INVESTMENT STRATEGY OUTLOOK

REGIONS ASSET MANAGEMENT

THE ECONOMY

September 2023

Your Guess Is As Good as Ours...

The U.S. economy is: a) shifting into a faster rate of growth; b) gently easing into a soft landing; or c) on the road to recession. You pick, and whichever scenario you believe, or want, to be the case, we've got the data to prove it. The only problem, of course, is that no data point ever actually proves anything, even when the reliability of the economic data is not in question. At present, not only are the economic data are all over the map, but we find ourselves with more questions about the reliability of the data than we can recall ever having.

The second estimate from the Bureau of Economic Analysis (BEA) puts Q2 real GDP growth at 2.1 percent, down from the initial estimate of 2.4 percent due to downward revisions to inventory accumulation and business investment, but nonetheless marking a fourth straight quarter of above-trend growth. That streak will last for at least one more quarter, as a surprisingly strong July puts a high floor under Q3 growth in real consumer spending, which in turn could push Q3 real GDP growth above three percent. We do, however, expect growth in real consumer spending to slow sharply by the end of Q3, setting up a virtually flat trajectory for Q4 spending and, in turn, Q4 real GDP. We will note that on September 28 the BEA will release the initial results of the comprehensive revisions to data on GDP, personal income, and corporate profits, among other series. How the economy looks, or how we think it looks, could thus be different at the end of the month than it is today.

Along with the revised Q2 GDP data, the BEA also released their first estimate of Q2 corporate profits, much broader than the S&P 500 measure of profits. Before-tax profits fell by 0.4 percent in Q2 while after-tax profits rose by 1.6 percent, yielding over-the-year declines of 6.5 percent and 6.2 percent, respectively. While many heralded the sequential increase in after-tax profits as proof of an improving earnings outlook, we pointed to a quirk in the data over recent years in which corporate tax payments are reported to decline significantly in the second quarter, thus flattering after-tax profits. Whether this quirk will remain in the revised data remains to be seen but, either way, we expect further pressure on corporate profit margins in the quarters ahead with further deceleration in revenue growth and little relief on the cost front unless firms begin making cuts in total labor expenses and/or capital spending.

Total nonfarm employment rose by 187,000 jobs in August, with job growth more broadly based across the private sector, an uptick in average weekly hours, and moderation in the pace of wage growth. At the same time, the unemployment rate rose to 3.8 percent from 3.5 percent in July due to a spike in labor force participation. Moreover, the most recent data from the Job Openings and Labor Turnover Survey (JOLTS) show a significant decline in the number of open jobs. Taken as a whole, the labor market data suggest an economy easing into a soft landing, and many pointed to slowing wage growth and the higher unemployment rate as taking further Fed funds rate hikes off the table. That narrative survives if one goes no further than the headline numbers, but the deeper one goes into the details of the data, the more suspect each of these observations becomes.

August job growth would have been even faster were it not for three factors: 1) the SAG-AFTRA strike took almost 17,000 jobs off payrolls in information services (striking workers are not counted as employed in the establishment survey data); 2) Yellow Inc.'s bankruptcy resulted in the loss of roughly 30,000 jobs in the truck transportation industry group; and 3) seasonal adjustment noise resulted in the seasonally adjusted data showing a decline in employment amongst education workers in state and local governments at a time the school year was starting up. In that sense, it may seem that measured August job growth is significantly understated.

Here's where things get messy, well, more messy. First, prior estimates of job growth in June and July were revised down by a net 110,000 jobs for the two-month period, a notably large revision. With the initial estimate of July job growth having been revised down, that means that in each of the first seven months of this year the initial estimate of job growth has subsequently been revised lower. Second, the response rate to the August establishment survey was only 59.3 percent, the second lowest response rate since the onset of the pandemic. This means that the initial estimates of August employment, hours, and earnings are all suspect and subject to revision, perhaps sizable, over coming months.

As to the unemployment rate rising for the "right" reason, i.e., higher labor force participation, higher participation amongst the 16-to-24 year-old age cohort accounted for nearly one-half of the total increase in the labor force in August. This is nothing more than seasonal adjustment noise, as the not seasonally adjusted data show the number of people in this age cohort in the labor force declined by 863,000 in August. This seasonal adjustment noise added two-tenths of a point to the unemployment rate, casting doubt on just how much labor market conditions eased in August.

The substantial decline in job openings shown in the July JOLTS data is even more suspicious. The response rate to the survey used to produce the JOLTS data has hovered around thirty percent for most of the post-pandemic period. This, along with a very small sample size, contributes to a notably high degree of month-to-month volatility and makes the initial estimates of the metrics in the JOLTS data prone to sizable revision. To that point, the initial estimate of job openings in June was, a month later, revised down by over 400,000, a ridiculously large revision from a base of roughly 9.5 million openings. We do have more confidence in the trends shown in the JOLTS data, including job openings trending lower and the quits rate falling back in line with pre-pandemic norms, both of which suggest a cooling labor market.

While FOMC members may conclude that, beneath all the noise in the data, the labor market has cooled enough to warrant holding the Fed funds rate steady at this month's meeting, the August inflation data, out a week before the meeting, will make the discussion a bit more uncomfortable. With a spike in retail gasoline prices and higher food prices, August headline inflation will likely approach 4.0 percent, significantly faster than in the prior two months. So, while a funds rate hike may not be in the offing at this month's meeting, the Committee could use their updated economic and financial projections, including an updated "dot plot," to send a hawkish message that would rattle the markets.

In addition to noisy and often contradictory data, there are two potential wild cards that could make it even more difficult to get an accurate read on where the economy is, let alone where it is going. First, a potential strike by the United Auto Workers, whose current contracts expire September 14, could shut down production amongst the "Big 3" at a time when production and inventories are finally normalizing after being badly impaired by supply chain snarls. Second, it is possible, if not likely, that October 1 will bring at least a partial shutdown of the federal government due to Congress remaining at an impasse on funding the government. All of which adds up to continued volatility in the financial markets. ▲

Sources: Bureau of EconomicAnalysis; Bureau of Labor Statistics

STOCKS

A Cooling Labor Market Viewed As Good News, For Now

August lived up to its billing as a challenging month for equity investors as the S&P 500 fell 2% and the MSCI ACWI ex. U.S. index lost 4%, but upward price momentum did return at month-end and pushed the S&P 500 back above its 50-day moving average, an important technical level. As a result of this surge, optimism is building that September may be more kind to equity investors than it has historically been. While that ultimately may be the case, the weak seasonal backdrop still presents a hurdle for equities to gain ground during the month. With few identifiable catalysts to push stocks higher leading up to the FOMC's September 19-20 meeting, stocks will likely take their cue from U.S. Treasury yields and the U.S. dollar. Stocks responded positively to falling Treasury yields in late August – more on that below, but the U.S. dollar could be a bigger driver of equity prices in September and a breakout to the upside for the U.S. Dollar Index, or DXY, could be viewed as a 'risk off' signal and sign investor sentiment is waning.

At the end of August and into September, both the July Job Openings and Labor Turnover Survey (JOLTS) and the closely watched August nonfarm payrolls report pointed toward the labor market cooling. Stocks rallied alongside prices of U.S. Treasuries as market participants interpreted a slowing labor market to imply that the FOMC was done raising rates. But, in our view, the labor market isn't cooling as quickly as the August data might indicate, and as a result, the FOMC may not be done just yet, calling into question the 'soft landing' narrative recently making the rounds and the month-end rally in domestic equities. In short, we believe equity investors are either misinterpreting, or perhaps ignoring, what a faltering labor market could mean for corporate profits and, in turn, equity prices. Higher Treasury yields increase competition for capital between stocks and bonds, so it stands to reason that as yields fall, stocks are more attractive on a relative basis, but, of late, market participants appear eager to buy stocks whenever Treasury yields decline, without care or concern for why yields might be falling.

At some point, bad news on the jobs front that forces Treasury yields lower won't be viewed as good news for stocks and those buying into the economic 'soft landing' narrative will be forced to revisit and question their position should consumer and investor confidence take a hit. A neutral stance between stocks and bonds, as well as across equity sub-asset classes, remains warranted entering September as we await and expect volatility to create dislocations, presenting opportunities to reallocate capital.

Challenging Times Ahead For The U.K., Euro Area, But Still Reasons To Remain Exposed To Developed Market Stocks Abroad. Shop price inflation in the U.K. rose 6.9% year over year in August, a sizable drop from an 8.4% year over year reading in July, and the lowest year over year rise since October of 2022. Most encouraging was the moderation in food cost pressures in August, which spurred a month-end rally in U.K. equities as market participants anticipated a less hawkish tone out of the Bank of England (BoE). However, with winter months approaching, the prospect of higher energy and electricity prices, along with a potential reacceleration of food price inflation, are risks that will likely prevent a near-term policy shift out of the Bank of England (BoE). Tough sledding likely lies ahead for the Eurozone and U.K., but it's easier to identify potential upside catalysts for Eurozone economic growth than it is for the U.K.

China's economic recovery has been lackluster, detracting from Eurozone economic growth projections, but China may be poised to take more aggressive measures to improve consumer confidence and spur consumption, likely boosting demand for euro area exports, and profits. Should the European Central Bank (ECB) stand pat on rates in September, despite the Eurozone CPI rising 5.3% year-over-year in August on higher food and energy prices, market participants could read that as a sign that the ECB is focused more on core inflation, which has been more stable, or that the bar to chin for future rate hikes is much higher. Expectations for Eurozone economic growth have been revised downward in recent months, but if the ECB leans dovish, Eurozone growth estimates could stabilize, stemming the tide of capital flowing out of Eurozone stocks. On the topic of Japan, the country's economic momentum has been a pleasantly positive surprise so far this year, as yields on Japanese Government Bonds appear to have stabilized after the Bank of Japan's (BoJ) recent policy tweak, and valuations remain reasonable. These are all reasons to remain exposed to Japanese stocks, which we expect to buoy the ACWI ex. U.S. index and reward diversified investors. ▲

BONDS

Range-Bound Rates Likely As Crosscurrents Remain

U.S. Treasury yields ended August little changed, but interest rate volatility was again elevated during the month, a backdrop that contributed to a general sense of unease on the part of fixed income investors. The 2-year Treasury yield ended the month down 3 basis points at 4.85%, but the 2-year yield traded up to 5.05%, a level last seen in June of 2007, late in the month before buyers stepped in amid signs of a cooling labor market. The 10-year yield rose 12 basis points on the month to close at 4.09%, masking intra-month volatility as the 10-year yield closed at 4.34% mid-month, re-testing its intra-day highs from October 2022. Treasury yields could remain range-bound into the FOMC's September 19-20 meeting, with the 2-year yield likely stuck in the 4.75% to 5.05% zone and the 10-year yield mired in a new trading range between 4.05% and 4.35% until further notice.

With the FOMC expected to 'skip' a rate hike in September on the heels of the August employment report, yields could move back toward the top-end of recent trading ranges as investors require higher yields to compensate for the prospect of inflation reaccelerating into year-end due to higher energy prices. Increased Treasury issuance could also put additional upward pressure on Treasury yields, particularly with a 'buyers strike' taking place abroad. Both the Bank of Japan and People's Bank of China have been selling Treasury holdings to support domestic interests, and each may remain an active seller of U.S. Treasuries over coming months. A duration profile in-line with that of the Bloomberg Aggregate Bond index (Agg) remains preferred as the near-term risk is skewed to the upside for yields, in our view, and with a 5% yield-to-worst on the Agg, investors are paid to wait for clarity on the path forward for the U.S. economy and interest rates.

Emerging Market Debt Valuations Appealing On An Absolute And Relative Basis. Emerging market debt (EMD) sold off in August as borrowing costs rose across the globe, leading to more appealing valuations after the asset class had become more richly valued on the heels of a strong three-month rally. While EMD is hardly 'on-sale' or a screaming buy after one month of modest credit spread widening, when weighing the opportunity cost of EMD against other yield-focused fixed income segments, specifically high yield bonds, the trade-off is more appealing than it has been in some time. Over the trailing 20 years, high yield has historically traded 160 basis points 'cheap' relative to EMD, but at month-end that spread was closer to 50 basis points, implying that high yield is expensive relative to its own history as well as relative to EMD. Valuations alone shouldn't drive significant portfolio changes as both High Yield and EMD present investors with a unique set of risks that must be considered, rather, it indicates that new marginal investment dollars could fare relatively well in developing markets abroad.

High Yield Trading Around 'Fair Value,' But The 'Rich' Could Get 'Richer.' High yield bonds weren't immune to volatility in August, but it's hard to tell with the credit spread on the Bloomberg High Yield index ending the month just one basis point wider. The 7% return of the Bloomberg High Yield index year-to-date through August has been impressive, but with high yield valuations now 'fair' as opposed to 'cheap' at the start of this year, market participants have been locking in profits and reducing exposure to riskier bonds in advance of a potential credit event or economic stresses caused by higher interest rates. Year-to-date outflows from high yield ETFs of nearly $9B are indicative of this de-risking trend, but despite ETF outflows, credit spreads have remained tight and have exhibited few, if any, signs of stress. While fairly valued at present, high yield bonds could get 'richer' relative to Treasuries as the credit spread on the index is more than 100 basis points above the 5-year low seen back in 2021. ▲

ALTERNATIVES

Sell High, Buy Low Opportunities

Investors received good news on another high-profile M&A transaction in August, as Amgen (AMGN) appeared to move closer to closing on its acquisition of Horizon Therapeutics (HZNP), which contributed in a big way to the HFRX Merger Arbitrage index's 1.3% gain during the month. Our conviction in the merger arb space has waned in recent months due primarily to the challenging antitrust/regulatory backdrop, which has led to a lack of deal flow and attractive investment opportunities. Microsoft's acquisition of Activision Blizzard received approval to close in late July and is now awaiting regulatory approval from the U.K. before being completed, and now with Amgen's acquisition of Horizon Therapeutics receiving FTC approval this month, deal spreads have narrowed materially, and returns have been pulled forward. After a 1.3% monthly gain out of the merger arbitrage category in August, barring an unexpected uptick in merger and acquisition (M&A) deal flow into year-end, investors are likely being presented with an opportunity to sell high.

In contrast to our waning conviction in merger arbitrage, we remain constructive on the outlook for convertible arbitrage, evidenced by our decision to allocate capital to a dedicated manager in the space in our Diversified Strategies portfolio in August. It was a sub-optimal time to enter the space due to the poor -1.1% monthly return out of the HFRX RV: FI Convertible Arbitrage index, but this pullback comes as little surprise given the index's outsized 8% year-to-date return through July. Some backing and filling should have been expected and August's performance doesn't change our view. More aggressive convertible arb managers entered August offsides after gains in prior months pushed portfolio positions in convertible bonds closest to conversion and most sensitive to equity prices higher, and those converts were hit the hardest in the August equity pullback. Conservative managers with strict hedging practices held up relatively well during the month. Weakness in convertible arbitrage is a buy low, or perhaps more appropriately given the modest monthly drawdown, 'buy a little lower' opportunity, in our view. ▲