

INVESTMENT STRATEGY OUTLOOK



THE ECONOMY

Well, That Didn't Last Long, Did It?

November 2023

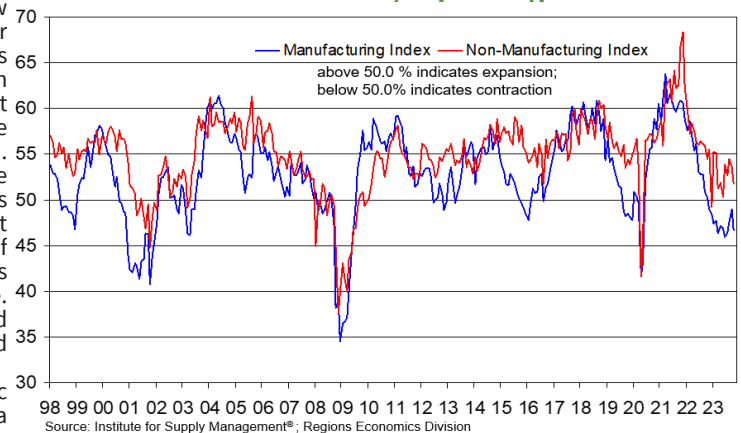
On October 26, the Bureau of Economic Analysis (BEA) released their initial estimate of Q3 GDP, which showed real GDP grew at an annual rate of 4.9 percent during the quarter, with consumer spending, government spending, and a faster pace of nonfarm business inventory accumulation the main drivers of growth. The initial print on Q3 real GDP growth fell right in line with what had been a firmer tone, at least on the surface, of much of the economic data. As we saw it, there were two alternative views of how to interpret the robust Q3 growth. One interpretation was that the economy was largely immune to the effects of higher interest rates, and what many for some time saw as an inevitable recession was off the table. The alternative take was that the burst of growth seen in Q3 was unsustainable, largely a function of one-off supports that would quickly fade and that, while perhaps less probable, recession was still a possibility in the not-too-distant future. We lean more toward the latter than the former interpretation, and we've been clear in our view that the pace of economic activity would slow sharply over the final quarter of 2023.

While it is far too soon, at least in terms of the flow of Q4 economic data, to draw any meaningful conclusions, the initial batch of data suggest Q4 growth got off to a very slow start. After the Institute for Supply Management's (ISM) September survey offered glimmers of hope that conditions in the factory sector were at least beginning to stabilize, the October survey was more of a cold slap in the face. The ISM Manufacturing Index fell to 46.7 percent in October from 49.0 percent in September, indicating a twelfth straight month of contraction. The details beneath the headline index were even more bleak. For instance, the index of new orders, an important forward-looking indicator, tumbled to 45.5 percent in October after having flirted with the 50.0 percent cut-off point between contraction and growth in September, with only three of eighteen industry groups reporting growth in new orders. At the same time, October was the thirteenth straight month in which backlogs of unfilled orders contracted, which is important in that contracting new orders and thinning order backlogs set up a weak profile for production and employment. To that point, while the ISM's gauge indicated factory sector employment fell in October, we found it much more telling that ISM reported that firms were more aggressively using layoffs to manage head counts, "indicating a more urgent need to reduce staffing." All in all, there are few signs that stability, let alone growth, is readily within reach in the manufacturing sector.

While the ISM Non-Manufacturing Index indicates the expansion in the broad services sector continued in October, it also shows the pace of that expansion slowed meaningfully, with the headline index falling to a five-month low of 51.8 percent. One striking detail of the October data was that export orders abruptly contracted after having grown steadily over the prior several months. This suggests that tepid global growth is finally starting to take a toll on activity in the broader services sector after having for months been a drag on activity in the U.S. manufacturing sector.

The Bureau of Labor Statistics (BLS) reported that nonfarm payrolls rose by 150,000 jobs in October, with private sector payrolls up by just 99,000 jobs and public sector payrolls rising by 51,000 jobs. At the same time, prior estimates of job growth in August and September were revised down by a net 101,000 jobs for the two-month period. The bulk of that downward revision came from private sector payrolls, continuing a string of downward revisions to the initial estimates of private sector job growth. One important caveat is that the UAW strike deducted roughly 34,000 jobs from manufacturing payrolls in October, as striking workers are not counted as employed under the BLS's reporting conventions. With the strike having been settled, pending ratification of the proposed contracts, those jobs will be added back in the November data.

ISM Index
diffusion index, net percentage



98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 23
Source: Institute for Supply Management®; Regions Economics Division

Even allowing for the impact of the UAW strike, the details of the October employment report were glaringly weak. The one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups, fell to 52.0 percent, the lowest reading since April 2020, and furthering a trend that has seen job growth become meaningfully less broad based across industry groups. To that point, hiring in health care accounted for almost all private sector job growth in October. The average length of the workweek declined by one-tenth of an hour in October. While a decline in hours worked in durable goods manufacturing was to have been expected given the impacts of the UAW strike, several other industry groups reported declines in average weekly hours. Hours worked have been drifting lower over the past several months, consistent with slowing, not accelerating, economic growth. The unemployment rate rose to 3.9 percent in October, and there were more people involuntarily working part-time due to slack business conditions.

As we noted above, with only a few data points for October to go on, it is far too soon to draw any meaningful conclusions regarding Q4 growth. That said, the few data points we do have at our disposal suggest a marked slowdown after the blistering pace of growth seen in Q3. And, while we may not be willing to draw conclusions at this point, market participants are showing no such reservations. Within a matter of a few days, much of the recent run-up in longer-term interest rates (which we discussed last month) was reversed and, after seemingly having finally accepted the FOMC's "higher for longer" premise, market participants are now expecting a more aggressive course of Fed funds rate cuts in 2024 than had been the case just a few weeks ago.

The FOMC will be taking notice not only of the recent declines in longer-term interest rates but also of the recent easing in overall financial conditions. Some Committee members had implied that tighter financial conditions may effectively substitute for additional funds rate hikes, so it would follow that a meaningful easing in financial conditions puts further rate hikes back on the table. While we still see further rate hikes as unlikely, at the very least easing financial conditions would seem to push rate cuts further out into the future as long as inflation remains well above the FOMC's target rate. With the economic data all over the map and the markets and the FOMC not on the same page, about the only thing we can confidently predict at this point is that equity prices and market interest rates will remain volatile in the weeks ahead. ▲

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management

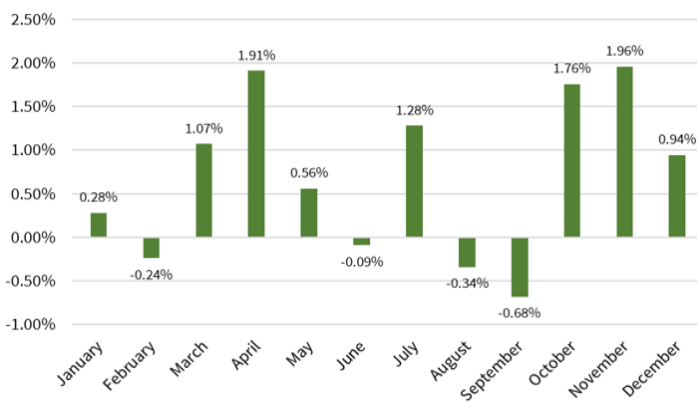
STOCKS

Seasonals, Lower Rates Spur Optimism

- The November through January time frame has historically been the best three-month stretch for the S&P 500, and the stars appear to be aligning for gains this time around as well.
- Investor sentiment has been decidedly bearish since August, but interest rates stabilizing, and a more positive seasonal backdrop could boost sentiment and risk appetite into year-end.
- The decline in Treasury yields so far in November will likely draw buyers back into mega-cap growth leaders as portfolio managers chase performance into year-end, but some year-to-date laggards could participate as tax loss harvesting ends.
- We expect market leadership to remain narrow or concentrated into year-end, with growth outpacing value, the U.S. faring better than the rest of the world, and large-caps (S&P 500) performing better than small-caps (Russell 2000).

Entering A Historically Strong Seasonal Stretch For Stocks. Over the prior 30 years, the November through January time frame has historically been a profitable stretch in the calendar for investors in the S&P 500. The stars appear to be aligning again for a positive finish to 2023 as the sharp drop in Treasury yields at the start of November could provide a boost for investor sentiment after a challenging August through October period which saw the S&P 500 lose 8.3% and the small-cap Russell 2000 decline by 16.8%. Stocks, broadly speaking, entered November in oversold territory and bearish sentiment, evidenced by the latest American Association of Individual Investors (AAII) survey, was at a level of pessimism not seen since last December, a dynamic that has fueled a rebound as yields fell sharply to start November. Interest rates stabilizing would be a tailwind for stocks and riskier bonds, broadly speaking, but mega-cap growth, specifically the 'Magnificent 7,' would likely benefit the most as portfolio managers will be quick to add to positions in this year's winners. Falling Treasury yields would also benefit consumer-oriented stocks in the discretionary and staples sectors, along with bond proxies such as real estate and utilities, but mega-cap information technology and communication services stocks that have led year-to-date will likely remain at the top of 'buy lists' into year-end.

S&P 500 30-Year (Average Return by Month)



Small-Caps Aren't Out Of The Woods Yet, But Could Fare Better In '24. Small-cap stocks have borne the brunt of the rise in Treasury yields, as the Russell 2000 index fell 8.1% from September 20 through the end

BONDS

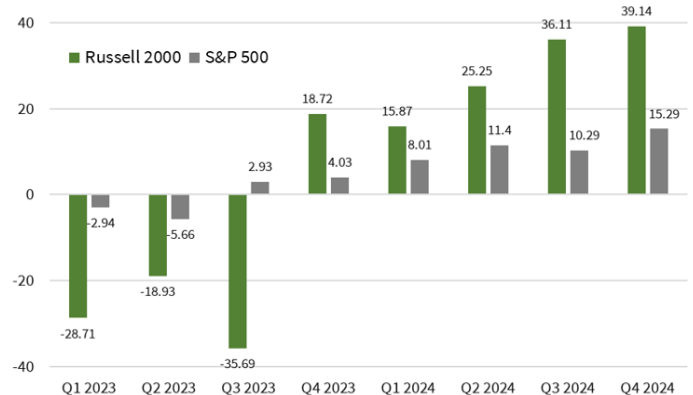
Cash Considerations

- Cash and short-term bonds understandably hold greater appeal with yields above 5%, but there are tradeoffs that must be understood as cash can be far from a risk-free investment when viewed through a total return lens by investors with longer time horizons.
- Corporate bonds have held up quite well considering the back-up in Treasury yields over the past month and a half as credit spreads have remained in check and current yields are well below average versus comparable Treasuries, indicative of solid demand.

of October. So, if rising Treasury yields/interest rates are a headwind for small caps then falling yields/rates should be a tailwind, right? The short answer is yes, but it's not so clear cut. If yields are falling due to economic growth expectations moving lower, then that headwind would offset some of the benefit received by smaller companies from lower rates/funding costs. The fall in Treasury yields so far in November has been due, at least in part, to weaker manufacturing data and a cooler nonfarm payrolls report from October, with both pointing toward slowing economic growth into year-end.

This is a headwind for the Russell 2000 which skews toward economically sensitive sectors. It's also notable that while Treasury yields have moved sharply lower to start of the month, the 10-year yield, specifically, is now back to where it was in late-September and yields across the curve remain elevated relative to recent history. With many companies expected to tap the capital markets in 2024 or 2025 as existing debt matures, borrowing costs and interest expense will rise, but to what degree remains to be seen. Small cap valuations are cheap but justifiably so as headwinds from higher rates have yet to be realized, but we can't ignore the forecasted increase in net income for the Russell 2000 over coming quarters, which could make small-caps worthy of consideration for more capital at some point in 2024.

Small Cap Profits Expected to Rebound in A Big Way Starting in 4Q23, A Potential Tailwind in 2024

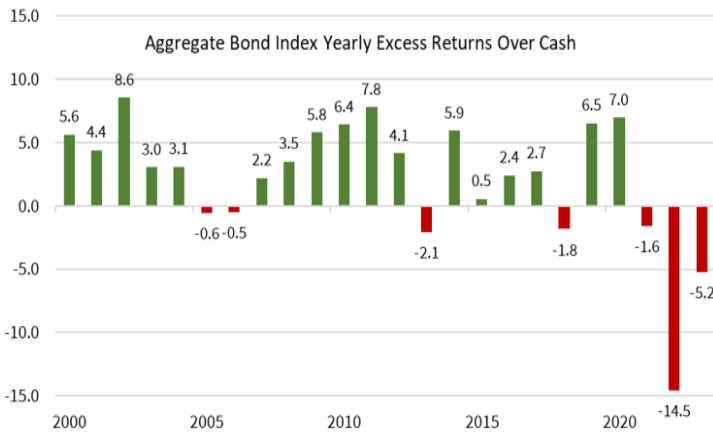


A Mixed Outlook For Foreign Markets Into Year-End. Japan's economic momentum remains impressive and leaves us relatively constructive on Japanese stocks into year-end. However, should the Japanese yen strengthen materially as the Bank of Japan (BoJ) alters yield curve control and yields on Japanese Government Bonds (JGBs) rise, economic growth projections for next year may need to be ratcheted lower. The Eurozone and U.K. are likely to remain challenged from an economic perspective for quarters to come, but over the near-term much may hinge on the weather. A colder winter could lead to a spike in energy/electricity prices which would put significant upward pressure on inflation and may force the European Central Bank (ECB) to further tighten monetary policy, tamping down economic growth. Valuations and dividend yields are appealing, but we don't expect euro area or U.K. equities to outperform into year-end. China is well worth watching into year-end as one of year's lagging areas could benefit as tax loss selling abates and portfolio managers look to load up on higher beta exposures to participate in a Santa Claus rally. As China goes, likely so go emerging markets, but the U.S. dollar weakening to start November is a most welcome tailwind for developing economies and, with South Korea banning the short selling of stocks until June of 2024, a bounce into year-end may be in the cards. ▲

Cash Vs. Bonds: Beware The Sirens’ Song Of Short-Term Rates.

Elevated yields on cash and ultra short-term bonds have lured investors to the front of the Treasury curve in 2023, and the call to ‘get short’ has grown louder in recent months as Treasury yields have risen sharply, leading to paper losses on longer duration bonds. The rise in long-term Treasury yields has led some investors to discard their strategic allocations to bonds in favor of cash, but that decision has tradeoffs that must be considered. Yields on longer-term bonds are a far more prescriptive measure upon which to base future return expectations than are yields on shorter-term bonds, which often prove fleeting as interest rates change. Thus, it’s more likely that an investor in the Bloomberg Aggregate Bond index will experience a total return at least in-line with the index’s current 5.3% yield over the next 7-10 years than it is that a holder of cash will experience a comparable rate of return, despite similar starting points for yields.

Cash Typically Only Outperforms Bonds When The FOMC Is Tightening Monetary Policy



A vital consideration when holding cash is that investors are rarely compensated with a yield above inflation for holding risk free assets, and while the current backdrop may seem like a ‘free lunch,’ it isn’t likely to play out that way over coming quarters. As has been the case in past cycles when short-term yields were elevated, the Fed ultimately cuts when the economy weakens and/or inflationary pressures subside, and the market usually moves to price in that sequence of events early-on, which is why peaks in long-term yields often occur

prior to the first rate cut. If an investor waits for the first rate cut as a signal to buy longer-term bonds, they will almost certainly show up late to the party and likely miss out on a sizable gain as investors with deep pockets and long duration liabilities clamor to lock in higher rates before policy rates are cut and yields fall. The decision to hold cash in lieu of bonds in one’s investment portfolio is not to be taken lightly, even with cash yields over 5% at present, as investors must be willing to take on reinvestment risk with a potentially sizable opportunity cost to boot. An outsized cash position might make sense given an individual investor’s specific circumstances, spending needs, etc., but the pros and cons must be weighed and measured before going that route.

Carrying a portfolio duration that is ‘too long’ versus one’s benchmark is preferable to being ‘too short’ as yields on long-term bonds will likely track short-term rates lower over the next year, but with longer duration bonds the total return benefit from such a move would be far more impressive. However, we don’t view duration management as a sustainable source of generating excess returns from fixed income and very few active managers have proven to be consistently good at timing interest rate inflection points. This is why we recommend a portfolio duration profile in-line with that of the Bloomberg Aggregate Bond index, relying instead on sector and security selection to drive excess return. e economy weakens. Current IG yields are interesting as they reach new highs for this cycle, but patience is warranted over the near-term given that longer durations

The Case For High Grade Corporates Grows Stronger As Treasury Issuance Rises. If the Bloomberg Corporate index’s yield to-worst (YTW) relative to Treasuries, which is currently well below its historical average despite elevated economic and geopolitical risks, is any indication, investor’s view investment-grade (IG) corporate bonds as better stewards of capital and more worthy of investment than U.S. government securities of similar duration. Capital tends to flow to where it is treated best, and the yield relationship between investment-grade (IG) corporates and U.S. Treasuries is telling in that regard.

Corporations took advantage of ultra-low interest rates in recent years to term-out debt, and as a result have the capital on hand and flexibility to wait for more enthusiastic and receptive markets before refinancing or issuing new debt. The U.S. Treasury, however, does not have this luxury. Also, the interests of Chief Financial Officers are closely aligned with shareholders as the maximization of profits is a function of optimizing a company’s capital structure. In sharp contrast, the U.S. Treasury is tasked with issuing debt to fund Congress’ spending plans and doesn’t take the wishes of taxpayers into consideration. All told, while we understand why investors might gravitate toward IG corporates relative to Treasuries in the current environment, there remains a place for both in a diversified fixed income portfolio as Treasuries would likely benefit relative to corporate bonds should the economic backdrop deteriorate and investors dust off the recession playbook.▲

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