PERFORMA

2024 OUTLOOK

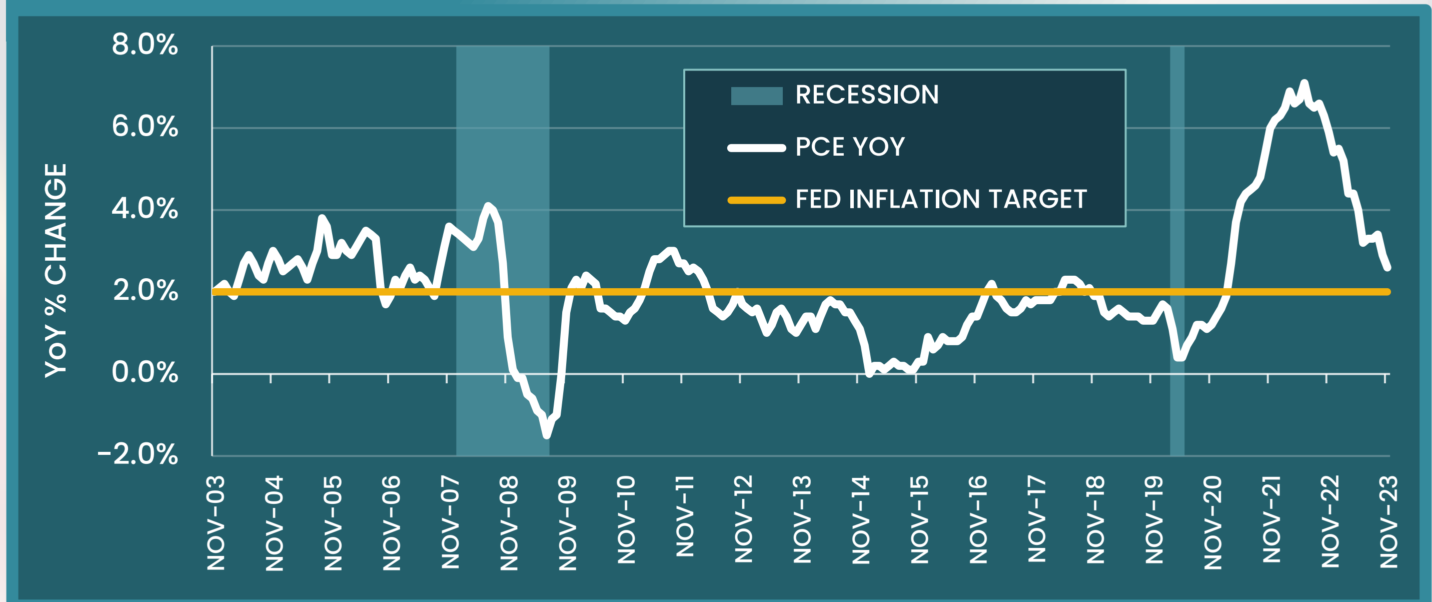
MARKET PERSPECTIVE

INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

2024 OUTLOOK | FOLLOW THE YELLOW BRICK ROAD

Almost four years after the initial COVID-19 outbreak and related lockdowns, supply and demand across the U.S. economy are coming back into balance. Indicators that defined the COVID era distortions have largely been unwound and a level of normalcy restored. Most important, inflation has trended meaningfully lower, which has allowed the Federal Reserve to take a patient, wait-and-see approach to monetary policy. Despite the improvement seen during 2023 and optimism about the year ahead, inflation remains above the Fed's 2% target, suggesting that the job is not yet complete.

HEADLINE INFLATION



SOURCE: PERFORMA, BLOOMBERG, BEA | PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX, SA

3 KEY THEMES FROM 2023 AND WHY THEY MATTER FOR 2024

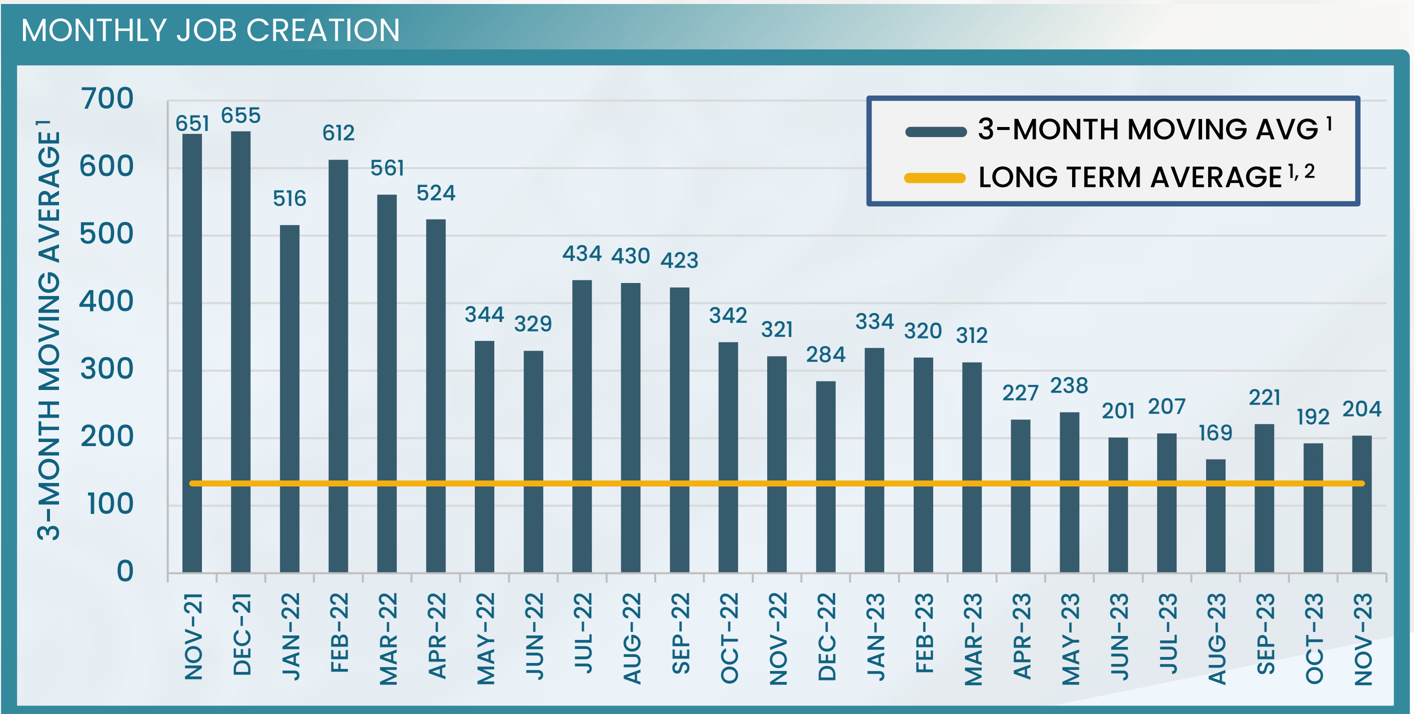
1. IMPROVEMENT IN INFLATION METRICS

It really was a perfect storm that drove inflation to the highest readings since the late 1970's/early 1980's. Supply chain disruptions, coupled with unwavering demand thanks to highly supportive fiscal policies at the outset of the pandemic, contributed meaningfully to the rise in inflation. Layer in a commodity price shock during the first half of 2022 due to Russia's war with Ukraine that sent not only energy prices higher, but also contributed to food inflation as agricultural commodities and fertilizer prices spiked. All the while, historically low mortgage rates during 2020 and 2021 and shifting consumer preferences sent housing prices skyrocketing, fueling rent increases and boosting overall inflation.

Over the last 18 months, most of the decline we have seen in inflation has been idiosyncratic in nature (the unwinding of the COVID era imbalances and 2022 commodity price shock). Going forward, monetary policy is likely to play an increasingly important role. If the Fed has success in softening labor market conditions and thus cooling wage pressures, it will surely help bring inflation back toward target. Housing inflation will be a second area of interest during 2024. With a lag, shockingly high house prices have played a key role in the overall inflation story. The rapid rise in mortgage rates from historically low levels has stagnated the housing market as homeowners are either unwilling or unable to sell. This has limited the supply of available homes, especially existing homes, which has helped keep prices elevated despite the rapid decline in transactions. While we were surprised by how little house prices fell last year given the massive gains seen from 2020 through early 2022 and the dramatic slowing in activity, we expect housing inflation to continue to trend lower in 2024, benefiting overall inflation.

2. LABOR MARKET RESILIENCE

The consensus view heading into 2023 was that the U.S. economy would fall into recession. That recession never transpired and economic activity was healthy. The labor market proved to be particularly resilient. Job creation, while cooler than in 2021 and 2022, was quite solid in 2023 versus historical norms.



SOURCE: PERFORMA, BLOOMBERG, BUREAU OF LABOR STATISTICS
[1] NON-FARM PAYROLLS, SEASONALLY ADJUSTED, THOUSANDS
[2] AVERAGE SINCE JANUARY 1970

Additionally, a range of other labor market indicators performed well throughout the year. For example, initial jobless claims, which tracks people filing for unemployment benefits, are at historically low levels, giving no indication that we are about to see a dramatic weakening in labor market conditions. While wage gains and data on job openings have cooled, both series suggest that the labor market is in great shape. Even the unemployment rate, which has moved off the lows, is trapped below 4%, a level rarely seen over the last half century.

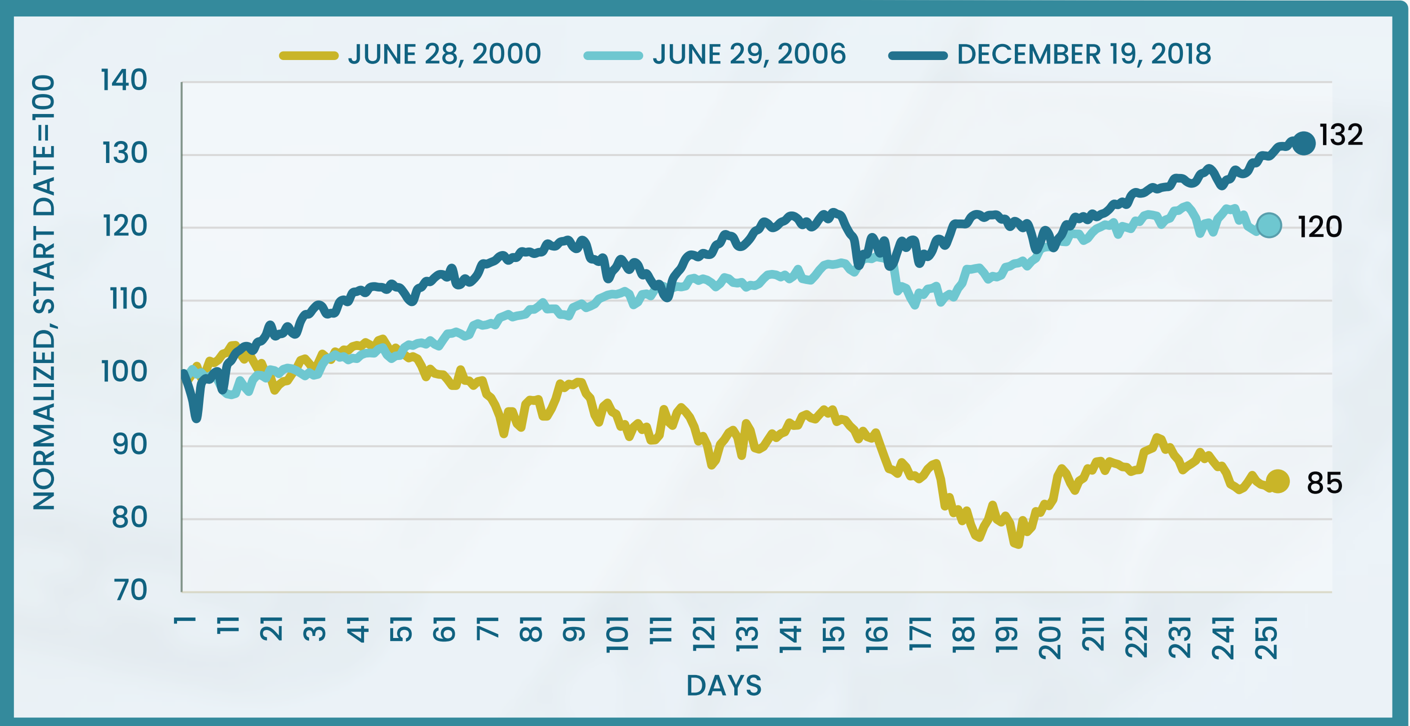
In the year ahead we will continue to track the labor market closely. Thus far, the Federal Reserve must be quite encouraged by the evolution of labor market conditions, however, risks remain. First, if the labor market is tighter than expected in the year ahead and competition for talent is fierce, wage inflation is likely to persist. Stronger wage gains would make the Fed's job of returning inflation to 2% more difficult and could reintroduce the idea of additional interest rate hikes. On the flip side, a significant deterioration in labor market conditions that sends the unemployment rate meaningfully higher would clearly be a negative for risk markets and broader economic activity. Of course, markets and the Fed are hoping for an outcome somewhere in the middle where conditions continue to soften without a meaningful increase in the unemployment rate and the economic expansion progresses. Keep an eye on temporary help hires in 2024 as it can be a good indicator for where the overall labor market is headed.

3. SOFT LANDING/NO LANDING = BUY EVERYTHING RALLY INTO YEAR END

The noteworthy decline in inflation, coupled with a resilient labor market in 2023, supported hopes that the U.S. economy will avoid the so call "hard landing" where unemployment jumps and the economy falls into a painful recession. In fact, optimism is so high that the S&P 500 recently took another run at an all-time high of around 4800 from early 2022 and the Fed has begun prepping markets for lower rates in the year ahead, even though inflation is not yet back to target. While we are sympathetic to the fact that markets have become increasingly Fed dependent over the years and the Fed's dovish pivot in December has only amplified increasingly bullish market expectations, we are more cautious.

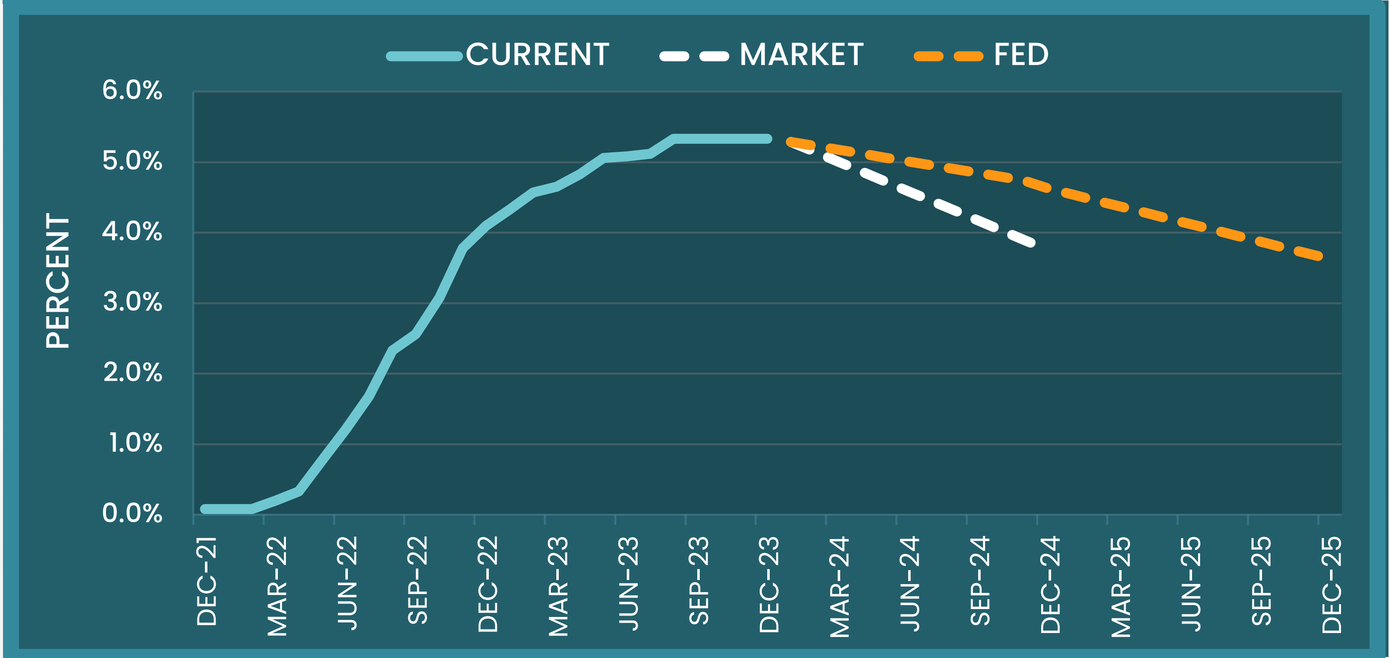
Sure, the road to Oz looks as golden as ever (right now) but that is not license to chase a market that has staged a dramatic rally into year end. Instead, we are comfortable staying the course, trimming organic overweights with a keen eye toward protecting to the downside. Given the balance of risks, we enter 2024 with a neutral stance from an asset allocation perspective and are maintaining interest rate risk (as measured by duration) that matches the benchmark within our investment grade bond strategies. Of course, our positioning is dependent on the unique circumstances of each client. Looking ahead,

we believe that our next strategic move will be to dial back risk exposure in favor of safer asset classes but, as we saw in 2019 (the last time the Fed pivoted), the exuberance of a Fed centric market can take quarters to subside. Let's face it, when the market is expecting the worst things usually work themselves out and when consensus is overly optimistic something always seems to go wrong.



SOURCE: PERFORMA, BLOOMBERG, S&P 500 INDEX

We conclude with one final thought on the recent divergence between market and Fed expectations. Heading into the last Fed meeting of the year, the market was expecting that the Fed would lower interest rates 1.00% - 1.25% by year end 2024. Meanwhile, the most recent Fed forecast at the time (published in September) was looking for just 0.25% by the end of 2024. Clearly, a big gap between the two. Heading into that December 13th FOMC meeting, we expected the Fed to leave its December forecast relatively unchanged, but they did not. The most recent Fed dot plot (published in December) now shows interest rates 0.75% lower by year end 2024. While the updated dots had two additional 0.25% interest rate cuts when compared to their September forecast, they still fell short of market expectations leading up to the meeting.



SOURCE: PERFORMA, BLOOMBERG, FEDERAL RESERVE

So how did the market respond to the updated Fed forecast? By pricing in even lower rates of course! As of late December, the market is now looking for the Fed to lower rates by approximately 1.50% - 1.75% by year end 2024. This strikes us as an aggressive outlook and one that would only be met if economic conditions deteriorate significantly. This type of divergence between market expectations and the Fed has been a hallmark of 2023 and a recurring theme on the way to normalization. Typically, expectations converge over time, but that realignment usually results in a bout of market volatility.

PERFORMA

ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for more than 30 years. Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds and separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our clients. We are 100% employee-owned and have $5.53 billion in captive assets under management and advisement as of October 31, 2023. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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