# LOOK AHEAD

Q3 2023

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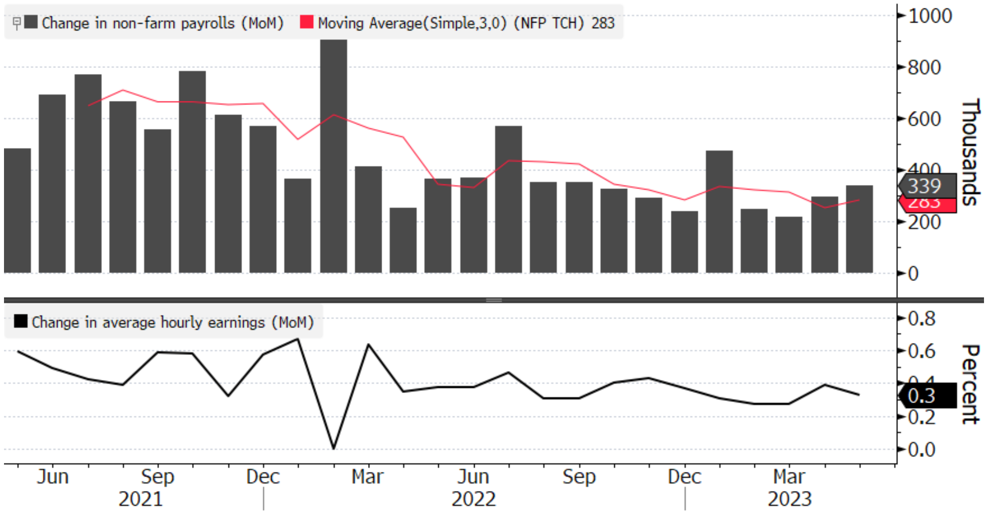
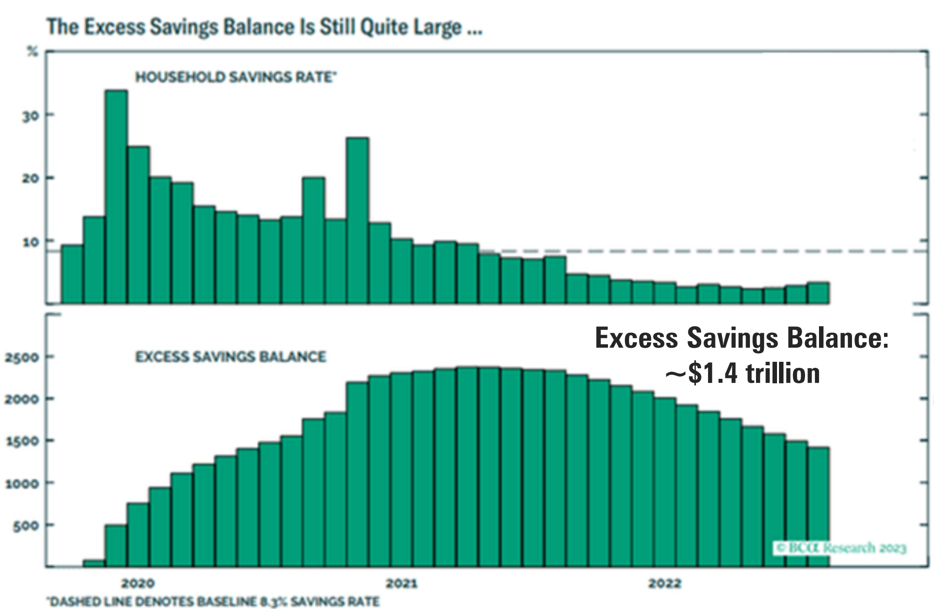
# Consumers Are Still Strong, But…

The most recent jobs report came in stronger than expected, potentially signaling more rate increases ahead from the Fed, but not so fast…wage growth continues to trend down.

**Employers add 339,000 while average hourly earnings moderate**

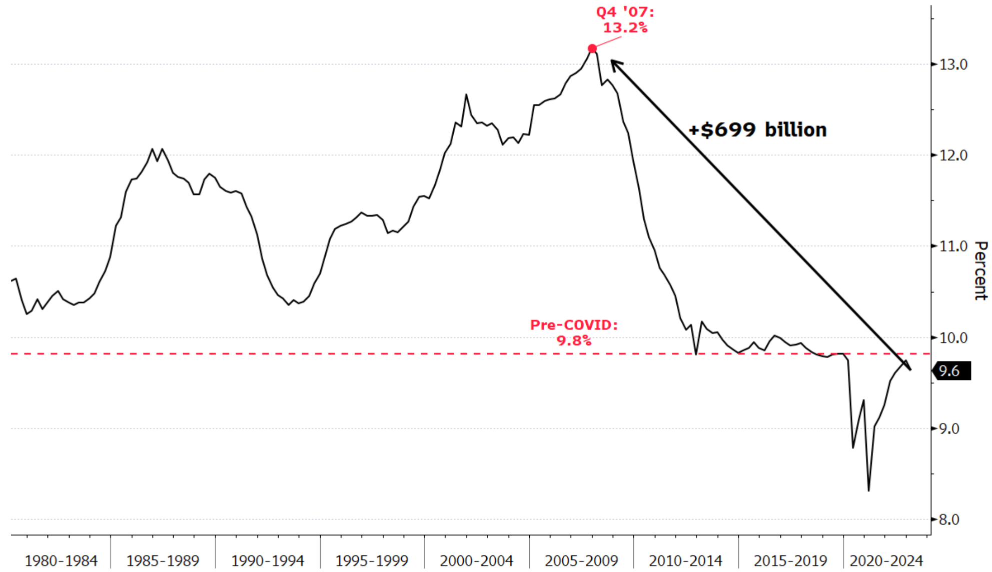



Consumers are finding ongoing support from excess savings carried over from pandemic stimulus. $1.4 trillion in supplemental savings is equivalent to 5% of GDP.




To further pad spending, consumers will likely tap into consumer credit. Consumers' debt load remains manageable and while the debt service burden on the American household recently moved back towards pre-pandemic levels, it is still relatively low.

**Household debt service ratio**
Debt payments as % of disposable personal income




Consumer confidence increased to a four-month high of 63.9 in June and is now 28% above the historic low from a year ago. However, confidence remains low by historical standards as income expectations have softened.

**University of Michigan Consumer Sentiment Index**


Data Sources: U.S. Bureau of Labor Statistics, BCA Research, U.S. Federal Reserve, University of Michigan

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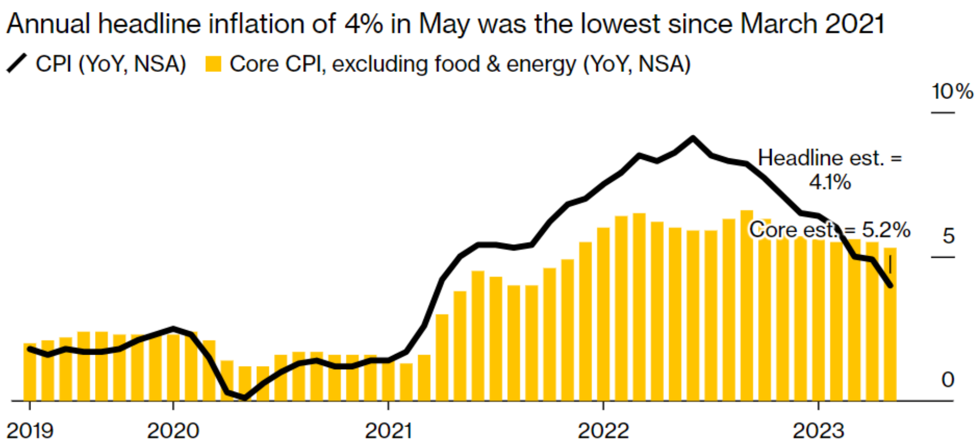
# Greedflation vs. Inflation

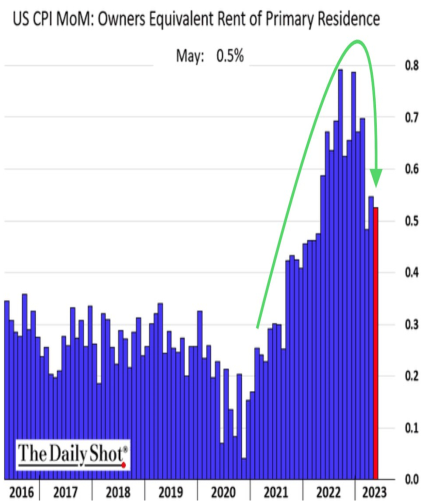
**Headline and Core Inflation – Transitory at Last**

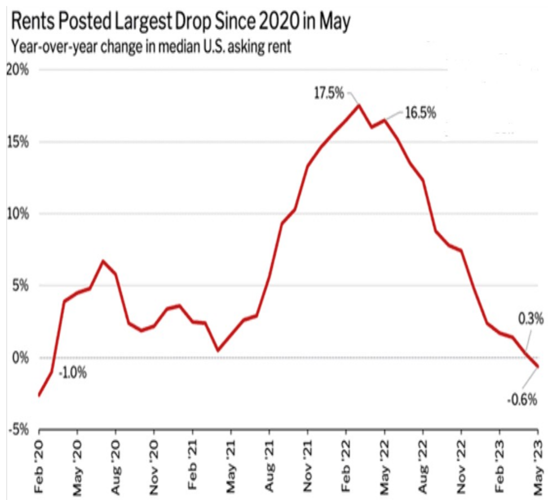
Headline and Core consumer prices have been moderating at a fairly rapid pace.

At 4%, year-over-year, inflation is now at its lowest level since March 2021.




Add to this rent inflation (representing almost 40% of headline CPI), which is also expected to moderate further.

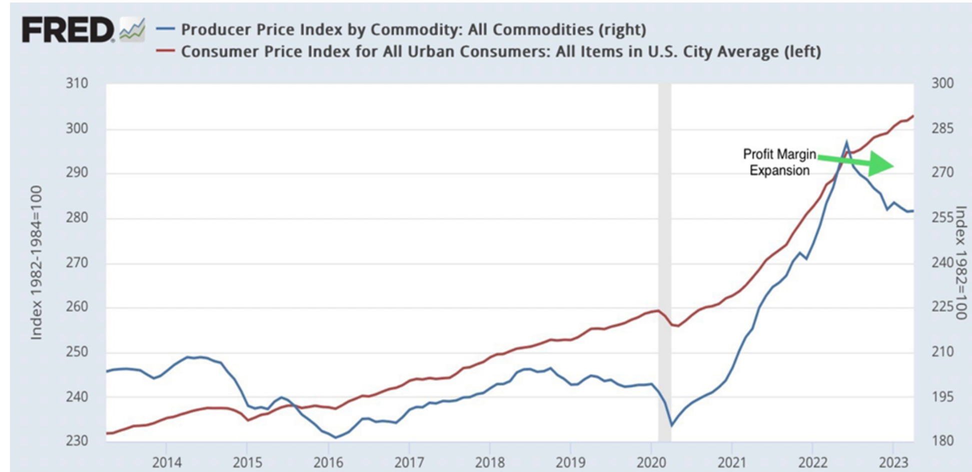



When you take out housing and just look at core services, the signaling is consistent; inflation is transitioning.


Producer prices (what it costs to produce something) are also moderating, but not as fast as consumer prices.

If Corporate America is consistent, cost savings will not be passed along to the consumer, creating a Greedflation opportunity; profit margins should expand.




Data Sources: U.S. Bureau of Labor Statistics, Redfin

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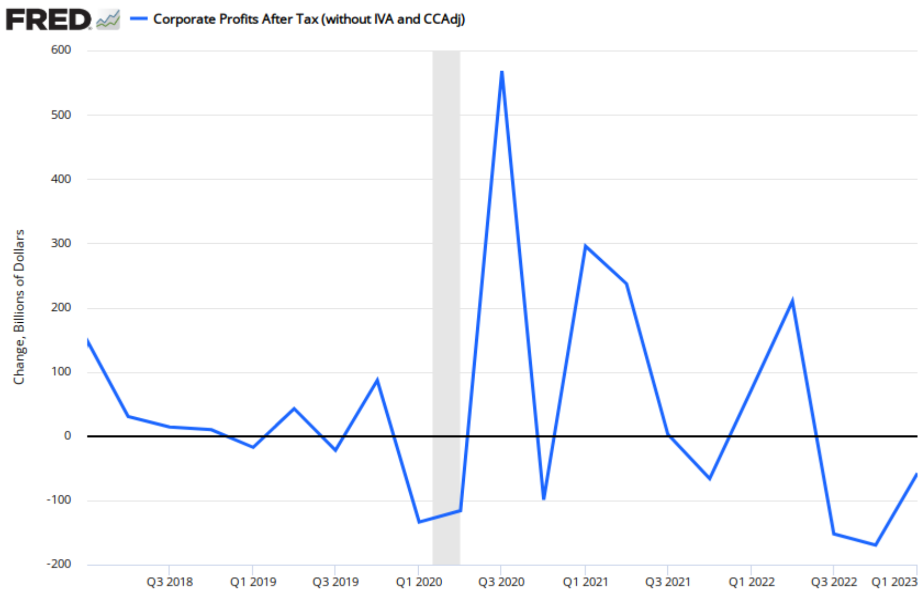
# U.S. Earnings

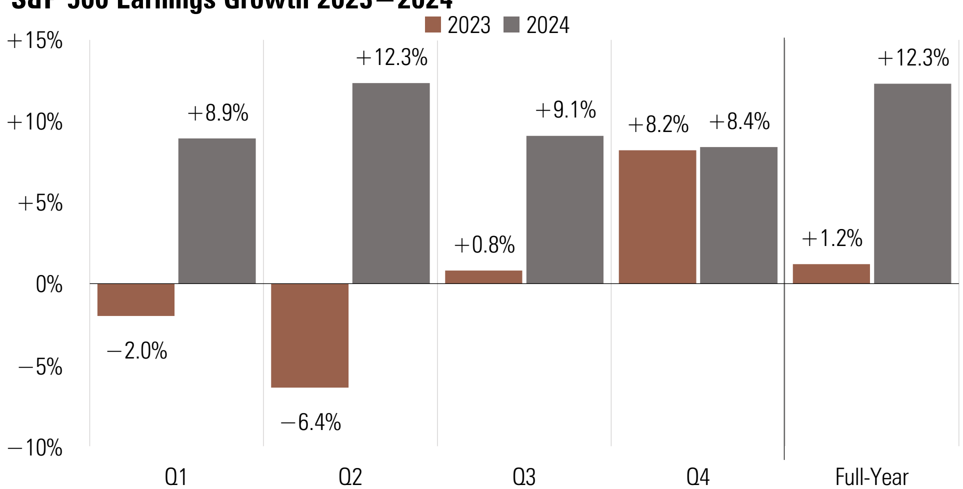
Corporate profit margins look to have bottomed and perhaps will expand back to trend, consistent with Greedflation.




While much of the media and economist class is focused on recessions and interest rate hikes, the real story is future earnings.

2024 S&P 500 earnings are expected to be strong, with analysts expecting 12.3% growth compared to the anemic 1.2% growth rate for 2023.

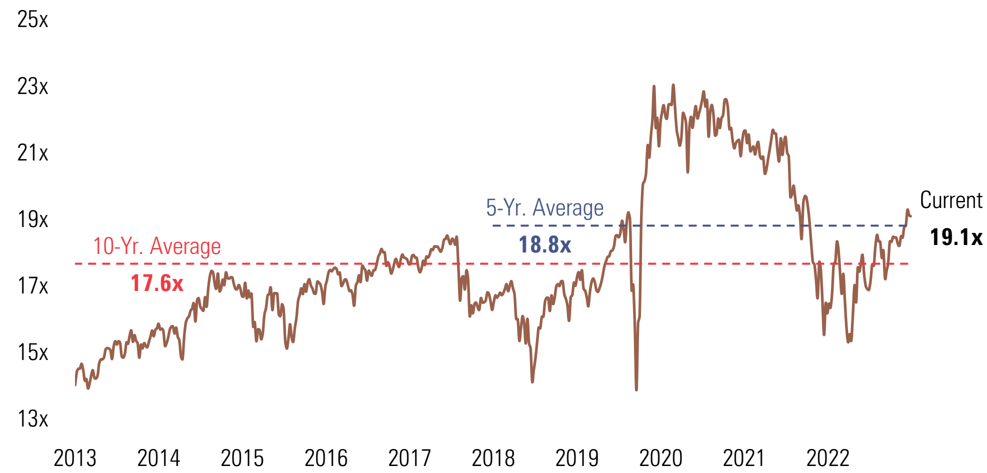
**S&P 500 Earnings Growth 2023–2024**




The forward P/E multiple for the S&P 500 index is currently at 19.1x, roughly in line with the 5-yr. Average, and about 8% above the 10-yr. average.

If economic growth data remains resilient and inflation continues to soften, a declining equity risk premium could offset slightly higher real interest rates and support current equity multiples.

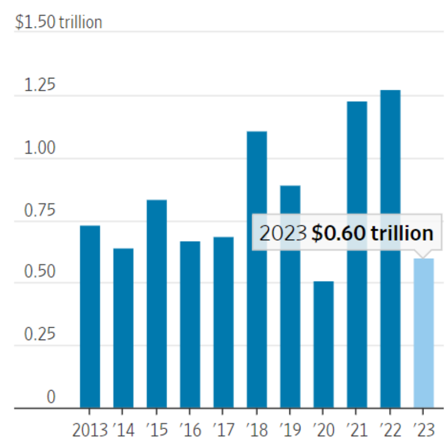
**S&P 500 Forward Price-to-Earnings**




U.S. buyback announcements are running at a record pace this year, with companies in the Russell 3000 announcing plans to buy back more than $600 billion in shares so far this year.

This should benefit corporate earnings per share in 2023 based upon year-over-year comparisons.

**Announced share buybacks, Russell 3000 companies**




Note: 2023 data is through May 22

Data Sources: U.S. Bureau of Economic Analysis, FactSet, Bloomberg, Wall Street Journal

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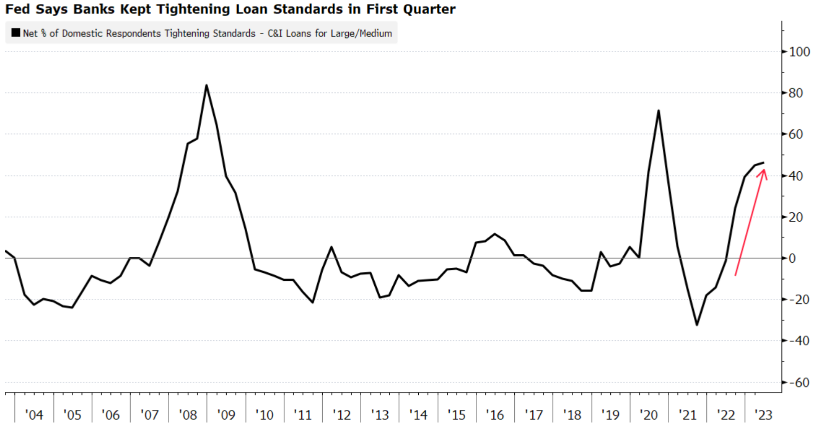
# Banking & Credit

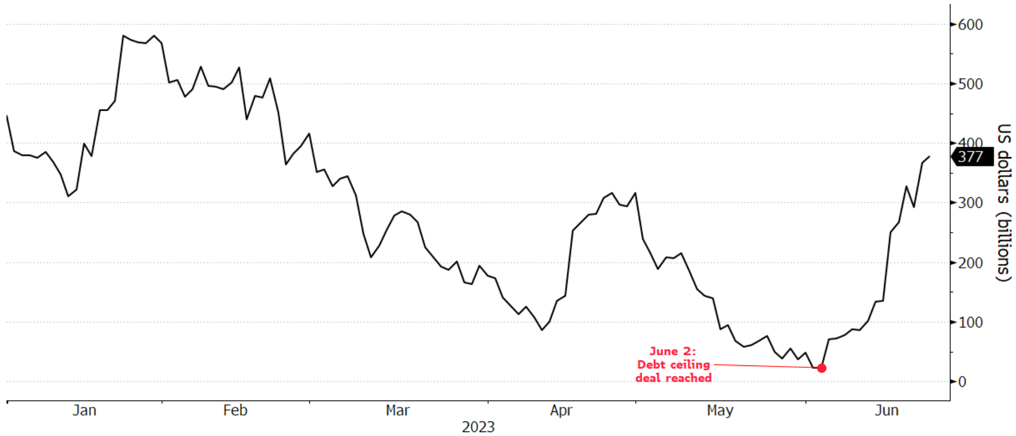
Credit conditions continue to tighten by most measures. According to the Fed's Senior Loan Officer Survey, the proportion of U.S. banks tightening terms on loans for medium and large businesses rose to 46% in the first quarter.

**Fed Says Banks Kept Tightening Loan Standards in First Quarter**



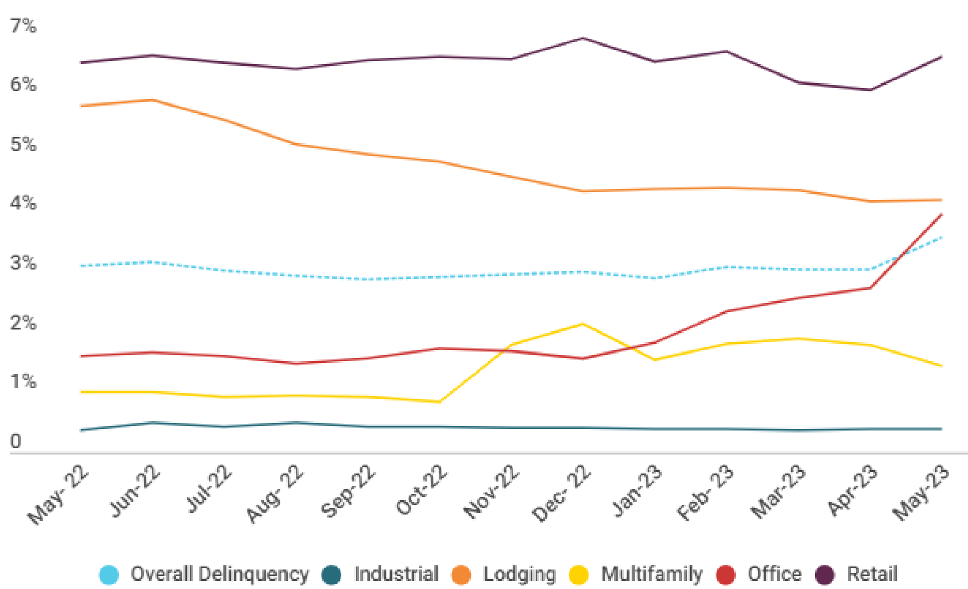

For U.S. banks struggling to hold onto deposits, the suspension of the federal debt ceiling presents a new challenge. The Treasury Department is ramping up bill issuance to replenish its coffers, which is likely to further boost the interest rates that alternatives like Money Markets and CDs can offer.

**Treasury Total Operating Balance**



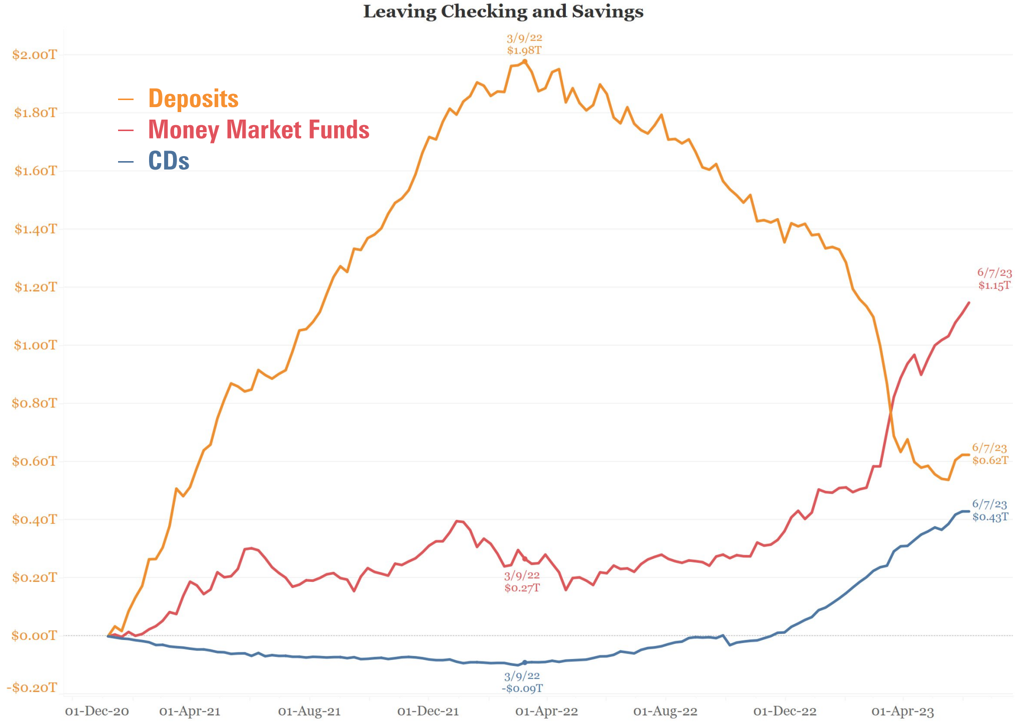

It's not been since the Financial Crisis of 2009 that we have seen credit distress in the commercial real estate sector. In May the overall CRE delinquency rate rose 53 basis points to 3.62%, the highest level since March 2022. The 53-basis point increase is the largest since June 2020 when delinquencies surged more than 3%.

**Delinquency Rates by Major Property Type**



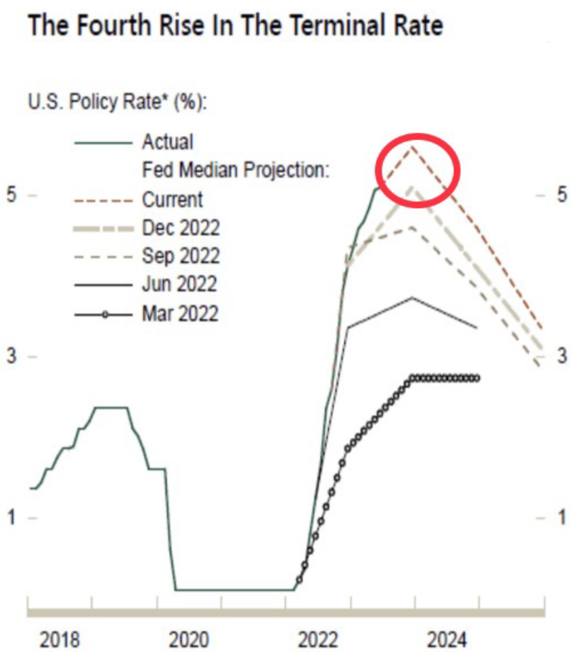

The drain on bank deposits will continue to act as a drag on the economy and a stain on banks. This trend might support further rate pauses in the coming quarter.

**Leaving Checking and Savings**

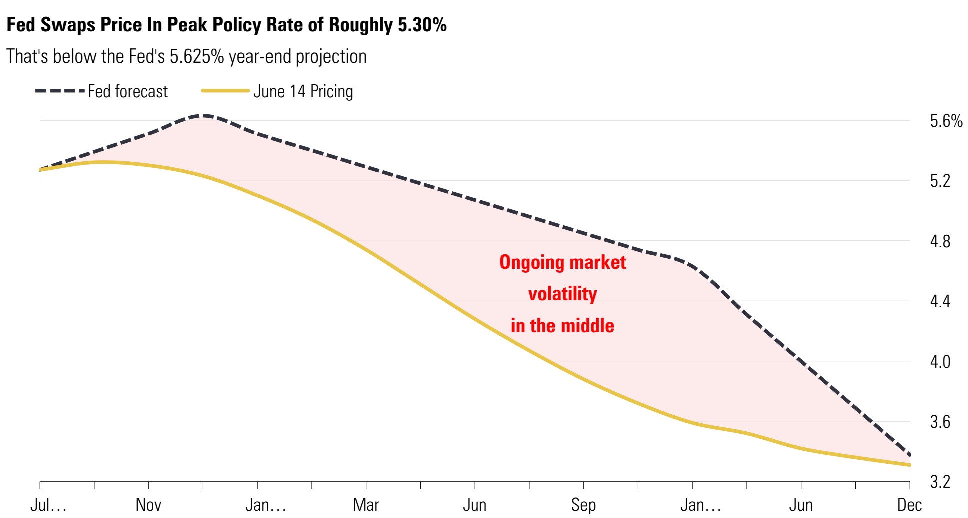


# Fed – Slower, Higher

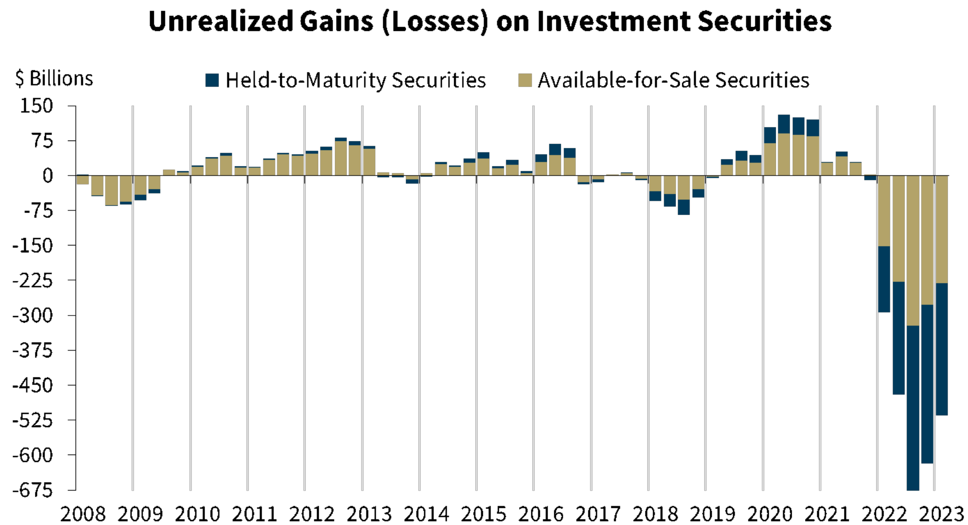
The Fed has increased its projected terminal rate for the fourth time this cycle, implying the Fed has underestimated the resilience of the economy and the persistence of inflation.




The gap between the Fed's forecast and investors suggests another round of volatility as the course for future rates continues to be debated.




That's why we believe the rhetoric out of the Fed may be more bark than bite. Bank stress is a threat to the economy. Combined with moderating inflation, the data should encourage the Fed to maintain a pause.




With the Fed pausing rate hikes at their June meeting, investors might wonder what impact that has on equity returns. From our friends at Bespoke, a pause in an interest rate cycle is not all that bad for equities – nearly 18% equity returns on average one year after a pause.

**Pauses During FOMC Tightening Cycles: 1994 - 2023**

| Tightening Period | | Performance Since | S&P 500 Performance (%) After Pause | | | | |
|---|---|---|---|---|---|---|---|
| Start | Pause | Start of Cycle (%) | One Week | One Month | 3 Months | Six Months | One Year |
| 2/4/94 | 7/6/94 | -5.04 | 0.58 | 2.46 | 1.40 | 3.26 | 24.18 |
| 6/30/99 | 6/28/00 | 5.98 | 0.13 | -2.40 | 0.24 | -8.29 | -15.71 |
| 6/30/04 | 8/8/06 | 11.45 | 1.11 | 2.16 | 8.98 | 13.91 | 17.78 |
| 3/16/22 | 6/8/22 | -1.52 | | | | | |
| | **Average** | **4.13** | **0.61** | **0.74** | **3.54** | **2.96** | **8.75** |
| | **Median** | **5.98** | **0.58** | **2.16** | **1.40** | **3.26** | **17.78** |

*Start = start of tightening cycles*

*Pause = First time FOMC leaves rates unchanged after at least three straight hikes*

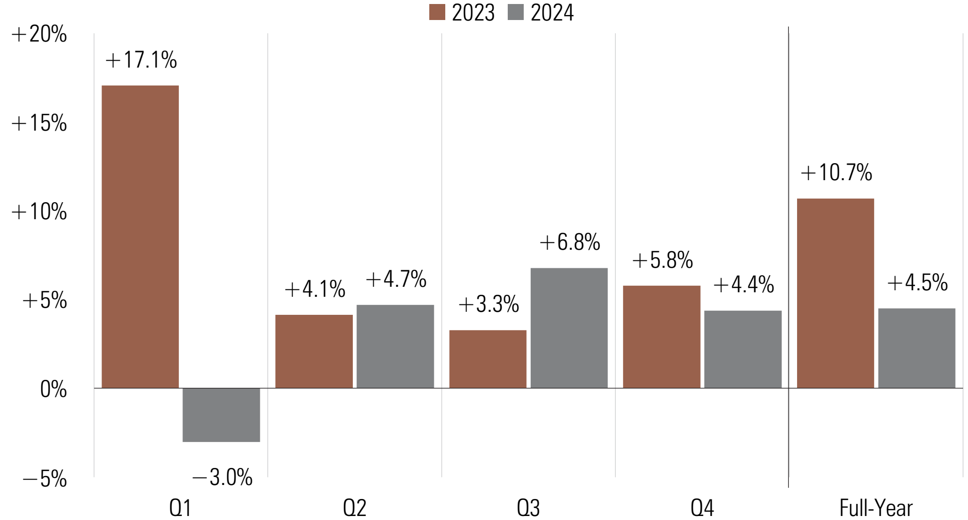
Data Sources: Daily Shot, FOMC, Bloomberg, FDIC, Bespoke

# Developed Markets

Developed markets equities have recently benefitted from macro improvements in the Euro Area, U.S. dollar weakness, and the faster-than-expected China reopening.

Developed Markets stocks trade on a forward P/E of 13.3x, a significant discount to long-term averages and a 30% discount to the United States.

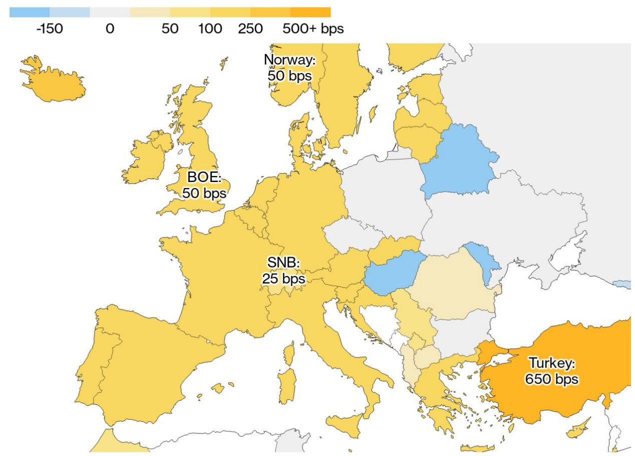
**MSCI EAFE Earnings Growth 2023–2024**




Anemic macroeconomic growth is not only driven by a rising rate picture but also high social costs and the ongoing war in Ukraine. In the coming months, Russia is expected to increase pressure on energy supplies to Europe. With a soft spot in China's consumption growth, European luxury goods and autos can create further drag.

**UK, Switzerland, Norway and Turkey All Hiked on Thursday**

Change in borrowing costs since start of 2023




Source: Bloomberg

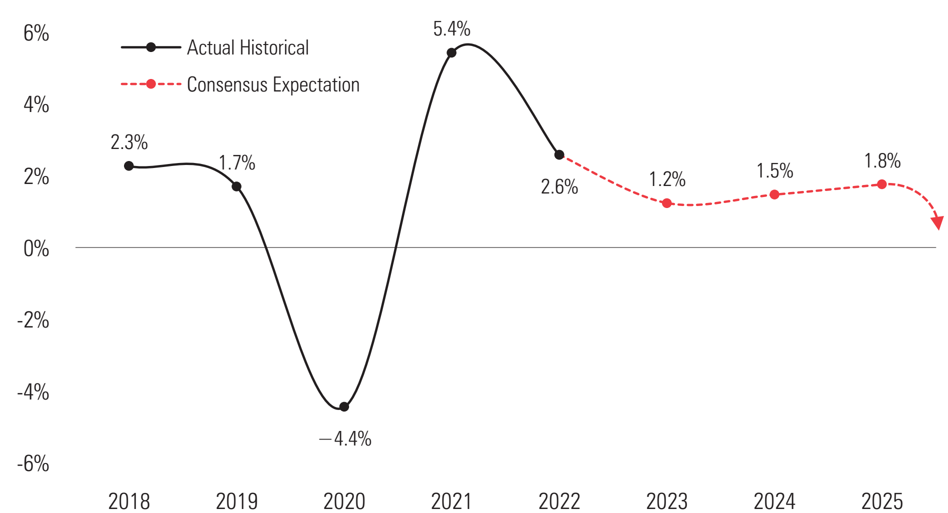
Note: Mapped data show change in interest rates for distinct central banks since start of year.

Bloomberg

While earrings are poised for a rebound and valuations are at a discount to the United States, the rising rate picture in the EU will create more macroeconomic drag.

**MSCI EAFE Forward Price-to-Earnings**


**Developed Markets GDP Growth**




Data Sources: Bloomberg

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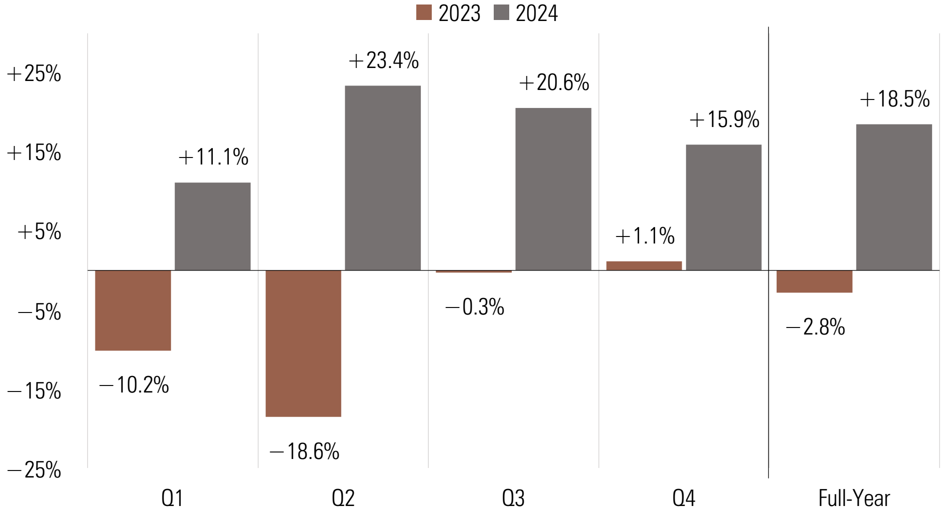
# Emerging Markets

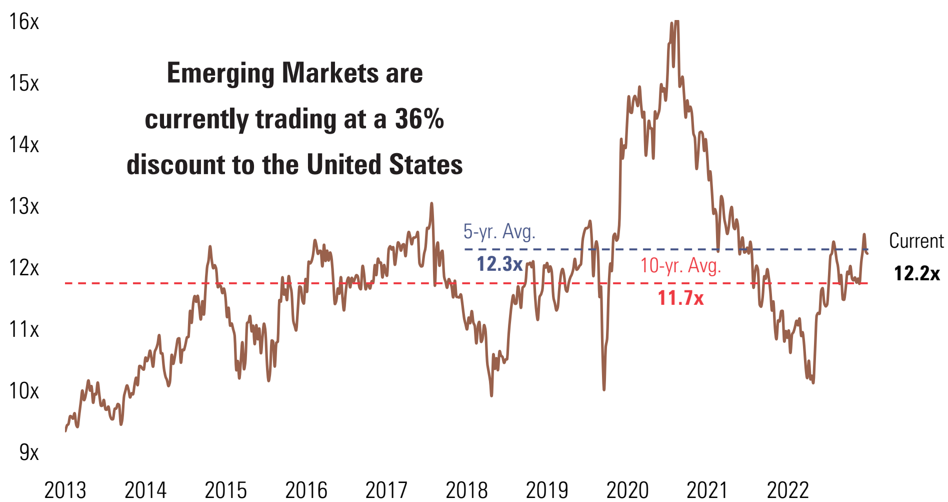
Emerging market equity performance should shift from a sentiment-driven rebound to an earnings recovery in the second half of 2023 and into 2024.

### MSCI Emerging Markets Earnings Growth 2023–2024

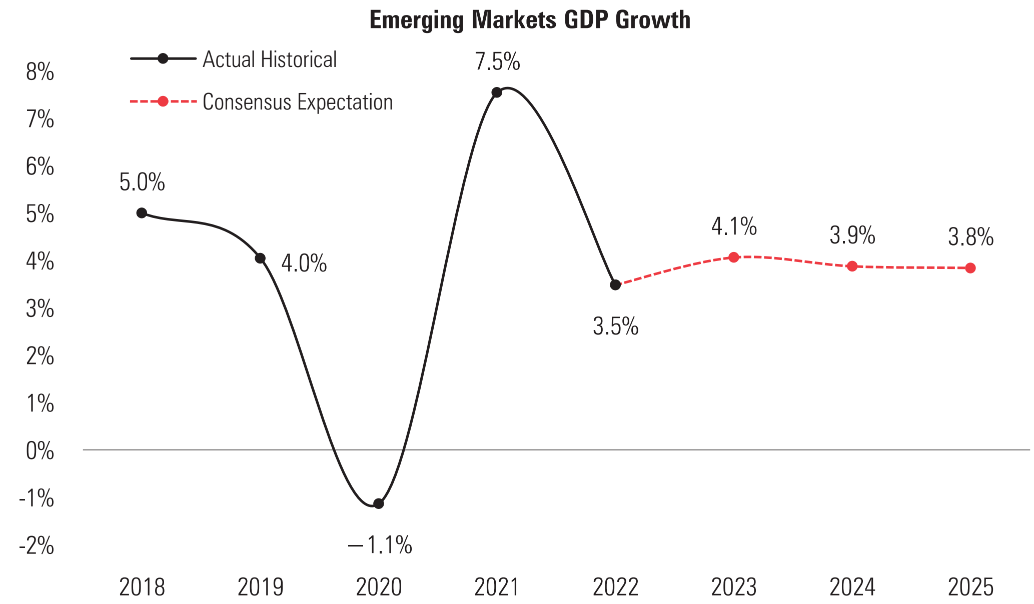



Emerging market valuations have risen off the lows seen in late 2022, but still remain heavily discounted relative to the United States.

### MSCI Emerging Markets Forward Price-to-Earnings

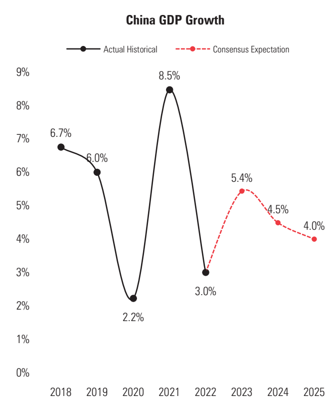


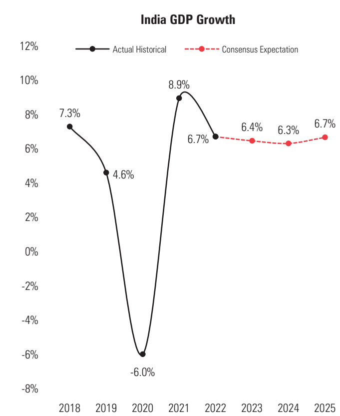

While GDP growth in emerging markets could moderate around the 4.1% level, China and India should present stronger growth in 2023.

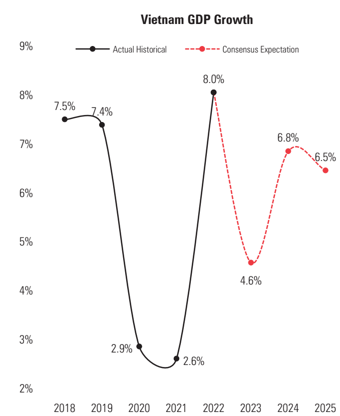



Despite a soft patch in recent economic data from China, GDP may benefit from the deployment of over $1 trillion of excess savings by Chinese consumers.

China's planned economic GDP expectation is at 5% for 2023, while Wall Street estimates are currently at 5.5%.



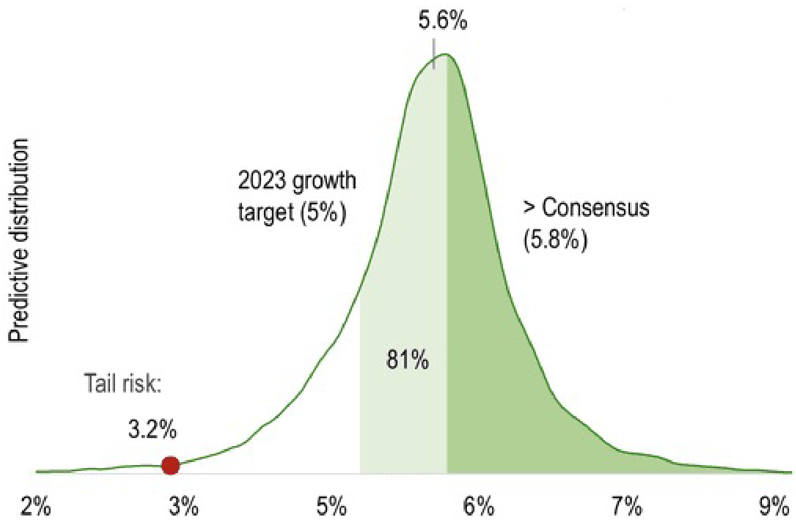



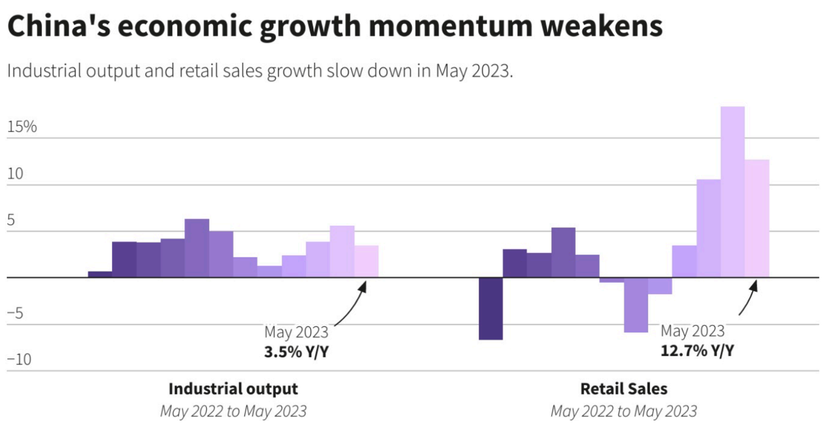

Data Sources: Bloomberg

# China – Make or Break Stimulus

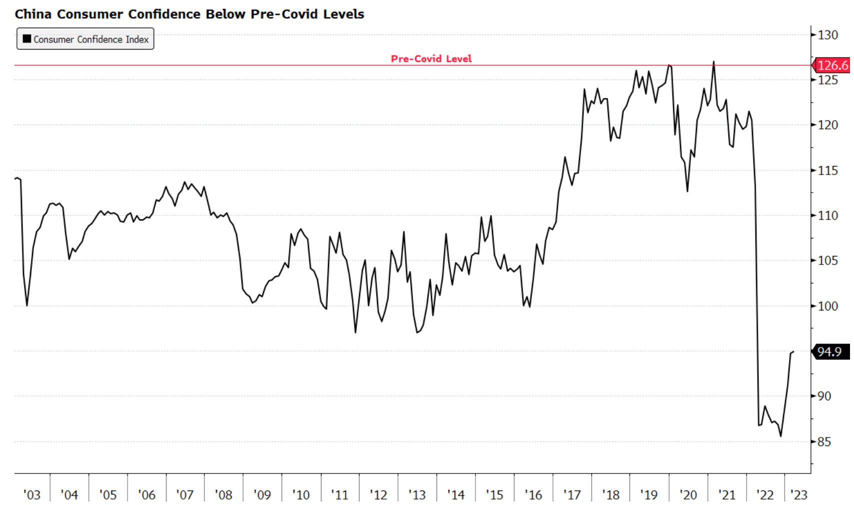
The government has set a modest GDP growth target of around 5% for this year, after missing the 2022 goal. Analysts are currently forecasting 5.8% GDP growth, with an 81% probability of growth exceeding Beijing's 2023 growth target.



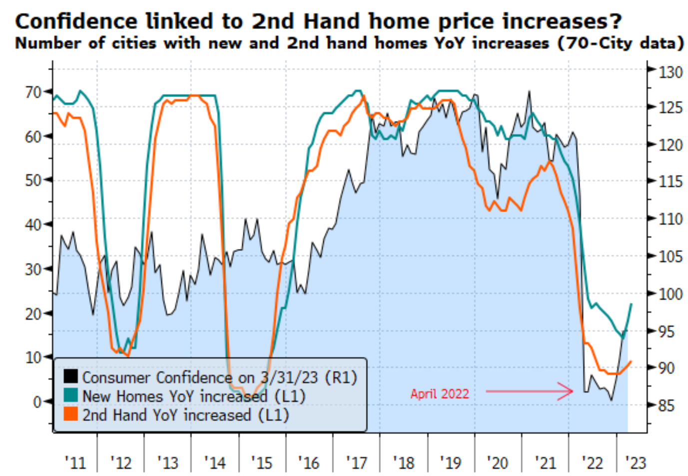

China's economy stumbled in May with industrial output and retail sales missing forecasts, adding to expectations that Beijing will need to do more to shore up the post-pandemic recovery.




Consumer confidence bounced off the record lows from 2022 but are still well below pre- Covid levels that will unleash more consumption.




It appears consumer confidence has been heavily linked to secondhand home prices rising since 2015, driving Chinese authorities to press for lower rates on home loans in an effort to revive the critical property sector.




**Recent Stimulus Actions *(with more to come)***

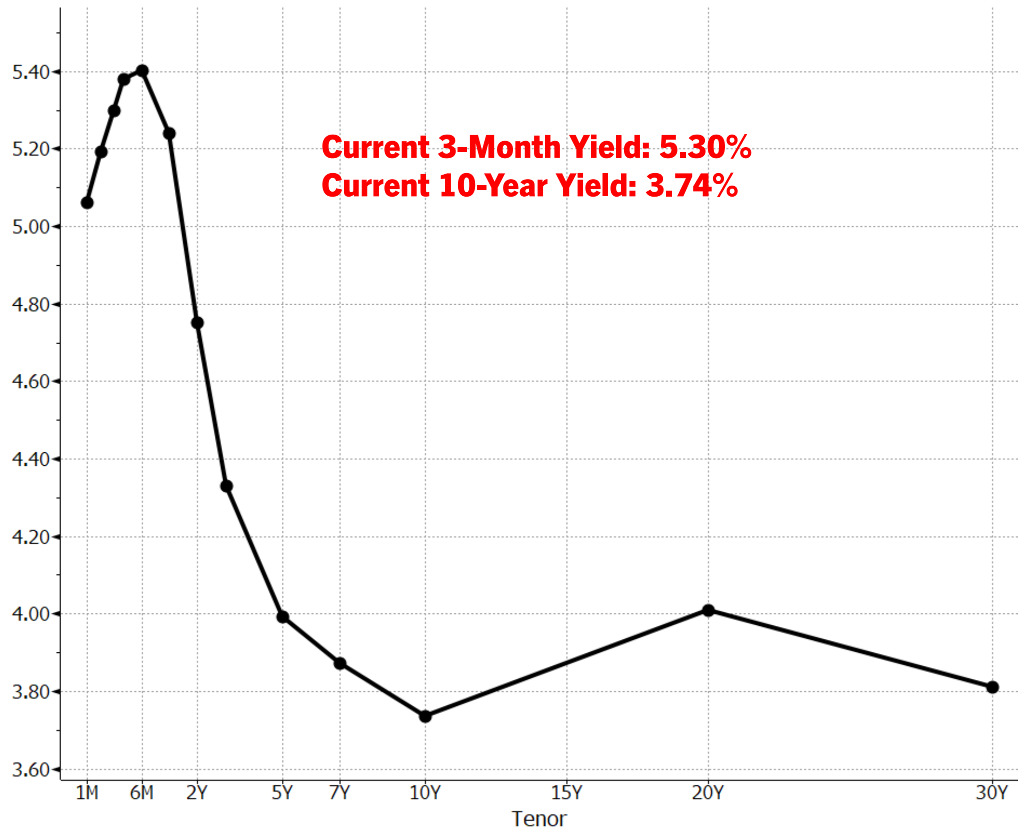
- **Cut the 1-year Loan Prime Rate (LPR), 5-year LPR, and the Medium-Term Policy Rate by 10 bps**
- **Announced a $72.3 billion package of tax breaks over four years for electric vehicles**
- **Announced that small businesses with monthly sales of less than 100,000 yuan ($14,000) would be exempt from value-added tax for 2023**

Data Sources: Real China Charts, Reuters, National Bureau of Statistics of China

# Fixed Income – Stuck Short

Ultra short duration treasuries are at an extreme inversion, with 3-month Treasuries yielding 156 bps more than 10-year Treasuries

**Current Treasury Yield Curve**




Investors can make a wholesale shift in the Fixed Income side of their portfolio to gain extra yield, but will face replacement risk as ultra-short bonds mature.

| 60/40 vs. 3-Month Treasury Yield | 60/40 Returns Treasury Yield | | | |
|---|---|---|---|---|
| | 1 Year | 3 Year | 5 Year | 10 Year |
| **Traditional 60/40 Portfolio** 60% ACWI, 40% Aggregate Bonds | 9.82% | 5.01% | 5.59% | 6.47% |
| **Current 3-Month Treasury Yield** | 5.29% | 5.29% | 5.29% | 5.29% |
| **Difference +/-** | +4.52% | -0.28% | +0.29% | +1.17% |

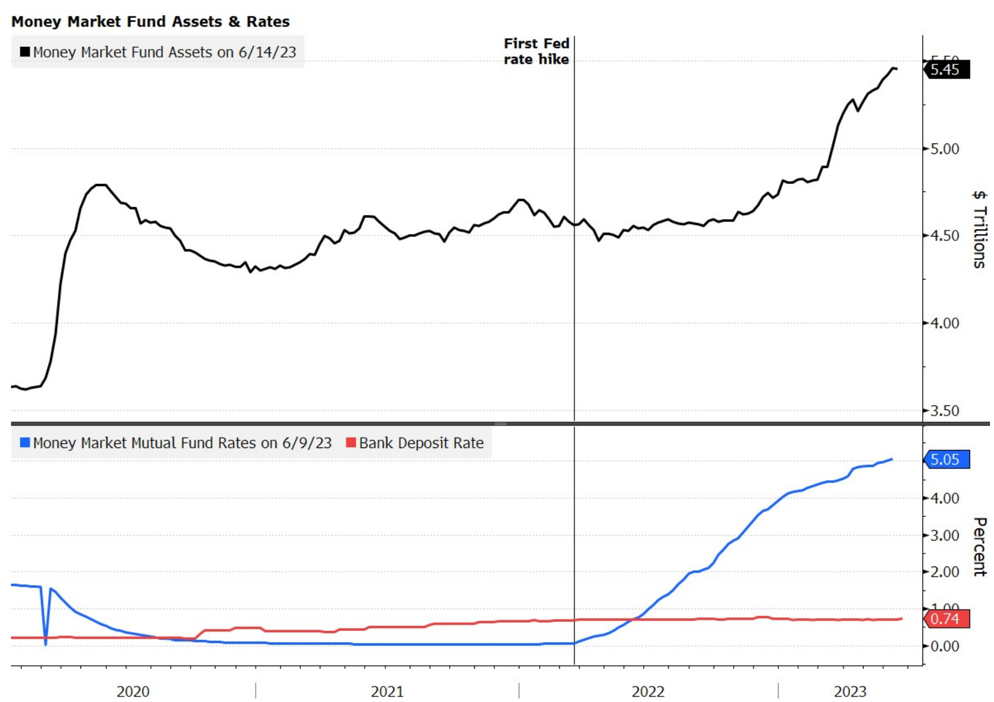
**Traditional 60/40 Portfolio Duration:** 6.27 years

**Current 3-Month Treasury Yield Duration:** 0.25 years

Since the first fed rate hike in March 2022, money market mutual funds have seen massive inflows.

Assets have increased $890 billion as bank depositors are still yield seeking and leaving for ~5% money market rates.

More upward pressure on shorter duration is possible due to increasing treasury bill issuance, potentially shifting money-market rates higher by 25 to 40 basis points.




Data Sources: Bloomberg, ICI, Bankrate.com

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# Our Views & Recommendations

## Our View

- We adjust our expectation for the Fed Funds to hover around 5.25% up to 5.50% in Q3. Bank credit stress and extraordinary treasury issuance look to be taking a back seat to the Fed's inflation fighting efforts. However, with inflation moderating, much of the Fed's estimates may be in setting higher-than-needed rate expectations.
- The U.S. consumer is still resilient, as strong jobs and wages provide a positive backdrop. However, expect an erosion in sentiment and possibly a slowing of services consumption.
- Europe will continue to experience inflationary pressures and higher rates. This will put pressure on bank stability and equity prices. We remain underweight in developed markets and Europe.
- China's recovery is on shaky ground as property values are wavering. Expect massive stimulus both in the property sector and direct to the consumer. A lift in China equities should unfold, not withstanding excess geopolitical risks.

## Recommendations

- Reaffirm your investment strategy and maintain strategic liquidity to cover spending needs and provide opportunities for cost averaging.
- Increase weightings in Developed Markets closer to targets while maintaining below target allocations driven by structural headwinds in macroeconomic policy.
- Maintain an overweight to Emerging Markets and China as they continue to represent reasonable earnings growth to valuation prospects.
- Migrate to benchmark duration in Fixed Income as the Fed nears their estimated peak.

### What's On Our Mind?

| ARE WE IN THE MIDST OF A SECULAR REGIME CHANGE FROM: | POSSIBLE ALLOCATION RESPONSES |
|---|---|
| Moderating Inflation → Possible Disinflation<br>Higher Interest Rates → Lower Rates for Longer | Cash alternatives and lower duration fixed income |
| Globalization & Importing Deflation → Deglobalization & Higher Costs<br>Carbon Driven Energy → Carbonless Economies | Commodity exposure – minerals, energy, & oil |
| Correlated Stock & Bond Movements → Uncorrelated Stock & Bond Movements | Non-correlated equity alternatives – illiquid, event-driven, hedge, China |

# Mean Reversion Dashboard

## Style Forward P/E as a % of 20-Year Average

| Size | | Value | Blend | Growth |
|---|---|---|---|---|
| | Large | 104.4% | 118.8% | 136.5% |
| | Mid | 93.0% | 98.5% | 113.3% |
| | Small | 116.6% | 110.4% | 89.1% |

## Regions & Countries Forward P/E as a % of 20-Year Average

**Regions**

| World | Developed Markets | Emerging Markets | Frontier Markets |
|---|---|---|---|
| 112.3% | 97.5% | 105.0% | 85.8% |

**Countries**

| United States | Germany | United Kingdom | China | Brazil | India |
|---|---|---|---|---|---|
| 120.8% | 86.4% | 84.7% | 87.1% | 74.2% | 125.0% |

## Sector Forward P/E as a % of 20-Year Average

**Sectors**

| Energy | Materials | Industrials | Consumer Discretionary | Consumer Staples | Health Care | Financials | Technology | Telecom | Utilities | Real Estate |
|---|---|---|---|---|---|---|---|---|---|---|
| 38.3% | 109.9% | 111.4% | 130.2% | 113.2% | 115.0% | 102.9% | 155.6% | 111.5% | 108.7% | 81.7% |

Data Source: Bloomberg



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# THANK YOU

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