Strategist's Corner
January 2024

Great Expectations

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In brief

- Financial markets are optimistic to start the year
- Investors currently believe inflation will slow, rates fall, and profits rise.
- To us, those beliefs look contradictory.

New Year's resolutions

The start of a new calendar year brings renewed enthusiasm and optimism. For many, the new year is accompanied by ambitious resolutions focused on self-improvement: eat healthier, exercise more, spend less.

Over 3,000 years ago, the Greek poet Archilochus wrote "We don't rise to the level of our expectations; we fall to the level of our training." I've always found that quote profound and obvious at the same time. If our changed behavior doesn't become a sustained habit, the resolution will be ephemeral and we will fall back on our old ways. I can personally relate to this as one of my new year's resolutions has already fallen short. I remain hopeful on the other two!

2024 investor expectations

Much optimism can also be found in financial markets today. Equity valuations and analyst expectations for 2024 imply that S&P 500 companies, in aggregate, will grow profit margins and earnings by over 10%. While lofty in any environment, this implies an economy that both avoids a recession and grows sales well above the post-2008 business cycle average. If that unfolds, it will be important to remind ourselves that sales growth is a combination of units and prices. Directionally, units are a function of economic growth while prices are what consumers pay, which of course aggregates up to the important inflation readings that central bankers and market participants tether themselves to. So, while equity and credit investors are discounting above-zero growth and sustained high prices for goods and services, bond investors are expecting 2% inflation, give or take, and lower central bank policy rates. Expectations aren't only high, but perhaps also contradictory.

Volatility is the market adjusting for incorrect assumptions

In one of my favorite novels, Charles Dickens' classic *Great Expectations*, Pip's schooling and training are expected to lead him to great wealth and prosperity. However, nothing is as it seems as most of his beliefs and assumptions are proved wrong. While things ultimately work out, Pip's journey takes a wild and unexpected course. The book parallels life; unexpected outcomes are the norm and expected outcomes the outliers.

Financial asset prices share a commonality and simplicity in that they reflect investors' aggregated expectations of future cash flows, but they're obviously complex, because the future is unknowable and predictions hard to make. So asset prices become volatile when investors are presented with new information that proves prior assumptions false.

If the prices of goods and services are falling and inflation reaches central bank targets, will companies be able to meet expectations of double-digit profit increases? Are central banks going to slash target rates while labor remains in short supply and the economy avoids a recession? Perhaps. If not, asset prices will adjust as assumptions and expectations shift.

Conclusion

Like many, I start the new year by setting goals for bettering my life and the lives of those around me. Knowing what gets measured gets managed, I recently bought a smart watch to help make my remaining two behavior changes permanent. Only time will tell whether, in Archilochus' terms, my expectations and training become synonymous.

The more important question is, "Will the economy and profits meet current investor expectations or will asset prices need to correct?" A lot like many new year's resolutions, we think the odds favor the latter, and that investors can potentially benefit from judicious active management.

The **S&P 500 Index** measures the broad US stock market.

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