CIO PERSPECTIVES

2024 Outlook: Navigating the Last Mile

TIAA | Wealth Management

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Executive Summary

- Over the course of 2024–2025, we expect inflation to continue to decline, covering "the last mile" toward the Federal Reserve's (Fed) 2% target. However, absent a major economic downturn, the Fed is likely to remain vigilant, fearful that above-trend GDP growth might reignite inflation.
- As the year progresses, interest rates are likely to decline as inflation eases and economic growth decelerates. However, rates should stay at higher levels relative to the pre-COVID era.
- After a well-above-average year for U.S. equity returns in 2023, we see 2024 shaping up as a below-average year, with minimal multiple expansion and mid-single-digit earnings growth close to the long-term average of 7%. Equity volatility is likely to rise into the first half of 2024 given the uncertainty of the disinflationary process, as well as weakening consumer spending and labor market fundamentals.
- In 2024, some of the headwinds for bonds will abate, setting them up for better returns, but with ongoing volatility. The attractiveness of high-quality bonds with intermediate and longer maturities has increased versus cash alternatives, as interest rates should be trending lower. Investment grade corporate bonds will likely perform better than high yield bonds, as they are more insulated from tighter financial conditions. Municipal bonds also look favorable due to their higher credit quality and notable tax-adjusted yields.
- In our view, investors should not construct their portfolios based on a bias toward a particular outcome for U.S. Presidential elections or geopolitical issues and should avoid trading on these developments. Rather, it is prudent to stay invested in one's long-term asset allocation and maintain a balance of different asset classes that can help mitigate swings driven by ongoing uncertainty.

CIO View

2024 Outlook: Navigating the Last Mile

2023 was a year of surprises for investors. Coming into the year, there was widespread fear of a significant slowdown for the U.S. economy, paired with downbeat prospects for risk assets such as equities. Instead, the U.S. economy accelerated for much of the year with help from resilient consumer spending, a tight labor market and expansionary fiscal policy. The Fed hiked its policy rates to 5.25–5.50%, the highest levels since 2001, in the most aggressive tightening campaign seen since the 1970s. Inflation, having reached a 40-year high of 9% in 2022, moderated to the 3–4% levels, prompting the Fed to pause its hiking cycle in July 2023 and adopt a "wait and see" posture.

A stronger economy—in combination with rising government borrowing needs to fund ever-larger budget deficits—caused interest rates to rise, creating headwinds for bond portfolios. Meanwhile, equities continued to climb the "wall of worry": investors shook off stresses in the regional banking sector, higher interest rates and geopolitical events such as the war in the Middle East, focusing instead on better-than-feared corporate earnings and the enthusiasm around the benefits of artificial intelligence (AI). As 2023 drew to a close, signs emerged that interest rates were peaking and some of the growth drivers of 2023 were beginning to fray.

2024 should prove to be a transition year for many macro themes and global market trends witnessed since 2021. We expect a marked deceleration for the U.S. economy and continuing struggles for Europe. In China, the recent stimulus measures to support growth have failed thus far to reinvigorate the world's second-largest economy. In the U.S., demand for labor should cool along with wage growth, leading to an increase in the unemployment rate from historically low levels.

Niladri 'Neel' Mukherjee
TIAA Wealth Management
Chief Investment Officer

However, given the recent challenges in hiring workers, employers are likely to carefully balance the risk of becoming too lean. Consumer spending may slow due to higher borrowing costs, rising delinquencies, tighter credit conditions, and slowing wage gains. Less affluent consumers will become more selective and cautious, pulling back on discretionary categories and dipping further into their savings. Additionally, even as the Federal budget deficit remains elevated, the fiscal impulse is likely to be a drag on economic growth in 2024.

Over the course of 2024–2025, we expect inflation to cover “the last mile” toward the Fed’s 2% target, as the Fed’s aggressive monetary tightening since 2022 cools the labor market and consumer demand. However, absent a major economic downturn, the Fed is likely to remain vigilant, fearful that above-trend GDP growth might reignite inflation. As such, policy rates are likely to remain at restrictive elevated levels for some time, eventually leading to measured rate cuts to support growth. The lagged impact of tighter monetary policy, combined with a loss in momentum for nominal GDP growth, are likely to be headwinds for corporate earnings. However, better-than-expected productivity growth as we head into 2025 would be supportive of profitability and an earnings recovery.

The stock market rally and the pullback in bond yields in November 2023 lead us to believe that the investment community is mostly anticipating declining inflation, reasonable economic growth, and the potential for Fed rate cuts in 2024. In our view, equity volatility is likely to rise into the first half of 2024, given the uncertainty of the disinflationary process (prices rising at a slower rate) as well as weakening consumer spending and labor market fundamentals. Throughout the year, interest rates are likely to decline as inflation and economic growth moderate and investors prepare for a less hawkish Fed.

However, rates should stay at higher levels relative to the pre-COVID era. Cash yields are attractive for now but should decline as the Fed moves to cut rates, and the appeal of high-quality bonds should further increase as the economy slows and price volatility in risk assets leads investors to diversify.

In this environment, there may be advantages to remaining fully diversified across multiple asset classes and regions, in line with one’s financial goals and risk tolerance. Until the Fed’s inflation mandate is reasonably within sight, factors such as high-quality, sustainable dividends, free cash flow generation, and relative earnings strength are likely to lead. As we go through this reset period for inflation, corporate profits, and monetary policy, investors with longer time horizons may see opportunities to deploy excess cash into U.S. equities, especially as volatility picks up. In the near term, bonds are more attractive than equities from a total return perspective. Over the long term, however, staying invested and having an appropriate allocation to equities should enable investors to participate in a U.S. growth story with the following key plotlines:

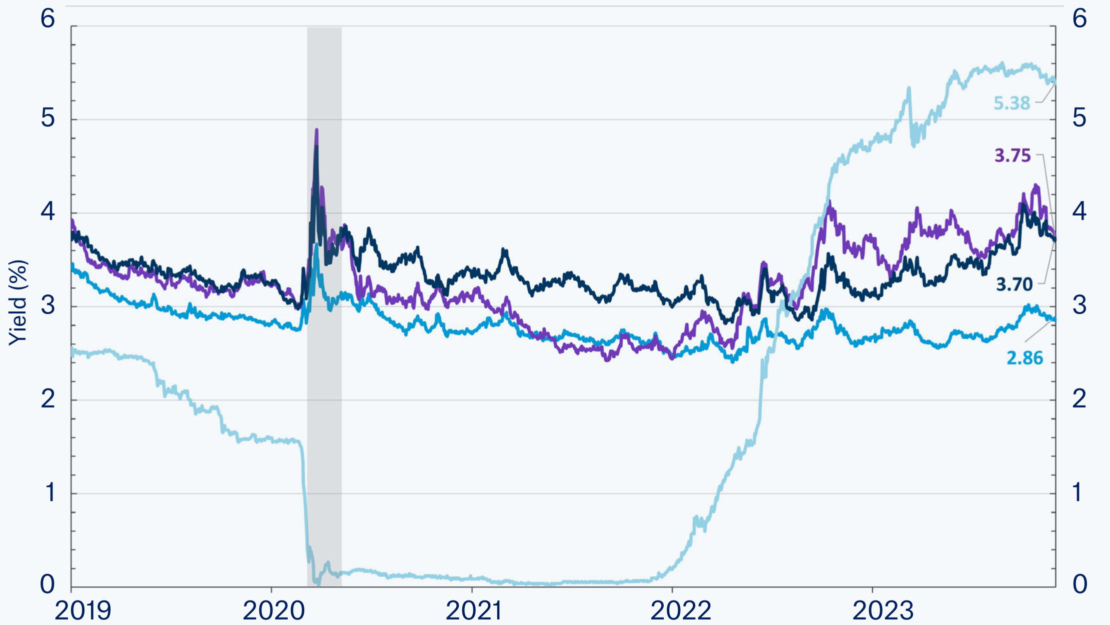
- Members of the millennial generation are aging into their prime years for earning, consuming, and investing. This supports the housing market and related spending, investments into growth-oriented asset classes, and services-based sectors.
- Accelerating innovation across all sectors of the economy as AI and robotics become further embedded into business practices. This should drive a broad uptick in productivity.
- Geopolitical differences and national security concerns driving capital expenditures and government investment into higher value-added industries such as manufacturing, semiconductors, and health care supply chains.
- Investments toward the transition to the new energy economy, including traditional and green commodities, which are projected to be in short supply relative to long-term demand.

Equity Outlook

What is the 2024 outlook for equities and different sectors of the equity market?

The U.S. economy continues to walk a fine line between expansion and a slowdown. The past 12 months have seen investors reduce their holdings in the more cyclical areas of the market (telecommunications, autos, banks, tech hardware, apparel) as they anticipate a moderation in economic growth. The bond proxies (REITs, utilities, and consumer staples) within the equity market have struggled as their yields cannot compete with the six-month Treasury bill (Figure 1).

FIGURE 1
Six-month T-bill versus dividend yield on S&P 500 Utilities, REITs and Consumer Staples



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

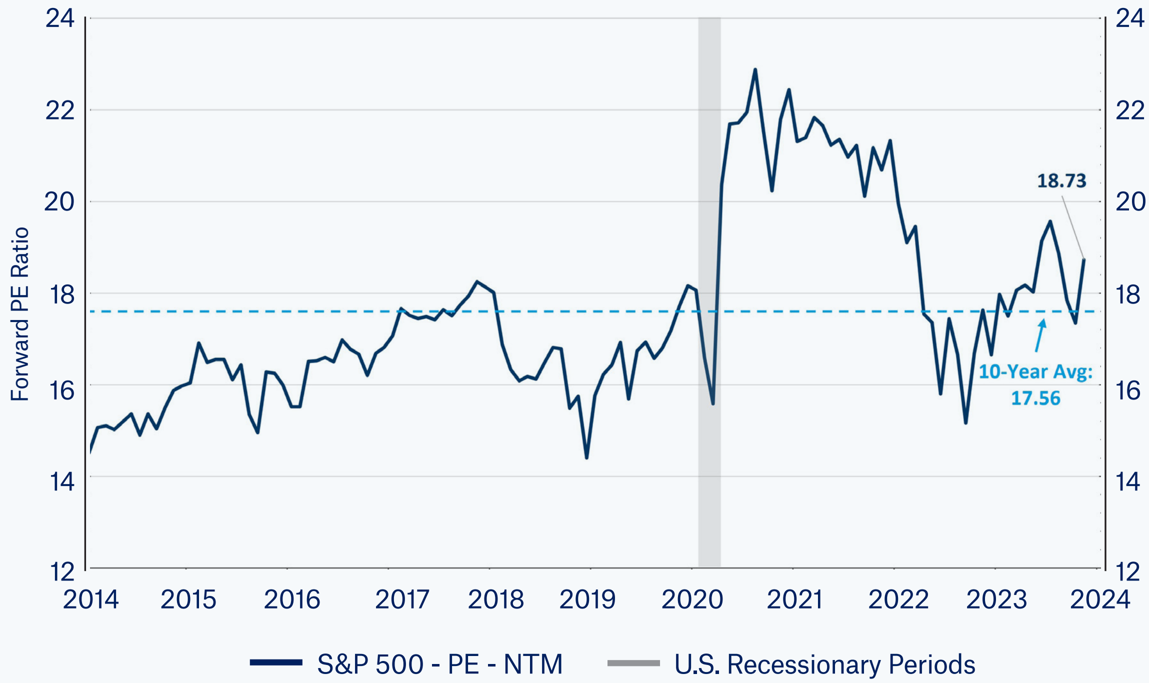
S&P 500 / Consumer Staples -SEC- Dividend Yield
S&P 500 / Real Estate -SEC- Dividend Yield
US Treasury Constant Maturity - 6 Month - Yield
U.S. Recessionary Periods
S&P 500 / Utilities -SEC- Dividend Yield

Equity Outlook Continued

After a well-above-average year for U.S. equities in 2023 (+21% YTD through November 30, 2023), we see 2024 shaping up as a below-average year of returns, with minimal multiple expansion and mid-single-digit earnings growth. S&P 500 earnings are forecast by Wall Street to grow by approximately 12% next year, which we see as somewhat aggressive given that the U.S. and global economies are expected to slow. The U.S. equity market is currently fairly expensive, with a price-to-earnings (PE) ratio of approximately 19 times forward 12-month estimated earnings. That's ahead of both its 5- and 10-year averages (Figure 2).

FIGURE 2

S&P 500 Forward PE Ratio versus 10-year average

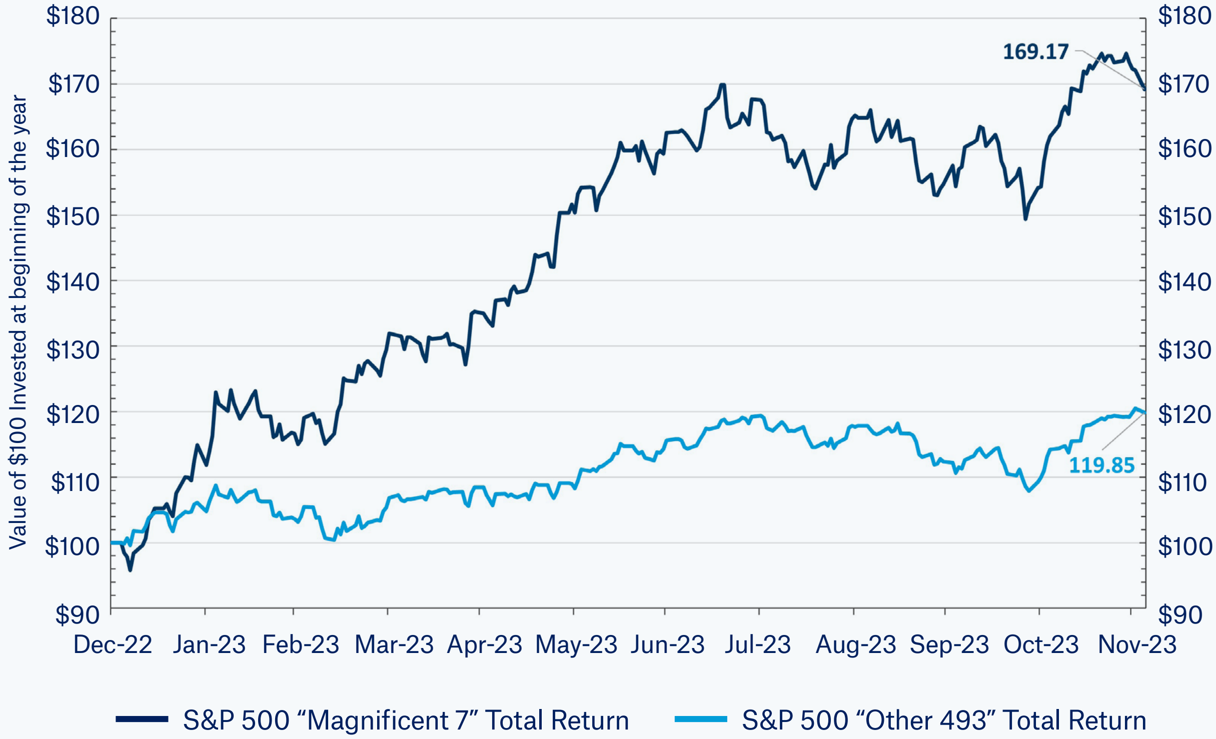


Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

Information technology stocks traded significantly higher in 2023 as investors gravitated toward stocks that they believe can deliver earnings growth in a slowing economic environment. A major theme and performance differentiator in 2023 was the rise of AI and the significant effect it could have on the U.S. economy over the next decade. While the S&P 500 has more than 130 members up more than 50%, the lion's share of 2023's outperformance was driven by the seven mega-cap technology names (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) that comprise 30% of the index (Figure 3).

FIGURE 3
S&P 500 "Magnificent 7" versus "Other 493" total return



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

Equities have recently had a strong run, reaching near the highs for the year. What led to this rally, and what is the key catalyst for stocks in 2024?

Coming into November, investor sentiment was somewhat subdued given the uncertainty about the direction of the economy. The hedge fund community was expecting Q3 2023 corporate earnings to be weak, and they positioned their portfolios in anticipation of further weakness in stock prices. As earnings came in better than feared and bond yields fell aggressively with the "soft landing" narrative gaining traction, many of these hedge funds realized they were on the wrong side of the trade and scrambled to buy stocks. This was a big catalyst for the S&P 500 run up of 9% in November 2023.

With the consumer accounting for 70% of the U.S. economy, the post COVID-era spending bonanza has propelled U.S. GDP growth despite the headwinds from two years of Fed rate hikes. This consumer spending was initially driven by excessive savings built up during the pandemic, but more recently it has been supplemented by an increase in credit card debt. This spending has driven 18 months of solid earnings growth for companies, but the big unknown now is how long the U.S. consumer can keep pace. U.S. households continue to be under pressure from higher costs of living and higher interest rates, which will also be a hurdle for U.S. corporate earnings growth in 2024.

Additionally, the ongoing stability of employment is the most critical variable in the outlook for the equity markets in 2024. If the Fed is successful in getting inflation back to its target 2% range—without triggering significant job losses—the economy and the equity markets should be largely unscathed. In the near term, the potential for "growth scares" from a rise in jobless claims and widening of credit spreads is likely to lead to higher levels of equity volatility. When the economy does begin to reaccelerate later in 2024, we would expect technology stocks to lag somewhat on a relative basis, as more cyclical areas play catch-up.

Non–U.S. equities have underperformed their U.S. counterparts over the long term. Does it still make sense to own non–U.S. equities?

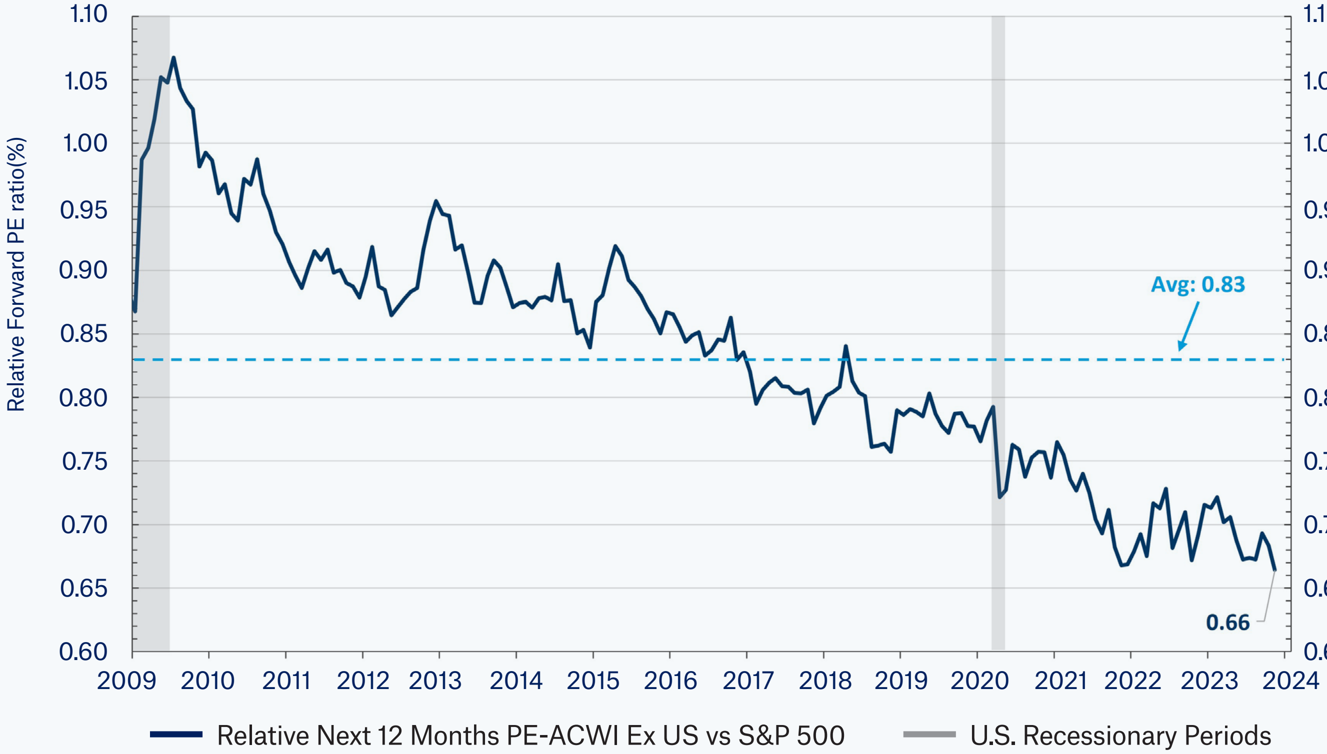
After outperforming U.S. equities in 2022, non-U.S. equities lagged their U.S. counterparts in the first 11 months of 2023. The sector composition of the U.S. equity market (28% technology) versus the non-U.S. market (12% technology) helps to explain why U.S. stocks outpaced non-U.S. stocks this year, as surging interest in AI technologies drove a 50% return for tech stocks in 2023. In addition, sluggish economic growth, higher inflation, more aggressive central bank policy tightening, and only a 9% weight in technology hurt European stocks. While many of the same factors weighed on emerging market equities, those economies saw inflation ease faster than in the developed markets, giving some EM central banks the opportunity to cut rates. Moreover, the tech sector accounts for 21% of EM equities, providing a boost from AI to many of those equity markets.

Equity Outlook Continued

We expect many of those same themes to play out in 2024. Elevated geopolitical risk tends to favor a stronger dollar and U.S. over non-U.S. assets. An increased pace of deglobalization (after seven decades of globalization) may lead to more desynchronized economic and earnings growth, highlighting the demographic, structural and technological advantages the U.S. holds over Europe. However, there are some bright spots for equity markets outside the U.S. Valuations (measured by the forward price-to-earnings ratio) of non-U.S. equities relative to U.S. equities have never been cheaper, suggesting that holding non-U.S. equities makes sense over the long term (Figure 4). In emerging markets, the tailwinds provided by AI, favorable demographics, and rapid economic growth (though perhaps not as rapid as the past 20 years) may benefit EM equities in the near and medium term.

FIGURE 4

Non-U.S. stocks are cheap relative to U.S. stocks



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

Fixed Income Outlook

2022 and 2023 were volatile years for the bond market. What is your outlook for fixed income for 2024?

Over the past two years, fixed income investors faced disappointing total returns, along with severe volatility. The 10-year Treasury yield traded within a historically wide 177–basis points (bps) range and touched 5% recently, the highest level since 2007. A confluence of factors including high inflation, aggressive monetary policy tightening, surging Federal budget deficits, and a resilient U.S. economy made 2022 and 2023 extremely challenging for bond investors.

In 2024 and 2025, two key developments could help stabilize rates and allow bonds to regain their traditional role as a hedge against other, more volatile asset classes: an improved inflation backdrop should restore the historically negative correlation between stocks and bonds; and higher yields mean bonds have more room to rally and cushion weakness from equities. This marks a change from the post-Global Financial Crisis period (2010-2019), when low yields limited the ability of bonds to buffer declines in equities.

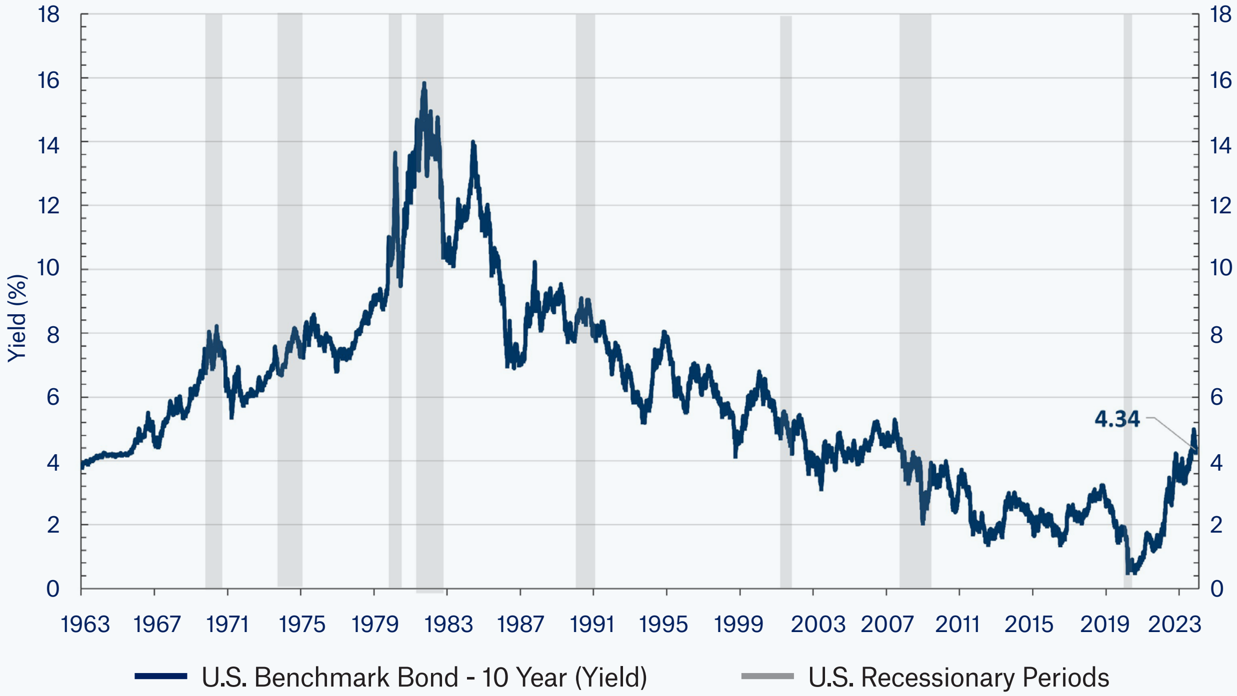
In 2024, we think some of the headwinds for bonds will abate, setting them up for better returns but with ongoing volatility. The outlook for fixed income looks compelling given that the Fed is at or near the end of its tightening cycle and inflation is trending lower. The next phase for the Fed is likely an extended pause while the central bank assesses the impact of the tighter lending and financial conditions. Interest rates will likely remain higher for longer given the deteriorating fiscal backdrop and the strength of the U.S. economy. However, the Fed may start cutting interest rates in 2024, as economic growth decelerates.

Continued caution may be warranted as investors navigate the lagged effect of monetary policy, which may become a meaningful headwind for the economy. Amid persistent economic uncertainty, we suggest investors lean into high-quality fixed income sectors that may prove to be resilient in the face of credit rating downgrades. Credit spreads currently remain tight and may not be priced for weaker economic conditions. Therefore, security selection has become increasingly important.

The attractiveness of high-quality bonds with intermediate and longer maturities has increased versus cash alternatives, as interest rates are likely near their cycle highs and should be trending lower in the future. In 2024, investment grade corporate bonds will likely perform better than high yield bonds, as they are more insulated from tighter financial conditions. Municipal bonds also look favorable due to their higher credit quality and notable tax-adjusted yields. Investors with higher allocations to cash or short-duration assets may consider adding duration to avoid reinvestment risk. In sum, we expect volatility to remain elevated next year, but given the decade-high yields and strong credit fundamentals, we expect total returns for bonds to be favorable (Figure 5).

FIGURE 5

10-year U.S. Treasury yield



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

Credit spreads have continued to tighten in 2023. Does the Chief Investment Office (CIO) think credit is positioned for weakening economic fundamentals?

The threat of an economic slowdown generally deters investors from investing in riskier assets. Prior to an economic slowdown, credit fundamentals have typically already begun to weaken as consumer and business demand slows and growth moderates, which leads issuers into a cycle of downgrades and defaults.

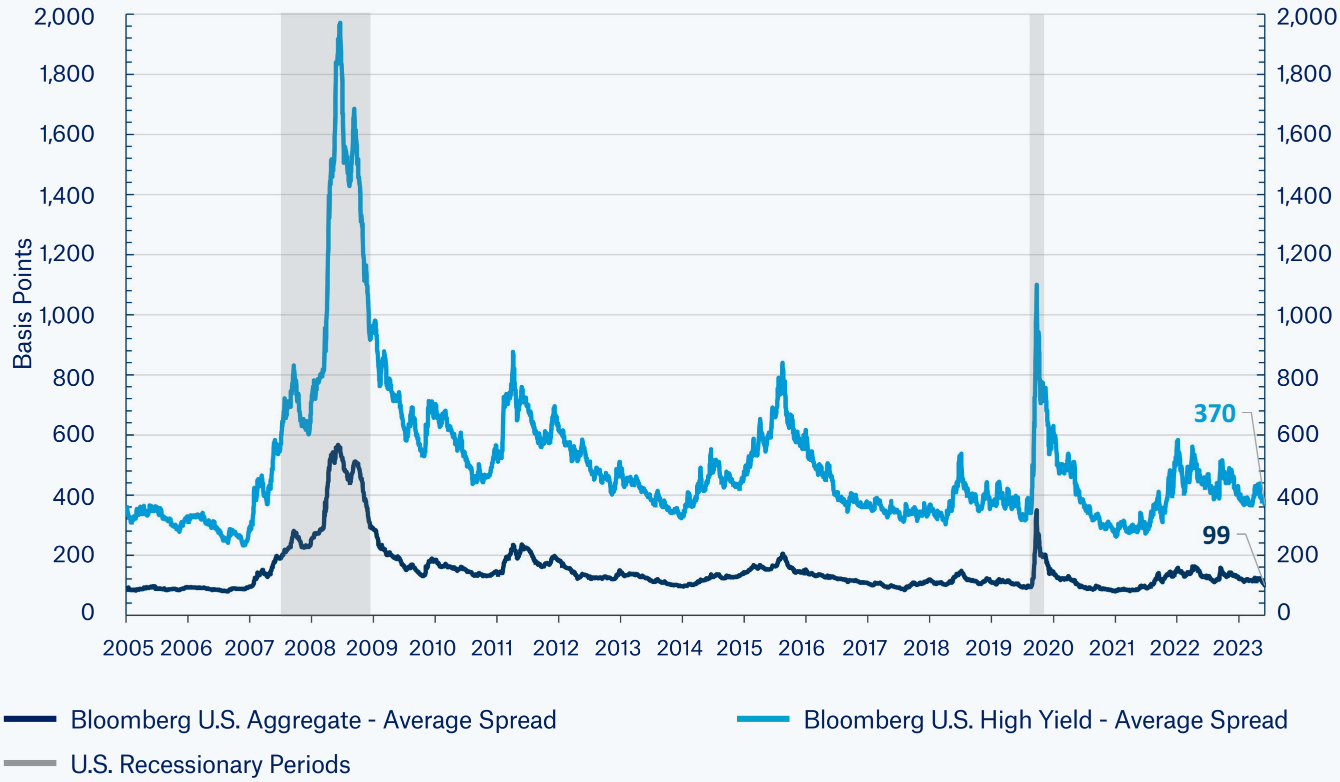
While this holds true in most economic cycles since the end of WWII, the outlook this time around may vary from that of prior economic slowdowns. Most investment grade corporate issuers are in better shape financially due to extensive refinancing efforts in 2020 and 2021 at record low yields.

This, coupled with a corporate default cycle that occurred at the beginning of the pandemic, likely weeded out some of the weaker issuers. The surviving companies are better prepared for a mild recession, as they have maintained strong fundamentals by conservatively managing their balance sheets and liquidity positions over the past two years.

In 2024, credit fundamentals will more meaningfully diverge between high-grade and speculative-grade issuers in the taxable bond market. More stress is expected in the high yield and leveraged loan markets, where high leverage, rate resets, and significant upcoming debt maturities will present increasing challenges as the economy slows (Figure 6).

In the municipal market, credit fundamentals also look better than they have in several years. Higher employment and a favorable housing market have bolstered state and local tax receipts. Also, state and local governments' rainy-day funds and financial reserves are close to 30-year highs. As such, we believe the credit outlook remains favorable for most high-grade corporate and municipal issuers.

FIGURE 6
Investment grade credit versus high-yield spreads



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023

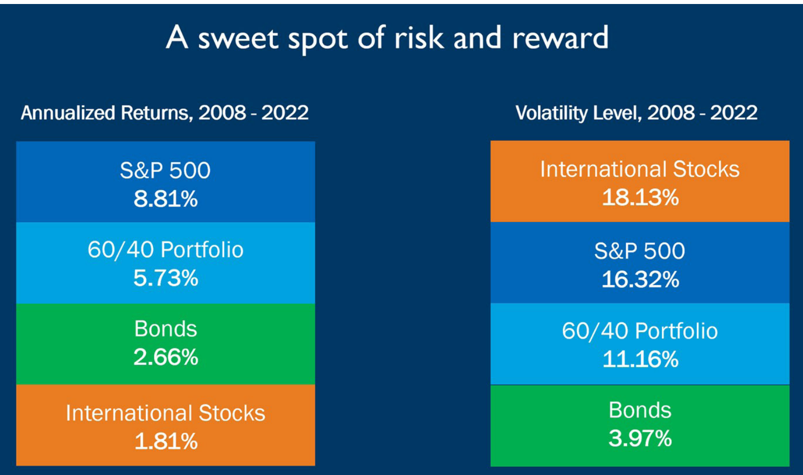
Long-Term Investing and the 60/40 Portfolio

After two years of negative performance, do bonds still make sense in a broadly diversified long-term portfolio?

Stocks and bonds both fell hard in 2022, dealing a blow to risk-takers and risk-averse investors alike. This unusual dynamic also prompted the question of the role bonds play in the so-called 60/40 portfolio (60% stocks, 40% fixed income)—one of the most enduring and recognizable strategies for long-term investors. The premise behind the 60/40 portfolio is that stocks and bonds generally don't move in the same direction--when one zigs, the other may zag. The 60/40 portfolio aims to generate higher returns when stocks rise and offers downside hedging when stocks fall, thanks to the relative price stability and income of bonds (Figure 7).

FIGURE 7

Annualized returns and volatility levels of asset classes and 60/40 portfolio



Source: Morningstar Direct (as of Dec. 31, 2022). Volatility is defined as standard deviation (2008-2022); the greater the volatility, the greater the variance to the mean return of a given asset. Standard & Poor's 500®Index (S&P 500) is an unmanaged, market cap-weighted index of 500 common stocks selected for their market size, liquidity and industry group representation within the U.S. equity market. "Bonds" are represented by Bloomberg Barclays U.S. Aggregate Bond Index, which is made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index. "International stocks" are represented by the MSCI EAFE NR Index (Europe, Australasia, Far East), which is a free float-adjusted market capitalization index designed to measure developed market equity performance, excluding the United States and Canada. You cannot invest directly in any index. Index returns do not reflect a deduction for fees or expenses. See citation at the bottom of the page for full details and definitions of the components in the 60/40 portfolio.

The prime culprit for historically poor performance of bonds in 2022 was soaring inflation, which prompted a spike in interest rates, pushed along by seven Federal Reserve rate hikes. Higher rates, intended to slow the economy and cap fast-rising prices for consumer goods and services, sank the values of previously issued bonds as investors sought out newly issued, higher-yielding ones. Equities suffered too, as investors pondered how a slowing economy could affect corporate profits.

Long–Term Investing Continued

Understandably, investors are asking themselves—and their financial advisors—whether 2022's lose-lose market can repeat. The bigger question: Do portfolios built around the diversifying attributes of bonds still make sense? We believe the so-called "death of 60/40" has been greatly exaggerated, and we believe bonds can still serve a dual role as income-generators and risk-mitigators.

While 2022 was a tough year for the bond market, history shows fixed-income returns have been resilient after negative years. Fixed-income indices have delivered eight periods of negative returns over the past 97 years (Figure 8). In each of the previous negative periods, however, investors who stayed the course were eventually rewarded.

FIGURE 8

Calendar year performance (%) of U.S. bond index over time[1]

Year	Total Return	Year	Total Return	Year	Total Return	Year	Total Return	Year	Total Return	Year	Total Return
1926	5.38	1942	1.94	1958	-1.29	1974	5.69	1990	8.96	2007	6.97
1927	4.52	1943	2.81	1959	-0.39	1975	7.83	1991	16.00	2008	5.24
1928	0.92	1944	1.80	1960	11.76	1976	15.60	1992	7.40	2009	5.93
1929	6.01	1945	2.22	1961	1.85	1977	3.04	1993	9.75	2010	6.54
1930	6.72	1946	1.00	1962	5.56	1978	1.39	1994	-2.92	2011	7.84
1931	-2.32	1947	0.91	1963	1.64	1979	1.93	1995	18.47	2012	4.21
1932	8.81	1948	1.85	1964	4.04	1980	2.71	1996	3.63	2013	-2.02
1933	1.83	1949	2.32	1965	1.02	1981	6.25	1997	9.65	2014	5.97
1934	9.00	1950	0.70	1966	4.69	1982	32.62	1998	8.69	2015	0.55
1935	7.01	1951	0.36	1967	1.01	1983	8.36	1999	-0.82	2016	2.65
1936	3.06	1952	1.63	1968	4.54	1984	15.15	2000	11.63	2017	3.54
1937	1.56	1953	3.23	1969	-0.74	1985	22.10	2001	8.44	2018	0.01
1938	6.23	1954	2.68	1970	16.86	1986	15.26	2002	10.26	2019	8.72
1939	4.52	1955	-0.65	1971	8.72	1987	2.76	2003	4.10	2020	7.51
1940	2.96	1956	-0.42	1972	5.16	1988	7.89	2004	4.34	2021	-1.54
1941	0.50	1957	7.84	1973	4.61	1989	14.53	2005	2.43	2022	-13.01
								2006	4.33	2023*	1.64

Source: Morningstar Direct

Data Through: 11/30/2023

Bond market performance improved in 2023 (*through November 30), and higher yields should help bonds play their role as a diversifier against falling stocks once again. In 2023, the 1- and 10-year Treasuries briefly hit the 5% mark compared with 0.77% and 1.63%, respectively, at the start of 2022—a significant difference for yield-starved investors.

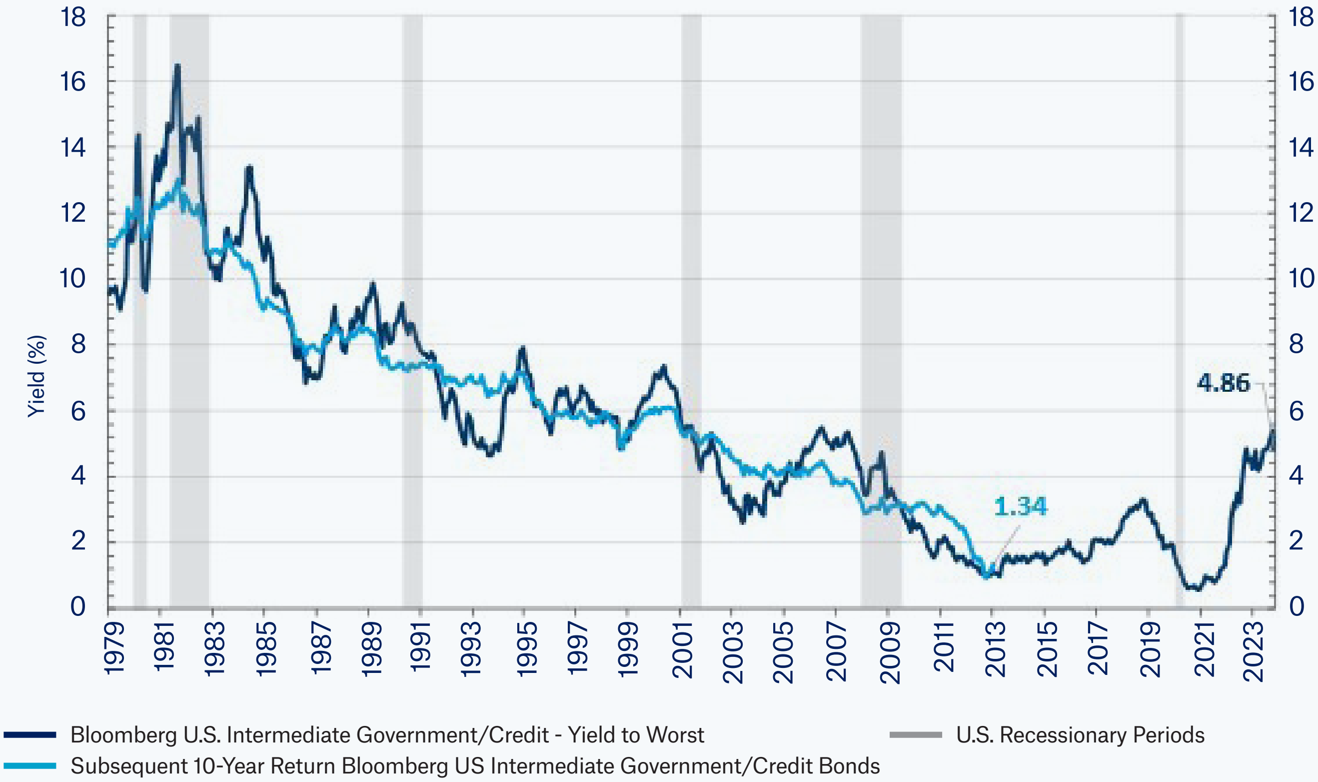
[1] U.S. Fixed Income: IA SBBI IT Govt Bonds TR USD from 1928–1975; BBgBarc U.S. Agg Bond Index from 1976 thereafter. The BBgBarc U.S. Agg Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Long–Term Investing Continued

Investors with more than a decade to save for retirement may benefit from an attractive entry point for bonds, since newly issued ones are delivering more attractive yields. This dynamic could set the stage for returns closer to historical norms (the median annual return for the Bloomberg U.S. Aggregate Bond Index from 2008 through 2022 was 4.2%). Bond yields today on the intermediate bond index are a good proxy for bond returns over the next 10 years, which suggests investors may realize above-average returns on bonds during that time span (Figure 9).

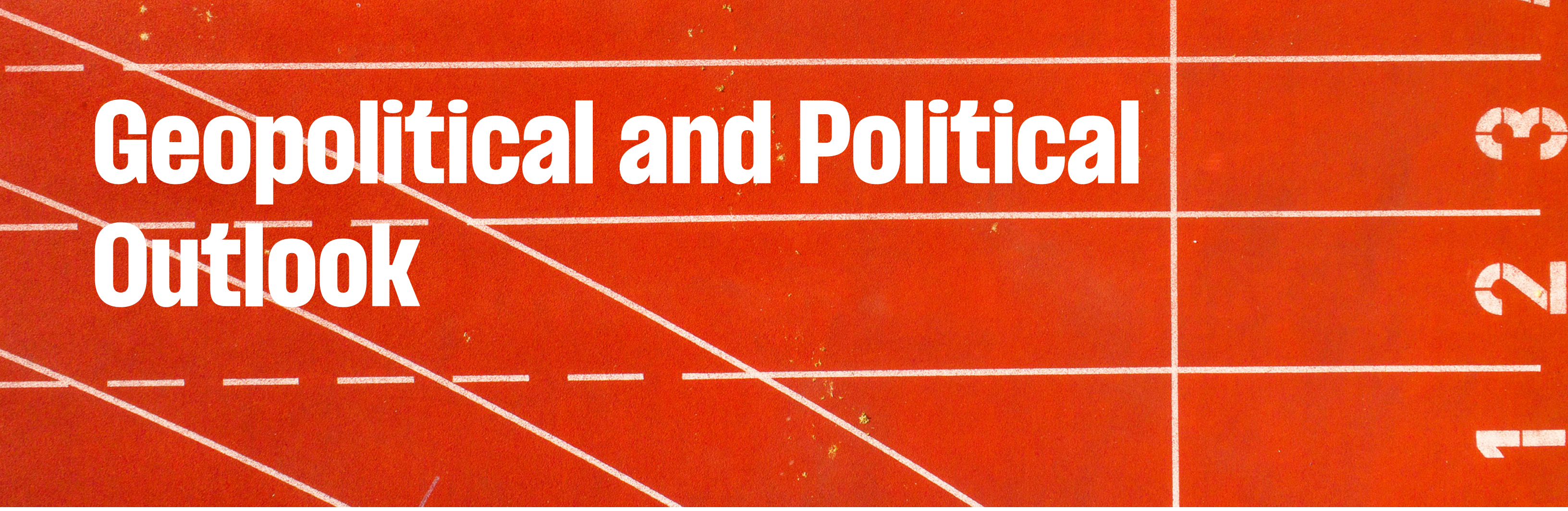
FIGURE 9

Bond yields versus subsequent 10-year bond returns



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2023



Geopolitical and Political Outlook

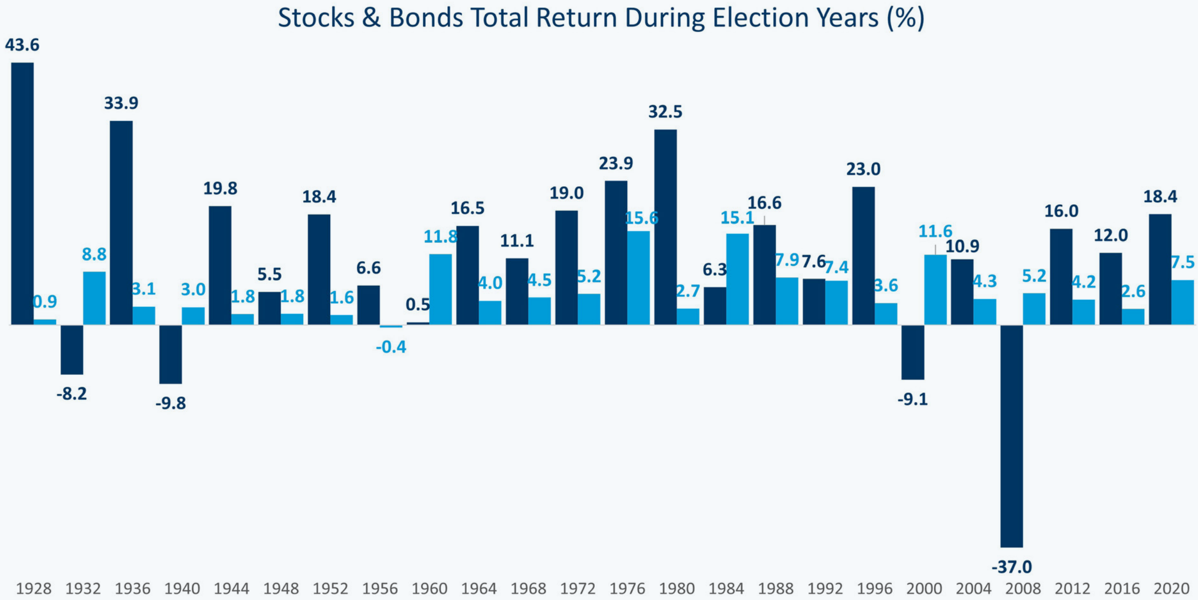
Political polarization in the U.S. feels more pronounced than it has been in many decades. How does the CIO envision the 2024 election impacting the economy and markets?

Presidential campaigns create lots of noise every four years, with markets often reacting to changing expectations and new information. Most often, after the election is over, investors go right back to focusing on what was top of mind before the election, e.g., earnings, the economy, inflation, the Fed, etc.

It's worth noting that there doesn't seem to be any meaningful change in the market's returns during an election year versus any other year. When comparing the returns of the S&P 500[2] during presidential election years to non-election years, election years demonstrate a slightly higher annual return (10.2% versus 10.1%), which is not a statistically significant difference. Returns for bonds[3] demonstrate a similar pattern (5.5% vs. 4.9%) (Figure 10).

FIGURE 10

U.S. presidential elections and market performance over time



U.S. Elections & Market Performance

In the 24 election years since 1928, only five years have experienced negative returns in either stocks or bonds

10.2%
Average total return for stocks

5.5%
Average total return for bonds

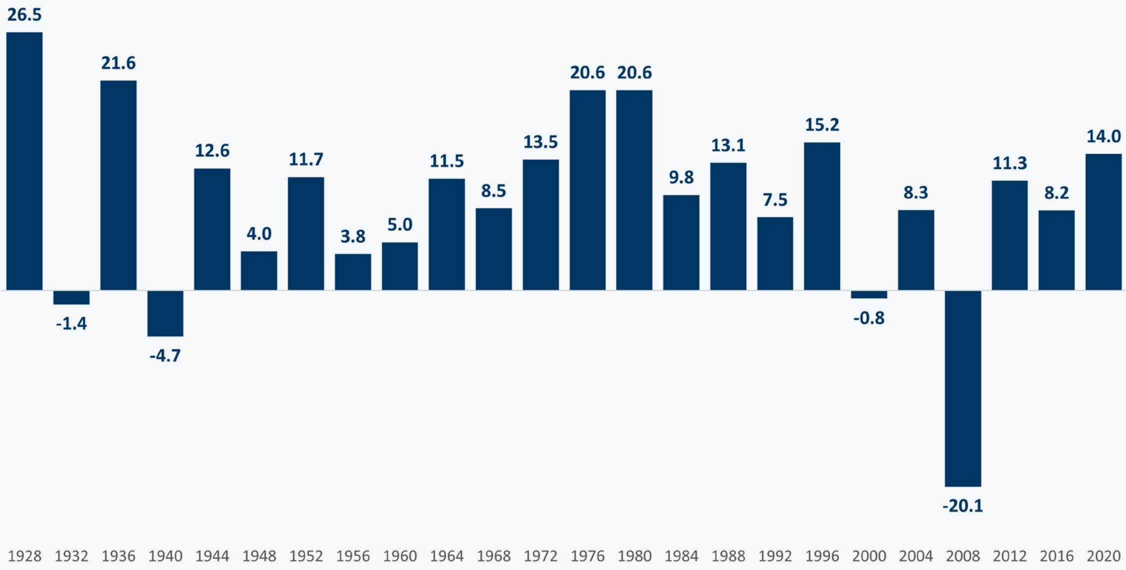
Source: Morningstar Direct

[2] U.S. Equities: Ibbotson Associates (IA) SBBI Large Stock TR USD Ext from Jan. 1928–Jan. 1970; S&P 500 TR USD thereafter

[3] U.S. Fixed Income: IA SBBI IT Govt Bonds TR USD from 1928–1975; BBgBarc U.S. Agg Bond from 1976 thereafter

When looking at historical performance, our recommendation is that long-term investors should not make portfolio changes based on their views on election outcomes. Overall, a long-term 60/40 portfolio[4] simply doesn't move much based on presidential elections (8.7% total return in election years versus 8.5% in non-election years), as shown in Figure 11. In fact, since 1928, 60/40 portfolio performance was negative in only four election years, and those occurred amid unique and seismic global events (Great Depression, WWII, tech bubble burst and the Great Financial Crisis).

FIGURE 11
U.S. presidential elections and 60/40 investment portfolio performance over time



U.S. Elections & Portfolio Performance

In the 24 election years since 1928, only four years have experienced negative returns

8.7%
Average total return for 60/40 portfolio

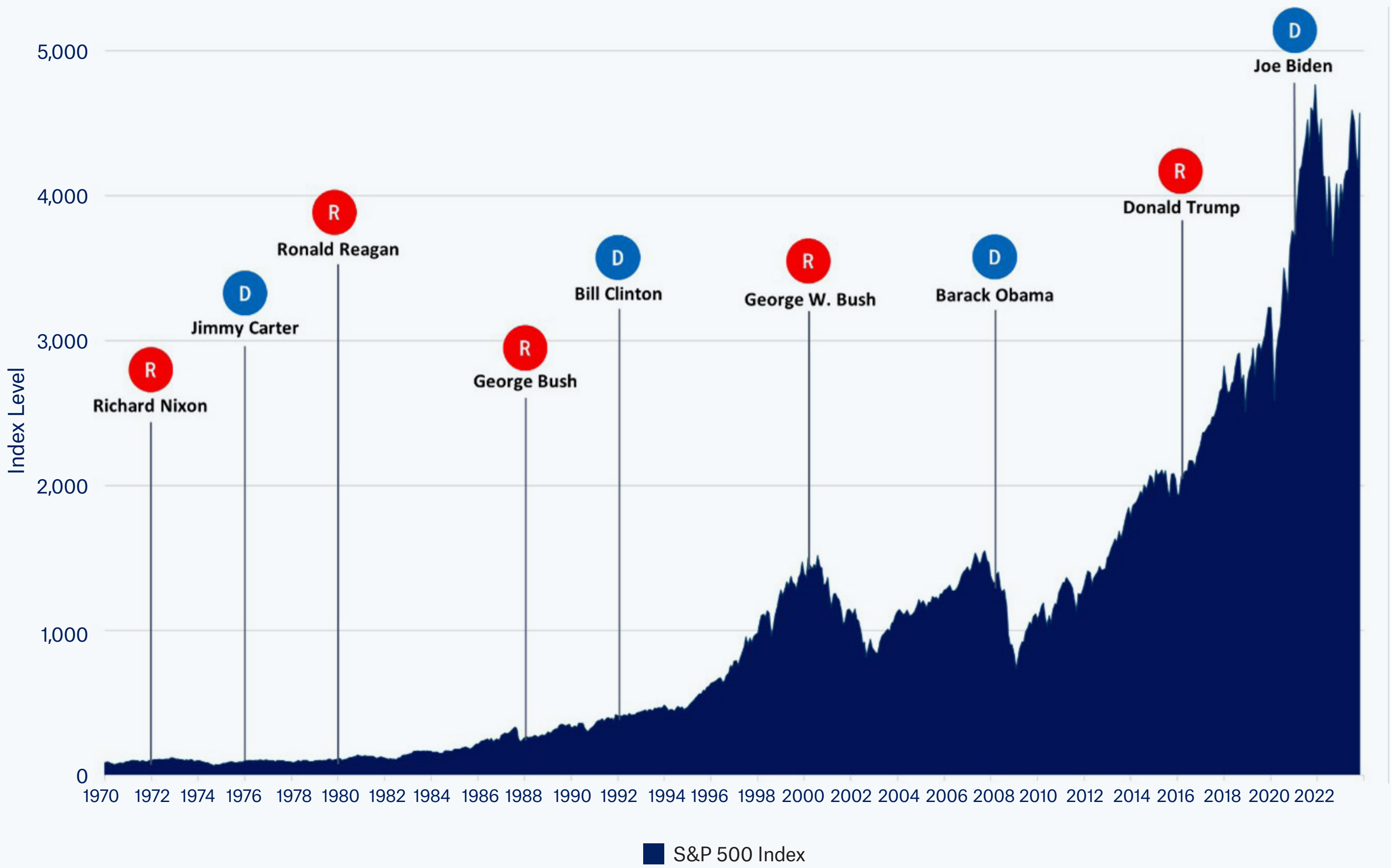
Source: Morningstar Direct

[4] 60/40 portfolio: 60% U.S. equities; 40% U.S. fixed income (annual rebalancing). U.S. equities: Ibbotson Associates (IA) SBBI Large Stock TR USD Ext from Jan. 1928–Jan. 1970; S&P 500 TR USD thereafter. U.S. fixed income: IA SBBI IT Govt Bonds TR USD from 1928–1975; BBgBarc U.S. Agg Bond from 1976 thereafter

Geopolitical and Political Outlook Continued

The impacts of individual presidential elections on investment performance are even more muted over time. Financial markets generally climb a "wall of worry" punctuated by peaks and valleys in performance, some of which are significant. However, over the past 50 years, the S&P 500 has continued to grow despite periods of high uncertainty driven by unique economic and geopolitical events, and by U.S. presidential elections (Figure 12). The bottom line is that presidential elections don't often affect stock and bond prices—and more importantly, the economy—as much as we tend to think.

FIGURE 12



Source: FactSet Financial Data and Analytics

Data Through: 11/30/2022

The wars in the Middle East and Ukraine, U.S.–China tensions, and rising protectionist sentiment around the world add layers of uncertainty to an increasingly interconnected global economy. How will these dynamics impact financial market performance in 2024?

The most recent time the world witnessed this level of geopolitical upheaval was when the Berlin Wall fell in 1989 and the Soviet Union collapsed two years later. Political polarization in Western democracies, China's rising global ambitions for economic and military influence, and the race for technological superiority have set us on a path toward a fragmented and multipolar world. Trading relationships have suffered between the U.S. and China, as has the flow of investments, capital, and cultural exchanges. The Russia-Ukraine and Israel-Hamas wars have further created fault lines in these relationships, with no potential end to the hostilities in sight.

America's perceived retreat as the global enforcer of law and order, combined with emphasis on local and regional trade relationships, are forging new trade blocs, with many developing countries banding together to pursue their collective self-interests. Their goal is to implicitly, and in some cases explicitly, reduce their dependencies on the U.S, especially as it relates to the role of the U.S. dollar.

Unfortunately, there seems to be little sign of geopolitical harmony anytime soon in this highly polarized world:

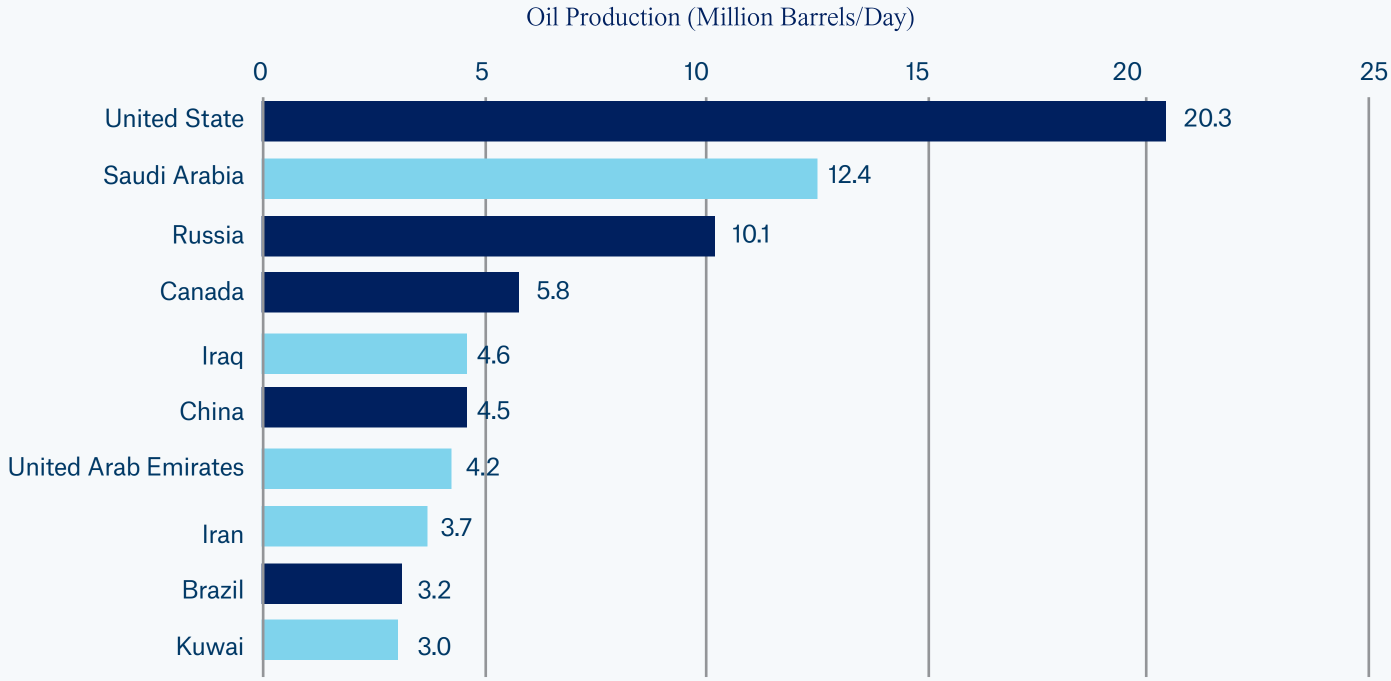
- In 2024, four of the world's largest countries and territories will hold elections that will shape global affairs during the second half of the decade. These include Russia, India, the U.S., and the European Union. In China, President Xi emerged from the Party Congress in 2022 with a grip on power unrivaled since Mao Zedong. Facing few checks and balances, Xi can continue to pursue a nationalistic policy agenda. In the U.S., there will be strong bipartisan desire to push harder against China on the economic, diplomatic, and security fronts, especially as election season heats up.
- In Europe, long-term energy security remains an acute economic risk, having been cut off from Russian oil and gas supplies. Additionally, across the continent, governments are shifting right, and some hard-right parties are securing more parliament seats and regional offices, riding on protectionist agendas.

Geopolitical and Political Outlook Continued

- Ongoing conflict in the Middle East raises additional concerns for the global economy. The region accounts for a significant amount of global oil production, playing a critical role in global energy security (Figure 13). The Middle East's geographical location is also important as a trade and transit route, with control over key choke points such as the Suez Canal and the Strait of Hormuz. An escalation of the conflict could lead to an oil and/or supply chain shock, hurting global growth prospects.

FIGURE 13

The top 10 oil[5] producers and share of total world oil production[6] in 2022[7] (Middle East producers in light blue)



Source: U.S. Energy Information Administration

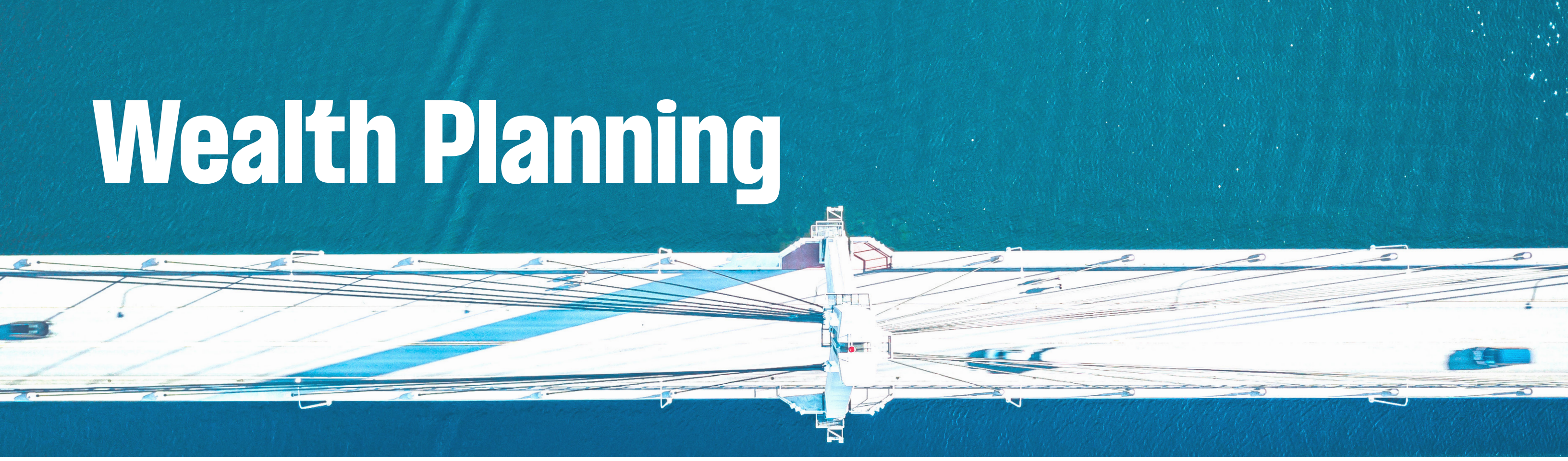
This increased global fragmentation is likely to add to ongoing economic uncertainty and market volatility. Investors may demand a higher risk premium for risk assets such as equities, which might negatively impact valuations. Decoupling can also weigh on profit margins of companies that once benefited from outsourced labor and now must allocate capital to revamp supply chains. Interest rates may stay at relatively higher levels due to reduced foreign demand for U.S. treasury bonds, higher prices for everyday goods due to reshoring, and government borrowing to finance domestic investments.

Geopolitical and market developments are sure to take unexpected turns as well, leading to confusing signals for key macro variables such as inflation, interest rates, currencies, growth, and policy. In our view, long-term investors should not construct their portfolios based on a bias toward a particular outcome or trade on geopolitical events. Rather, it is prudent to stay invested in one's long-term asset allocation and maintain a balance of different asset classes that can help mitigate swings driven by ongoing uncertainty.

[5] Oil includes crude oil, all other petroleum liquids and biofuels

[6] Production includes domestic production of crude oil, all other petroleum liquids, and biofuels and refinery processing gain

[7] U.S. Energy Information Administration, International Energy Statistics, Total oil (petroleum and other liquids) production, as of September 22, 2023



Wealth Planning

Are there any major tax considerations to be aware of in 2024? Will the sunsetting of the Tax Cuts and Jobs Act of 2017 impact wealth planning over the next couple of years?

In addition to the U.S. presidential election, all 435 seats in the House of Representatives and 34 out of 100 seats in the Senate will be up for election in 2024. The timing of the election, along with the expiration of the Tax Cuts and Jobs Act of 2017 (TCJA), make the future of taxes and tax policy uncertain. It is too early to predict what will happen, as the TCJA provisions could be allowed to expire simply because neither party has enough support to push through changes before the end of 2025. Given this, it may be wise for taxpayers to take advantage of current planning opportunities and be prepared for future changes.

Absent congressional action, the individual tax landscape is set to change significantly at the beginning of 2026. Planning now can help taxpayers maximize their tax savings over the next couple of years. As a first step, taxpayers may want to review their individual income tax rates and anticipated income over the next couple of years. The TCJA lowered ordinary income tax rates and expanded tax brackets. When these rates and brackets revert to their prior levels, most individuals will see an increase in their income tax liability come 2026. To prepare, taxpayers may want to accelerate their income now. Roth IRA conversion(s) or exercising stock options are two potential ways to increase income before 2026.

Taxpayers may also want to focus on capital gains, as the TCJA separated the tax brackets for long-term capital gains from ordinary income. With the potential for higher capital gains tax rates on the horizon, taxpayers may consider selling highly appreciated securities prior to 2026. If holding the security is favorable, repurchasing it at a stepped-up basis can help offset any future long-term capital gains.

Deductions are another consideration. Most taxpayers have taken the standard deduction since the passage of the TCJA, as it almost doubled the standard deduction. With the expiration of this provision, more taxpayers will likely elect to itemize deductions. Amongst other tax strategies, between now and 2026, taxpayers may consider "bunching" charitable contributions and other deductions into one tax year, allowing them to itemize their deductions for that year and then take the standard deduction in the remaining year(s). Also, as the state and local tax (SALT) deduction may no longer be capped at $10,000 beginning in January 2026, taxpayers who plan to itemize may wish to wait to pay any state and local tax until January 1, 2026 or after, if possible. Appropriate tax strategies may differ depending on each individual's circumstances.

Finally, as the amount taxpayers can pass on free from federal estate and gift tax is also set to be reduced beginning in 2026—to about half of the current amount—taxpayers with large estates may want to consider removing assets from their taxable estate prior to 2026. Taxpayers can do this several ways: they can take advantage of annual gifting (in 2024, the annual gift tax exclusion is $18,000 per donee); they can utilize the lifetime gift and estate tax exemption amount (in 2024, the federal lifetime gift and estate tax exemption amount is $13,610,000); or they can make five years' worth of gifts in one year into a Section 529 college savings plan for children and grandchildren as yet another way of removing assets from their taxable estate prior to 2026.

Given the uncertainty of the expiration of some or all TCJA tax provisions come 2026, it is a good idea for taxpayers to begin planning now by meeting with their personal tax and legal advisors to determine how these potential tax changes might impact their individual circumstances.

Contributing Authors

Niladri ' Neel' Mukherjee
TIAA Wealth Management Chief Investment Officer

Michael Sowa, CAIA
Sr. Director, Asset Allocation and Manager Research

John J. Canally, Jr., CFA
Chief Portfolio Strategist

Todd Starcher, CFA
Sr. Director, Portfolio Construction

Robert Marshall
Managing Director, Equity Portfolio Management

Jill Richman
Sr. Director, Fixed Income Portfolio Management

Alicia Waltenberger
Senior Director, Wealth Planning Strategies

Bryan White, CFA
Director, Fixed Income Portfolio Management

Ali Dellinger
Director, Advisory Communications & Business Operations

John Greene
Content Developer

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