ASTOR
INVESTMENT MANAGEMENT

FUNDAMENTALLY DRIVEN.

ASTOR ECONOMICS IN FOCUS
FIRST HALF 2024 OUTLOOK

- Our base case is the U.S. economy successfully realizes a soft landing, with lower inflation and decent growth, in the first half of 2024.
- This view is the market consensus and is supported by moderating inflation and a softer but robust labor market that may allow the Fed to cut several times.

We see several risks to this outlook:

- On the upside, economic growth, wages, and inflation tick heat back up (from a variety of causes), pushing off Fed cuts to later in the year, with negative implications for fixed income.
- Or on the downside, data worsens, the labor market and consumer turn weak, the Fed is behind the curve, and the U.S. experiences a shallow recession.
- It is worth noting that the overwhelming consensus view for 2023 was for a recession that did not materialize. With the base-case a soft landing, the non-consensus views are always worth paying attention to.

MARKETS: 2023

2023 was one of the most interesting years to be an investor. Volatility raked wide swaths of the bond market throughout the year, as regional banks came under pressure, inflation expectations swung up and down, and Fed policy was priced and repriced. The yield on U.S. 10-yr treasuries began the year at 3.87%, went as low as 3.30%, as high as 5.0%, and ended 2023 just below 4%. The MOVE Index (a measure of fixed income volatility derived from options on U.S. Treasury Bonds) saw levels unmatched since the great financial crisis.

Optimistic investors pushed equities higher in the first half of the year as disinflation took hold. This was swiftly undone in Q3 on concerns that rates would need to stay elevated for longer, and equities hit five-month lows, and small and mid-cap stocks were down for the year through late October. Ultimately, the pendulum swings both ways. With inflation and employment gains moderating, the narrative of an end to the Fed hiking cycle and potential rate cuts in 2024 overwhelmed the markets, sending the S&P 500 to all-time highs and bonds from a down year to a solid positive (Chart 1).

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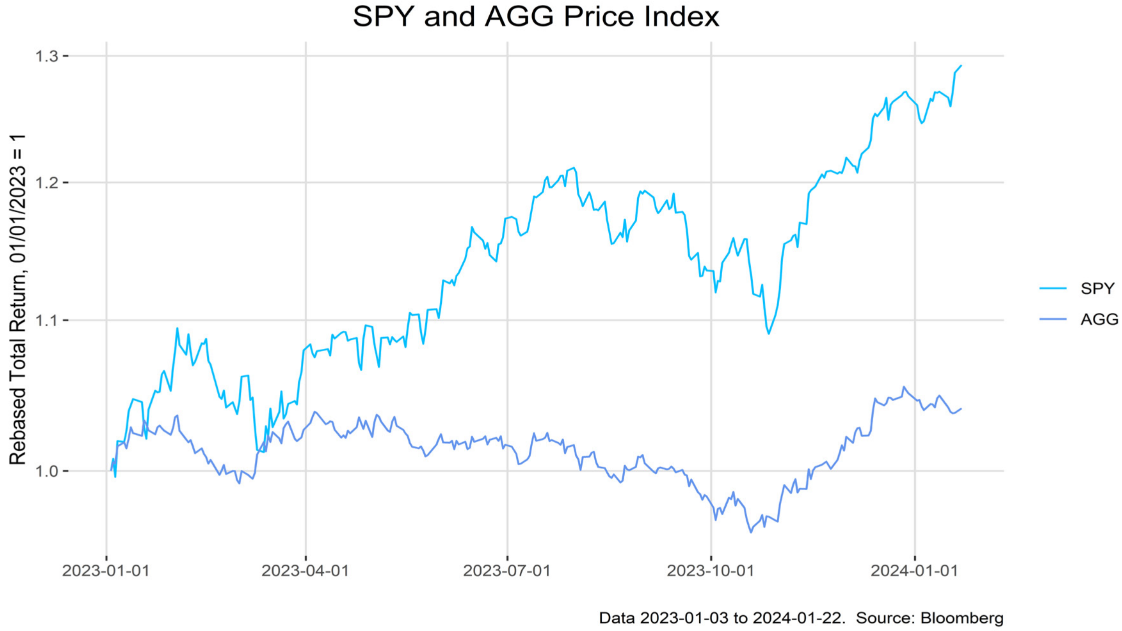

Chart 1: As of 01/31/2024 | Source: Bloomberg. The chart above represents returns for SPY and AGG Price Index Q4 2023 but does not depict the returns of any Astor strategy. Past performance does not indicate future results.

First Half Outlook: 2024

What should we expect for stocks and bonds in 2024? From where we sit today, we think the fundamental risks are roughly equally balanced against our benign base case scenario of a cooling but still growing economy, with moderating inflation that allows the Fed to slowly cut rates towards 3%. This would be reassuring for credit and duration, the two components of fixed income returns we think are most relevant in asset allocation, and broadly supportive of equity prices. However, there are upside and downside risks to this outlook that should give any investor pause. We discuss three potential paths for the economy and thus stocks and bonds below.

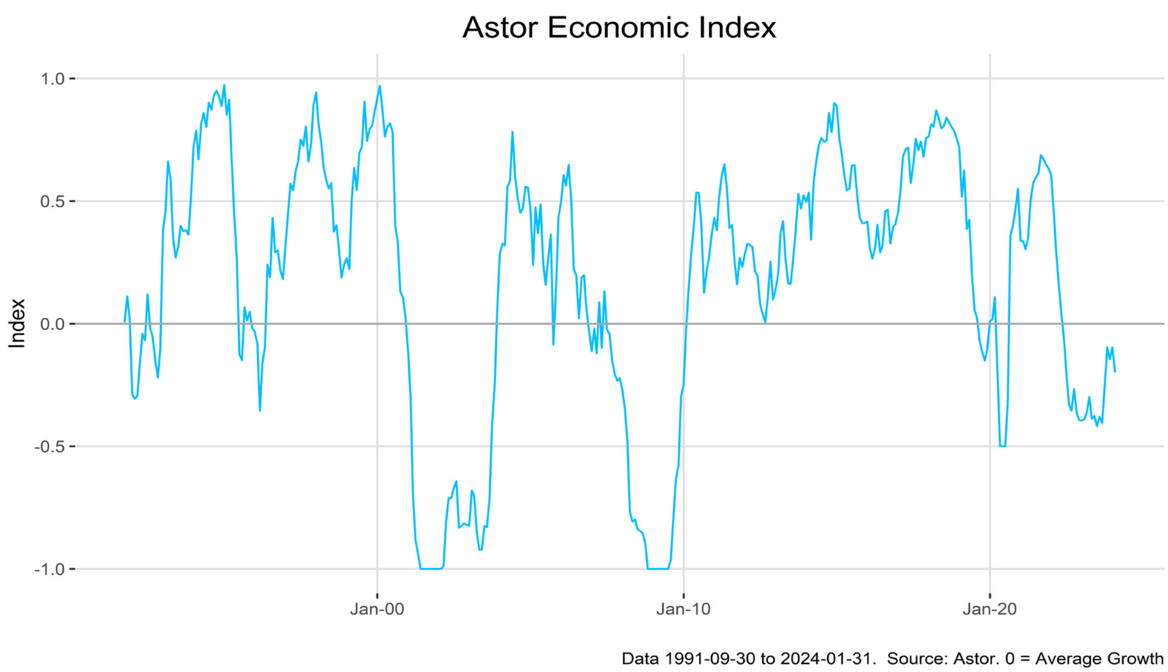

Chart 2: Source: NBER Astor Data. As of 01/31/2024. The Astor Economic Index® is a proprietary index created by Astor. It is not an investable product. See Disclosure section for additional information strategy.

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Scenario 1

Start with our base case scenario, which we believe is mostly the consensus view and thus partly priced into bonds and stocks. Indeed, the Astor Economic Index®(AEI) is at about its average reading – a level consistent with normal economic growth. In this narrative, the U.S. economy continues towards normalization – the much-ballyhooed soft landing. Core PCE continues towards the Fed's target, allowing the FOMC to gradually cut as the policy rate rises in real terms (Chart 3). Importantly, the economy would continue to tick along from decent consumer spending and a slightly softer labor market (non-farm payrolls ended the year at a modest 216,000 m/m gain). In this scenario, it should pay to own some (although not all) duration and high yield fixed income, andincome and retain an average exposure to equities.

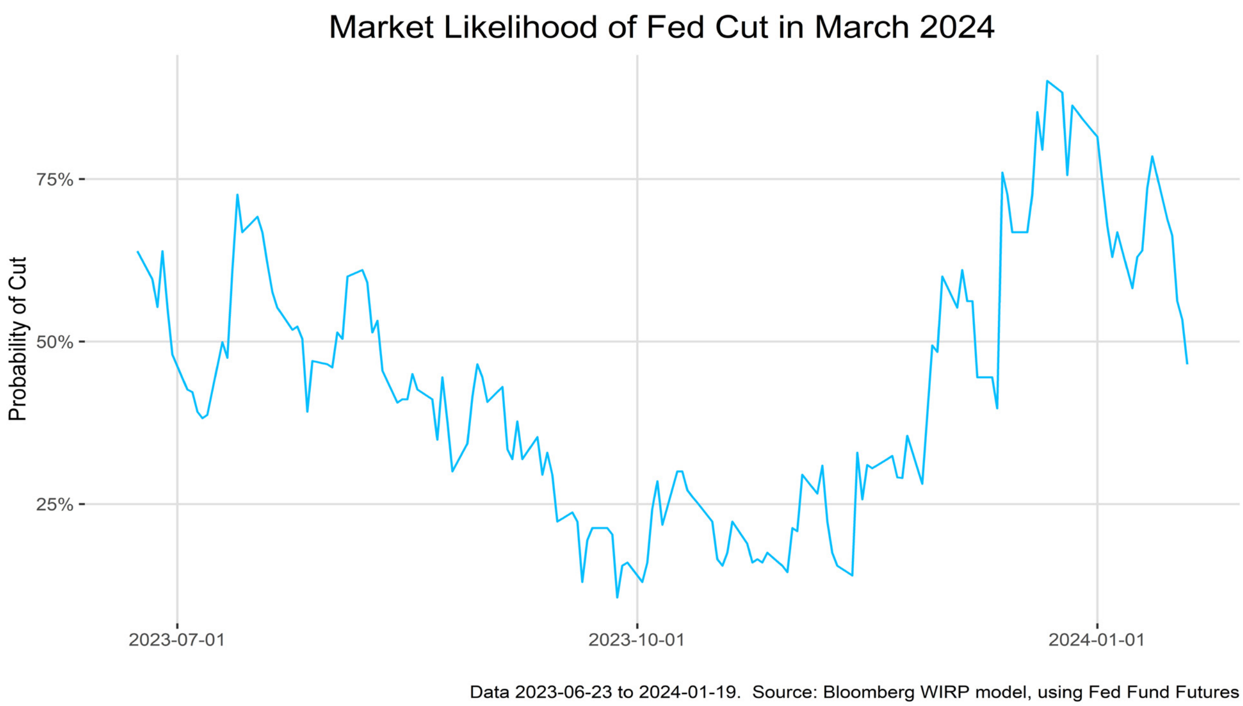

Chart 3: As of 01/31/2024. Source: Bloomberg. The chart above represents market likelihood of Fed cut in March 2024 but does not depict the returns of any Astor strategy.

Scenario 2

The next scenario is upside risks to growth, with a resurgence in inflation and a hot economy. Here the proximate cause may be goods inflation from geopolitical strife, continued pressure in services and housing, or low productivity or hot wages. A return to an economy above potential may not even be necessary – a continuation of CPI above the Fed's target would suffice to induce a response (core CPI ended the year up 3.9% y/y – Chart 4). Services, and in particular rent of shelter, has proven unresponsive to Fed policy to date, and makes up the bulk of inflation these days (Chart 5). As a result, the Fed may need to hold firm longer than anticipated. Note that inflation expectations have consistently missed the mark this cycle. Regardless of the spark, bonds that are priced to perfection (the market expects ~ 5 cuts in 2024) for a cooling economy would sell off. It would likely be advantageous to have an above-average exposure to equities in this scenario, as consumers continue to spend on goods and services.

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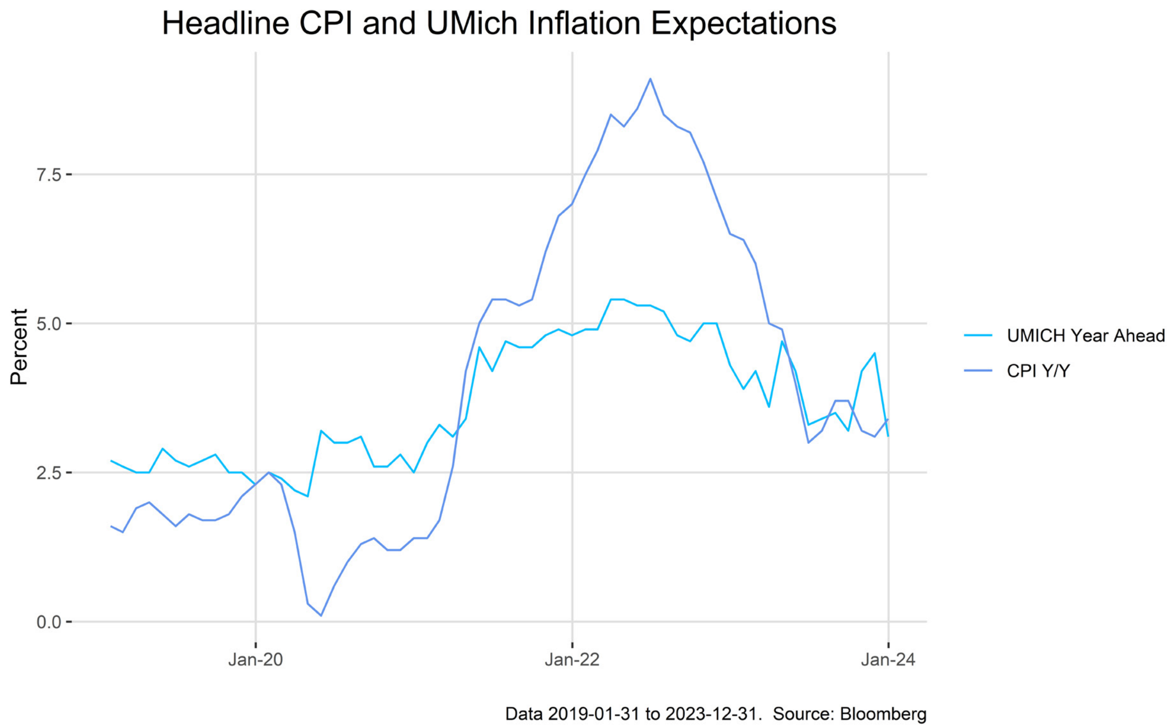

Chart 4: As of 01/31/2024. Source: Bloomberg. The chart above represents CPI and UMich inflation expectations in 2024 but does not depict the returns of any Astor strategy.

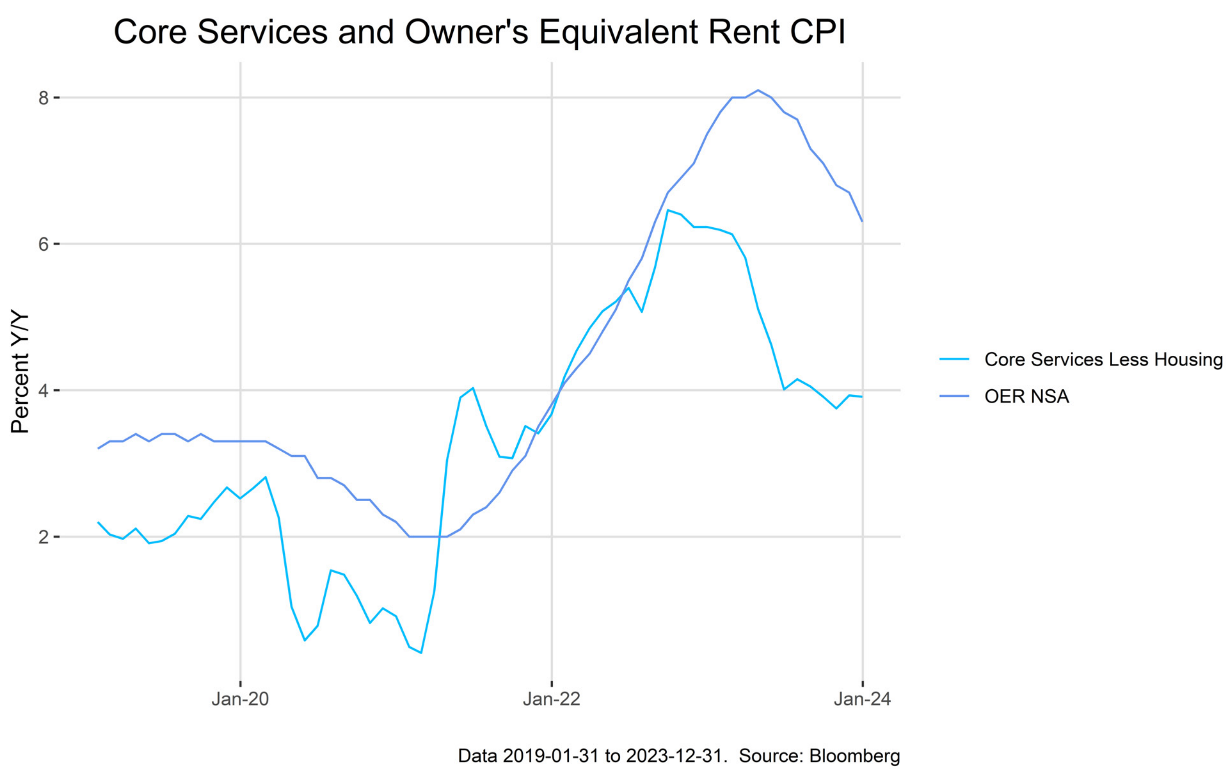

Chart 5: As of 01/31/2024. Source: Bloomberg. The chart above represents core services and owner's equivalent rent CPI in 2024 but does not depict the returns of any Astor strategy.

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Scenario 3

Lastly, let's consider what could go wrong with the Fed and labor markets. The downside risk to a soft landing is that the Fed may overindex to its recent experience with inflation and be reluctant to react to data, thus disregarding warning signs of a quickly weakening economy, such as rising continuing claims. As a result, the economy could tip into an outright recession from overly restrictive policy. The most recent PPI print suggest that inflation may be cooling faster to target than the Fed has previously thought. The other downside risk is the labor market, which has driven real consumption and thus the economy in 2023. We see no truly alarming data points at this juncture – jobless claims are contained, and non-farm payrolls have moderated towards their historical trend. However, there are incipient signs of weakness, with Average Weekly Hours falling alongs with the quits rate. Relative to our base case, in this scenario, it would probably pay to own significantly more duration and much less credit and equities.

The Consumer Spotlight

A weaker labor market would bring several risks to the consumer. While non-farm payrolls are strong, JOLTS hiring rate, the household survey, and the ISM services employment index have all weakened. Crucially, the service sector of the economy has been the solid foundation for the macro-economy even as manufacturing has lagged. Despite recurring concerns about a spending slowdown, the consumer has remained resilient. A moderation in hiring has been welcome respite for wage pressure and generally consistent with a tighter labor market (sub-4% unemployment). Given all of this, where could things go wrong?

If we had to try and pick at threads, while retail sales numbers continue to be solid, revolving credit usage has rose. Through November, total revolving credit has risen by over $100B in 2023 to just over $1.3T total outstanding. At the same time, interest rates on credit cards overall have risen sharply since the first quarter of 2022, to an all-time high of 21.47%. Since 1995, that number had barely risen above 15%. If the consumer is utilizing more credit, and the cost to service the debt has gone up, there are less discretionary funds to cover these costs, which need to be paid somehow.

Delinquency rates on these revolving credit accounts as well as overall credit have been rising since early 2022 (Chart 6). As of the last data reported by the Fed (9/30/23), these delinquency rates are the highest since early 2012. To be fair, we are just now reaching the lowest levels pre-financial crisis era, but the path and pace of change warrant investor attention.

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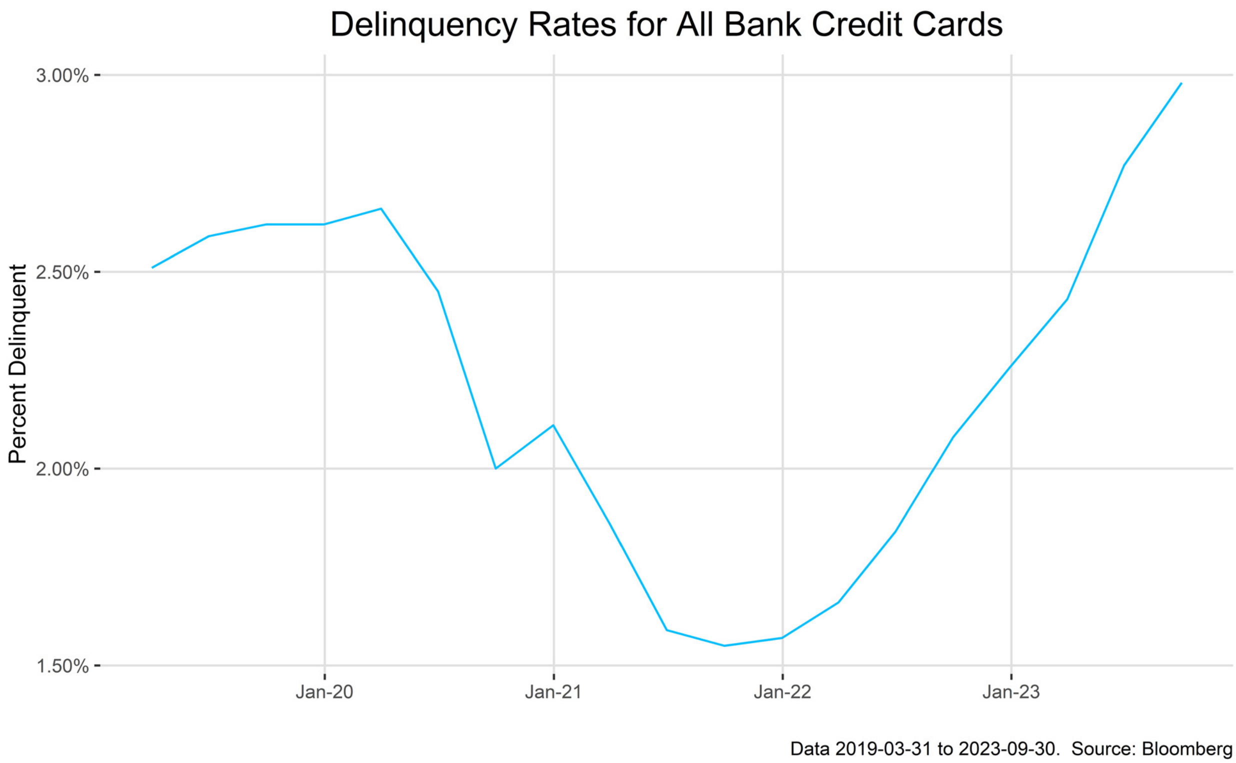

Chart 6: As of 01/31/2024. Source: Bloomberg. The chart above represents Delinquency rates for all bank credit cards for 2024 but does not depict the returns of any Astor strategy.

The takeaway here is that credit is becoming more of a burden to the U.S. consumer. If the economy were to stall and employers retrenched, this would affect the labor dynamic. The most likely outcome of a threat to incomes would be a pull-back in spending from consumers, which in turn is a potential threat to an economic expansion, given the importance of the consumer in the U.S. economy.

Conclusion

As 2023 shows, predicting the next year or even the next quarter of economic trends is very difficult. The dueling rate narratives in Q3 v Q4 ’23 highlighted the risks around the base-case scenario. Aside from our outlooks themselves, a surge of optimism in the last two months of 2023 and subsequent rally in both bonds and risk assets may have left financial markets a bit exposed to disappointment to start the year. To be sure, the VIX (volatility index) has returned to low levels last seen prior to Covid. This could mean the market is a bit complacent currently. Additionally, an early-year challenge to the market’s view of over 5 rate hikes could spook the market as well.

Keeping a close eye on leading indicators, digesting narratives, and understanding what is currently priced into the market may be the key to asset allocation next year. At Astor, we will be doing all the above when considering our equity and fixed income allocations in 2024.

DISCLOSURES: There is no assurance that Astor's investment programs will produce profitable returns or that any account will have similar results. You may lose money. Past results are no guarantee of future results.

BENCHMARK INFORMATION & DEFINITION:

Standard & Poor's 500 Total Return Index: *The S&P 500 Index measures the performance of 500 large cap stocks, which together represent approximately 80% of the total equities market in the United States. The Total Return calculation includes the price-plus-gross cash dividend return. The S&P 500 is registered trademark of McGraw Hill Financial. An investment cannot be made directly in an index.*

The Bloomberg U.S. Aggregate Bond Index: *U.S. Agg is a abroad-based index representing the dollar-denominated, investment grade bond market and includes Treasuries, government securities, and mortgage securities.*

Beta: *A quantitative measure of the volatility of a given portfolio, relative to the S&P 500 Index, computed using monthly returns. A beta above 1 is more volatile than the index, while a beta below 1 is less volatile.*

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