THOUGHTS FROM THE FRONTLINE

ME

A Muddle-Through Year

By John Mauldin | January 6, 2024

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First, let me wish you the best for the new year. I look forward to exploring it with you.

It's forecast season again, the time when people like me tell people like you what will happen this year. Sadly, we are often wrong. It turns out predictions are hard, especially those about the future (with apologies to whoever said that first).

However, these forecasts can still be useful in the same way stripes in the road are useful. Unexpectedly bad things can always happen, of course. Yet the stripes help you move in a generally safe manner. Moreover, if circumstances force you out of your lane, then you know some new challenge is ahead. You might need to consider a different route.

For 2024 I expect a "stay in your lane" year. It will no doubt bring events we don't currently anticipate. We will have to navigate around them, possibly at significant cost, but I think we'll Muddle Through. Some unexpectedly *good* things will happen, too, even if you don't hear about them.

In sum, we'll stay on course toward the debt crisis I've long anticipated. At this point, nothing short of a major miracle can prevent it. But that's still a few years away. Meanwhile, the economy will proceed much like it has been, with stubborn inflation and low unemployment keeping recession at bay.

How it will happen matters, though. That's the part we really need to consider.

Soft Landing?

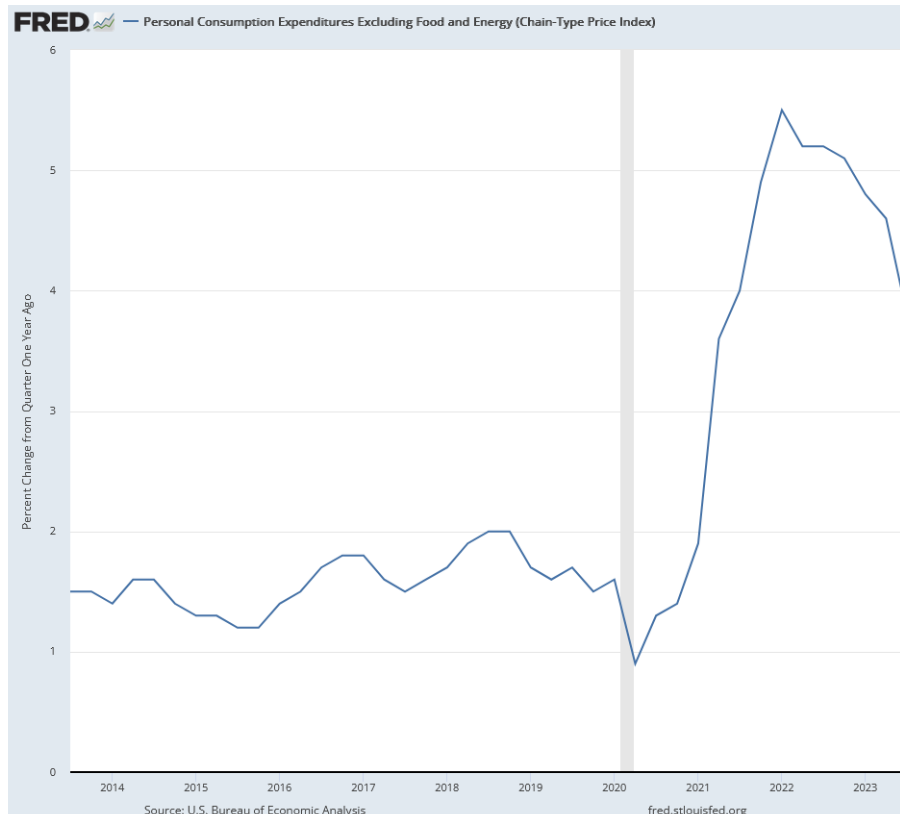
I generally start these annual forecasts by looking back to the previous one—a sometimes humbling but important step. As it turned out, my 2023 outlook (see Year of the Pause) was almost (but not quite) dead on.

For example, I said, *"I now believe it is entirely possible the Fed will not stop hiking until it gets to 5.5%."*

That was not consensus at the time. There was already weeping and wailing and gnashing of teeth about the rate hikes we'd already experienced.

Four more hikes took the federal funds rate from 4.5% last January to 5.5% in July, where it remains today. I believed then (and now) that Jerome Powell was quite serious in his intent to stamp out inflation even if it meant tightening policy to a point that seemed extremely aggressive at the time.

I went on to say both inflation and the higher rates meant to squelch it would continue having serious cumulative effects. That happened, too, and is continuing. Inflation has improved but is still too high. Here is a 10-year chart of the annual change in Core PCE, the Fed's preferred inflation gauge.



Source: FRED

For most of this period inflation stayed below the Fed's 2% target. It has been above target since early 2021 and remains so today, even after falling considerably (note the chart is through Q3 2023 and will be updated later this month, likely falling further).

Incidentally, is it fair to call these three years (and counting) of above-target inflation "transitory?" When I think of the word transitory, I don't imagine 3–4 years. I don't believe that's what "team transitory" meant.

This was serious, the worst inflation in decades, and it's not over yet. The "core" index shown here excludes food and energy prices which rose painfully at times. Many, many prices remain much higher than they were in 2020 and are unlikely to return. Stopping further damage, while good, doesn't reverse what already happened. Only a period of outright *deflation* would do that, and no one foresees any such thing (well, maybe except Lacy Hunt).

The Fed did what it could by raising rates, knowing it risked a recession. I thought (and said in that 2023 forecast) we would see a mild recession last year. It didn't happen that way; real GDP growth was positive in the first three quarters and looks likely to have risen again in Q4. The unemployment rate barely budged, too. Did the Fed produce the fabled "soft landing" many of us thought impossible?

As I said last week, 85% of economists were predicting a recession last year. I was one of them. I felt uncomfortable being in the consensus, and it turns out being uncomfortable being in the consensus was actually the right feeling.

A recession could still be coming… or it could have already happened. Remember we actually saw two straight down quarters in GDP in the first half of 2022. That was a "technical recession" even if not confirmed by the official scorekeepers. Possibly it released enough pressure to extend this expansion period.

Frankly—and this is pure speculation—I wonder sometimes if the word "recession" has lost the meaning we all give it. We know excessive debt depresses growth, despite what neo-Keynesians and MMTers say. The demographic-driven labor shortage also discourages layoffs, which were once the prime demand reduction channel.

> "We have roughly 162MM people currently employed in this country, with another 8.8MM new job openings posted, so call about 171MM on the demand side. The current US labor force is roughly 168MM, so while not perfectly matched (still more demand), it is getting there and what the Fed wants to see." (Source: The Bahnsen Group)

Maybe mild but steady growth will be the new normal, punctuated by occasional weak quarters. A short recession here and there is possible but I suspect we'll Muddle Through the next few years. I don't think the amplitude of GDP will be anywhere near as volatile as it was over the past decades.

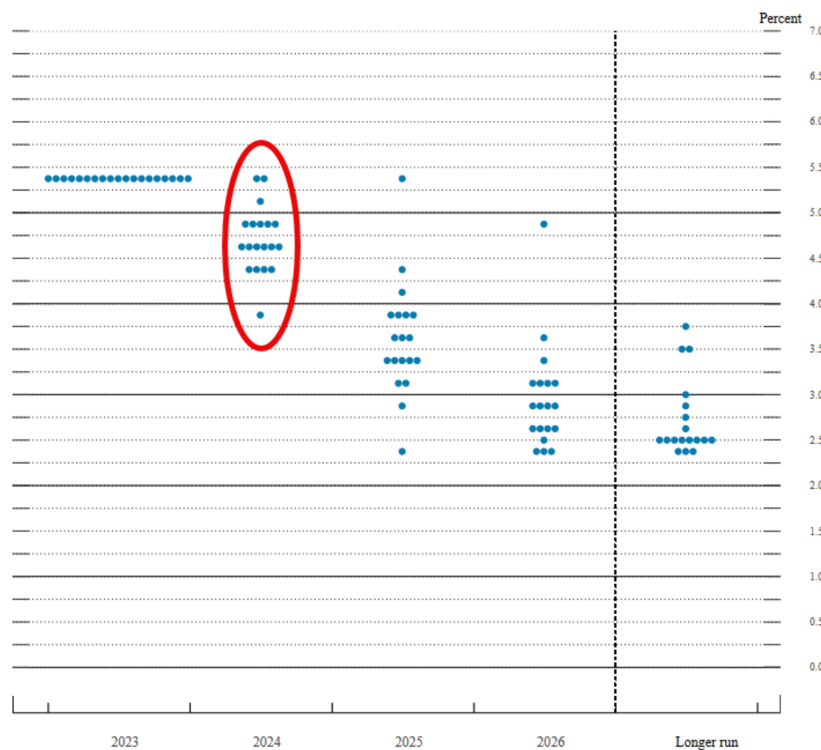
That would be a new kind of business cycle requiring adjustments in our thinking. Much of our planning assumes 3% growth will resume. While that could happen occasionally, I think we will be lucky to average 2% for the rest of this decade, and in general I think real GDP will stay closer to 1%. Not exactly robust. Think Europe. Hopefully we can avoid turning Japanese. But for now, let's talk about next year.

Dots and Markets

For better or worse, the 2024 economy will depend heavily on the Federal Reserve's choices. Jerome Powell's tighter policy has had serious but (so far) manageable effects on rate-sensitive sectors like housing and commercial real estate. This helped bring inflation down but it's still too high. What does the Fed do now?

Before we answer that, remember that keeping rates where they are is effectively more tightening. That's because steady nominal rates combined with falling inflation means real interest rates are still rising. Fed officials know this; indeed, I think they're *betting* on it to finish the job. Whatever inflation level they want to see, they'll need to start normalizing quickly upon reaching it. Otherwise, their soft landing could turn into something harder and more painful.

The Fed's policymakers helpfully tell us what they are thinking in the "dot plot" economic projections. Since Powell started with the rate hikes, the Fed has generally stuck to the middle of their forecasted dot plots. I expect that to continue. Here is what they said as of the December meeting.



Source: FOMC

The red circle is their estimate for where the federal funds rate will be at the end of 2024. Each dot represents the opinion of one committee member. You can see they are mostly clustered near 4.75%, which would imply three quarter-point rate cuts this year.

Again, though, these are just their own individual forecasts. All the FOMC members are careful to say they are data dependent, etc. The dot plots are a rough guide, at best. The futures market is currently "predicting" six rate cuts. My friend Peter Boockvar says this disconnect sets up a potential market disruption if we get deeper into 2024 and the Fed isn't cutting as much as traders expect. Here's Peter (from a Jan 2 note).

> "If the Fed cuts 3 times as the dots say, it would be a modest reset in response to falling inflation, but markets might be disappointed as that is not what is now priced in. If the Fed cuts 6 times as the market is pricing in, it's because the unemployment rate is 4.5% or more which would most likely mean economic recession and faltering earnings. Also, a REAL rate of about 250 bps used to be normal once upon a time."

This is a really good point. I personally think Powell will lead the committee to cut rates slowly. He's looking years ahead, intent on making sure inflation doesn't come back in 2025 or 2026. If they start cutting faster, it will be because they think the economy is weakening more than we have seen so far.

As I filed this letter I saw Friday's +216,000 December job growth, which was above the +175,000 estimate. Nothing there suggests a slowing economy or an imminent need to cut rates. We will see what the market does with this information next week. But the two-year yields jumped up. So more "higher for longer," as I have been saying.

I know many market participants (especially the leveraged ones) would like to see six rate cuts, but the economic environment that would require six rate cuts is not something anybody should want. Again, for emphasis, cuts of 150 basis points or more would mean we are in recession, or the Fed thinks one is near.

I don't expect such weakness. I think the baseline will look a lot like 2023: mild GDP growth, low unemployment, and slowly moderating inflation. You all know I'm as skeptical of Fed officials as anyone. But on this, I take them at their word. They think the economy is in a good place—not great, but "good enough"—and that cutting slowly is the way to keep the trend going, even if it means some trade-offs.

Everyone asks me for a forecast on the stock market. The correct answer is I don't know. I do know that the price-to-earnings ratio and other valuation markers are quite high, which does not bode well for future overall market returns. I remember writing in 2001 or so that investors still expected to see 15% compound returns into the future. I said returns would be flat for the decade, and GDP would be 2%. I was slightly optimistic.

Possible Drama

Every forecast has risks. What could happen to derail this slow-moving but reliable train of progress?

Financial accidents are always possible. Numerous highly leveraged players have managed to stay afloat despite rising rates. But each passing month means more debt matures and needs to be rolled over at higher rates. We got a little taste of this last year when Silicon Valley Bank and First Republic failed. Those losses, while huge, were systemically manageable—though one hopes those episodes woke up the regulators who are supposed to be watching for trouble.

I talked with one major bank CEO this week who agreed the three major bankruptcies last year were management failures, not systemic problems. Banks in general are selling their bad debt in a more or less orderly manner. Hundreds of billions of dollars are waiting to buy distressed commercial real estate at a discount. I am sure there will be some minor bank problems, as there always are, but nothing like 2008–2009.

Another geopolitical crisis could also be problematic. The Ukraine war greatly aggravated the inflation pressure that was already building in early 2022. That one is still ongoing and now we have a second conflict in Israel/Gaza, which is now spreading to critical Red Sea shipping routes. Further escalation or threats to energy supplies would be bad.

The US elections are also going to create a lot of sound and fury this year. It appears, despite many of us wishing otherwise, the presidential race will be a Trump-Biden rerun. Both candidates have their weaknesses I need not repeat here. Partisans in each party will promise doom if the other side wins.

A little inside political baseball here. There is a group called No Labels, started by Nancy Jacobson roughly 14 years ago, which focused on getting congressmen and senators from both parties to work together to pass important legislation. They have been increasingly effective. For the last two years, they have been working to get on the ballots in all 50 states to run a third-party candidate if, and the operative word is ***if***, there is a repeat of the 2020 Biden/Trump presidential election. It increasingly looks like that will be the case.

If, and again it is a BIG if, Nikki Haley somehow manages to show well in Iowa and win New Hampshire and South Carolina, it is my understanding that they will wait until after Super Tuesday and if it becomes likely the nominee would somehow be Nikki Haley, they will not run a third-party candidate. When/if it looks to be a repeat of Trump/Biden, they will announce their candidate. They will be well funded and the polling I have seen shows a serious interest among a potential plurality of American voters for someone other than Biden or Trump. It will of course depend on who the candidate is. I have no idea who that could possibly be. The people involved are quite serious and sophisticated and are not interested in a spoiler campaign. They will want to win.

Not convinced? It seems Democrats and many (mostly Never-Trumpers) Republican leaders are very worried. They are both worried about a credible third-party candidate siphoning off votes and throwing the election to their opposition. This is to the point that a large "secret" meeting took place a few weeks ago where they talked about how to either keep No Labels off as many ballots as possible or threaten potential candidates with significant harassment. They are all for democracy as long as they get to limit the choices. Quoting from the article:

> "Through every channel we have, to their donors, their friends, the press, everyone—everyone—should send the message: If you have one fingernail clipping of a skeleton in your closet, we will find it," one speaker said during the call. "If you think you were vetted when you ran for governor, you're insane. That was nothing. We are going to come at you with every gun we can possibly find. We did not do that with Jill Stein or Gary Johnson, we should have, and we will not make that mistake again."

It will all be very dramatic, but will it matter, economically speaking? I think probably not *unless* the winner's party also wins both House and Senate control or can somehow produce bipartisan cooperation.

I won't hold my breath waiting for that to happen. But it needs to. That's the only way any substantial legislation will pass. Without it, tax policy, regulation, spending and all the other things that have economic effects probably won't change much. Leaving them on hold simply lets the debt spiral further out of control, making the eventual crisis that much worse.

Election drama may also affect the Federal Reserve. On paper, Jerome Powell is as bipartisan a leader as anyone can expect, having been nominated to the chair by both Trump and Biden. Yet he's still going to be accused of political bias, no matter what he does. Democrats will cry foul if the Fed doesn't try to stimulate growth with extra rate cuts and Republicans will complain if it does. Powell's only choice is to not play the political game and focus on the data.

On a more positive note, keep in mind we might see some *good* surprises, too. They probably won't emerge from either Wall Street or Washington. But around the world, smart people are quietly working on innovations that could change life and the economy for the better.

Artificial intelligence technology is developing at breakneck speed. The amount of capital, brainpower, and resources going into it are just incredible. As with all innovations, some of it will go badly wrong but the breakthroughs will come. I believe AI will start having noticeable impacts on everyday life in the very near future.

I don't have the space to go into it this week, but those warning of potential problems with artificial intelligence do make one very good point. Artificial intelligence is only as useful as the data it is allowed to see and process. If you tell the software it must have a particular type of social/political viewpoint, that will bias its output. If you instruct the software that there is no difference between men and women, that is going to warp its presentation.

Do you really want artificial intelligence controlled by humans setting their version of DEI guardrails on information? It will create false results. Don't even get me started on the problems of "hallucinations" created in various artificial intelligence programs. The potential problem, I am told, is that when an artificial intelligence program gives an answer, that becomes part of its information base and so it will continue to express the bad information or hallucination as fact.

Biotechnology, especially anti-aging medicine, is also developing fast. I'll be at a meeting this month to review some new, potentially exciting, findings. These innovations also have the potential for immediate economic impact if they can cut healthcare spending, keep people productive, and cure some of the diseases that rob the world of prime talent.

Those would be truly wonderful, and perhaps help cushion the coming debt crisis. A cushion is only so much help, though. Better to not crash in the first place… but I think we've lost that chance.

Though it bears repeating, history tells us that we will get through this coming crisis and the period afterward will be one of remarkable progress and comity, something hard to imagine now. Just as it would be hard to imagine the present in 2014, other than in general terms and direction, thinking about 2034 is also daunting. But you and I will hopefully go through it together.

Washington, DC, New York, and Cape Town

I will be in Washington, DC, on January 20 and then take the train to NYC for a few days. Then the next planned trip is to Cape Town, South Africa, in June. Shane and I will also try and spend a few days either on safari somewhere in Africa or perhaps in Europe on that trip. Too far out in the future to make firm plans.

We are hot and heavy planning for this year's Strategic Investment Conference in the latter part of April. This will be the 20th annual conference and I believe it will be the best ever. You will be getting details soon.

I look forward to writing for you this coming year and am diligently working on a book for later in the spring. I can confidently forecast a lot of writing and research in my future.

And with that, it is time to hit the send button on this first letter of 2024. Later in the year we will celebrate the 25th anniversary of this letter. I have so many readers who tell me they were there with me at the beginning in early 2000. It always makes me feel good to have longtime readers and friends tell me how I have helped them. Thank you for your time and I hope to be able to make this next year even more valuable. And don't forget to follow me on X.

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