Three Potential Paths Forward

An impressive U.S. stock market rally that few analysts predicted continues to build momentum. The S&P 500 has risen 18% this year, while 8 of the 11 S&P 500 sectors are in positive territory. Two factors have mainly driven the buoyancy of U.S stocks: Hype around artificial intelligence (A.I.), and the potential for a “soft landing” for the U.S. economy. The latter is supported by retreating inflation, a solid labor market, robust services sector, and a pickup in the residential housing market.

Economically sensitive areas of the market, including small-cap U.S. stocks and high yield bonds, have recently perked up, potentially signaling that investors are growing more eager to take risk. To be sure, the negative narrative continues to linger, but that bear is not growling too loud at the moment. The substantial recovery in equities since the October 2022 lows of roughly 27% for the S&P 500 and 53% for the technology sector is a stark contrast to the deterioration in corporate profitability, a historic inversion of the yield curve, higher global short rates, the potential for a higher-for-longer Fed, stretched valuations, and a sputtering Chinese recovery.

FIVE KEY TAKEAWAYS

1. Equities have displayed strong momentum this year
2. Monetary policy will remain tight for some time
3. The most likely path forward includes a mild recession
4. Investors can prepare for a “soft landing” by staying balanced
5. Bonds and cash are attractive asset classes for income and diversification
Equities have rerated significantly since October 2022

Companies face revenue headwinds due to declining sales and eroding pricing power, forcing them to cut worker hours and to raise productivity.

- Consumer spending flattens for a couple of quarters as pandemic excess savings are exhausted, student loan repayments commence, and job growth weakens.
- Healthy consumer and corporate balance sheets cushion the impact of an increase in unemployment.
- Inflation continues to fall, with core inflation gradually declining to the Fed’s 2% target. But this process takes time as inflation in the service sector remains sticky.
- The Fed keeps rates at relatively higher levels to ensure inflationary pressures are under control and contemplates cutting rates in 2024.
- Lower interest rates in combination with the Fed balancing both its growth and inflation mandates lay the foundation for a new business cycle.

Scenario

1

50% probability

A mild U.S. recession, followed by a growth and profit recovery in 2024
The U.S. economy remains resilient despite the rapid increase in borrowing costs. Gross domestic product (GDP) growth glides down to below trend levels but remains positive.

Wage growth moves to a sustainable 2-3% range, helping core inflation decline to an acceptable level near the Fed’s 2% target.

Demand for labor cools, job openings decline, and job cuts occur in targeted industries. At a macro level, stable real wages are able to cushion consumer spending.

Demand for services remains at expansionary levels while the manufacturing downturn stabilizes.

The Fed acknowledges major progress on inflation. However, with the economy still growing and labor scarcity continuing to plague some sectors, the Fed remains cautious on outright rate cuts or reversing quantitative easing.

Stock market volatility remains low, as evidence grows of the Fed achieving their inflation goals without causing a recession or systemic financial risks.

Global cyclical stock market sectors catch up to growthier segments of the market, with defensive sectors lagging.

The dollar continues to weaken, giving a boost to international markets – both in developed and emerging markets.

Bond market total returns continue to be attractive but lag stocks from a 12-18-month perspective.

A “soft landing,” with slowing inflation and moderate growth

The next great bull market gains traction, driven by historic levels of technological innovation led by the deployment of A.I. across the global economy. In this scenario, capital investments by governments and companies accelerate to fortify local supply chains and grow higher value-added manufacturing capabilities. The global push toward a low-carbon energy transition creates winners and losers in the push-and-pull between the need for fossil fuels and investment in clean technologies. Lastly, millennials starting families finally supports home construction and other long-term investments.
A deeper dip for growth and corporate profits

- GDP growth turns negative for a few quarters as consumer and corporate spending comes under pressure.
- The service economy loses momentum as household savings rise.
- Companies are forced to lay off workers across most sectors, leading jobless claims to increase further. A significant decline in labor demand causes wage growth to normalize and even turn negative, and the unemployment rate rises to around 5%.
- Core inflation drops quickly to the Fed’s 2% target and may even undershoot, as the lagged impact of the historic levels of monetary policy tightening and the recent contraction in money supply takes hold.
- Concerns around financial stability and deflation cause the Fed to cut rates in 2024. Bond yields decline, delivering positive price gains across fixed income. In this scenario, long-duration bonds outperform and low-quality credit sectors lag.
- Corporate profits decline by more than 20% from the peak, in line with the average recession. Risk aversion across financial markets causes stock valuations to decline, but the A.I. enthusiasts remain buyers of weakness in technology-related areas, keeping valuations reasonably anchored above long-term averages.
- Cyclical and value-oriented stocks underperform the defensive and growth areas of the stock market.
- The dollar stabilizes and strengthens as the U.S. outperforms international equities.

We think that a mild recession is the most likely near-term scenario, but acknowledge that the possibility of a softish landing (slower economic growth without recession) has recently increased. However, we would advise investors to not fixate too much on the “recession or no recession” question, since predicting the timing of a downturn is difficult in normal times and is unusually difficult in the post-Covid economy. Additionally, the typical reaction of the market to forward looking macro-indicators seems to have weakened, which along with the arrival of the A.I. trade and the dominance of a few mega cap stocks and technology-related exposures unique to the S&P 500 index, has made a mockery of several market predictions.

Four questions remain as investors grapple with the potential of a near-term slowdown:

- Where will corporate earnings settle?
- How might weaker consumer sentiment translate into a pullback in spending?
- Will employers be forced to lay off workers to protect profit margins?
- Will the Fed have to accept a higher level of inflation in the medium term?

As we move through this phase of the business cycle with contradictory flashes of both late and early cycle signals, investors should remain balanced and stay invested in their long-term asset allocations, in our view. High quality bonds have a greater valuation support than equities, which are further along in pricing in a rosier outlook. Additionally, the opportunity set for active managers remains attractive given valuation and return dispersions within both the equity and fixed income asset classes.
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