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# *2023 FALL INVESTMENT OUTLOOK*

The stock market has gone nowhere over the summer months. Despite the upward momentum experienced during June and July amidst surprisingly strong economic data, the S&P 500 has essentially made a roundtrip back to the starting levels of mid-June, encompassing a 5% trading range. As summer gives way to fall, the market is experiencing a nearly two-month sell-off in response to stubbornly high inflation and a continued rise in bond yields. Small caps per the Russell 2000 have declined more than 11% since July 31st, more sensitive to the uncertainty in the economic outlook over the coming 3-4 quarters than large multinationals.

Collectively, crude oil prices, interest rates, and the U.S. dollar indicate that the Federal Reserve's tightening cycle may not yet be finished as some in the investment community assume. Global benchmark Brent crude oil has risen nearly 30% since late June to $93 per bbl, leading to two straight months of rising headline inflation and clouding the timing of when the Fed's interest rate hiking mission could be complete.

As a result, the yield on the benchmark 10-year Treasury note has risen more than 80 bps since early summer to a current 4.52%, the highest levels since the fourth quarter of 2007. Such a trend is indicative of a lengthening of the so-called term premium for holding longer maturity bonds over shorter ones (which has been negligible over the past decade as rates were held at 0%) under the assumption that inflation could remain quite sticky over the coming years. The Bloomberg U.S. Treasury Index is on par for its third straight year of losses, down 1.2% year-to-date. The U.S. dollar has rallied ten straight weeks, up 6% since mid-July albeit such a move could be interpreted as an investor vote on advantaged U.S. growth relative to the rest of the world.

The Federal Reserve maintained its current policy rate of 5.375% (mid-point) at the most recent FOMC meeting on September 20th while signaling one additional 25 bps hike before year-end. While the committee raised its growth outlook for this year and next given the surprisingly strong U.S. economy year-to-date, the 2% inflation target is expected to remain elusive until 2026 per the committee's projections, leading to a higher-for-longer interest rate regime and allowing more time for the long and variable lags of tighter policy to eventually kick-in.

While the Fed may have caught the "soft landing bug" as former Treasury Secretary Larry Summer recently opined, recession risks remain very real. As history has shown, the Fed has a poor track record of forecasting and regime shifts in both the economy and financial markets happen slowly at first, and then suddenly once the cascading effects begin. Leading indicators continue to point to a weaker trend in both jobs and growth in the months ahead, which is probably why the average stock is up moderately less on a year-to-date basis than the capitalization-weighted headline index as viewed through the lens of either the S&P 500 Equal Weight Index +2.5% total return or the Value Line Geometric Index +0.6% change.

2023 YTD Total Returns

| | 9/22/23 | % Change |
|---|---|---|
| Dow 30 Industrials | 33,964 | +4.1% |
| S&P 500 | 4,320 | +13.9% |
| NASDAQ Composite | 13,212 | +27.0% |
| MSCI ACWI ex-USA | 294 | +7.2% |

## *Outlook*

Economic growth has proven to be much more resilient in 2023 than most expected. First half progress was slightly more than 2% annualized and current Bloomberg forecasts point to an expectation of 2.0% growth in the third quarter, too, with just one week remaining. Such expansion is modestly in excess of the economy's 1.8% long run potential per Federal Reserve assumptions, indicating little slack at the moment.

The Citi Economic Surprise Index continues to trend higher in positive territory, indicating the economic data is generally exceeding forecasts at the moment. Job growth has been solid with 235k additions to payrolls on average through August, underpinning our consumer-led economy. Households have used excess savings and accrued the benefits of prior refinancing to help support spending. Core inflation has eased to a current 4.3% from 6.7% a year ago. The federal deficit has increased since July '22, an unheard-of phenomenon during an expansionary period and accretive to growth despite its longer run risks. Other parts of the economy that had been weak over the past year like housing, manufacturing, and electronics appear to be bottoming. Such trends have led many economists to revise their growth expectations higher throughout the year with some scrapping recession calls altogether.

However, there are plenty of headwinds looming that could interrupt the recovery of the past 3 ½ years and several warning signs continue to flash caution. The Conference Board's Leading Economic Index has fallen for 17 straight months, the longest consecutive decline outside of the Global Financial Crisis and the '73-'74 recession. The yield curve has been inverted for 218 straight trading days, the longest period over the past seven decades, with the 3-month Treasury currently yielding 5.47% and 95 bps wider than the 4.52% yield on the longer-dated 10-year Treasury note. Such a signal is indicative of a fed funds policy rate that is highly restrictive relative to the FOMC's assumed 2.5% neutral rate over the longer run. Furthermore, the yield curve has undergone a slight bear steepening over the summer months with longer maturity yields marching higher than shorter ones.

Both of the above indicators have preceded nearly every recession going back to the 1960s although the timing has varied widely. Campbell Harvey, the Duke University economist who pioneered the use of the yield curve as a recession indicator, says its predictive power remains intact. "The inverted yield curves have forecasted eight of the last eight recessions – without a false signal. Ignore the signal at your own risk."

As former bond manager Bill Gross recently opined, "a thriving finance-based economy cannot do well if low-risk investments yield higher than high-risk investments." It impairs the banking system's ability to extend credit since banks borrow at short term rates and lend at longer term ones. But for the Fed to cut rates soon and for a soft landing to occur, one has to believe that the excesses and malinvestment of the previous cycle have been completely washed clean and that the core inflation rate will approach 2.0% before economic growth falters. We continue to be suspect of such a scenario.

The sharp rise in oil prices over the summer is a big challenge for the Federal Reserve. This spike could move the prices of consumer and industrial goods higher as well as lead to higher gasoline prices, crimping discretionary spending. Further, economists forecast core inflation exiting 2024 at 2.4%, well above the 2.0% threshold. The Fed does not see core inflation reaching 2.0% until 2026 and its alternate measure, core services prices excluding housing (which is correlated to wage growth) has been stuck in the 4.1%-4.7% range over the past year, demonstrating the stickiness of inflation.

Job openings have fallen by nearly 2.5 million in 2023 and the number of officially unemployed workers has risen as folks come back into the labor force. This has pushed the ratio of job openings to unemployed persons down to a current 1.4 from 2.0 a year ago, showing a relative loosening of labor market conditions, a trend that the Fed would like to see continue. However, such a ratio has historically been well below 1.0 during healthy economic cycles thus wage pressures are likely to be a stubborn inflation input until either job openings plummet further or the number of unemployed persons spike, which usually only happens in a recession. Recent labor negotiations between the Teamsters/UPS and UAW/automakers also demonstrate a resurgence of labor power and a wildcard that complicates the issues around inflation.

The backup in longer rates has forced the average interest rate on a 30-year fixed mortgage to 7.64% in the latest week, the highest level since the third quarter of 2000. While residential investment has likely bottomed in this cycle, housing is now the most unaffordable that it has been in more than 40 years and the lack of turnover will impede its ability to contribute inordinately like it historically has unless rates fall dramatically lower soon. Lending standards for both consumers and businesses also remain tight, which will further slow the rate of credit growth over the coming quarters.

While the consumer has been strong in 2023 through the summer months, there is a risk that a spending slowdown looms to finish the year as some of the one-off factors from the Covid era begin to fade. Excess savings is likely to be drawn-down by year-end according to a study by the San Francisco Fed and student loan payments have resumed in September with recent weekly payments to the Department of Education averaging $150 billion annualized compared to the measly $12 billion run-rate during the first eight months of 2023. Weakness is also becoming more apparent in the labor market underneath the surface. Recent monthly payroll data has been revised lower and leading job metrics such as temp employment and hours worked have trended down. Per Bloomberg forecasts, payroll growth is expected to average just 50k monthly additions in the fourth quarter and weaken further into the first quarter, averaging just 12k monthly additions.

As the reality of higher rates is felt more broadly over the coming quarters there are risks lurking in other parts of the economy away from the consumer. The federal fiscal year ends on September 30th and there is an increasing risk of a government shutdown. Also, the federal budget deficit is approaching 8% of GDP and expected to widen well into the future. This funding shortfall is currently being financed with new Treasury debt alongside a Federal Reserve which is no longer a buyer, a formula for potentially even higher rates. Commercial real estate and the high yield market will also see refinancing needs begin to grow next year and borrowing costs re-setting higher. In global high yield, for example, there is $41 billion maturing in 2024 but a staggering $113 billion the following year, Bloomberg compiled data show. Additional rate hikes would almost ensure greater strain on the banking and property sector as well as cause some disorder in the capital markets as this rollover of debt commences.

Unfortunately, other regions of the global economy are trending much weaker than the U.S. and recent activity indices point to continued challenges. The Eurozone is practically in a recession with sequential growth expected to average just 0.1% in the third and fourth quarters. The combined manufacturing and service sector purchasing manager index (PMI) sits at 46.7 with more respondents indicating business activity is declining rather than expanding. China PMI data has also moved lower over the past two quarters with a similar composite index barely above the 50 line which separates expansion from contraction. The credit-driven policies of the past are no longer as efficacious as Chinese leadership grapples with a distressed property sector. Policymakers will need to resort to different measures to unlock the high level of household savings in that economy or risk missing its 5% intended growth target.

Equity valuations face increasing risks from higher-for-longer interest rates. The 5.5% earnings yield of the S&P 500 is the same as a 3-month Treasury bill, a depressed spread that was last seen at the height of the 2000s stock market bubble. With real interest rates solidly above 2.0% levels, the market P/E valuation should probably be at a mid-teens multiple instead of the current 18.2x ratio based on the historical relationship between bond yields and equity multiples, albeit much of the premium is being driven by the high valuations of the “Magnificent 7” mega cap tech stocks.

Wall Street consensus earnings estimates for next year also seem too optimistic with corporate profits expected to accelerate at an 11-12% pace following this year’s flat performance. Such a forecast conflicts with market expectations of three interest rate cuts by the end of next year that are currently priced into the futures market, an indication the economy is supposed to weaken. It also clashes with Bloomberg economic forecasts for GDP growth of just 1% next year, half the pace seen thus far in 2023. From a quarterly perspective, GDP growth is forecast to weaken to just a 0.4% annualized rate in the upcoming fourth quarter and a 0.1% clip in the first quarter of ’24. Based on historical bear markets and economic cycles, stocks are not pricing in a recession at the moment but are at risk of a steep correction if one were to occur. In market data going back to 1971, stocks are almost always lower several quarters following the last Fed hike if there is a recession within a year.

## ***Investment Conclusion***

There have been select opportunities to put cash to work incrementally in equities where long run fundamentals of some distinctive competence companies are currently being mispriced amidst the uneven economic backdrop. However, broader buying is likely to require a weaker macro and deeper market correction. Gold-related investments are also at attractive valuations and have historically been a great hedge whenever the economy weakens and the rate hiking cycle concludes. In the meantime, cash and shorter maturity Treasuries are an excellent alternative with annualized yields above 5%, the highest levels since 2006.

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