Q3 2024: Market Insights on Stocks, Bonds, and the Economy

Plus, top stock picks for the quarter.

David Sekera, CFA, Preston Caldwell, and Susan Dziubinski • Jul 15, 2024

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Q3 2024 Update: Market Insights on Stocks, Bonds and the Economy

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Susan Dziubinski: Hello, and welcome to Morningstar’s Third Quarter 2024 U.S. Stock Market Outlook. My name is Susan Dziubinski and I’m an investment specialist with Morningstar.com. On the surface, the US stock market enjoyed a decent second quarter in 2024, rising more than 3%. Yet, much of the gain was concentrated in the stocks of companies that stand to benefit from the boom in artificial intelligence. Given that, how should investors be thinking about stock investing heading into the third quarter and what should they have on their radars? Here today to share their outlooks for the market and the economy are Dave Sekera, chief US market strategist for Morningstar Research Services and Preston Caldwell, chief US economist with Morningstar Research Services.

Dave, over to you.

Dave Sekera: Hey, good afternoon Susan. Good to see you again and welcome everybody. Just to review today's agenda, I'm going to start off with our valuation of the US equity market and our outlook. I'll then talk about our sector valuations and some top picks by our sector directors for each of the individual sectors. I'll review the valuation by our economic moat. I'll then pass the baton off to Preston. He'll provide his US economic outlook and then I'll take control and review how mega-caps have done thus far this year, both the overvalued and undervalued mega-caps. Then wrap things up with our outlook for the fixed-income market and then we'll be happy to take as many questions and answers as we can at the end of that session.

Q3 2024 Stock Market Outlook: Is the AI Stock Trade Over?

Q3 2024 US Stock Market Outlook

Let's get into it. As of June 24, when we ran our numbers and we published our report, the U.S. equity market was at a price/fair value of 1.03, meaning that the market was trading at a 3% premium to a composite of our fair values. For those of you that are new and haven't watched this before, just to let you know we take this bottom-up approach to the market valuation. A lot of other strategist typically start off with a much more top-down view. They will come up with some sort of model or algorithm in order to determine what they think S&P 500 earnings are going to be for the year. They then apply some sort of forward multiple to it and get their price target, which to me always seems more like an exercising goal-seeking than anything else.

Now, I will mention the market has still been on a tear for the last couple of weeks since we ran this number. Right now that price/fair value is actually probably closer to 5% to 6% at this point in time. So the market is really starting to just barely get into that area that's right in that stretch to overvalued market area. However, at this point in time I'm not ready yet to tell investors that they should be underweight equities overall. I still think that from a portfolio standpoint for a long-term investor, even though we're at some relatively rich valuations from a market-level basis that you still want to be invested at your target goal. And we'll talk about some ways that you can tilt your portfolio into those areas that we think are undervalued and steer clear of some of those areas that are overvalued.

Which Stocks Are Undervalued?

Just taking a look at the Morningstar Style Box, I'll just highlight that value stocks do remain undervalued, trading at about a 9% discount to fair value, whereas core stocks and growth stocks are trading at somewhat rich premiums of 7% and 6%, respectively. So I would look to overweight the value category, underweight core, and underweight growth stocks at this point. And then by capitalization, just because AI stocks are for the most part all large-cap stocks, large cap stocks have moved further into overvalued territory, that's probably a good area to start to underweight and then use that capital to overweight small-cap stocks and mid-cap stocks. Just as a point of note, we're seeing actually a big rally in small-cap stocks today following the CPI numbers that came out this morning. Maybe that's an indication that we're starting to finally see that sector rotation or that capitalization rotation in the small-cap stocks, which of course we think look very undervalued.

Is the US Equity Market Overvalued?

Just taking a look at how our price/fair value metric has panned out over time. You can see most recently was at 1.06 at the beginning of 2022. At that point we actually were recommending investors to underweight the equity market, not only were they trading at relatively rich evaluations overall, but the beginning of 2022, in our outlook we noted that there were four main headwinds that the market was going to have to contend with in 2022. We were expecting inflation to increase, we were expecting interest rates to increase, we were looking for the economy to weaken, and we were looking for the Fed to start tightening monetary policy. All of that really played out over the course of the year in 2022. We saw stocks take a big dive. In fact, by October of that year, we thought that they had traded well below our fair value estimates getting to one of the lowest levels that we've seen since the end of 2010.

Now, of course, the market has swung back quite a bit. In fact, we're now at that kind of 1.05, 1.06 premium again. But at this point, those headwinds are not necessarily headwinds anymore. In fact, most of them are actually tailwinds. As far as the other headwinds, the only one left is the economy. We do think that the economy will slow in the second half of the year and be relatively slow in the first half of 2025 before then starting to re-accelerate again in the second half of 2025. But when you look at those other three headwinds from 2022, we're now looking for inflation to continue to keep moderating, which again, looking at the CPI numbers this morning is still continuing to happen. We expect the interest rates are probably on a multiyear period of decline. So we're expecting long-term interest rates, such as the US Treasury 10-year, to move down this year and for the next couple of years. And we're also looking for the Fed to start easing monetary policy.

So, I think we're in one of those areas that depending on how earnings come out, just because we're in an overvalued market, doesn't mean that it can't remain overvalued until there is some sort of catalyst that could cause the market to sell off. Having said all of that, I do think that the best opportunities are going to be in those areas that have underperformed over the past year and a half, areas where you have negative market sentiment, the areas that we consider to be unloved. And of course, and always most importantly, in our view, those areas and those stocks that are undervalued.

Artificial Intelligence Stocks Drives Strong Gains in 2024

I'm going to skip through a lot of this pretty quickly. I think the real interesting thing to note here in the second quarter that while the market was up over 3%, it really was only five stocks that pushed the market higher; Nvidia NVDA, Apple AAPL, Microsoft MSFT, Alphabet GOOGL, and Broadcom AVGO. If you were to take those out of our index, we actually would have had a negative return in the second quarter. And I think that shows just how concentrated the market returns have been. In fact, if we even break it down into the core and into the growth stocks, again, if we pull those same stocks out of those categories, respectively, those also would have posted negative returns. And then lastly, while we had very big returns in the large-cap space, mid-cap and small-cap stocks both suffered losses. Really, there's very few AI plays in either of those categories. But again, that is where we see the best value for investors going forward at this point. And somewhat a similar story for year-to-date returns. I'm not going to belabor that point in the interest of time.

Remain Overweight the Value Category and Small-Cap Stocks

At this point, just showing how the US market has panned out from the end of last year to this year. So when we ran the numbers, it's trading at a 3% premium at this point. Like I said, it's probably closer to a 5% to 6% premium. But again, still remain overweight those value stocks. I think now is a good time to move to an underweight in the core, whereas it was a market weight at the beginning of the year. Core stocks haven't traded phenomenally higher this year because of those AI stocks in the core category. And then growth stocks still being in underweight because we just think that for long-term investors, those stocks are still too rich as compared to other long-term intrinsic valuation.

Quarter-to-Date Sector Returns

As far as quarter-to-date sector returns, I think it's interesting just to see just how much AI stocks have overwhelmed losses everywhere else that we've seen. When you look at those categories that have increased over the year, its communications, technology, those are the two sectors that have the preponderance of stocks that do benefit over the long term from artificial intelligence. And even utilities got caught up in that play. Now last October, we had noted that we thought utilities were trading at extremely depressed levels. Our utilities analysts said that utilities back then were trading at some of the lowest levels that he had seen over the past decade. But fundamentally, he thought that the outlook for utilities was as good as it's ever been.

We’ve seen a pretty big run in utilities both this past quarter and the last year. And to some degree, it’s because it’s gotten caught up with the AI play as well.

Of course, AI computing requires multiple times more electricity than traditional computing. But that was already incorporated in our fundamental outlook. So, to some degree at this point, if you’re just buying utilities today based on that theme, I think you’re already almost eight months too late to that trade. Having said that, there are still some utilities stocks we’ll highlight that we think will benefit from that trade as well. Consumer defensive stocks did pretty well. I think a lot of people looking at the Walmarts WMT and the Costcos COST of the world, the discounters are doing very well as we see consumers under pressure, shifting their spending into those types of discount areas. But other than that, losses everywhere else. And I think that’s indicative to some degree of the market concentration in AI but also pricing and the expectation for slower growth for the next couple of quarters until it can start to rebound in the second half of next year.

Stock Market Performance Remains Concentrated

Similar story, although not to the same degree as far as the year-to-date returns. Again, I think it’s just really much more looking at how artificial intelligence plays. It really had an outsize impact on the individual sectors. And then let’s get into specifically an attribution analysis for the Morningstar US Index. They’re really getting to the point where as a long-term investor at best, I think you can get their cost of equity. And in some of these cases where they’re getting to be too far above fair value, we think you’ll get below-market returns on those stocks. This chart just shows where we were at the end of last year and where we are now.

Really the couple to highlight would be Alphabet, that’s moved from a four-star stock into 3-star territory, Meta Platforms META now in 2-star territory. Meaning we think that one’s overvalued. Eli Lilly LLY, again, a thematic stock. Not AI, but their weight-loss drugs. Again, another stock that we think is just way too overvalued, even when we consider the upside potential of their GLP weight-loss drugs. And then also just note JPMorgan JPM, again, probably one of the best run of the megabanks in the U.S. that’s kind of investors’ go-to stock for investing in the megabanks, but again, getting to be richly valued.

Is the AI Stock Trade Over?

Over the past one and a half years, the market really has been dominated by thematic investing and no theme has been as dominant as artificial intelligence. When I look at these stocks, the ratings that they were at the end of 2022, I'd note these were all either 4- or 5-star-rated stocks, meaning that we thought that they were undervalued to very significantly undervalued, except for Apple, which was a 3-star stock trading near fair value at that point in time. Meta Platforms, I think back then was trading under half of our fair value estimate. It's run up so far. It's now a 2-star-rated stock.

And actually, I was checking some of these others before I came in. Nvidia actually overnight went to a 2-star stock. Now that is getting into overvalued territory in our mind. Tesla TSLA also now is a 2-star rated stock. That's had a phenomenal run over the past month or two as well. And looking at some of these others, Broadcom is now almost in that 2-star category. So if it moves up much from here, that's going to move that star rating there. Same with Microsoft, that's almost a 2-star-rated stock. And Apple has been on a tear. You know, what can I say? The stock has really moved up after the developers conference in which they talked about their artificial intelligence plans. Talking to our analysts, we didn't change any of our long-term assumptions on Apple. Our fair value is unchanged. So, while the market has been moving up, we held our fair value steady and we think Apple is not only a 2-star-rated stock, but actually getting pretty close to moving into 1-star range.

So, in my mind, this really tells me that, yes, while some of these could get overvalued more in the short term just because of the momentum and because some of these stocks like Nvidia will probably still post, ridiculously high growth for the next couple of quarters, as a long-term investor if you're buying into it today, we're very cautious that, our view is that you'll probably get, below-market or below historical returns going forward.

Will Inflation Continue to Fall?

I'm going to skip over a lot of this. Preston will cover a lot of it in his section as far as the economy, but again, talking about some of the tailwinds for the market right now. Again, inflation is on that downward path. We had some good inflation data that came out this morning. However, at the rate of economic growth, we do expect that it will slow. So we saw a relatively weak print in the first quarter, although as Preston will get into, I think it's interesting to note that based on some of the dynamics of how GDP is calculated, it feels like the economy is probably a little stronger than that in the first quarter, but some of those numbers got shifted into the second quarter.

Rate of Economic Growth is Slowing, but No Recession

But really, I think it's much more the trend, thinking about the second half of this year looking for relatively slow growth, somewhat stagnant growth in the first half of next year and then rebounding in the second half of 2025. And then lastly on that note, I also want to talk about what we've seen in first-quarter earnings. Just anecdotally seeing more companies, especially consumer discretionary companies, talking about how low-income consumers, I mean, they've already been under pressure. They felt the brunt of high inflation, starting well over a year ago. But we're now starting to see that, starting to hit the middle-income households as they pull back on discretionary spending. And I know Preston's got a couple of slides that he'll review just talking about where we are as far as, what might be left as far as, excess savings, but also talking about how the savings rate now is actually below prepandemic levels. And so I think with the two years of compound inflation, excess savings, either being used up or close to being used up and savings rates already at low areas, that is one area of concern that I do have moving forward.

Value and Small-Cap Stocks Are Undervalued

And these are two new charts that I put together for the webinar this time around. I just wanted to highlight how value stocks are currently trading on a price/fair value basis relative to the overall market valuation. So this is a relative valuation analysis. So it takes the price/fair value of the overall market. And then I subtract from that the value stocks. So you can see while we're not at, the cheapest levels that we got to at the end of maybe that was in 2019, we still are at, on a historical basis going back to the end of 2010, value stocks being on a relative value basis much more undervalued than the rest of the marketplace. And then here looking at small-cap stocks, and I think this one's really kind of an eye-popping chart showing just how undervalued small-cap stocks are as compared to the broad market, price/fair value. We are seeing a big tick up in small-cap stocks today.

Sector Valuations and Top Picks

So, personally, I'm kind of hoping that maybe this is the indication that we'll start seeing small-cap stocks start to outperform the broader market going forward. As far as sector valuations, this chart just highlights where we see some of the better opportunities, where we see on a percentage basis by sector, 4- and 5-star rated stocks, where some of those sectors that have a higher percentage number of 1- and 2-star stocks, those that we think are overvalued. But getting into the individual sectors, again thematic investing has dominated the market, the communications sector, the tech sector, at the end of 2022, those were two of the more undervalued sectors. At this point, communications has moved all the way up to being fairly valued and technology trading at least a 10% premium to fair value. Now, I'd note technology in the past during some market rallies has gotten even further overvalued than 10%. But at that point, like I said, you're really kind of now trading more of a momentum play than necessarily a valuation play.

I do think we're at that point where, an overvalued stock, continued to more overvalued in the short term. But, personally, that's not necessarily a game I'm willing to play. Consumer defensive stocks are also now overvalued. A lot of that is going to be Walmart. So, Walmart, I think, is going to look good from an earning standpoint for the next couple of quarters as they pick up foot traffic, people moving down into the discounters and away from your traditional grocery stores. But when you model it on that long-term view, we do think Walmart is overvalued.

And then opportunities in the real estate market, still the most undervalued. A lot of opportunities there in real estate with much more defensive type of characteristics and some interesting plays in the basic-materials and the consumer cyclical areas. And then lastly I just want to end on energy. So, I think energy right now is very well positioned. What I like about energy is we actually have a pretty bearish view on the long-term price of oil.

So, when we look at midcycle analysis of West Texas Intermediate, based on our supply-demand forecast and what we think it takes to pull oil out of the ground, the cost dynamics, we actually expect WTI to fall all the way to $55 a barrel. Also, just thinking about the dynamics of, EVs becoming a larger percentage of cars on the road. In fact, we're still looking for, 60% to two-thirds of all cars by 2030. Global new auto production being electrified, whether that's a hybrid or a battery electric vehicle. So, again, even with that bearish view on oil, energy prices or energy stocks still look undervalued. And, of course, from a portfolio standpoint, I think it provides a really good natural hedge in your portfolio if inflation for whatever reason were to stay higher for longer or if there was any other additional geopolitical conflict, I think you could see those energy stocks move up, pretty quickly as well.

Taking a look at, what new stocks we have from our sector directors, a couple of new interesting plays in the basic-materials sector. Don't really want to spend a whole bunch of time, I would just recommend going to whichever Morningstar platform you use in order to get our research, read through the analysis here. Yeah, I would just say, kind of the short story here with IFF that we do think that they are returning back to focusing on their core competencies. They've divested a couple of acquisitions they made that really haven't worked out. And then we're also seeing destocking that occurred, a couple of years ago, coming to an end, so we're looking for a much more normalized price and volume going forward. And Nutrien NTR to some degree is also a similar story. We're looking for a potash demand to grow faster than supply over the next couple of years.

And then Polaris PII is another one where we think the market is overly pessimistic regarding the long-term view for that company. Essentially what happened is at the beginning of the pandemic sales went through the roof. Everyone was looking for, those kind of like outdoor products, the ATVs and the snowmobiles that they sell. So of course that pulled forward a lot of forward demand. But over the long term, we do expect demand to normalize. And then Kilroy Realty KRC, this is one where it is an urban office space. For those of you that think that there's already too much pessimism in urban office space or think that urban office space is probably at its lows, this would be one that I think might be interesting to take a look at. But again, I do think you need to do your due diligence and read through our research to make sure you have a comfort level on that one.

Exxon Mobil XOM, a name everybody is going to be pretty familiar with, moved into 4-star territory. So I think that is probably one of our better plays among the global majors. And I still like the cybersecurity space. I know we've talked about cybersecurity and fundamentals there and why we think there's such a good long-term structural tailwind. Our pick in the cybersecurity space is Fortinet FTNT. And then among the defensives, a couple of new picks: Estee Lauder EL, Baxter BAX, and Humana HUM. So a couple of other new picks for you to take a look at and see if they fit within your portfolio.

Valuation by Economic Moat and Stock Picks

Taking a quick run valuation by economic moat. Looking at returns, year-to-date. You know, wide moat stocks have outperformed the broad market. When I ran the numbers, the Wide Moat Composite Index was up 19.5% versus the broad market at 13.75%. So wide-moat stocks are now trading at a 6% premium. But really it's the large cap and those core and growth wide-moat stocks that are getting to be at those overvalued levels. So, for those of you that have an interest in looking at the mid-cap and the small-cap space or valued stocks, we do still see opportunities for you there. You know, among narrow-moat and no-moat stocks, they are trading at a similar discount right now—really not much of a discount, just a 2% discount from fair value. So, in that case, I would actually prefer, investing in those narrow moat stocks that they do have some long-term durable competitive advantages at least for the next 10 years, not necessarily as long as what we expect for wide moat, which is a 20-year time frame. But again, with the economy poised to slow, I'd be very careful and I'd only invest in those no-moat stocks that have very deep discounts from their intrinsic valuation.

And then just a screen that I like to do every quarter to try and identify new investment ideas for potential buys. So, a couple of new stocks here, looking at those undervalued large-cap stocks that have wide economic moats and in this case, sorting it by those that have a Low or Medium Uncertainty. So a couple of new picks on the list here. NXP Semiconductors NXPI is an interesting one. That's one that we actually just upgraded our moat rating from narrow moat to wide moat. I think if you're looking for something in the tech space, that's one that I would highlight for investors today.

Looking at mid-cap stocks, a couple of new picks here. The one I would highlight is going to be Kraft Heinz KHC. This is one that we've actually just upgraded our economic moat rating this past quarter to narrow moat. The short story here is when they got bought out by 3G Capital Partners a number of years ago, we think the company overly focused on short-term performance to the detriment of building long-term economic value at the company. Their short-term earnings looked pretty good back then, but they weren't reinvesting in the business like they should have. That caused the stock to end up selling off as the fundamentals deteriorated. But we think at this point they've really over the past two years now I think it has really gone back to basics: refocusing on their core business, reinvesting in their brands, going back to that focus of trying to build, long-term economic value of the company. And that's really what pushed us to raise that moat rating up to narrow.

And then lastly a number of different small-cap stocks here to take a look at to see what might fit into your portfolio. So, with that, I'm going to turn the baton over to Preston to review his US economic outlook.

2024 US Economic Outlook

Preston Caldwell: Thank you, Dave. I would say the most unusual aspect of the US economy over the past year, though, has been the utter imperviousness of economic growth to the largest Fed rate hikes in the last 40 years. But that erstwhile resilience notwithstanding, I do think GDP growth is likely to slow over the next two years. There are a number of factors that drove up GDP growth in 2023, which are fading in impact, and the effects of elevated interest rates are far from fully playing out. So, we expect an annual average terms growth to trough at 1.4% in 2025, but on the back of aggressive Fed rate cuts, I expect growth to accelerate again, cresting in 2027 and 2028.

We Expect GDP Growth to Weaken Until Fed Starts Cutting Interest Rates

Inflation Expected to Normalize, Allowing Fed to Cut Interest Rates

We expect the Fed to cut aggressively because of slowing growth along with normalizing inflation. Inflation we're expecting to average 2.4% in terms of the PCE price index this year in 2024. That essentially marks the return to normal, but then we expect it to fall even further, dipping below the Fed's 2% target in 2025 and 2026, which really would leave no room for doubt that that victory over high inflation is complete. And our inflation forecast, I'll get into more detail, but it's predicated on improved supply-side conditions, which have dramatically reduced inflation already, but should continue to play out. And most of all, slowing GDP growth in the near term will create additional slack in the economy, pushing down the prices across the board and ensuring that wage growth normalizes.

When Will the Fed Cut Interest Rates?

Comparing our views to consensus, we're a little bearish in the near term, but turn out to be bullish in the longer run because of our views on the supply side. And then, looking at the bottom chart, we're expecting inflation to fall quite a bit faster than consensus does, even though consensus is also ultimately expecting inflation to return to normal. And so with our views that inflation is going to come down more aggressively and there's going to be a bit weaker economic growth than consensus expects, we are naturally expecting a greater degree of monetary policy loosening. And we expect ultimately the federal-funds rate to drop by 350 basis points by the end of 2026, taking us down to a target range of 1.75% to 2.00%.

We expect the 10-year Treasury yield to fall to 2.75% on average by 2027. I think, across the board, this is a level of interest rates that is consistent with continued healthy economic growth. So in other words, this is in line with our assessment of the long-run neutral rate of interest. But if I were to pinpoint one sector in particular, which is really pivotal for the cyclical dynamics in the economy, in housing, I think much lower mortgage rates are going to be needed not only to stimulate a housing recovery but even to avert a larger downturn.

GDP Growth Expected to Weaken Until the Fed Cuts Rates

So, zooming into the near term, we saw real GDP growth dip to 1.4% quarter-over-quarter annualized in the first quarter after averaging a very strong 4.1% in the second half of 2023. But, as Dave alluded to earlier, there were some temporary factors weighing on first-quarter growth. So net exports and inventories, which are very volatile components subtracted 110 basis points from first-quarter growth. So, if we subtract the impact of those components, which yields final domestic demand, that grew at a solid 2.4% in the first quarter. And then we're expecting growth in the second quarter at 1.9%. So, based on that growth it's still at a fairly healthy level. There are early signs of deceleration, but we need to see more data before we really proclaim a downtrend. But that said, I do think a downtrend is coming.

Looking at the bottom chart—and here I'll focus on the year-over-year numbers, which smooth out some of the noise—we're expecting growth to go from 2.9% as of the first quarter year over year to about 1.6% in the fourth quarter of this year, and then trough at around 1.3% year over year in the third quarter of 2025 and then start to accelerate after that as the Fed cuts rates. Now, there's a number of factors that are going to weigh on growth. I think you have state and local governments, their spending should slow down as their surpluses have been exhausted. This manufacturing building boom, which was a major factor, propping up investment spending in 2023 is starting to plateau. And so it won't have an incremental impact on growth going forward. And most of all, I think consumers are going to start to pull back due to depletion of excess savings.

Supply-Side Expansion Helps Explain Resilient GDP and Falling Inflation

One factor that also helps explain the resilience of economic growth has been very strong productivity growth. If we think about, what are the supply-side drivers of GDP, we can disaggregate it into labor productivity and total hours worked, or total labor supply. And the productivity component was up 2.1% year over year as of the first quarter, which is a very strong number. And so to some extent that means that supply is probably creating its own demand. It also is relevant because it means that the potential growth rate of GDP is probably hovering at about 2.5% to 3.0% right now. And that should continue over the next two years. And what that means is the Fed, in order to continue to put downward pressure on inflation, really doesn't have to engineer a recession. They just have to push GDP growth below its potential. So, if we see GDP growth slow to something like 1.5% over the next year or so, that's well below potential growth and will exert widespread disinflationary pressure by creating additional slack in the economy, including in labor markets.

Is Consumption Growth Slowing?

Turning to the consumption data, the consumption data is quite volatile. And even if we, looking at the top chart, the red line, if we smooth the data by looking at a three-month-over-three-month annualized growth rate, there's still a lot of volatility. So, we really have to smooth the data to the extent of looking at the year-over-year growth rate to identify the underlying trend. And on that basis, consumption was still up by 2.4% year over year as of May data. I think it's still premature to talk about a consumption slowdown, even though we are definitely seeing early signs of it. And I would not be surprised if additional coming months' data confirms a consumer slowdown. And the reason I wouldn't be surprised, the reason why I do expect a slowdown is looking at the excess savings situation. So, the personal savings rate stands at 3.7% right now, which is well below the prepandemic average.

Excess Savings Are Dwindling, Households to Cut Back on Spending

It's been low since 2022 as consumers have been spending down their excess savings. And there are various estimates of excess savings out there, but really by any measure those savings are being depleted. And therefore, we do expect consumers to start to retrench and become more prudent in their spending. And that will mean slower consumption growth, and that will weigh on the economy over the next year or so.

Private Fixed-Investment Spending Likely to Slow in 2024

Turning to investment spending, as I mentioned with housing, I do think we need much lower mortgage rates to that point. The median mortgage payment as a share of household income has jumped from 19% before the pandemic to now 28% as of this year. And what you see on the top chart is also our forecast. So, conditional on mortgage rates coming down dramatically, we do think that affordability will go back to prepandemic levels. Historically, we see very large responses of housing activity and housing demand in response to changes in affordability. I do think this will ultimately be needed. And right now, I think homebuyers are really getting sold on the ability to refinance at much lower rates down the line. If that hope evaporates, then I think housing demand could fall again.

In terms of nonresidential investment, we expect it to slow from 4.50% in 2023 to 0.75% in 2025. As I mentioned, the manufacturing building boom is fading in impact. That will weigh on growth. We also have commercial real estate being hit by credit crunch. And also businesses are eventually going to respond to this consumption slowdown by curtailing their own investment. This could be slightly offset. It will be slightly offset, I think by the AI capex boom, but that's not enough to fully offset these negative factors that I mentioned.

Slowdown in Job Growth to Renew Now Through 2025

Looking at labor markets, while the headline numbers were a bit strong for the latest job reports because we had downward revisions to previous months' data, I would actually say it was a quite bearish report. So the three-month average annualized growth rate for nonfarm payroll employment dipped down to 1.4%, which is the lowest since early 2021. So, on that basis, we are really seeing a genuine slowdown in the labor market right now. We've also seen the unemployment rate tick up from roughly 3.5% to now about 4.0% on average in the last few months. And, as a result of that and expanding labor supply, we've seen wage growth continue to moderate, hitting 4.4% year over year in the first quarter based on our composite measure. That's consistent with 2.9% inflation, if we assume about 1.5% productivity growth rate, which is the difference between the two.

So, we're really just almost there in terms of getting to a normal wage growth consistent with the Fed's inflation target. And I do think we'll get there with just a little bit further slowing in the labor market. And that will come, in my view, to some extent over the rest of this year but especially in 2025. We expect employment growth to go from 1.8% year over year as of the first quarter to 0.5% year over year by Q4 2025. There are two reasons why that's the case. One, firms will seek to curtail their labor input as demand falls, as consumption falls, as I've talked about. But also, heretofore firms have been cutting pretty aggressively on average weekly hours per worker. But now there's not much further room to cut in terms of average hours.

So, the employers can't pull on that lever anymore. They're going to have to rely more on reducing the growth rate for overall employment, overall payroll. We'll see firms cutting more aggressively their hiring and even extending into layoffs to some extent, which will reduce employment growth in 2025. And so we're expecting the unemployment rate to average, after averaging 3.6% in 2023, we expect it to average 4.4% next year and then even 4.5% in 2026. With the unemployment rate still being elevated throughout most of 2026, that's one reason why we expect the Fed to continue to cut at a fairly strong pace throughout 2026, which is one area in which we diverge from the market.

Inflation Outlook 2024

Turning to inflation, the charts here don't reflect this morning's data but obviously we had some very good news this morning. These charts, focus on the PCE price index. On that basis, through May, we were at a 2.7% three-month annualized growth rate for core PCE inflation. That's much improved from where we were at the beginning of 2024. And based on this morning's news, I would say that's probably going to decline further to about 2% or even lower for the three-month growth rate for core PCE. We're really back to the benign inflationary conditions that we saw in the second half of 2023. So, the stars are definitely aligning for an imminent rate cut now. Still too soon to talk about a July rate cut, but I do expect the Fed to start to lay the ground for a September cut on this basis.

Looking at the bottom chart, most of the categories that drove higher inflation at the beginning of the year have come back down. Housing has remained stubbornly high, but we did actually see a very significant reduction in housing inflation in today's data. If that repeats, if we continue to see housing inflation normalize, then that's really the last shoe to drop because, if we look at it on a year-over-year basis, core inflation was just 1.9% for, that is core PCE excluding housing as of May. If we fix housing, then really the whole inflation problem should be gone.

Inflation Forecast by Category

This chart shows our inflation forecasts broken out into a key category of good. And, we expect continued disinflationary momentum for core goods, both durables and core nondurables, owing to the continued existence of the improved state of supply chains exerting downward pressure on prices or at least reducing the growth rate of prices. And then as you can see, we expect housing inflation to come back to normal over the next two years. That's going to be another major downward impetus. And for all other categories of inflation, really wage growth is the key determinant there. So, as wage growth continues to normalize, that should ensure those parts of the economy come in line as well.

When Will Housing Inflation Normalize?

Again, to add more support for our view on housing, I've said for a while that it's really a matter of when, not if, housing inflation normalizes because the leading edge data, which is represented by the purple line on this top chart, has indicated for a while now that that housing inflation is normalizing. The market rent represents the average rent sign on new leases, whereas the housing component of the CPI and the PCE reflects the average rent on all leases, which tends to be stickier and respond with a lag with respect to new leases with respect to market rent. So really, we've just been, we've been looking in the rearview mirror as far as the housing component of the inflation indexes because it's really reflecting that runup in market rents that happened in 2021 and 2022. But the gap between the two is closing, and market rent growth has slowed to around 2% yea -over year. So that indicates strongly that housing inflation should continue to normalize.

And on the supply chain front, which is important for goods prices, it's true we have seen shipping disruptions, but we don't see anything like the broad-based supply chain disruptions right now that we saw in 2021 and 2022, at least as gauged by the New York Fed's Global Supply Chain Pressure Index. And I think that's because we've had cooling goods demand and we see so much more slack in other parts of the supply chain. So, even when you have a squeeze on one area of the supply chain, like global container shipping being affected by the Red Sea disruption right now, that's not enough to create the kind of stress that would cause inflationary pressures to spring up again. And on that specific front, we're continuing to see additions, large additions to the global container fleet this year and next year. And that should continue to help offset the negative impact from the Red Sea disruption.

Federal-Funds Rate Cuts to Begin in 2024

Turning to a quarter-by-quarter forecast for monetary policy for the federal-funds rate, we are expecting still the first cut to come in September, another cut in December. So 50 basis points of cuts this year. And ultimately, as I said, 350 basis points of cutting through the end of 2026. And so we hew fairly close to what the market's pricing in over the next three or four quarters. But as you get toward the end of 2025 and into 2026, we're expecting much more cutting than the market is expecting because of our views on greater slack developing in the economy with the unemployment rate being at 4.5% in 2026 and also inflation running below the Fed's 2.0% target. I think the Fed will respond fairly nimbly in response to that change in conditions and pivot to a much looser monetary policy stance very quickly.

And one thing I would note is that, if you look at the yield curve, it's still quite inverted. The 10-year yield, even more so today. The 10-year yield has dropped down to around 4.2% or below it. And much below the federal funds rate at about 5.3%. What that means is that the bond market is expecting the Fed to ultimately cut rates fairly substantially, consistent with the purple line expectation shown on that top chart. And what that means is that the Fed has to cut merely to fulfill those market expectations. If it were to keep the federal-funds rate at its current level for longer than the market expects, that actually would constitute an effective tightening. So, some degree of cutting is needed just merely to keep really the stance of monetary policy constant.

With that, I'm going to kick it back over to Dave to wrap up the presentation.

How Have Undervalued Mega-Cap Stocks Performed in 2024?

Sekera: Great. Thank you, Preston. Appreciate that. Actually, in the interest of time, I'm going to go through these slides relatively quickly. We have a lot of great questions coming in. Keep them coming. And I want to get to as many of those as possible. Again, the reason that we always have the spotlight on mega-caps is just because their capitalization is so large that how these stocks move does skew the overall broad market index.

So, again, looking at some of the undervalued mega-cap stocks that we had highlighted at the beginning of the year, pretty mixed performance with a couple of them underperforming and being down thus far this year, like Johnson & Johnson JNJ. Again, I really like Johnson & Johnson here. I think that's an attractive situation. We've talked about that a couple of times. But again, looking at, some of these other stocks, the Alphabets, the Berkshires BRK.B, the Exxons, still doing relatively well year to date. And then looking at the updated list—actually, I got to note here, Adobe ADBE was a 4-star-rated stock. It sold off after its first-quarter earnings. Our fair value estimate was unchanged. But over the past week or two, that stock has moved back up enough that it's now a 3-star-rated stock. So, it still trades at a pretty decent discount to fair value and puts it in the bottom of the three-star range, but that is a 3-star-rated stock.

Overvalued Mega-Cap Stocks Become Even More Overvalued

Now, a number of the stocks that we thought were overvalued at the beginning of the year have actually become more overvalued. I mean, some of them to me, I just really don't understand. The one I would highlight here is Costco. It's a 1-star-rated stock. I'll admit I'm a consumer at Costco. I really enjoy the retail and shopping experience there. But that company is trading at about 50 times our forward earnings estimate and that actually makes it more expensive than our forward earnings estimate on Nvidia, if you can believe that. And a couple of these others here that have gotten more expensive over the past couple of weeks as well, moving down in the star rating category. Our updated list, Apple now being moved to that list of overvalued mega-cap stocks as well. Then lastly, just wrap it up with our fixed-income outlook.

Fixed-Income Outlook

Let's go ahead and skip that. So really, the gist of it is, we expect that the 10-year is on a multiyear downward trend using Preston's forecast. We're looking for an average 10-year this year of 4.25%. Of course, the 10-year was much higher than that for the first half of the year. So, by definition, that means it's going to be lower in the second half. And then falling to an average of 3.75% in 2025 and then 3.00% in 2026. We think that it's a good time to be invested in longer-duration fixed income and be able to lock in the currently high rates that we have right now. Having said that, I would stick probably with Treasury bonds as opposed to corporate bonds. Last quarter, we had moved to an underweight in corporates just because credit spreads had tightened to the point that we didn't think that it was giving any room for increases in downgrades or defaults in the second half of the year.

Again, in a soft landing, we're not expecting a big increase. But again, with indexes being where they are, the average spread only being 91 basis points on the investment-grade index and 318 on the high-yield index over the past 24 years, less than 20% of the time has the spread on the corporate-bond index and only 15% of the time has the spread on the high-yield index been at or below their current spreads. Just to show you just how tight things are over the long term, we do these long-term charts. We show different instances where credit spreads blew out based on specific catalysts. But again, even in the soft landing, I'd be very cautious on corporate bonds, both investment grade and high yield.

Dziubinski: I'd like to thank Dave and Preston for their time today. And of course, thank everyone for joining Morningstar's Third Quarter 2024 US Stock Market Outlook webinar. We hope you'll join us again next quarter. Happy investing.

Watch Q2 Update: 2024 Outlook for the Stock Market and Economy for our previous quarterly outlook.

The author or authors do not own shares in any securities mentioned in this article. Find out about Morningstar's editorial policies.

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