Equities Outlook

2024 Year Forecast

Jason Herried, CFA
Senior Vice President, Director of Equity Strategy & Portfolio Manager

In our quarterly Economic & Market Outlook, we reviewed 2023 market drivers and provided summary 2024 outlooks for stocks, bonds and alternative investments. We'll now provide additional detail on our views about 2024—starting this week with equity markets.

2023 Review

First, let's summarize where we're starting. As a whole, 2023 turned out to be a much better year for the economy and stock market thanks to a fourth quarter rally triggered by a one percentage-point decline in key interest rates. In the end, investor caution proved unnecessary as the pace of economic growth was solid (whereas recession seemed likely when the year began). In addition, inflation moderated, which allowed the Fed to signal in November that it had likely made its last rate increase for this cycle.

Stocks finished the year with double-digit gains across the globe. Markets with large exposure to the 2023 standouts—the "Magnificent 7"—such as the S&P 500 Index and Russell 1000 Growth Index, were the top performers with gains of 26% and 43% respectively *[Figure 1]*. The "Magnificent 7" stocks are mega-sized companies in the sectors of Technology (Apple, Microsoft, Nvidia), Communication Services (Alphabet, Meta Platforms) and Consumer Discretionary (Amazon, Tesla). These stocks far outperformed other sectors thanks to strong balance sheets, exposure to artificial intelligence trends ("AI") and rebounds from weak 2022 performance.

Figure 1

2023 Equity Market Performance Summary

U.S. EQUITY	5 YEARS	2023	3 MONTH
S&P 500	15.7%	26.3%	11.7%
Russell 1000 Growth	19.5%	42.7%	14.2%
Russell 1000 Value	10.9%	11.5%	9.5%
Russell 2000 (small-cap)	10.0%	16.9%	14.0%
INTERNATIONAL EQUITY			
MSCI EAFE (developed)	8.2%	18.2%	10.4%
MSCI EM (emerging markets)	3.7%	9.8%	7.9%
S&P 500 SECTORS			
Technology	27.0%	57.8%	17.2%
Communication Services	13.3%	55.8%	11.0%
Consumer Discretionary	13.7%	42.4%	12.4%
Industrials	14.2%	18.1%	13.1%
Materials	13.6%	12.5%	9.7%
Real Estate	8.9%	12.4%	18.8%
Financials	12.0%	12.1%	14.0%
Healthcare	11.6%	2.1%	6.4%
Staples	10.9%	0.5%	5.5%
Energy	13.4%	-1.3%	-6.9%
Utilities	7.1%	-7.1%	8.6%

Source: Morningstar Direct

Despite a brief interruption in 2022, the bull market for stocks like the "Magnificent 7" has been in place for the past five years as investors have bid up prices based on future prospects. Accordingly, the U.S. indices have become concentrated in a small number of stocks, which has been a performance headwind for more diversified investment approaches. To provide some perspective, below are a few interesting points about the Top 10 stocks in the S&P 500, which includes the "Magnificent 7":

- The top 10 stocks increased 62% in 2023 compared to 8% for the remaining stocks.
- As compared to the S&P 500, the top 10 stocks are trading at a 38% premium (PE: 26.9x) compared to a 12% discount (PE: 17.1x) for the remaining stocks.
- The top 10 stocks represent over 32% of the index, although their share of earnings is 23% *[Figure 2]*.

While these businesses are exciting and increasingly important in our daily lives, we suggest trimming overweight positions to manage risk.

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2024 Outlook

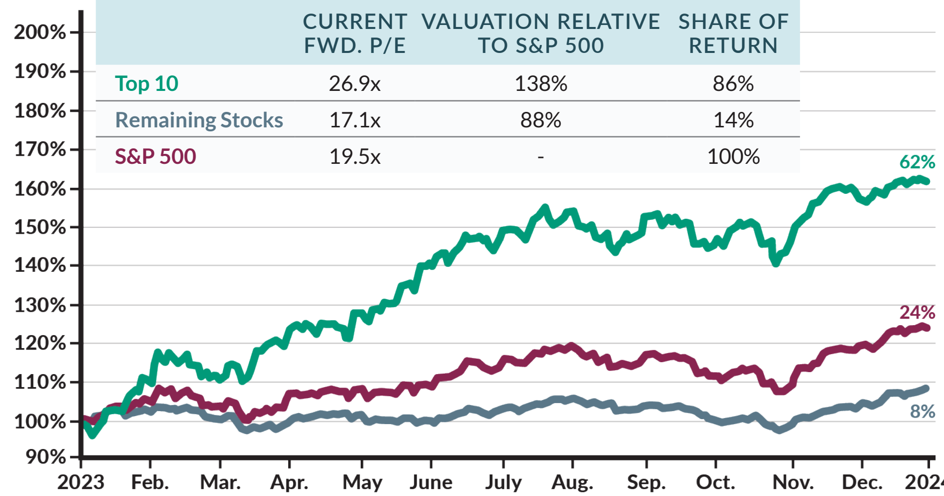
Legendary value investor Benjamin Graham is credited with the analogy that the market is like a voting machine in the short run and a weighing machine in the long run. Investor sentiment is the voting machine. Fundamentals are the weighing machine.

Figure 2

Performance of the Top 10 S&P 500 Stocks

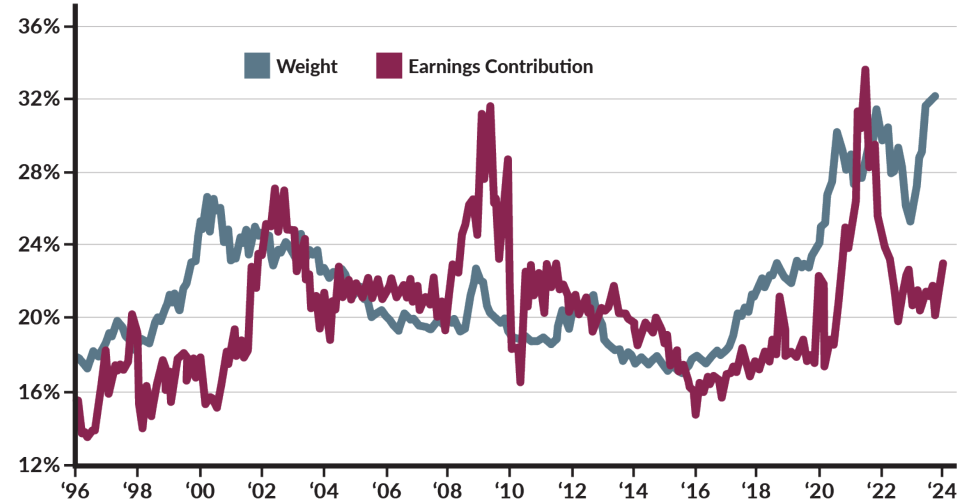
Indexed to 100 on 1.1.23, price return, top 10 held constant

	CURRENT FWD. P/E	VALUATION RELATIVE TO S&P 500	SHARE OF RETURN
Top 10	26.9x	138%	86%
Remaining Stocks	17.1x	88%	14%
S&P 500	19.5x	-	100%



Top 10 Stocks Percent of Market Capitalization

Earnings contribution based on last 12 months

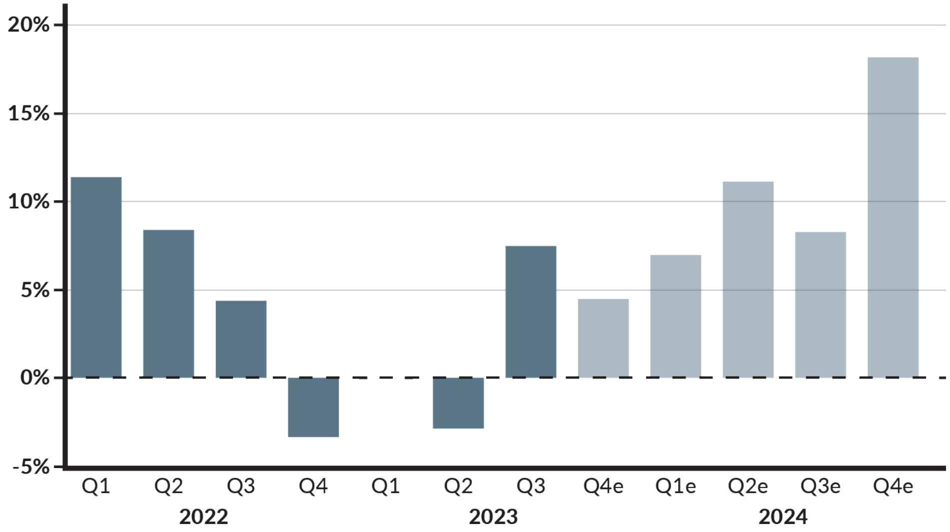


Source: Bloomberg

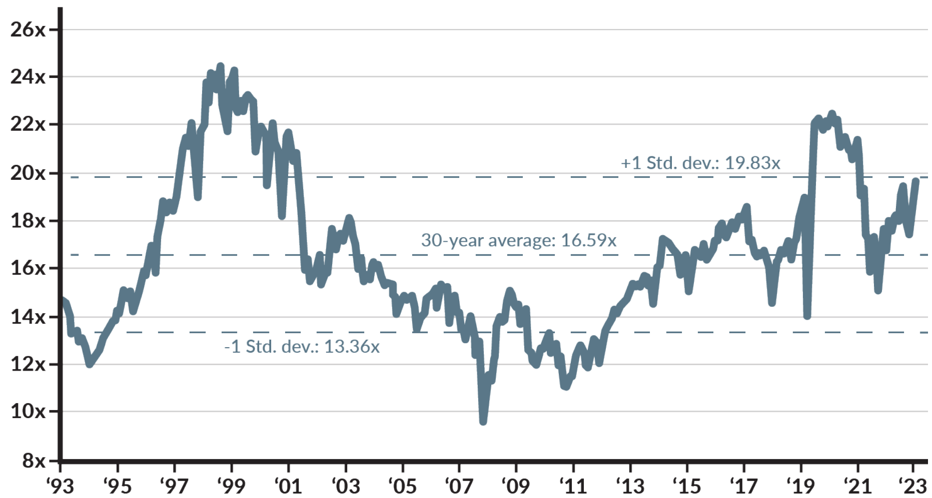
Figure 3

S&P 500 Operating Earnings Growth

vs year ago period



S&P 500 Index: Forward P/E Ratio



Source: LSEG I/B/E/S , FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, JP Morgan Asset Management as of 12.31.2023

Investors "voted" for higher prices in 2023 as sentiment changed from recession fears to soft-landing hopes. That's led to higher price-to-earnings ratios (for the S&P 500 Index, 20x expected 2024 earnings vs. 17x a year ago). This change suggests investors are more confident that the economy will continue to expand in 2024—meaning little recession risk is priced in.

But what does the weighing machine say? Well, corporate earnings are thought to have increased just 1% last year. Looking ahead, earnings are expected to increase 11% with progressively faster growth as the year progresses *[Figure 3]*.

Those are big expectations for earnings. We expect they are likely to be revised lower. Here's what that could mean:

- Since valuations have less room to expand than in 2023 (given sentiment is already optimistic), it's reasonable to expect a single-digit return for stocks.
- However, if we avoid an economic recession, we could see another year of double-digit returns—which isn't actually uncommon. Of the 44 years since 1980, 32 have recorded positive returns. Of those, 26 were higher by 10% or more.

Portfolio Adjustments

All told, we have a period of:

- Optimistic investor sentiment;
- Continued concern about the future economic prospects;
- Above-average recession risk.

This is time to review portfolios for opportunities to rebalance. Rebalancing realigns portfolio risk to long-term targets and takes profits in recent outperformers to add to areas of the market that have not recently performed to the same degree. U.S. growth stocks, for example, outperformed in 2021 and 2023 but underperformed in 2022. Given their above-average valuations at present, now is a good time to reduce overweight positions in our view.

We are looking to redeploy stock-market profits into bonds given more attractive yields. Investment-grade bonds are expected to earn about 5% over the next 10-15 years based on current yields. That compares to an expected average return of 7% for stocks.

Within the stock market, we have been adding to small company stocks after a period of limited exposure. Small company stocks tend to be more economically sensitive and have more debt. Thus investors have shunned them given elevated recession and interest rate risks. That changed in the fourth quarter as investors expected interest rates to decline. As sentiment changed during the quarter, small caps were a top performer with gains of 14%. We think the negative sentiment toward small and mid-cap stocks relative to the mega-cap stocks like the "Magnificent 7" makes the former more attractive in the coming years.

Key Risks

Every year comes with a litany of risks and surprises, and 2024 is unlikely to be any different. Geopolitical tensions are among our biggest concerns in the coming years, so investing in line with your time horizon is important, so as to avoid getting caught having to sell stocks at an inopportune time.

From an economic perspective, recession risk remains elevated and resurgent inflation would likely prevent the Fed from cutting rates to the degree markets are anticipating. While the U.S. election will create uncertainty, election-related stock-market volatility tends to be temporary. Taking this into consideration, election-related selloffs should be viewed as opportunities to add to stocks.

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. Over the coming weeks, we'll share more specific outlooks for stocks, bonds and alternative investments. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. **Thank you for your partnership and trust in Johnson Financial Group.**