MARKET OUTLOOK

2024: A Long and Winding Road to Normal

"The long and winding road…I've seen that road before…
It always leads me here."

– The Beatles, 1970

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Executive Summary

- After years of dislocations and abnormal circumstances, the markets and economy are returning to more normal conditions and a more normal cost of capital.
- Fixed income is fairly valued and set up to finally deliver more normal returns going forward.
- The economy is attempting to adjust to these higher levels of borrowing costs, but may still have bumps in the road ahead of it.
- Domestic and global politics may remain notably abnormal, particularly with the election cycle ahead, with implications for taxes, government spending and global trade.
- Equity valuations have moderated, but further adjustment to the new cost of capital appears needed, particularly among large cap stocks.

The Long and Winding Road of Performance

On the surface, the market has appeared quite strong in 2023, with the S&P 500 up over 20% since the beginning of the year. This headline strength, however, makes the outcome look far stronger than the reality of the situation. Despite the market's strength on a year-to-date basis, it is still clawing back ground from the bear market decline experienced in 2022. In fact, the S&P 500 remains below its early 2022 highs, even after such a strong 2023 (Exhibit 1).

EXHIBIT 1: Stocks Have Recovered From 2022 Lows, but Remain Below Previous Highs[1]

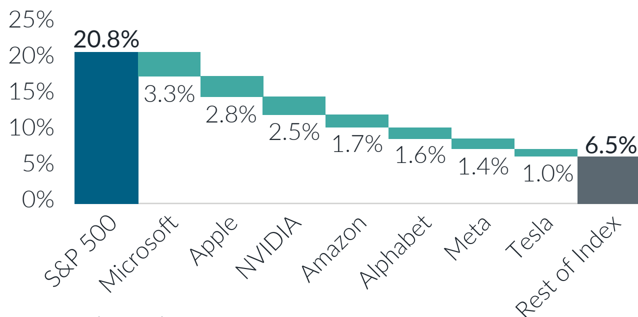
S&P 500

Source: Glenmede, FactSet
Data through 11/30/2023

Perhaps just as important, the S&P 500's headline performance masks more modest performance for the remainder of the field of equities outside of the now-defined Magnificent 7 (Exhibit 2). Those seven stocks have accounted for roughly two-thirds of the S&P 500's year-to-date return. The remainder of stocks in the index delivered a total return of 6.5%, a far more subdued outcome. Looking broadly, the more muted return for the average stock in the S&P 500 seems to align more closely with the outcomes experienced by other areas of the global equity markets, including smaller capitalization stocks as well as stocks in international developed and emerging markets.

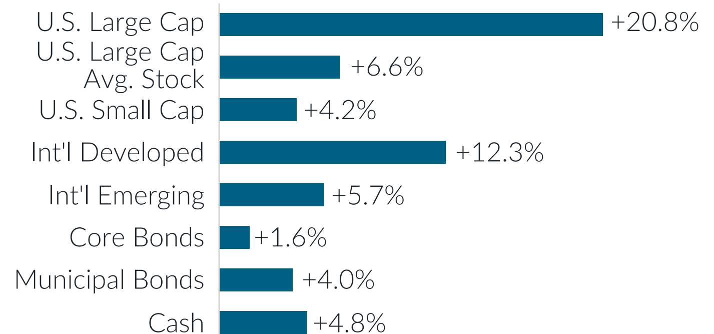
EXHIBIT 2: Large Cap's Recovery Would Be Less Notable if Not for the Magnificent 7[2]

S&P 500 Year-to-Date Contributions to Total Return



Source: Glenmede, FactSet
Data through 11/30/2023

Performance of Major Asset Classes: YTD 2023



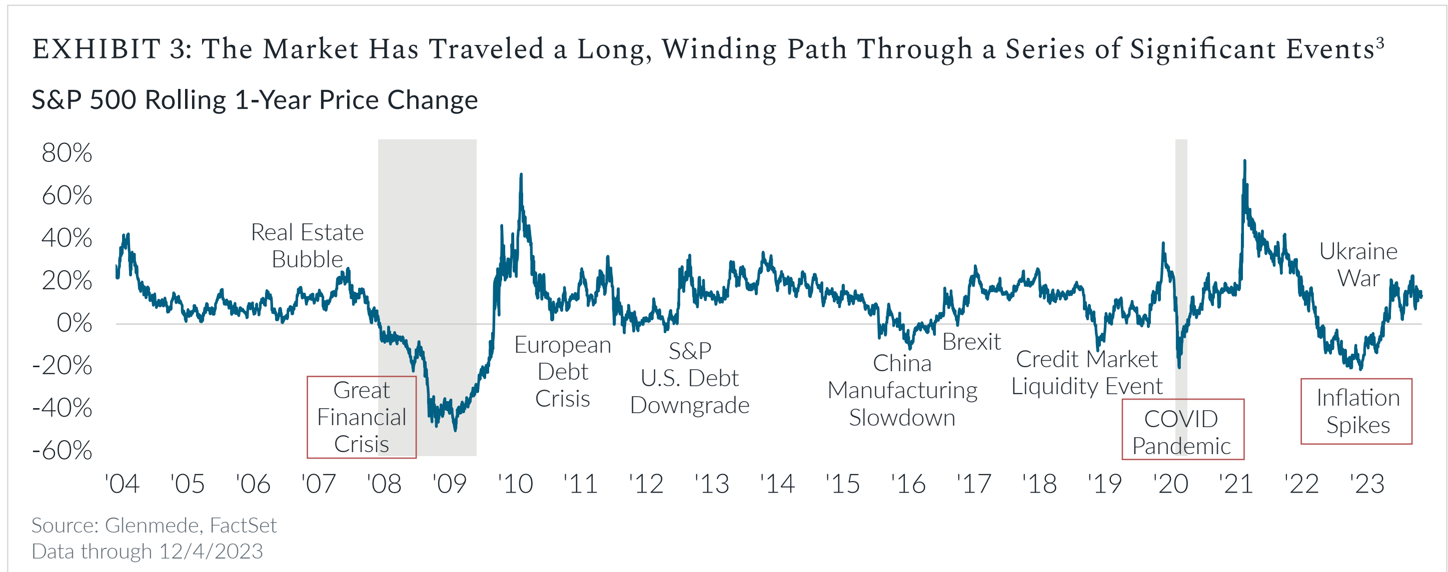
[1] The S&P 500 is a market capitalization weighted index of U.S. large cap stocks. Past performance may not be indicative of future results. One cannot invest directly in an index.

[2] On the left are year-to-date cumulative total returns for the S&P 500 index and the top 7 contributors to performance, also referred to as the Magnificent 7. On the right are year-to-date cumulative total returns for various asset classes represented by the following indices: U.S. Large Cap (S&P 500), U.S. Large Cap Average Stock (S&P 500 Equal Weighted), U.S. Small Cap (Russell 2000), Int'l Developed (MSCI EAFE), Int'l Emerging (MSCI Emerging Markets), Core Bonds (Bloomberg U.S. Aggregate), Municipal Bonds (Bloomberg Municipal Bond) and Cash (3mo T-Bills). Past performance may not be indicative of future results. One cannot invest directly in an index.

So, the market's performance through 2023 may not be quite as good as it looks on the surface. Stepping back even further, the market's performance comes at the end of what may be a long and winding path back to normal for both the markets and the wider economy (Exhibit 3). This path has been dotted with a long string of significant events such as the 2008-2009 financial crisis, the European debt crisis, the first rating downgrade of U.S. government debt, a pandemic and an inflation surge.

EXHIBIT 3: The Market Has Traveled a Long, Winding Path Through a Series of Significant Events[3]

S&P 500 Rolling 1-Year Price Change



Source: Glenmede, FactSet
Data through 12/4/2023

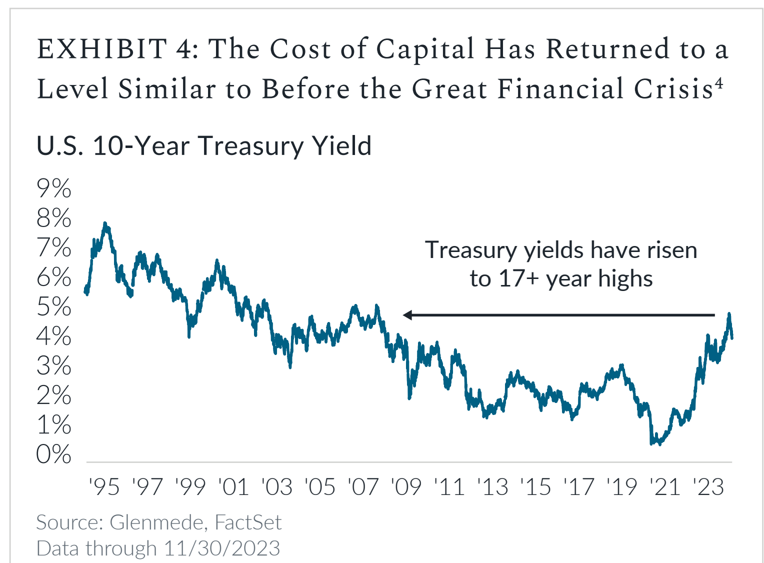
Seemingly unusual events should be expected to occur infrequently during such a long period of time, but the effects of a few of these events thrust the markets and economy into quite abnormal territory. In particular, the Great Financial Crisis pushed monetary policy to its limits, driving short-term rates down to the zero-bound and requiring central banks to complement such decisions with significant bond-buying and expansion of their balance sheets. Then, just as policy was beginning to return to normal in 2019 after years of such abnormal circumstances, the economy ran into a once-in-a-century pandemic that forced shutdowns and isolation, triggering renewed need for extreme policy. The Federal Reserve (the Fed) responded with a second push to 0% rates and more bond buying while the federal government pushed fiscal policy to provide stimulus to both consumers and businesses. This stimulus brought the economy back from the brink in 2020, but eventually contributed to runaway inflation in 2022 when supply chains could not provide enough goods for rebounding demand and businesses could not rehire enough employees to provide wanted services.

The Return to a Normal Cost of Capital

These last circumstances have led to a rather abrupt return to normal for monetary policy, with the Federal Reserve raising its target fed funds rate by 5.25% and longer-term bond yields rising to levels last seen nearly two decades ago, prior to the Great Financial Crisis (Exhibit 4). Further, this shift in yield levels occurred in less than three years, a sharp contrast to the 13 years it took for yields to fall to their lows. Because of the sharpness of the move in rates, longer-term bond investors have experienced losses for three years in a row as income payments were not enough to offset the decline in the prices of those longer-dated bonds as yields rose.

EXHIBIT 4: The Cost of Capital Has Returned to a Level Similar to Before the Great Financial Crisis[4]

U.S. 10-Year Treasury Yield

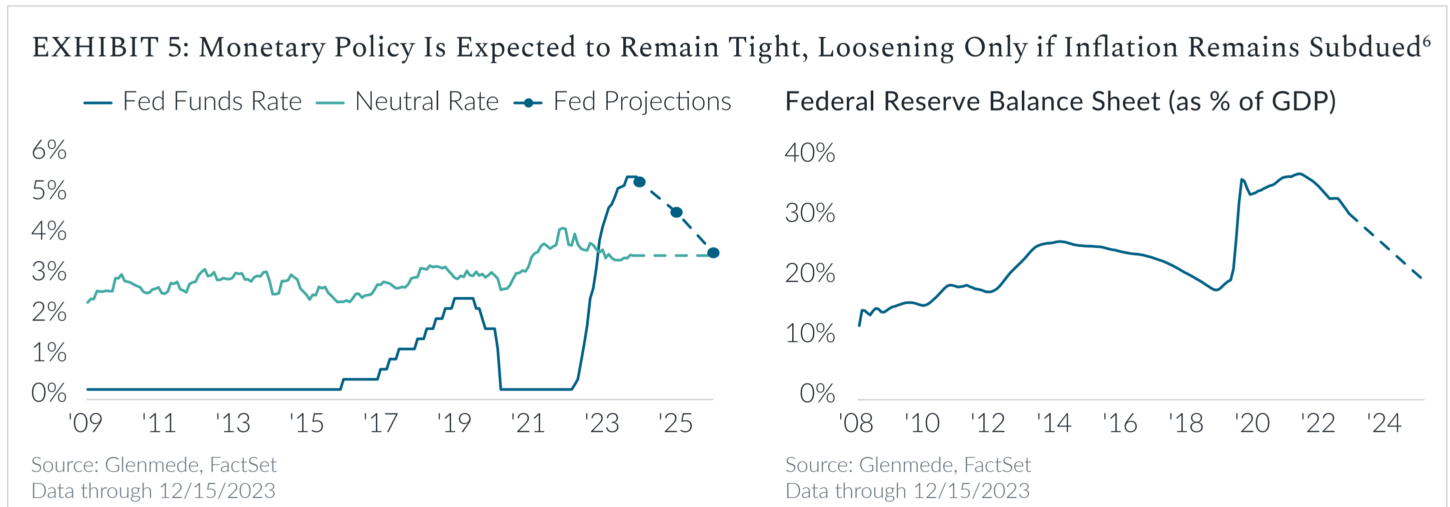


Source: Glenmede, FactSet
Data through 11/30/2023

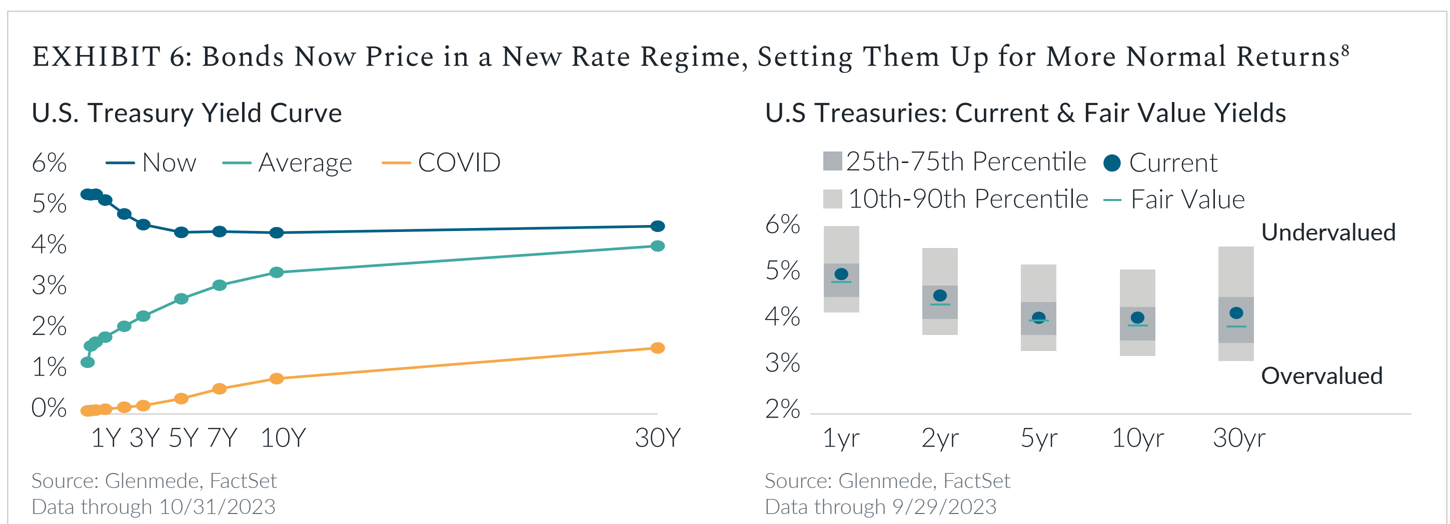
[3] Highlighted are significant market events in the past 20 years. Outlined in red are key events that triggered material changes in monetary and fiscal policy. The S&P 500 is a market capitalization weighted index of U.S. large cap stocks. Past performance may not be indicative of future results. One cannot invest directly in an index.

[4] Data shown are 10-year U.S. Treasury bond yields over time.

The higher level of rates is quite unlikely to return to the depressed levels experienced in the previous decade. While inflation has moderated from its highs in 2022, the Federal Reserve plans to keep monetary policy tight for a while to make sure that inflation does not reignite. Based on surveys of the members of the Federal Open Market Committee, some rate cuts are possible further out in 2024 and 2025, but any rate cuts are likely to be implemented at a relatively slow pace and are not likely to bring rates below the neutral rate of 3.0%-3.5%.[5] At the same time, the Federal Reserve is expected to continue reducing its balance sheet as bonds mature and are not replaced with new purchases (Exhibit 5).



While the experience for longer-dated bond owners has been unusually difficult, the change in rates and the pricing of bonds have actually reset bond prices and yields to more normal and favorable levels going forward. While not yet in the typical more upward sloping shape, the U.S. Treasury yield curve now appears to be at a more normal level, and once the Fed begins to slowly reduce interest rates on the front end, it will likely complete its return to normal. Perhaps more important for bond owners, bonds now appear to price in proper expectations for future short-term rates as well as a more normal term premium,[7] setting them up for more normal returns going forward (Exhibit 6).



[5] The neutral federal funds rate is the theoretical level of rates that is neither economically stimulative nor restrictive.

[6] Shown on the left panel is the fed funds rate (upper limit). Data in green is Glenmede's estimate of the neutral federal funds rate over time (i.e., the level of rates that is neither economically stimulative nor restrictive) based on expectations for real interest rates via the Holston-Laubach-Williams model and Glenmede's 10-year inflation expectations. Fed projections refers to the level of fed funds from the Federal Open Market Committee's dot plot projections. Shaded areas represent recession periods of the U.S. economy. Shown in the right panel are the total assets on the Federal Reserve's balance sheet, less eliminations from consolidation in trillions of U.S. dollars as a share of gross domestic product. Actual results may differ materially from projections.

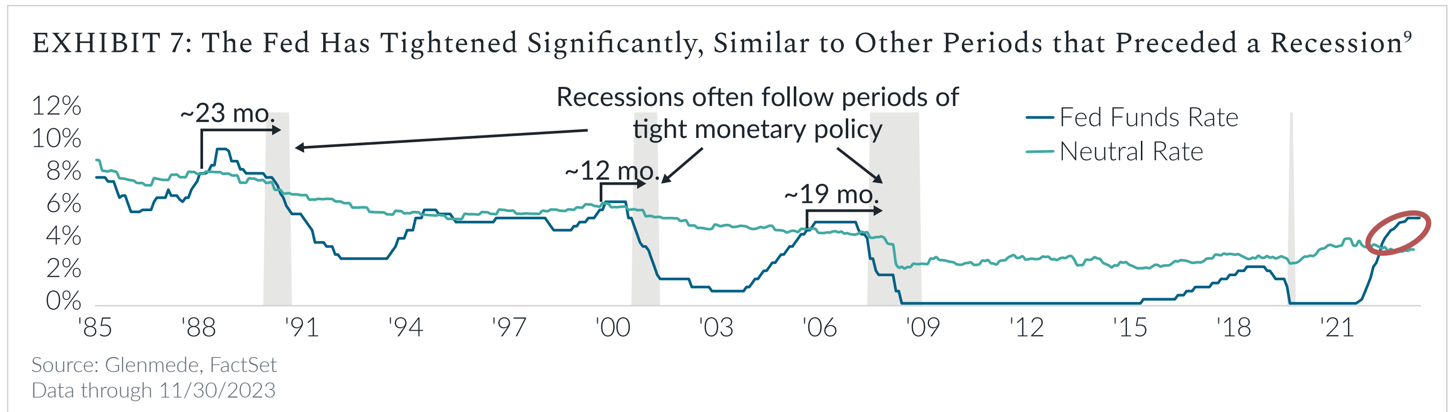
[7] A term premium is the extra yield embedded in the price of a bond to compensate the bond holder for accepting the fluctuations in the price of a fixed rate bond as market rates change.

[8] Shown in the left panel are snapshots of the U.S. Treasury yield curve at various points in time. "Now" reflects the yield curve as of the latest date shown, "Average" reflects the yield curve as the average of each maturity's yields over the past 20 years, "COVID" reflects the yield curve as of 11/17/2020. Shown in the right panel are the valuations for U.S. Treasury debt securities at various places along the yield curve, based on Glenmede's proprietary Global Expected Returns Model.

An Economy Adjusting to Higher Borrowing Costs

Of course, the implications for the bond market are not the only impact of this abrupt return to normal and higher-rate environment. Monetary policy's primary impact is on the economy. In fact, the Federal Reserve has a history of creating economic swings, often due to leaving monetary policy too loose for too long and having to respond by overtightening to bring the economy back to more solid ground, often through contraction in the economy. The current environment appears quite similar to other periods that preceded recessions, given the magnitude of the Fed's rate hikes as well as the degree to which current rates are now above the Federal Reserve's own measure of neutral (Exhibit 7).

EXHIBIT 7: The Fed Has Tightened Significantly, Similar to Other Periods that Preceded a Recession[9]

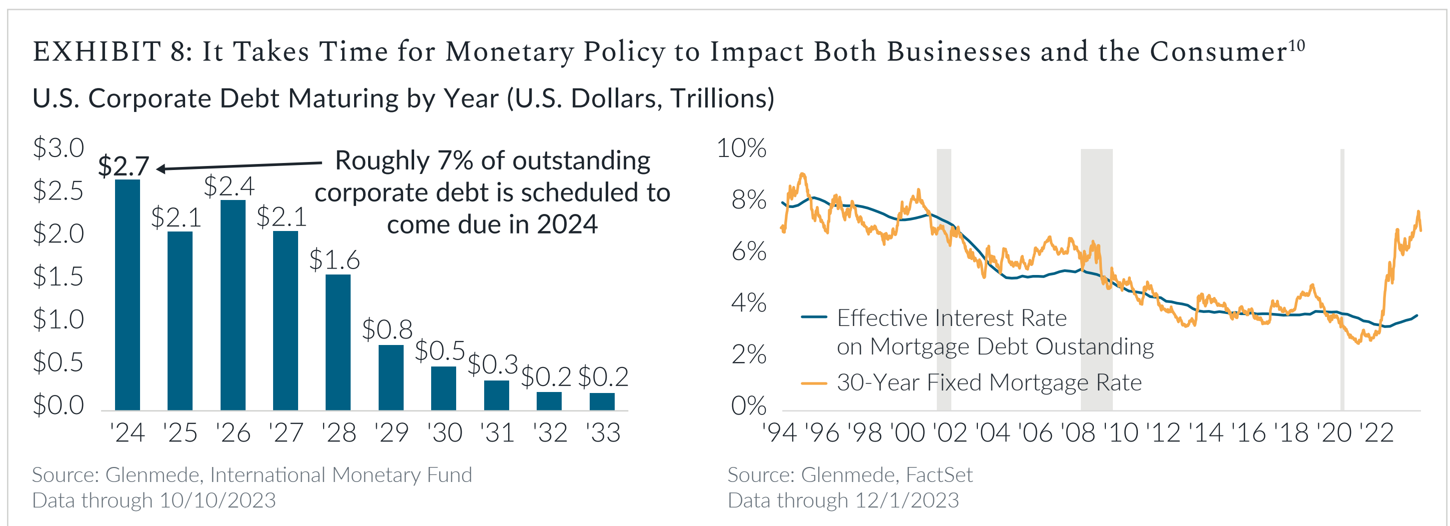


Source: Glenmede, FactSet
Data through 11/30/2023

The level of rates and monetary policy affects the economy by increasing the cost of borrowing for consumers and businesses. This occurs immediately for new borrowers and over time for existing borrowers as they go to refinance existing debt or transact in some way that requires obtaining a new loan. The changes to the cost of new borrowing influences current business and personal spending decision-making, with the higher cost of borrowing often acting as a deterrent against marginal spending decisions. The impact on existing borrowers, however, is more of a budgetary impact, increasing their costs and squeezing out other spending over time as the rates on loans change for recurring borrowing.

As a result, it takes time for monetary policy to impact all consumers and businesses across the economy, what many refer to as the "long and variable lag" of monetary policy. In fact, two excellent examples of this lag are the refinancing of corporate bonds, of which roughly 7% is expected to mature in 2024, and the stark difference between the mortgage rates paid by existing homeowners and the market rate for new mortgages (Exhibit 8).

EXHIBIT 8: It Takes Time for Monetary Policy to Impact Both Businesses and the Consumer[10]



Source: Glenmede, International Monetary Fund
Data through 10/10/2023

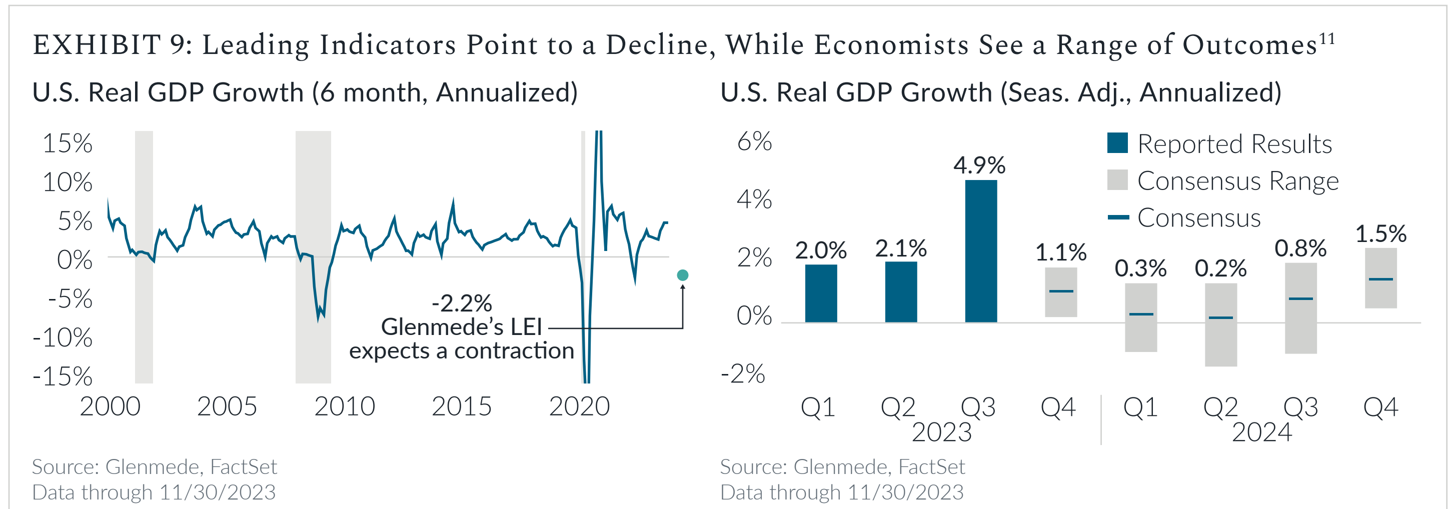
Source: Glenmede, FactSet
Data through 12/1/2023

[9] Fed funds rate is the Fed's target rate (upper limit). Data in green is Glenmede's estimate of the neutral federal funds rate over time (i.e., the level of rates that is neither economically stimulative nor restrictive) based on expectations for real interest rates via the Holston-Laubach-Williams model and Glenmede's 10-year inflation expectations. The dashed lines denote the number of months from when the fed funds rate crossed the neutral mark to the first month of a recession. Shaded areas represent recession periods of the U.S. economy. Past performance may not be indicative of future results.

[10] Shown on the left are the amounts of outstanding U.S. corporate debt scheduled to mature by year, measured in trillions of U.S. dollars. On the right is the average rate on outstanding 30-year mortgages in blue and the prevailing rate for new 30-year mortgages in yellow. Gray shaded regions represent periods of recession in the U.S.

It is likely because of these long and variable lags that there is such disagreement over the likelihood of a recession. Glenmede's U.S. Leading Economic Indicator (LEI) continues to point to a likely recession within the next 6 to 12 months, a reflection of its assumptions regarding the severity and timing of the impact of previous rate hikes. In contrast, the average economist sees growth slowing to a 0% rate in the first quarter of 2024, but narrowly avoiding an outright decline. However, there are a notable number of economists in the bottom end of the range of expectations that still have a recession as their base case expectation (Exhibit 9). At minimum, growth in the economy and associated growth in corporate profits will likely be quite slow.

EXHIBIT 9: Leading Indicators Point to a Decline, While Economists See a Range of Outcomes[11]



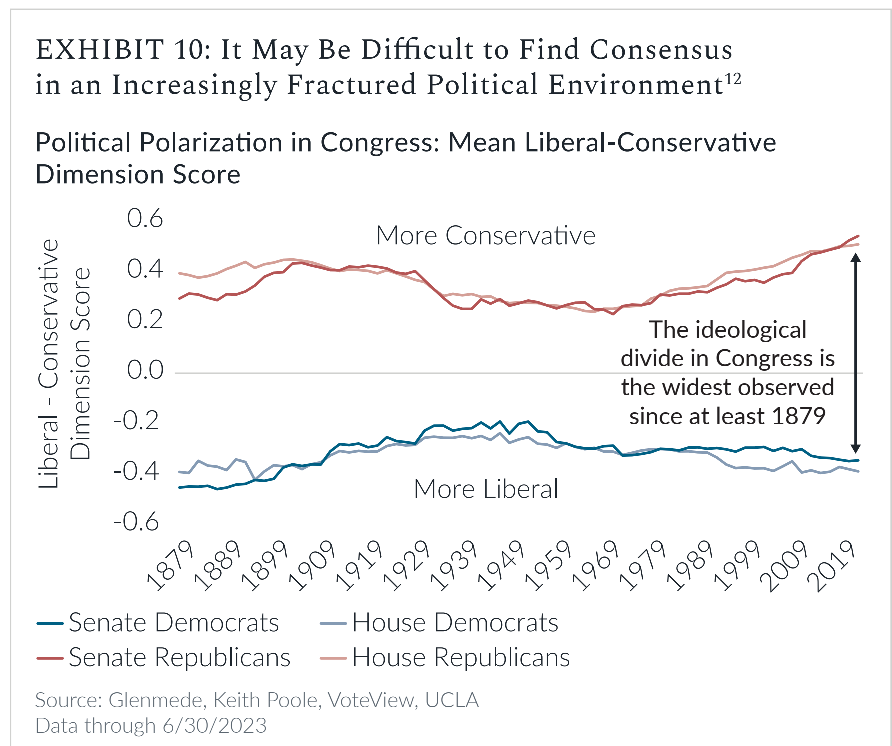
Source: Glenmede, FactSet
Data through 11/30/2023

Source: Glenmede, FactSet
Data through 11/30/2023

Abnormal Domestic and Global Politics

One area of abnormality that has grown over the last 20 years is domestic and global politics, which is an observation likely not lost on anyone. It may still be too early to draw too many conclusions about the 2024 elections as the public often does not start paying attention until around the first-in-the-nation Iowa caucuses. Yet, those caucuses are set to take place on January 15th, and an early look at expectations shows a unique political landscape with the current frontrunners of both parties polling quite poorly on favorability. Further, any future President's ability to implement desired policies will likely hinge on the outcome of the congressional elections, where majority control in both chambers is razor thin and at risk of flipping. The increasing polarization in Congress is expected to pose significant challenges for passing substantial legislation (Exhibit 10).

EXHIBIT 10: It May Be Difficult to Find Consensus in an Increasingly Fractured Political Environment[12]



Source: Glenmede, Keith Poole, VoteView, UCLA
Data through 6/30/2023

[11] On the left, the blue line is reported 6-month rolling real GDP growth and the green dot is the 6-month forward estimate for real GDP growth from Glenmede's U.S. Leading Economic Indicator, a composite index of leading economic data covering components such as business and consumer sentiment, industrial conditions, home building activity and monetary policy. Shaded areas represent U.S. recessions. On the right is real GDP growth; reported data is shown by the blue bars, and the range and consensus average of estimates from economists are shown by the grey bars and lines. All data is seasonally adjusted and annualized. Actual results may differ materially from projections.

[12] Data shown are a representation of how politically liberal/conservative each party's constituency in both the Senate and House of Representatives has been for each session of Congress since 1879, based on a methodology derived by Keith Poole. It assumes independent politicians are included with the party with which they tend to caucus.

It is unlikely that the unusually high level of political polarization will subside in 2024, so political gridlock may be in the cards. Historically, markets have shown a preference for gridlock, as it often translates into policy predictability and stability. However, the rising cost of servicing the U.S. national debt is a growing concern for both the market and policymakers in Washington. The next administration will likely have to make difficult decisions between tax hikes and government spending cuts and likely need bipartisan cooperation to get any such legislation passed. Amid the political uncertainties and divergent viewpoints, a rare area of bipartisan consensus has emerged regarding international trade policies. Both major political camps seem inclined to move away from extensive globalization toward policies favoring onshoring and friend-shoring, relocating supply chains to politically stable and economically allied nations.

Equities' Return to Normal

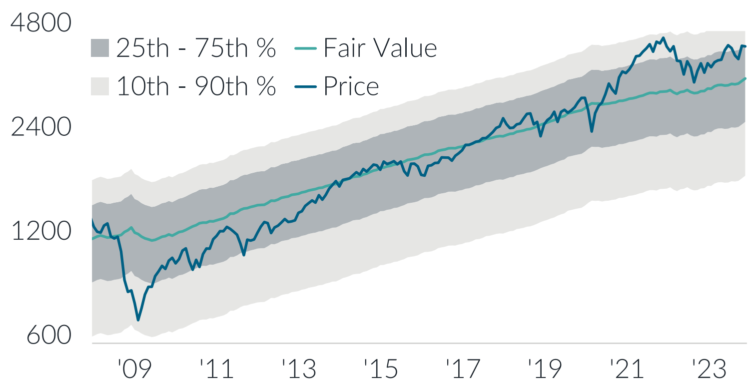
Unlike fixed income, equities do not yet appear to fully price in the rise in the cost of capital. As of the end of November, large cap stocks were still priced near their 75th percentile of valuations, around 20% above our estimate of fair value based on normalized earnings (Exhibit 11). Such valuations are not a harbinger of immediate declines, but may provide a headwind to longer-term future returns and can affect nearer-term returns most when fundamental growth is weak and investors begin to search for a valuation justification for continued ownership. Such weakness often occurs around recessions or periods of slow growth, similar to the current period.

Looked at another way, equity and fixed income valuations have shifted materially in the past 20 years. Exhibit 12 shows the current yield on cash and fixed income as well as the current earnings yield on large cap stocks compared to the 20-year average for each. Of note, both cash and fixed income are currently yielding considerably more than they have on average over the last 20 years, while equities are currently providing an earnings yield that is lower. For this reason, investors may still want to mitigate some risk in portfolios through defensive equity investment strategies or simply by under weighting equities within an overall portfolio and over weighting cash and fixed income.

Valuations for equities do not look quite as unfavorable if one were to stray from the U.S. large cap space. In fact, U.S. small cap, international developed and international emerging market stocks all appear far more fairly valued relative to normalized earnings (Exhibit 13). Further, there appears to be even more divergence that becomes apparent if one were to split U.S. large cap into growth and value categories; U.S. large cap value appears closer to its normal range, while U.S. large cap growth appears not far from its 90th percentile

EXHIBIT 11: Equity Valuations Remain Above Fair Value[13]

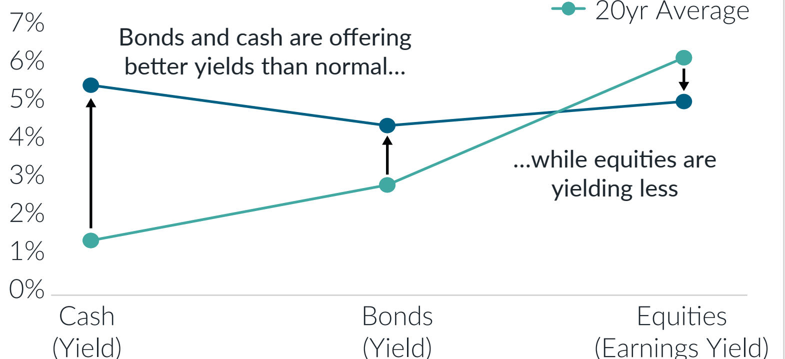
U.S. Large Cap - Long-Term Valuation & Ranges



Source: Glenmede, FactSet MSCI
Data through 12/1/2023

EXHIBIT 12: Bonds and Cash Are Again Competitive With Equities[14]

Effective Yield by Asset Class



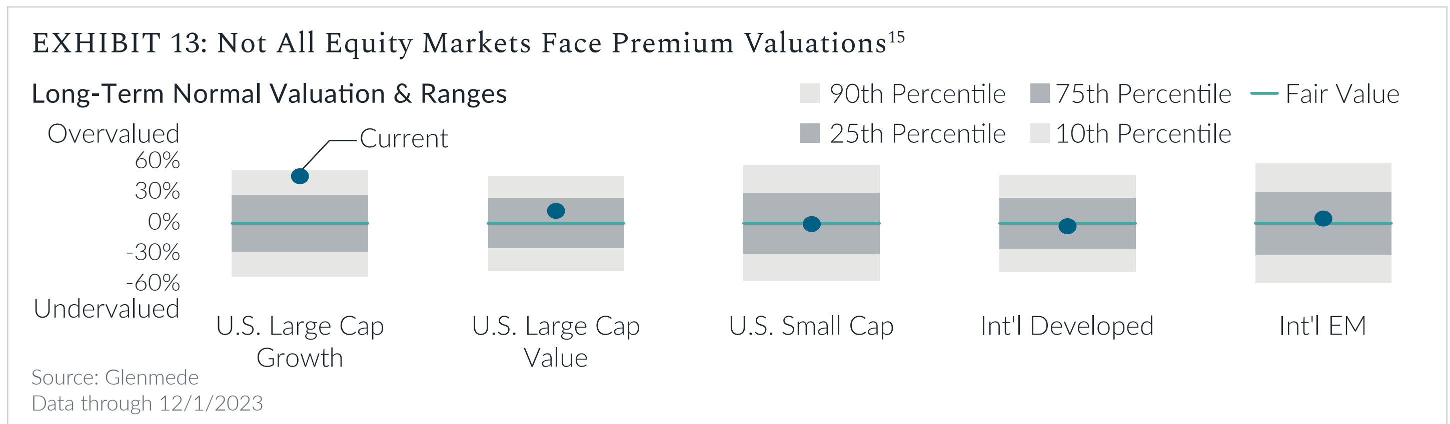
Source: Glenmede, FactSet
Data through 12/1/2023

[13] Glenmede's estimate of long-term fair value for U.S. large cap is based on normalized earnings, dividend yield and book value using MSCI's USA Index, which is a total return index with dividends reinvested. Past performance may not be indicative of future results. One cannot invest directly in an index.

[14] Shown in blue are the current yields on cash (represented by 3-month U.S. Treasury bills), bonds (represented by 10-year U.S. Treasury bonds) and equities (earnings yield, represented by the MSCI USA Index). Shown in green are the same data points, represented by the average values over the last 20 years. Past performance may not be indicative of future results. One cannot invest directly in an index.

level. Such valuations are likely the result of the Magnificent 7, highlighted before, which account for roughly half of the market capitalization of U.S. large cap growth stocks.

EXHIBIT 13: Not All Equity Markets Face Premium Valuations[15]

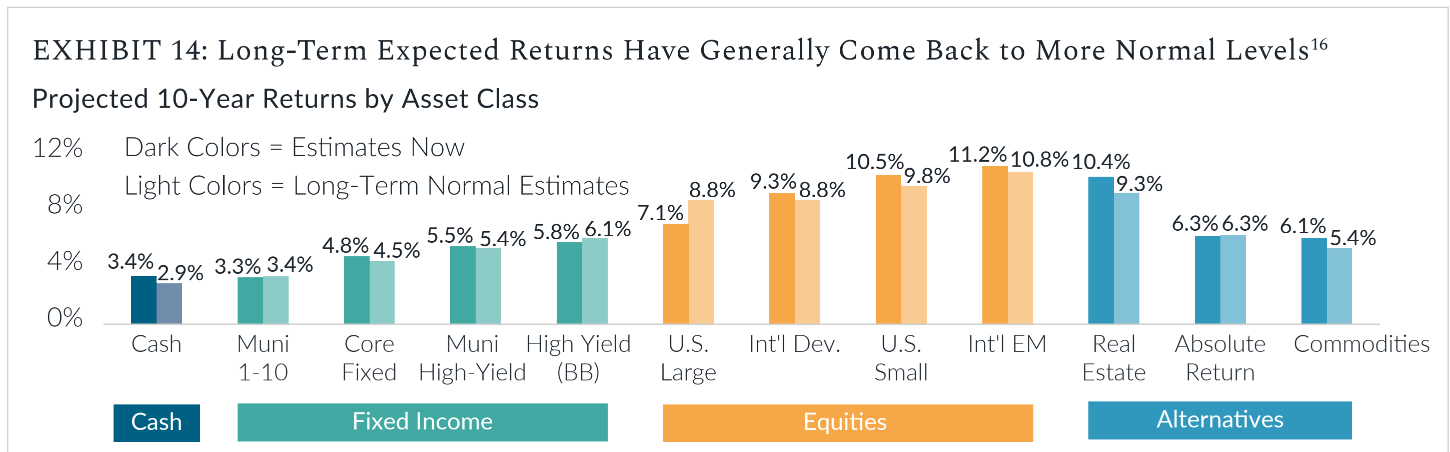


Source: Glenmede
Data through 12/1/2023

The Benefits of a More Normal Starting Point

While equities may have a little more adjustment to get to normal, particularly among U.S. large cap stocks, a good degree of the market has adjusted back to normal. Equities, on the whole, are still down from their early 2022 highs and normalized earnings for equities have steadily risen, providing a higher base for future valuations (Exhibit 14). Cash and bond yields are considerably higher than the start of 2022 and may be considered near their normal resting place. Other asset classes such as real estate, absolute return and even commodities suggest that forward long-term returns are likely to be more normal than not.

EXHIBIT 14: Long-Term Expected Returns Have Generally Come Back to More Normal Levels[16]



The path here has been long and winding. It has included multiple shocks, credit events, disruptions and events that few were able to forecast. Those bumps along the way were jarring in many cases, but that path has brought us back to a point that may now be more favorable longer-term. There may still be some near-term bumps in the road ahead as further adjustments within equities and the economy appear warranted, justifying ongoing defensive positioning in portfolios until those transitions are complete. The picture for becoming more constructive on the whole is building, as longer-term expected returns inch toward more normal levels, and investors will find themselves better positioned to reach their long-term goals, whether they are personal or charitable in nature.

[15] Data shown are Glenmede's estimates of long-term fair value for U.S. Large Cap Growth (MSCI USA Growth Index), U.S. Large Cap Value (MSCI USA Value Index), U.S. Small-Cap (MSCI USA Small Cap Index), International Developed (MSCI EAFE Index) and International Emerging Markets (MSCI Emerging Markets Index) based on normalized earnings, normalized cash flows, dividend yield and book value. One cannot invest directly in an index.

[16] Data shown are Glenmede's proprietary estimates for 10-year expected returns for a number of asset classes. Proxy indexes for each asset class are as follows: Cash (Bloomberg Treasury Bellwethers 3M), Muni 1-10 (Bloomberg Municipal Bond 1-10 Index), Core Fixed Income (Bloomberg U.S. Aggregate Index), Muni High Yield (Bloomberg Muni High Yield 2% Issuer Cap), High Yield (BB) (Bloomberg U.S. Aggregate Credit Corporate High Yield BB Index), U.S. Large (MSCI USA Index), Int'l Dev (MSCI EAFE Index), U.S. Small (Russell 2000 Index), Int'l EM (MSCI EM Index), Real Estate (FDSAGG World / Real Estate Index), Absolute Return (HFRI Fund of Funds Composite), Commodities (Bloomberg Commodity Index). These figures are projections, which though arrived at in good faith, are not guaranteed, and actual returns may differ materially from projections. One cannot invest directly in an index.

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