed income purchases more desirable by increasing the bonds

underlying market value as we have locked in higher returns than should soon prevail in the bond market.

Inventories for high quality corporate and municipal fixed income securities decreased during the fourth quarter, although we successfully continued to purchase quality issuers with shorter term duration (3 to 5 years) bonds for client portfolios. We have also continued to replace maturing short term U.S. Treasury Bills and Notes with corporate and municipal bonds to lock-in the higher yields for a longer duration.

### REAL ESTATE: REAL ESTATE TRANSACTION VOLUME HAS SLOWED DRAMATICALLY AND BUYERS ARE ON THE SIDELINE AWAITING INTEREST RATE CUTS.

The fourth quarter was a very slow quarter for the real estate markets. Across all product types there were very few transactions. Buyers are clearly sitting on the sidelines waiting for sellers to adjust their pricing expectations and for the expected decrease in interest rates.

For the first time in many years the commercial real estate market is facing headwinds. Rents have softened, and vacancies, concessions, and marketing times have all increased. Landlords are having to adjust expectations to meet demand. The residential real estate market has also slowed dramatically. Prices have decreased, listing times have increased, and transaction volume has slowed.

During 2024, HDA predicts the real estate market to remain largely unchanged during the first half of the year, and then transaction volume and prices to increase once the Federal Reserve begins cutting interest rates. HDA plans to closely monitor the markets and will make strategic acquisitions and dispositions when appropriate.

### SUMMARY AND CONCLUSION:

The Federal Reserve is achieving success in bringing down the inflation rate. While GDP growth is slowing, it appears a soft landing rather than a recession will be the outcome. HDA expects stock market appreciation to accelerate the latter half of 2024 as interest rates are expected to decline. The bond market should see lower yields as the Federal Reserve cuts interest rates. The real estate market should expect increased transactional volume when interest rates decline as well.

### CLIENT REFERRALS

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