Q4 2023 OUTLOOK SUMMARY

RATES, RESILIENCE AND RETHINKING RECESSION

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The indefatigable US economy continued to plow ahead in the third quarter, defying ongoing calls for a slowdown. A surprisingly robust monthly jobs report to close out the quarter only served to emphasize the resiliency of the economy in the face of higher rates, further muddling the outlook for future policy decisions by the Federal Reserve.

At the same time, investors are also grappling with threats of a US federal government shutdown, strikes at several US auto makers, tensions with China and, most recently, a burgeoning war in the Middle East. With so much uncertainty, investors need to maintain a long-term vision for their portfolio and capture new opportunities as they reveal themselves. PGIM brings the following perspectives from its affiliates to examine both opportunities and challenges present across asset classes.

PGIM Fixed Income

At this point, the main forces pushing the yield curve higher are the central banks and a heavy supply of government bond issuance. Upward momentum in long-dated yields could easily continue through year end—pushing Treasuries towards 5% and Bunds to 3%—and yields could go beyond those levels if fundamentals heat up again. However, our base case envisions bullish market fundamentals continuing to develop as they have in recent months, coming to the fore as a market driver as we move towards and into 2024. This market outlook implies that the major central banks are on the precipice of an inflection point—for the Fed, that may mean 50-75 bps of rate cuts in 2024 from the current fed funds midpoint of 5.375%. In the end, this forecast for government bond yields remains. The bottom line is that a bumpy transition to a bull market is still underway with visible clouds near term. The longer-term outlook is favorable with rates near their cycle peaks. A broad range of fixed income products appear well positioned for solid risk-adjusted returns over the long term on both an absolute and relative basis.

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PGIM Quantitative Solutions

Our view has shifted to a more balanced one, as the incoming hard economic data in the US lessens the possibility of a near-term recession occurring. The third quarter also likely marked the trough in the earnings cycle as growth expectations for future quarters turn positive and move past the negativity of Q2. However, we are cognizant that the high valuations of US equities already price in an optimistic scenario, so it's difficult to see much further upside. While sector composition often explains much of the difference in valuation between the US and the rest of the world, US stocks are expensive even after accounting for composition effects. Within equities, we prefer US and Japan over Europe, as Europe will likely experience more challenges in its fight with stagflation. On a cross-asset basis, the equity risk premium of the S&P 500 has recently dipped below the risk premium for high-yield bonds, making the former relatively less attractive on valuations.

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Jennison Associates

Sentiment in the near term is clouded by uncertainties due to—but not limited to—repeated threats of a government shutdown, auto strikes, the restart of student loan repayments, and the lagged effect on financing costs and spending intentions from interest rates that are at 15-year highs. These impediments will likely weigh on economic growth into year-end and deepen the deceleration that we have been anticipating since the year began. US consumers, with less robust prospects overall, are beginning to show stress—primarily at lower income levels. Overall, a healthy employment backdrop and residential real estate strength, which bolsters net worth, are variables that point to a moderate slowdown. As it relates to consumer-oriented companies, we believe those that remain tightly focused on leading brands, retailers, and service providers are best positioned to take wallet share and grow revenues and profits on a multi-year basis. Longer term we believe the market overall will continue to favor companies with asset-light business models, high incremental gross profit margins, subscription model revenue streams, disruptive products, large total addressable markets, and faster organic growth with long runways of opportunity.

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