LOOK AHEAD

Q4 2023

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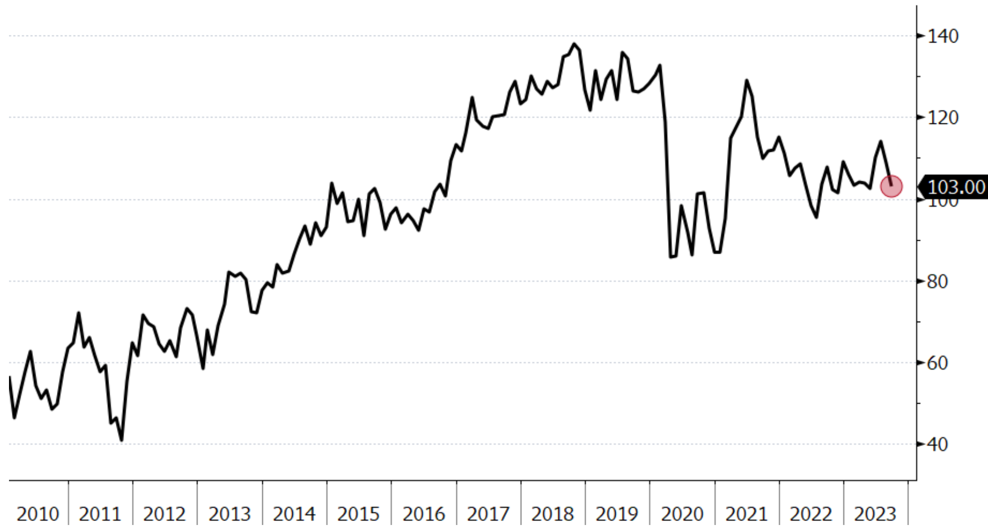
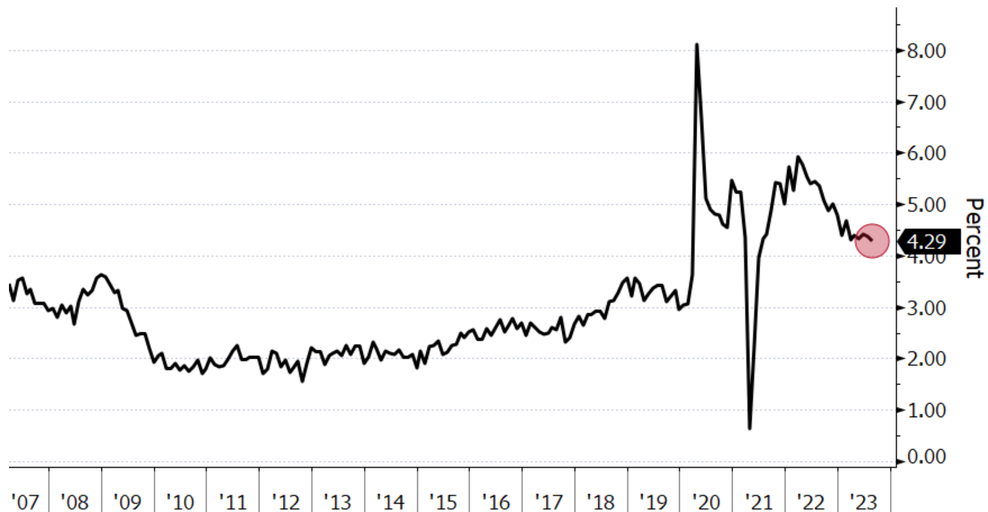
The Consumer's Getting Shaky

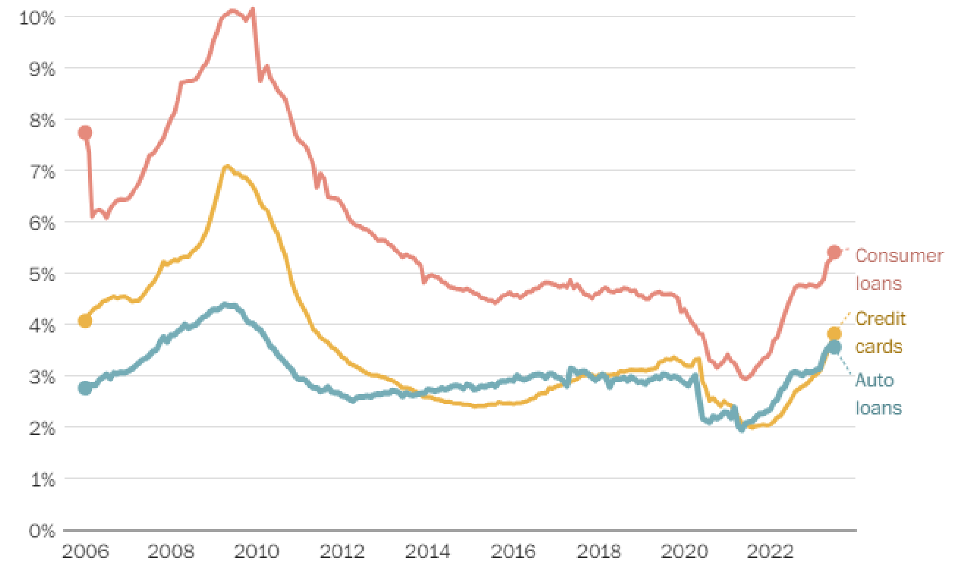
With consumers hearing more negative news about inflation and the economy, consumer sentiment is weakening, according to the Conference Board's Consumer Confidence survey.



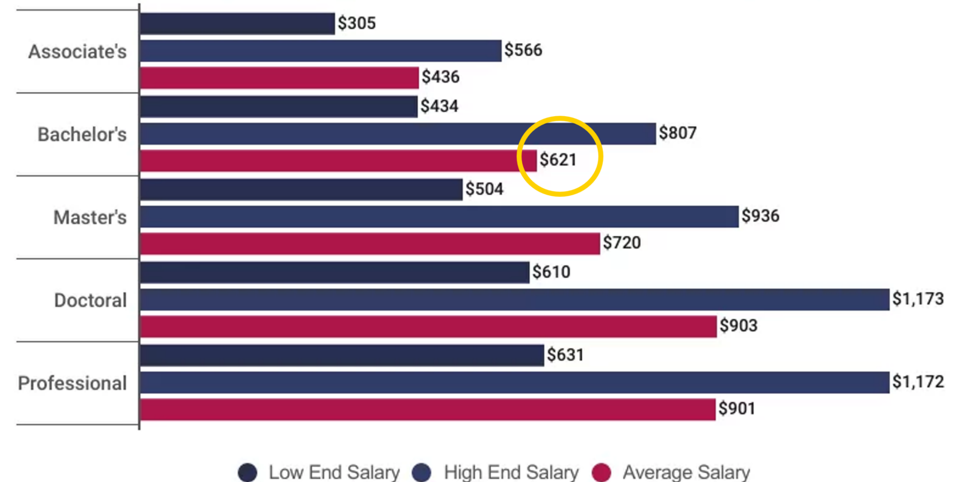
Wage growth continues to moderate, with average hourly earnings up 0.2% from July – the smallest increase since early last year – and 4.3% from a year ago.



Default rates are also rising, with delinquencies on auto loans, credit cards, and consumer loans at their highest levels in a decade.



One other important potential drag on the consumer is the resumption of federal student loan payments on October 1st, with a $621 monthly payment translating to a 12% reduction in monthly spending for workers with a bachelor's degree who have been working for 5 or more years.



Data Sources: Conference Board, Bureau of Labor Statistics, Equifax

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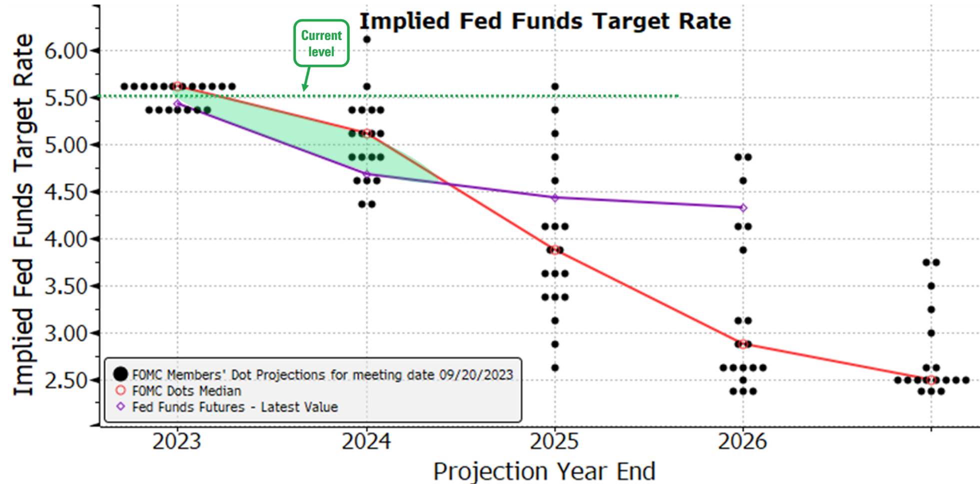
Restrictive Monetary Policy

The Fed's updated dot plot shows the members expect rates to go up one more time before year-end to 5.75% before falling to 5.25% by the end of 2024 and ending 2026 around 4%. The median Fed forecast is for a series of gradual rate cuts over the next several years.

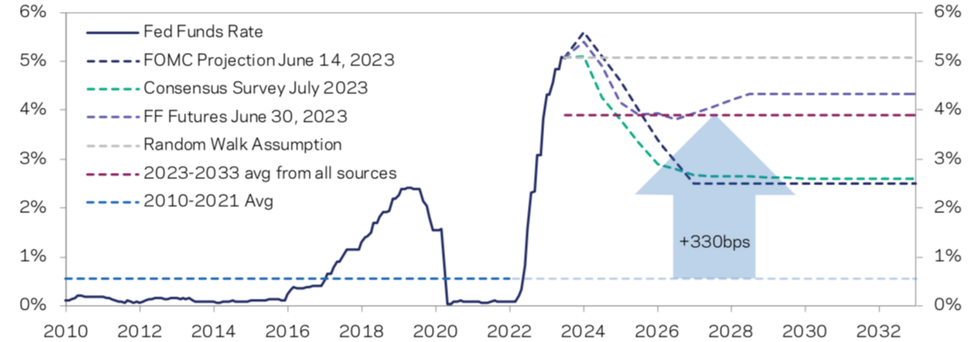
However, the gap between the Fed's forecast and investors suggests another round of volatility as the course for future rates continues to be debated.



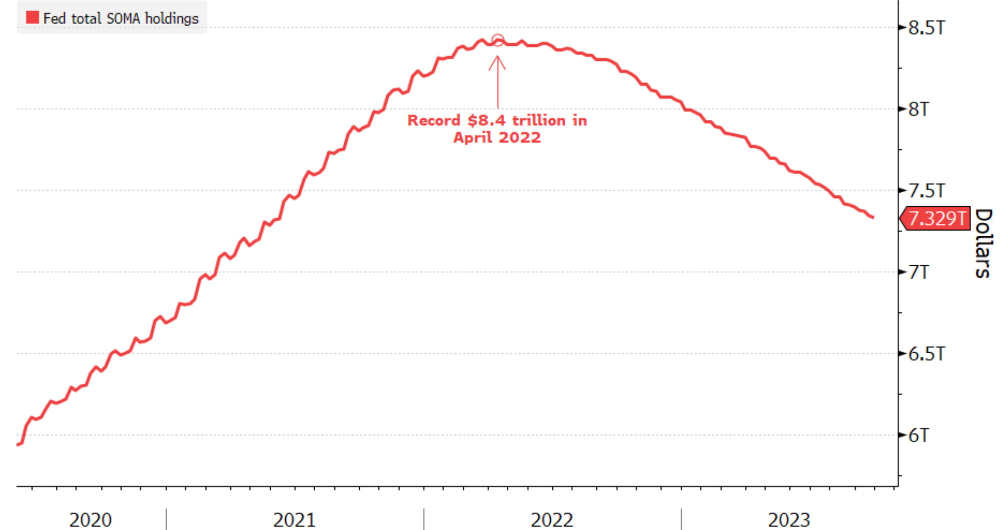
Here's the reality of what history holds when it comes to Fed Funds rates: Rates historically drop like a rock. When the economy slows, as it will, the Fed has erred on the side of caution and cut rates quickly. It's their job to protect the American worker and not put them out to pasture.

Fed Funds policy rates have spent a long period of time near the 4.5% range rather than the 0.5% range from 2010-2021.

Productivity is up for American workers, offsetting higher wage growth, which could mean we return to our past with a more normalized Fed Funds rate around 4%- -- much higher than the fed's longer run forecast of 2.5%.



The Fed continues to shrink its massive balance sheet, which is usually interpreted as a strategy for tightening monetary policy. The balance sheet shrinking will add more unpredictable tightening to an already higher-for-longer interest rate policy.



Data Sources: Federal Open Market Committee, AQR, Federal Reserve Bank of New York

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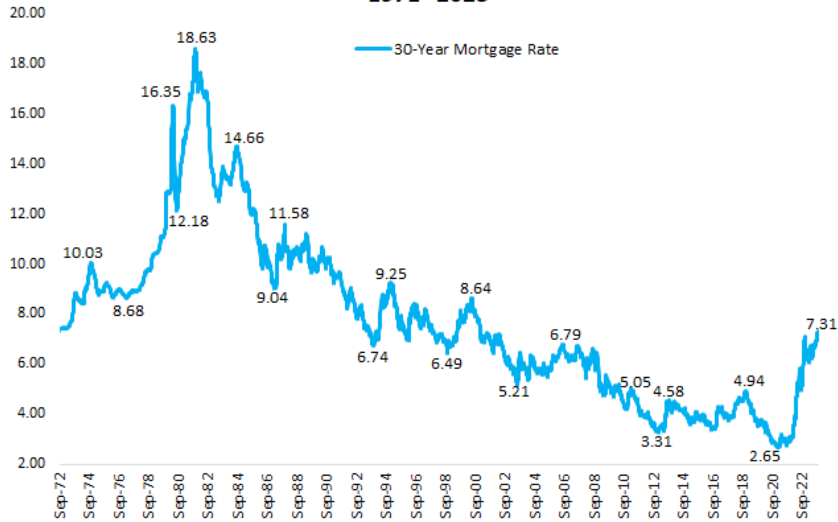
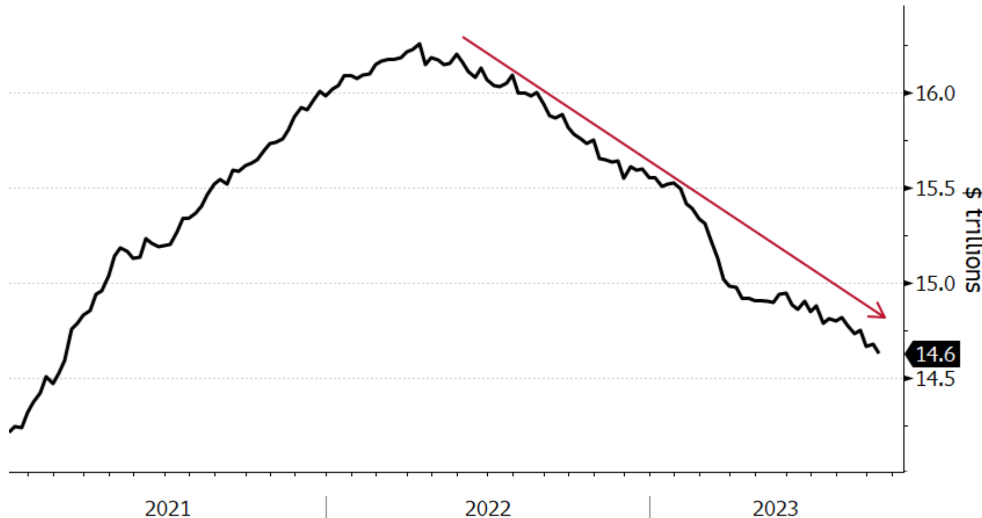
The Economic Outcomes from the Fed's Hit Job

Mortgage rates are at generational highs, with the average rate on a 30-year, fixed loan hovering above 7% for six straight weeks.



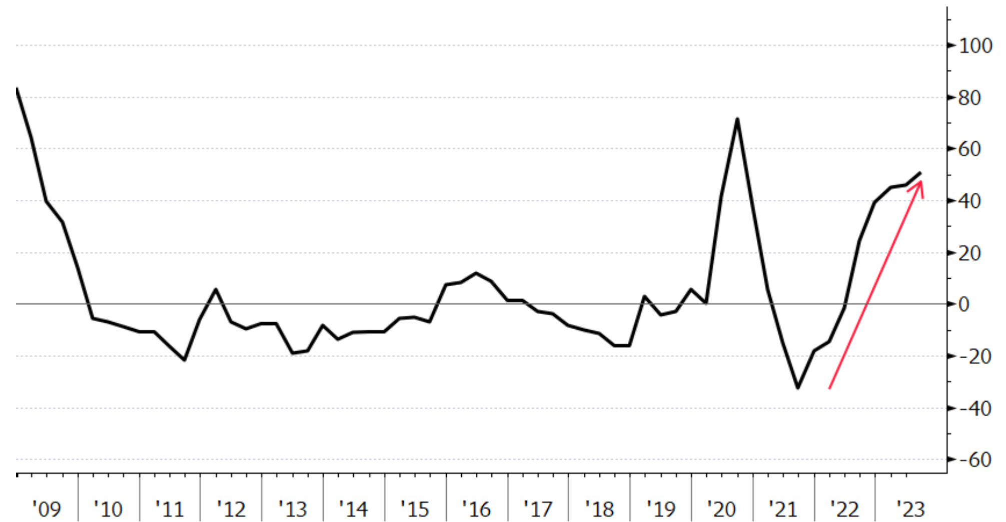
Tightening lending standards have resulted from the record amount of deposits leaving banks for higher-yielding alternatives (money market funds and T-Bills). This is leaving banks with less liquidity and tighter credit standards.

Domestically Chartered Commercial Banks Deposits, SA



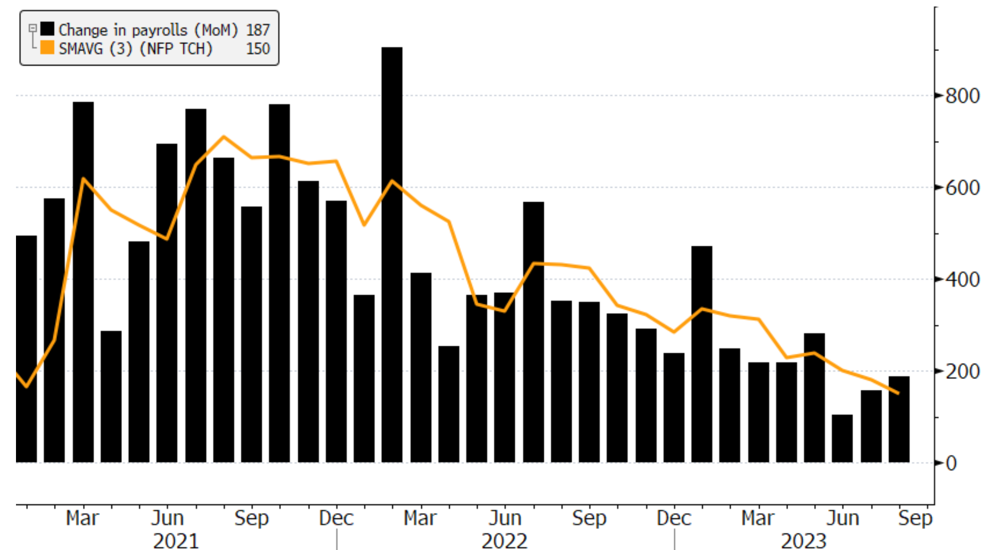
Concurrently, the Federal Reserve said that banks reported tighter standards and continued weak demand for loans in the second quarter, extending a trend that began before recent stresses in the banking sector emerged.

Fed Says Banks Kept Tightening Loan Standards in the Second Quarter



In the end, the Fed's Economic Hit Job is weakening labor growth. Perhaps in the quarter ahead we see further softness in employment. After a run of 29 months in which job growth never dipped below 200,000, the last three months have all fallen short of that mark.

US Employment Growth Is Moderating



Data Sources: Creative Planning, Federal Reserve Board, Bureau of Labor Statistics

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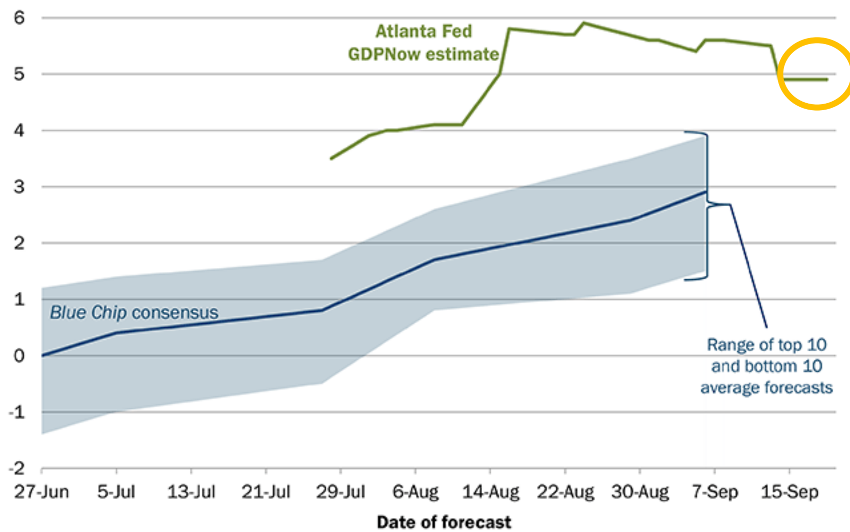
Economic & Earnings Growth Recovery

The current state of affairs in the U.S. economy is very strong, with GDP for Q3 expected to grow at nearly a 5% rate according to the Atlanta Fed.

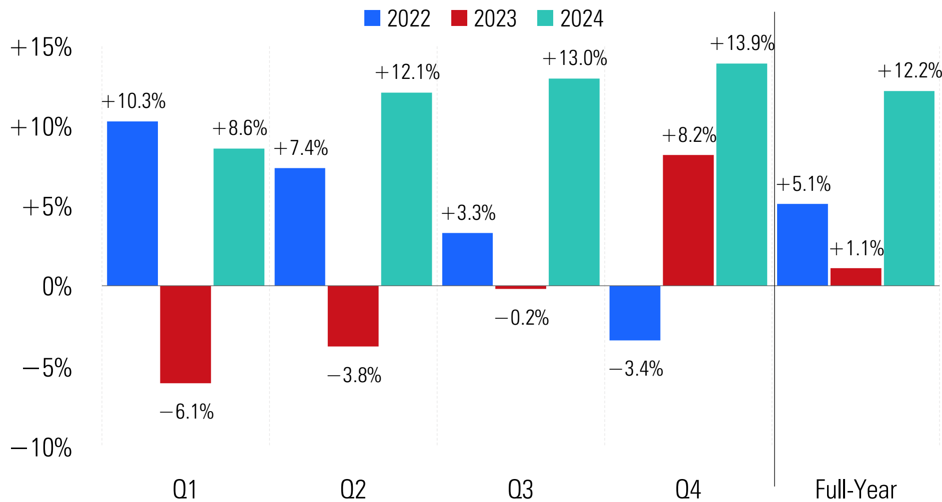
Evolution of Atlanta Fed GDPNow real GDP estimate for 2023: Q3
Quarterly percent change (SAAR)



As for earnings growth currently, we are in a soft patch, but that should be in our rear-view mirror.

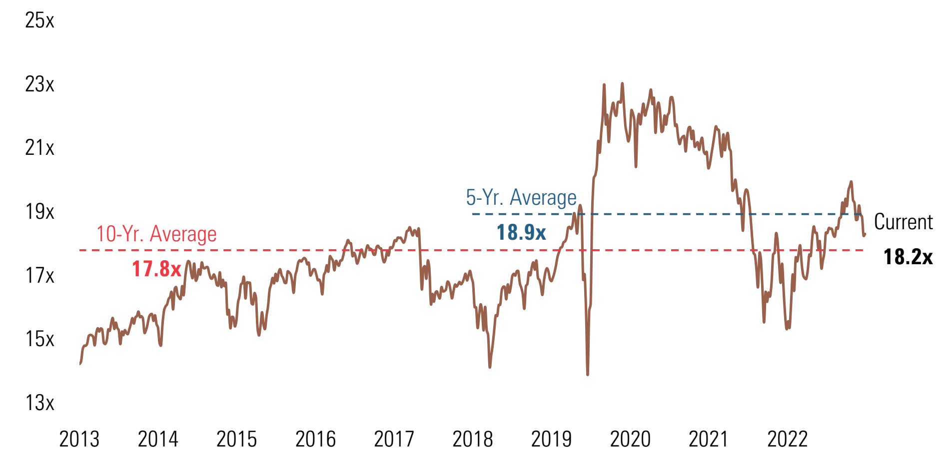
It's not hard to see the hurdle rate for 2022 earnings growth was harder to beat for calendar year 2023. Yet, 2024 by comparison will get the benefit of the weak earnings growth seen in 2023.

S&P 500 Earnings Growth: 2022—2024



Valuation-wise, the forward P/E multiple for the S&P 500 index is currently at 18.2x – roughly in line with the 5- and 10-year averages. 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 equity multiple expansion.

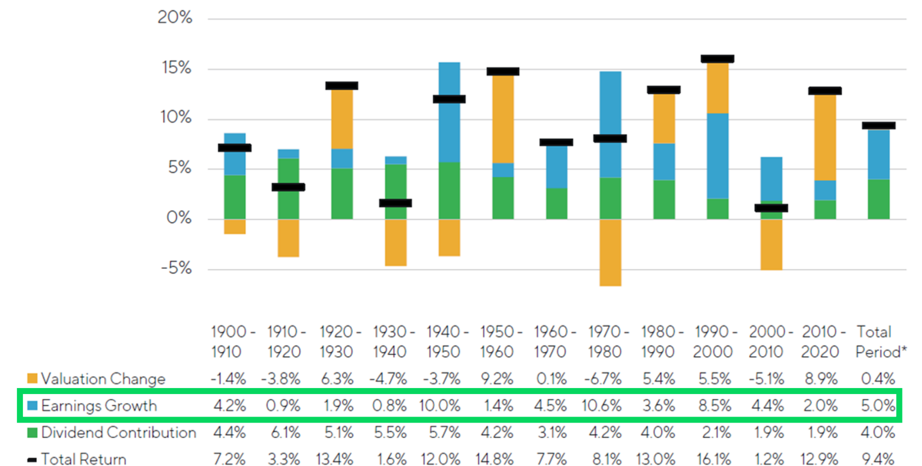
S&P 500 Forward Price-to-Earnings



If you look at the past 100 years of equity returns, earnings growth is the largest contributor to returns.

Side Note: 96% of S&P 500 total return is generated by earnings growth and dividends, while a paltry 4% is driven by valuation or speculation changes. As you can see, if this over 100-year trend continues we should have decent equity returns in 2024.

S&P 500 COMPOSITE TOTAL RETURN DECOMPOSITION BY DECADE
(FROM 1900 THROUGH 2021)



	1900 - 1910	1910 - 1920	1920 - 1930	1930 - 1940	1940 - 1950	1950 - 1960	1960 - 1970	1970 - 1980	1980 - 1990	1990 - 2000	2000 - 2010	2010 - 2020	Total Period*
Valuation Change	-1.4%	-3.8%	6.3%	-4.7%	-3.7%	9.2%	0.1%	-6.7%	5.4%	5.5%	-5.1%	8.9%	0.4%
Earnings Growth	4.2%	0.9%	1.9%	0.8%	10.0%	1.4%	4.5%	10.6%	3.6%	8.5%	4.4%	2.0%	5.0%
Dividend Contribution	4.4%	6.1%	5.1%	5.5%	5.7%	4.2%	3.1%	4.2%	4.0%	2.1%	1.9%	1.9%	4.0%
Total Return	7.2%	3.3%	13.4%	1.6%	12.0%	14.8%	7.7%	8.1%	13.0%	16.1%	1.2%	12.9%	9.4%

Data Sources: Federal Reserve Bank of Atlanta, FactSet, Bloomberg, GQG Partners

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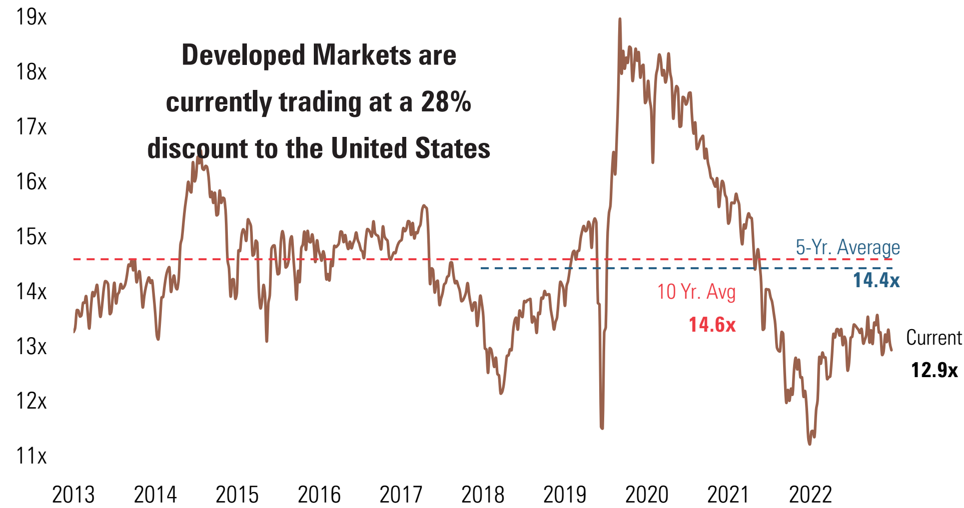
Developed Markets

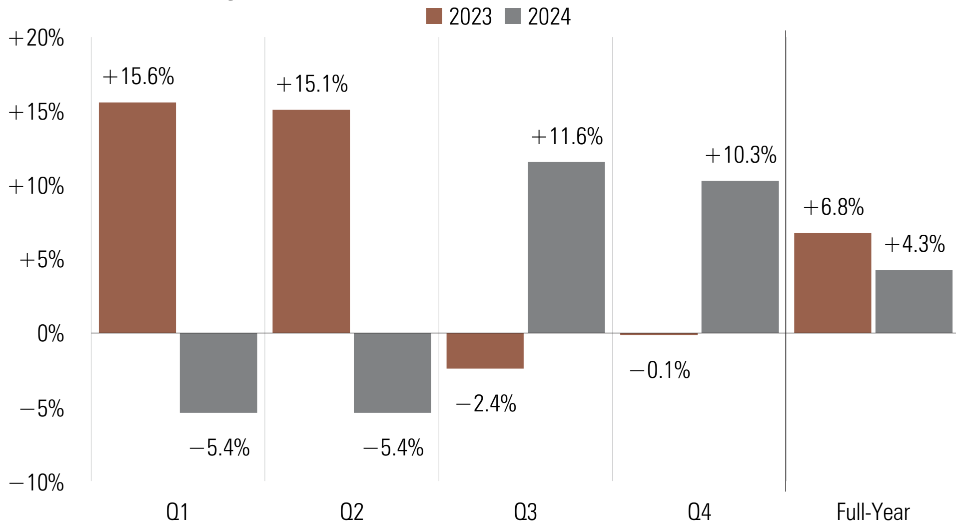
Things have not been as bad as feared at the outset of the year for developed markets equities as investors have reassessed the risks around Europe. Earnings have been resilient, and margins have remained relatively healthy.

Developed Markets stocks trade on a forward P/E of 12.9x, a significant discount to long-term averages and a 28% discount to the United States.

MSCI EAFE Forward Price-to-Earnings

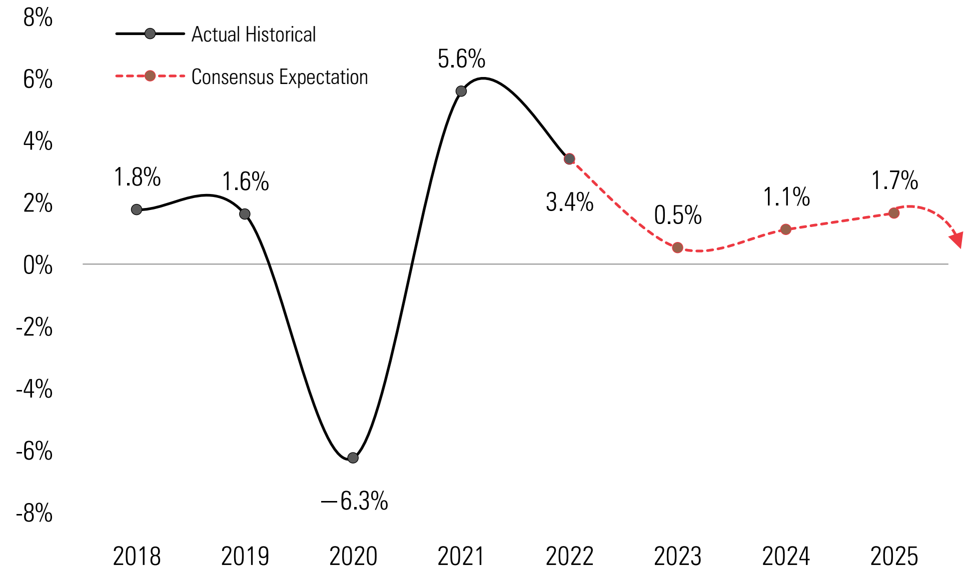


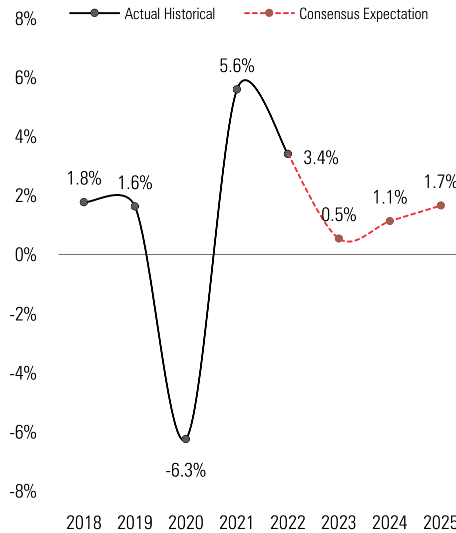
MSCI EAFE Earnings Growth 2023–2024

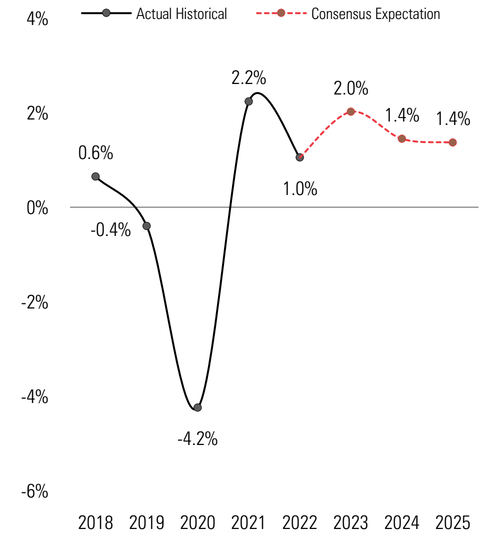


The developed market economies have been stagnating as Europe's manufacturing sector has been hit by monetary tightening and its exposure to China, where the re-opening boost was short-lived.

Developed Markets GDP Growth







Data Sources: Bloomberg

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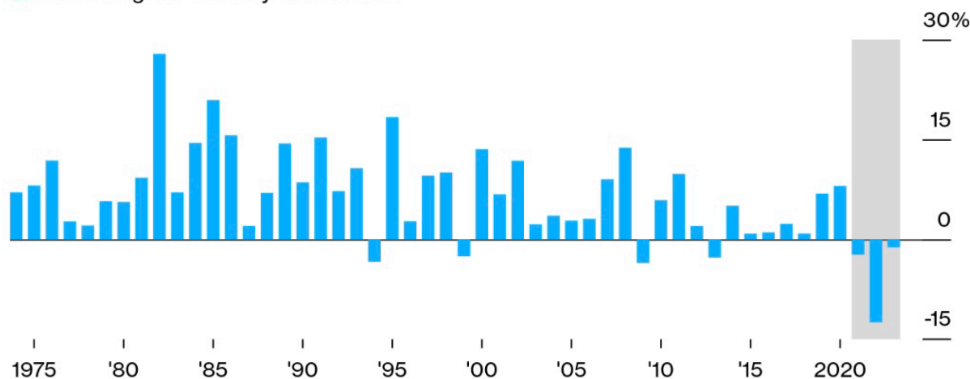
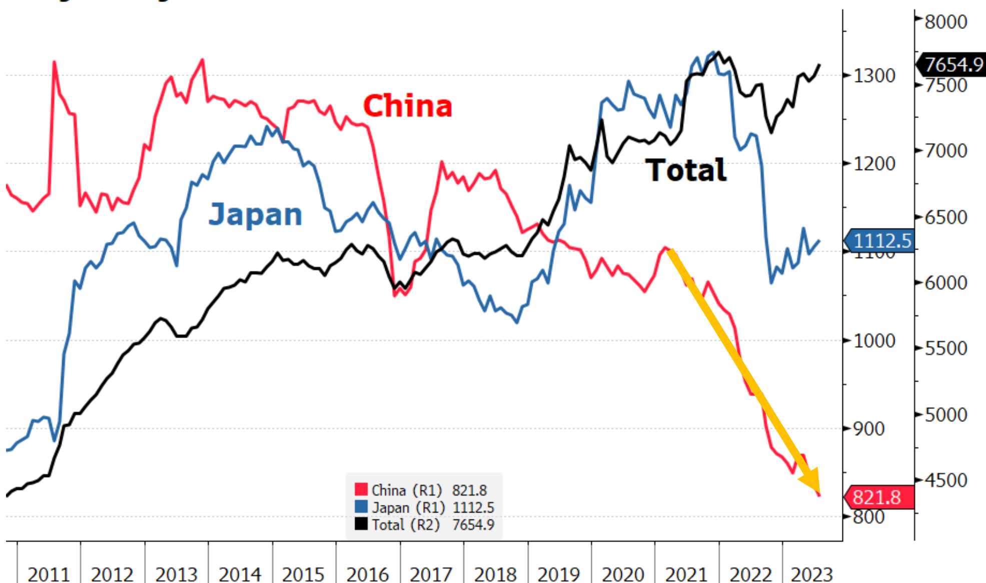
Fixed Income – Shifting Duration

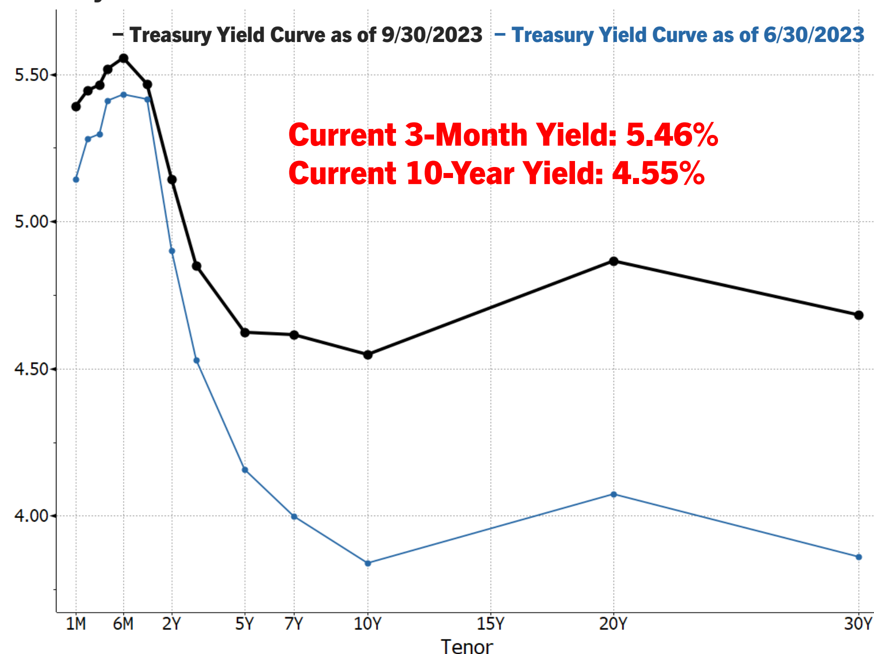
The pain for bond investors may not be over, even if the Fed stops raising rates, as sticky inflation and widening deficits may continue to drive losses.



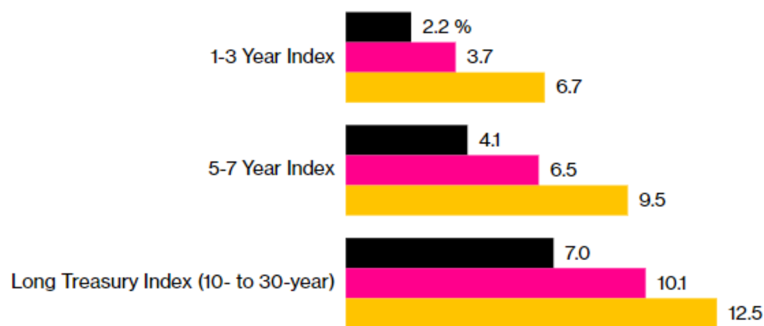
China continues to curtail its purchasing of our enormous fiscal debt, cutting its holdings of U.S. Treasuries to $822 billion – the lowest level since 2010.



While the yield curve remains deeply inverted, long-end Treasuries have reached new multiyear highs in September, with the 10-year yield 70 bps higher than at the end of the third quarter.



So, when should investors shift from short duration to benchmark duration? Historically, treasuries maturing in 5 to 7 years have consistently outperformed shorter-dated treasuries following the last rate increase, on average returning 9.5% over following 12 months.



Data Sources: Bloomberg, U.S. Department of the Treasury

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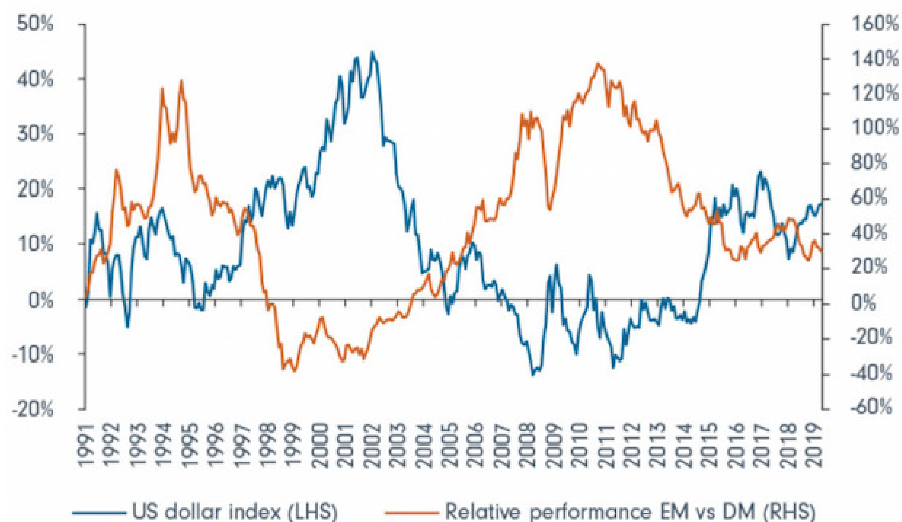
Emerging Markets – Waiting on a Weak Dollar

Historically, the direction of the U.S. dollar has been closely linked with the performance of emerging markets. When the U.S. dollar strengthens – as it is currently – emerging market economies typically feel pressure to raise interest rates to defend their currencies. This often proves to be a negative for equity market performance.



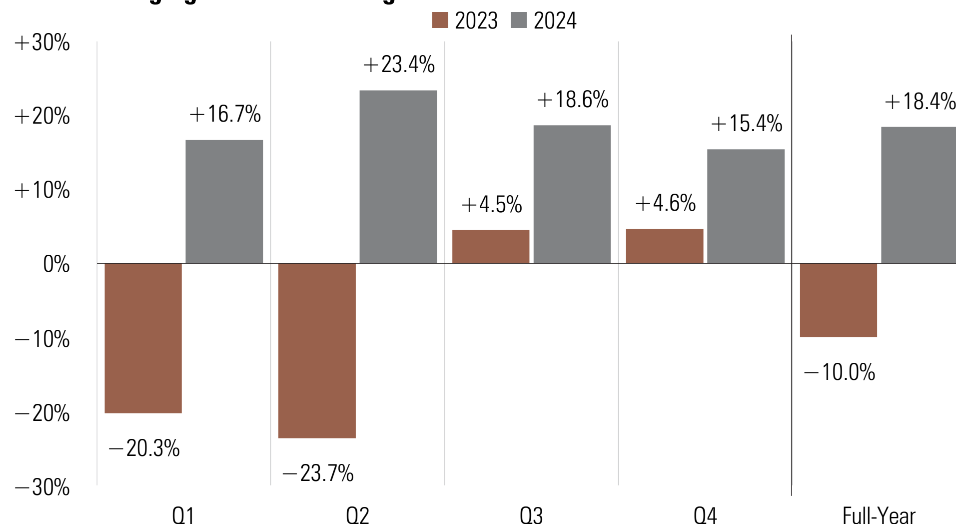
During prior rate cut cycles – apart from 2007-2008 – emerging markets equities perform quite well as the U.S. dollar weakens.

MSCI EM Index vs. U.S. Dollar During Rate Cut Cycles

Rate Cut Cycle Start	Rate Cut Cycle End	Return % MSCI EM Index	Return % U.S. Dollar Index
5/31/1989	2/3/1994	+201.21%	−6.57%
9/28/1998	6/29/1999	+58.32%	−0.21%
1/2/2001	6/29/2004	+39.93%	−5.64%
9/17/2007	12/15/2008	−47.22%	+5.16%
7/31/2019	3/17/2022	+14.91%	−1.34%
Average %		**+53.43%**	**−1.72%**
Median %		**+39.93%**	**−1.34%**

Emerging market equities are facing similar hurdles to developed markets counterparts, including average growth and similar drivers regarding the U.S. dollar and the global rates outlook. However, EM and U.S. earnings growth look to be strongest in 2024 compared to developed markets.

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

Data Sources: Fidelity, Bloomberg

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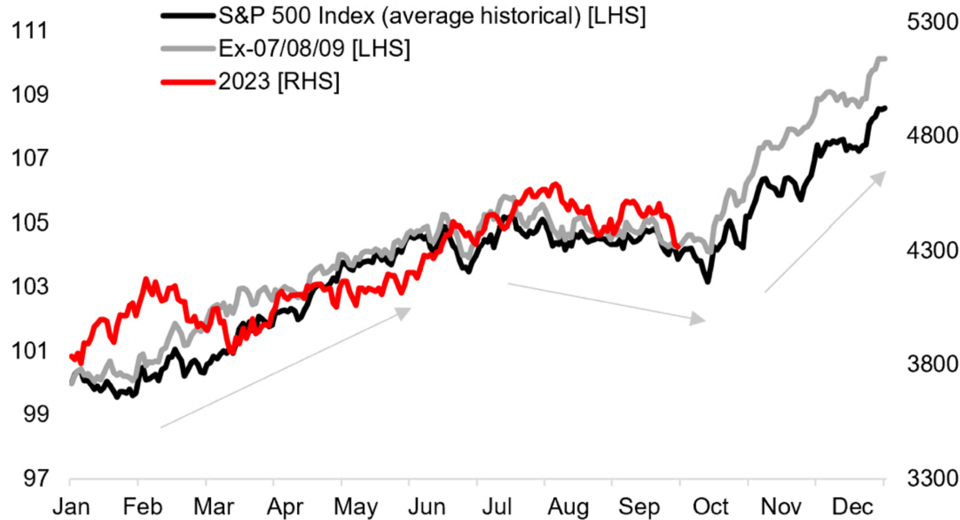
Historical Patterns Are Positive

We are entering a very strong seasonal period for the S&P 500, with the historical patterns suggesting a stronger finish to the year as we emerge from the earnings growth slumber.



A pause in hiking rates is also generally a catalyst for better equity returns one year later, with the S&P 500 returning 8.75% on average over the past three pauses in an FOMC tightening cycle.

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
	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

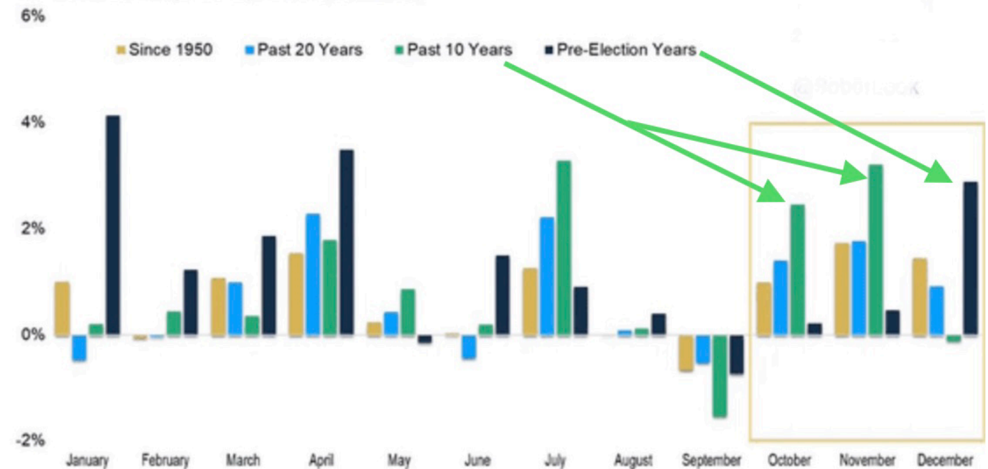
Pause = First time FOMC leaves rates unchanged after at least three straight hikes

When the Fed cuts and cuts quickly, it's usually generated from large drops in inflation. That's probably why equity markets perform handsomely, with the S&P 500 returning 15% on average one year after a large drop inflation.

Performance After Large Drops in Inflation

	CPI (Y/Y, % Chg)			S&P 500 Performance		
Date	Level	12-Month Peak	Decline	Three Months	Six Months	One Year
3/31/48	6.8	19.7	-12.9	11.0	2.7	-0.1
7/31/49	-2.9	9.9	-12.8	6.6	13.4	18.6
5/31/52	1.9	9.3	-7.4	4.9	7.5	2.8
12/31/75	6.9	12.3	-5.4	13.9	15.6	19.1
9/30/82	5.0	11.0	-6.0	16.5	27.4	37.9
7/31/09	-2.1	5.6	-7.7	4.9	8.7	11.6
6/30/23	3.0	9.1	-6.1			
			Average	**9.7**	**12.6**	**15.0**
			Median	**8.8**	**11.1**	**15.1**

The fourth quarter – especially in a pre-election year – is historically the best quarter of the year, with the S&P 500 up nearly 80% of the time and up more than 4% on average (twice as much as the next best quarter)



Our Views & Recommendations

Our View

- Expect the Fed to raise rates one more time in this cycle. The Fed may be overestimating the rate glide path back to 2.5% as history suggests the Fed usually cuts rates quickly on the way down. We expect the Fed to adopt a higher neutral rate of 4% not withstanding any economic crisis.
- The U.S. consumer is showing early signs of distress. The degree of distress will determine the future interest rate trajectory. We expect a contained amount of strain as higher wages continue to present needed consumption firepower.
- Both developed and emerging markets will benefit from a pause in U.S. interest rates. A pause – and ultimately lower rates – will help reduce inflation in foreign markets, weaken the U.S. dollar, and reduce interest costs for dollar-denominated foreign debt.

Recommendations

- Reaffirm your investment strategy and maintain strategic liquidity to cover spending needs and provide opportunities for cost averaging.
- Rebalance back to target weightings to take advantage of recent pullbacks in U.S. equities as well as emerging and developed markets drawdowns. Rebalancing in small cap should be a high priority as small cap should benefit from a pause in the current interest rate cycle.
- Maintain an overweight to Emerging Markets to take advantage of 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 Higher Interest Rates ➞ Higher-than-expected terminal Fed Funds rate	Cash alternatives and benchmark duration fixed income
Globalization & Importing Deflation ➞ Deglobalization & Higher Costs 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	100.5%	112.2%	127.4%
Mid	89.7%	92.8%	114.0%
Small	98.1%	97.8%	88.0%

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

Regions

World	Developed Markets	Emerging Markets	Frontier Markets
108.4%	94.5%	100.0%	81.7%

Countries

United States	Germany	United Kingdom	China	Brazil	India
114.1%	84.1%	86.1%	83.6%	69.9%	123.5%

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
44.0%	109.0%	102.9%	114.1%	105.3%	113.2%	105.7%	136.1%	106.5%	100.3%	76.4%

Data Source: Bloomberg

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