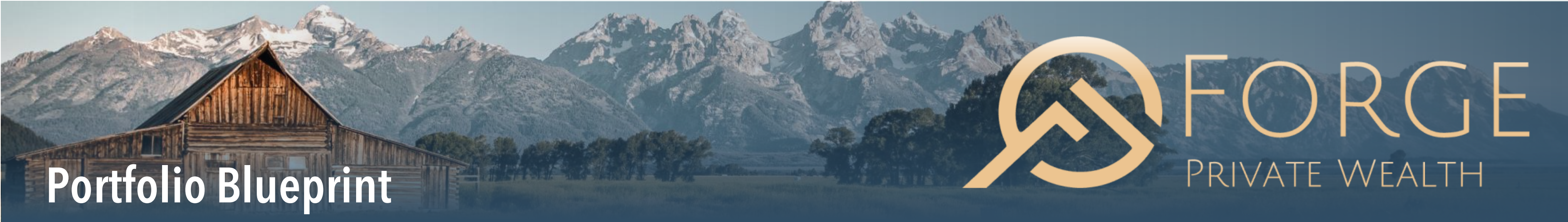


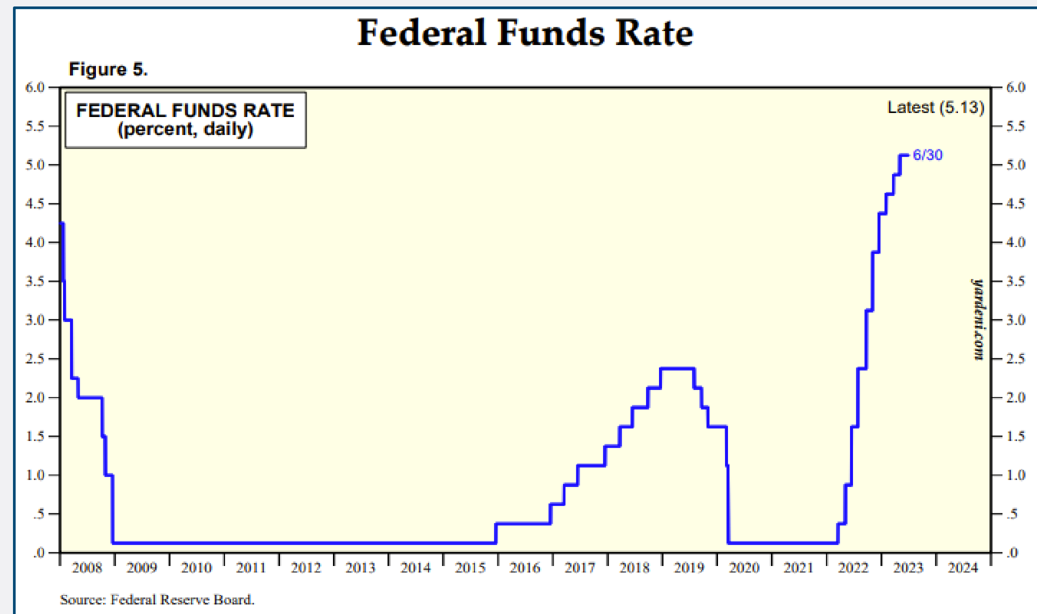
Monthly Talking Points

Macro View

A number of indicators have been telling us to be cautious about the economy and markets. The biggest debate is whether inflation comes down with a hard, painful landing or with a soft landing. Most endings come with the former, but there seems a higher probability of the latter as we move forward. Inflation continues to be stickier than the Federal Reserve wishes, translating into a high probability of at least two more rounds of tightening.[1] Monetary policy acts with a lag, so this month we will look at some of the key inputs to policy and provide comments.

The Fed Funds Rate is the measure we use for policy rates, or those rates which the Fed targets. Since at least 2008, we have seen rate increases that have represented drastic moves on the part of the Fed. Going forward, we believe that the pace and magnitude of rise in rates will slow, with a good chance we may see rates being brought down sometime in the first half of 2024.

The Fed uses the Personal Consumption Expenditure (PCE) as it's measure of inflation.[2] Our opinion of rate increases being in the late innings rests on the both the PCE and the CPI looking like they are getting under control. We are not sure if the Fed will reach its stated goal of 2% inflation, but there is a good chance we will see something "in the twos" by year end.



Source: https://www.yardeni.com/pub/fedfundsrate.pdf

1 https://www.cnbc.com/2023/06/14/fed-rate-decision-june-2023.html
2 https://www.stlouisfed.org/en/publications/regional-economist/july-2013/cpi-vs-pce-inflation--choosing-a-standard-measure

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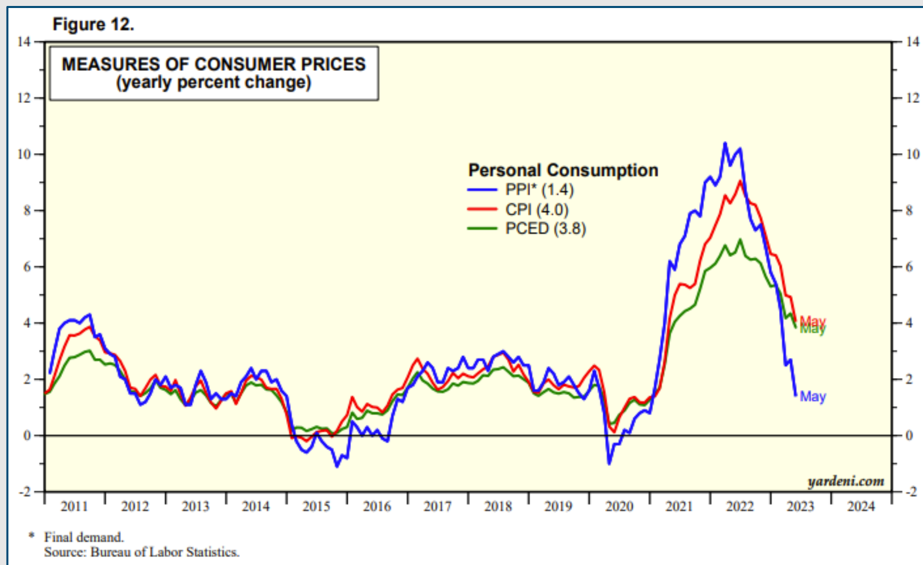
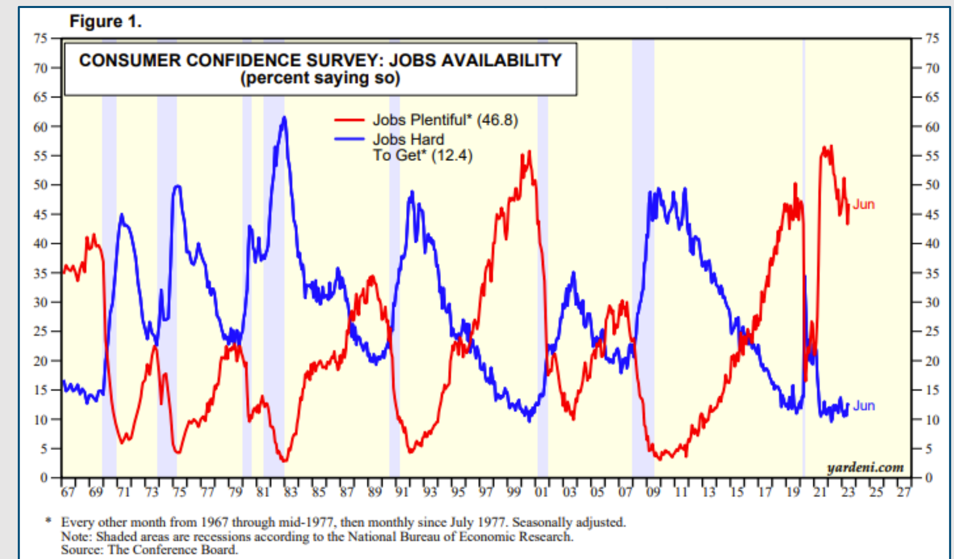
If we do go into a recession, our opinion is that it stands a good chance of being shallow and short. One reason is that job availability is still high. The Jobs Plentiful Index still is quite strong compared to data going back to 1967. In addition, the Jobs Hard to Get Index shows a very low reading on the same time period.



Source: https://www.yardeni.com/pub/consumerpricemonitor.pdf



Source: https://www.yardeni.com/pub/jobavail.pdf

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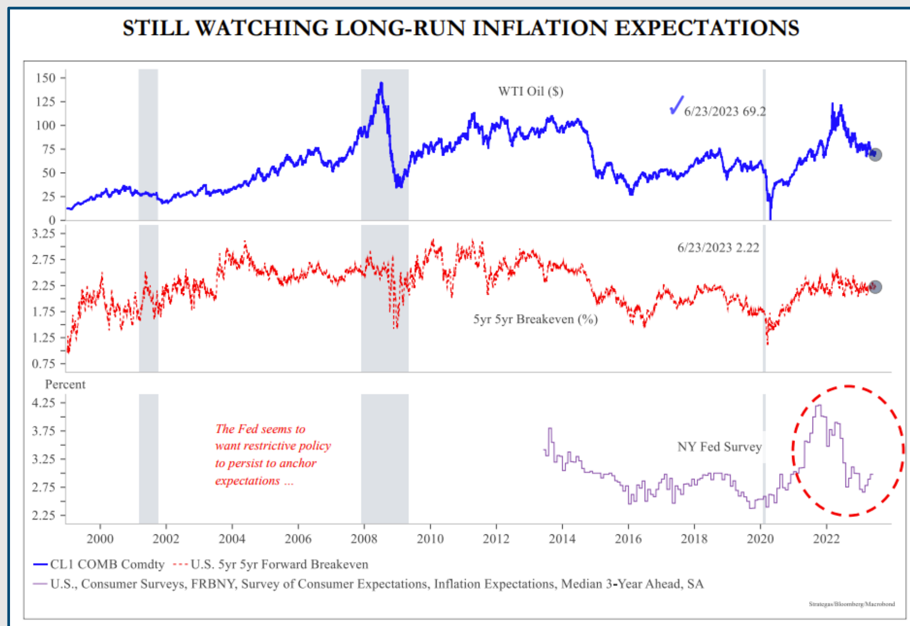
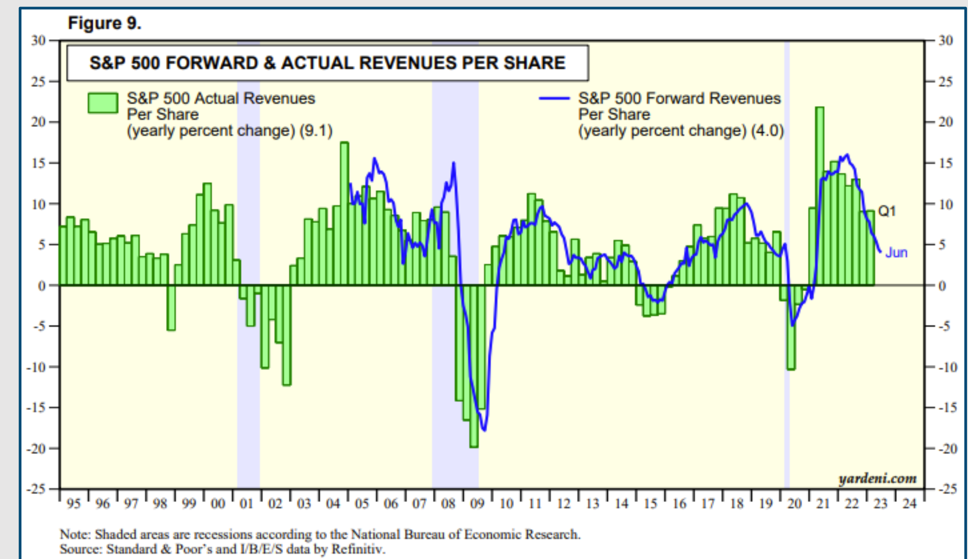
Macro View

As inflation is somewhat self-fulfilling, the Fed closely watches inflation expectations. Although they are coming down, the Fed continues to anchor them at a low rate. And finally, we look at S&P 500 revenue per share. We use revenue this month, as top line growth is still somewhat strong, but is coming down. If consumer sentiment holds up, we could see a trough later this year.



Source: Strategas



Source: https://www.yardeni.com/pub/bussalerev.pdf

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Conclusion

As the Fed continues to monitor inflation data focusing on the stickier segments, it will be the labor market acting as the arbiter of monetary policy. If they see wage inflation easing, and the jobs gap closing the path of rates hikes stand a chance of changing this year. If in fact the landing is not quite soft, then the probability of a recession remains shallow.

INDEX	MONTH-TO-DATE	YEAR-TO-DATE
S&P 500	6.61%	16.89%
NASDAQ	6.55%	39.35%
Russell 2000	7.95%	7.24%
Russell 1000 Growth	6.84%	29.02%
Russell 1000 Value	6.64%	5.12%
S&P 600 Small Cap	8.23%	6.03%
EAFE (USD)	4.55%	11.67%
Bloomberg Agg. Bond	-0.36%	2.09%
DJIATR	4.68%	4.94%

Chart Source: Bloomberg LP (via subscription)

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Equities: Sector Summaries

Strategy and Opportunity

In the present environment, which does give us significant uncertainty, we do have high conviction that sector and security selection will be important. Below are our sector allocation summaries:

Overweight

Energy – Perhaps the most controversial of all sector recommendations, higher capital expenditure and weaker global growth has caused the sector to underperform year to date. We have taken profits but believe that factors such as earnings, free cash flow, and attractive valuations are still present. This is a sector which historically has shown high volatility and should be actively managed.[1]

Staples – With historically attractive performance in slow to recessionary environments, this industry tends to do well at "peak inflation."[2] Consumers will spend in a weak economic environment. The main risk is that staples tend to underperform in a rising interest rate environment.

Healthcare – Demographics are generally positive for this sector and it has defensive properties. Risks include a cyclical economic upswing.[3]

Materials – Similar to energy, our view is that this sector is undercapitalized. As long as government goals of EV sales continue, commodity prices should benefit, given their relative scarcity. Risks include potential recession and a strengthening U.S. dollar.[4]

Neutral

Industrials – A rise in the value of US dollar is generally considered negative for this sector, as high percentage of sales are abroad. However, the trend is reversing, making their products cheaper to foreign buyers. Risks are margin erosion and recession.[5]

Utilities – Somewhat of a bond substitute, this sector is looking more attractive now that rates may have peaked. However, the "income function" of these stocks continues to see competition from fixed income. Risks are higher fixed income rates and risk-on market rallies.

Technology – We upgraded the sector this month, as the emergence of artificial intelligence (AI) appears to be a durable, long-term cap-ex investment for many industries. Risks are concentration, valuation, and higher interest rates for a long-duration sector.

1 https://www.investopedia.com/financial-edge/0712/the-8-most-volatile-sectors.aspx
2 https://www.forbes.com/advisor/investing/inflation-and-stock-market/
3 https://www.investopedia.com/articles/stocks/08/investing-in-healthcare.asp
4 https://www.bairdwealth.com/siteassets/pdfs/market-insights/sector-allocation2.pdf
5 https://www.kiplinger.com/investing/strong-us-dollar-bad-news-for-investors

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Equities: Sector Summaries

Underweight

Communications – As with technology, price recovery is more liquidity driven than it is driven by fundamentals. Social media is likely to come under further government scrutiny. Risks include valuations and concentration, as Meta and Google continue to dominate the sector.

Discretionary – We highlight continued concentration risk from Amazon and Tesla, in addition to the impact of a possible recession. The sector struggles in high-interest-rate environments.[6] Risks include durable outperformance by sector leaders and "sticky" wage gains, which could motivate consumers to spend.

Financials – We recently sold off all small banks, and current holdings concentrate on large banks and non-lending entities. Too much uncertainty remains, although select companies will emerge unscathed and could be rewarded with exceptional stock performance. Estimates do not reflect potential problems in loan books. Risks to our view include inexpensive valuations and the possibility the banking crises is actually "contained." Basel III appears to be imposing more stringent capital requirements on regional banks, which breeds competition from the "shadow banking" industry.[7]

Real Estate – We believe this sector demands the most discerning judgment. Commercial (office buildings) still have too many questions to answer about repurposing, and how they will meet debt service. Significant financing risk remains, as most real estate is financed by small banks.[8] Other risks include a fall in yields and less competition from the bond market, as well as continued high mortgage rates that could lead to continued strength in multifamily and cloud-based infrastructure buildouts.

6 https://www.schwab.com/learn/story/which-sectors-might-benefit-from-rising-rates
7 https://www.federalreserve.gov/newsevents/speech/bowman20230625a.html
8 https://www.axios.com/2023/03/21/small-bank-struggles-could-hit-the-real-estate-market-hard

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Fixed Income

The month of June saw lower volatility in the fixed income markets. Much of the action in the fixed income markets was dominated by the expectation of a Federal Open Market Committee (FOMC) rate hike "pause," which came to fruition on June 14. But that move was accompanied by a hawkish warning that more rate hikes (potentially two) are still on the horizon for 2023.[1]

Inflation worries seemed to subside quite a bit, as both the Consumer Price Index (CPI) and Producer Price Index (PPI) printed lower and below consensus expectations. CPI printed at a somewhat tame 4.0% year-over-year and PPI printed at a low 1.1% year-over-year. As both figures showed less inflation pressure, it was enough to convince the fixed income market that a June rate hike was not in the cards, and the FOMC rewarded the market's expectations with a "pause" in June. Additional data coming in showed slight easing in inflationary pressures in the employment market and a jump in the unemployment rate (up to 3.7% from 3.5%). The Fed was provided with all the "ammo" needed to pause in June without surprising the markets. Our opinion is that hikes will resume in July and possibly August, as inflation is far from defeated, both domestically and globally. This is evidenced by the Bank of England surprising markets with an inter-meeting hike of 50 basis points on June 22, and many other central banks having to come back to the table with hikes after their pause, most notably Australia and Switzerland. [2,3]

1 https://www.cnbc.com/2023/06/14/fed-rate-decision-june-2023.html
2 BOE: https://www.reuters.com/markets/rates-bonds/bank-england-hikes-rates-5-surprise-move-tackle-stubborn-inflation-2023-06-22/#:~:text=The%20BoE's%20Monetary%20Policy%20Committee,policymakers%20last%20met%20in%20May
3 SNB: https://www.cnbc.com/2023/06/22/swiss-national-bank-opts-for-smaller-rate-hike-but-says-more-are-likely.html#:~:text=The%20SNB%20announced%20a%2025,75%2Dbasis%2Dpoint%20rises]

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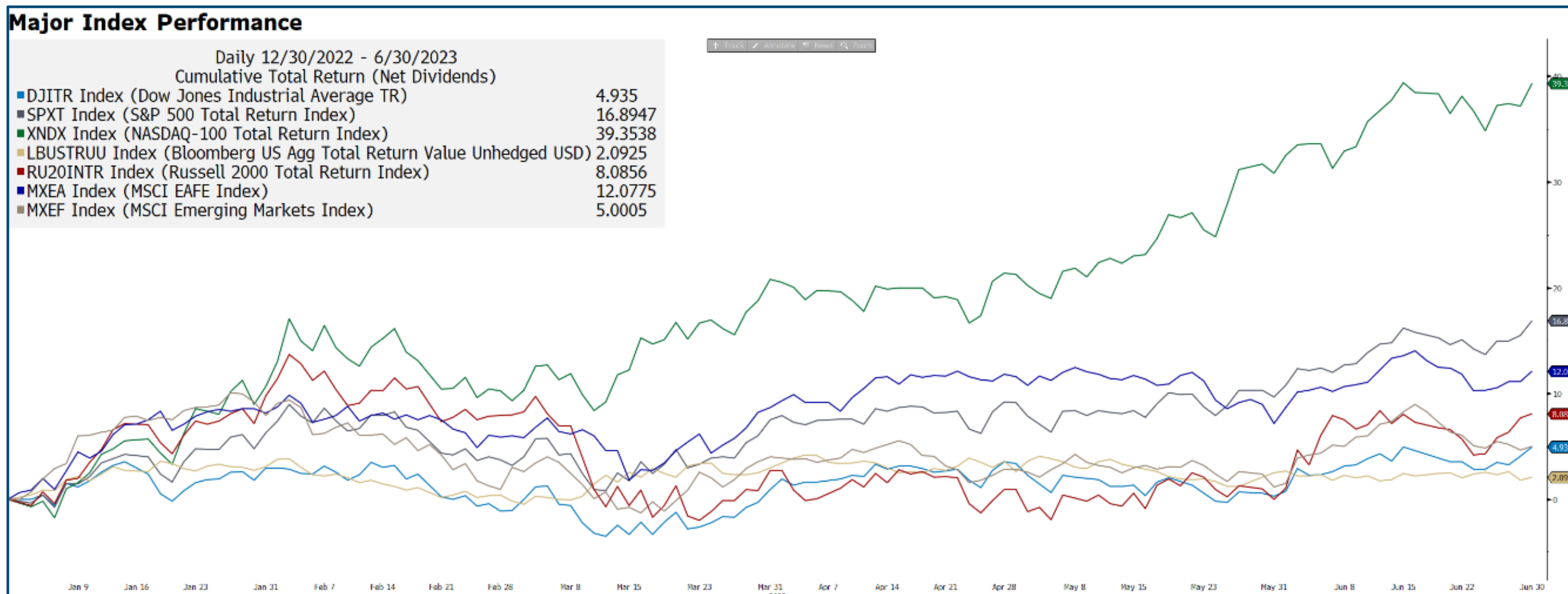
Interestingly, the GDP data released in June showed a noticeable uptick in economic growth – printing at a 2% QoQ – higher than the 1.4% survey and led by significant gains in new home purchases. Sentiment has been steadily improving, especially as measured by the University of Michigan survey, showing renewed optimism and easing inflation expectations. Many respondents note the stability that the debt ceiling agreement has brought and the continued strength of the consumer. We do want to note that that optimism may be somewhat short-lived as student-debt repayments are set to begin shortly and may retailers are predicting a cautious consumer for the next 3 to 6 months. [4]

Some of this is likely due to less inflationary pressure, but we wonder how much of it is simply euphoria from an S&P 500 that finished up 16.8% year-to-date and a NASDAQ 100 that finished up 39.3% year-to-date (both as of June 30, 2023).



Source: Bloomberg, LP

4 https://studentaid.gov/announcements-events/covid-19

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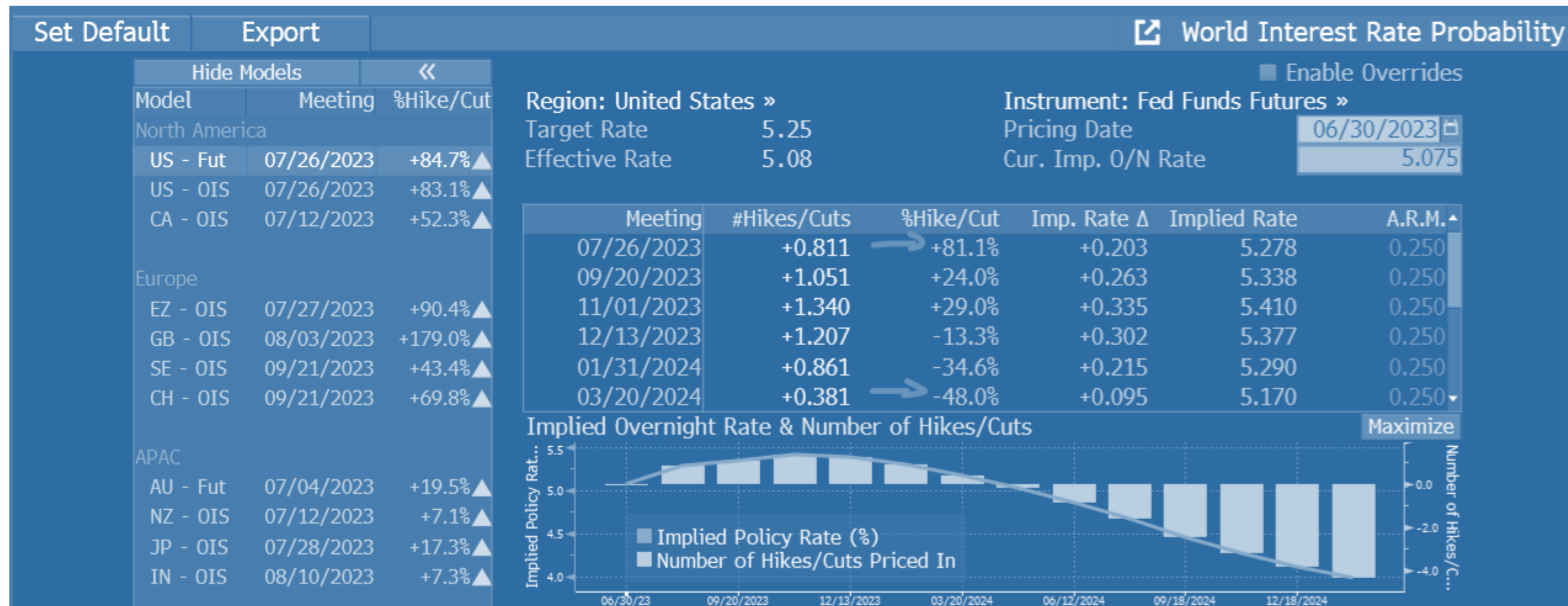
We will end by focusing on the continued inversion of the yield curve and its impacts. The 2-year/10-year spread finished the month of June the most inverted since 1981, at approximately 106 basis points.[5]

As well as the equity markets have performed thus far in 2023, bonds are still telling investors we are not out of the woods, especially with retail starting to slow and Chairman Powell hinting at two more possible rate hikes in 2023. This sets the stage for a terminal Fed Funds rate of 5.625% or higher. In fact, Fed Funds Futures are pricing in an 81% chance of a 25-basis-point hike at the July 26 meeting with no rate cut likely until March 2024.



Set Default | Export | World Interest Rate Probability

Model	Meeting	%Hike/Cut
North America		
US - Fut	07/26/2023	+84.7%
US - OIS	07/26/2023	+83.1%
CA - OIS	07/12/2023	+52.3%
Europe		
EZ - OIS	07/27/2023	+90.4%
GB - OIS	08/03/2023	+179.0%
SE - OIS	09/21/2023	+43.4%
CH - OIS	09/21/2023	+69.8%
APAC		
AU - Fut	07/04/2023	+19.5%
NZ - OIS	07/12/2023	+7.1%
JP - OIS	07/28/2023	+17.3%
IN - OIS	08/10/2023	+7.3%

Region: United States » Instrument: Fed Funds Futures »
Target Rate 5.25 Pricing Date 06/30/2023
Effective Rate 5.08 Cur. Imp. O/N Rate 5.075

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
07/26/2023	+0.811	+81.1%	+0.203	5.278	0.250
09/20/2023	+1.051	+24.0%	+0.263	5.338	0.250
11/01/2023	+1.340	+29.0%	+0.335	5.410	0.250
12/13/2023	+1.207	-13.3%	+0.302	5.377	0.250
01/31/2024	+0.861	-34.6%	+0.215	5.290	0.250
03/20/2024	+0.381	-48.0%	+0.095	5.170	0.250

Source: Bloomberg, LP

5 https://finance.yahoo.com/news/us-2yr-10yr-yield-curve-122657298.html

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Fixed Income

Take Aways

- In the Corporate space, we continue to watch several sectors, including Banking and lower rated Consumer Discretionary names that require financing. We are still actively staying away from Commercial Real Estate exposure, as it is the most-shorted segment of the market right now. We would add that although we may no longer be seeing a run on banks, we are still seeing assets being slowly "walked" away from regional banks and into money market funds–although even money markets are now seeing weekly outflows, as investors start to chase the red-hot tech sector. If considering Consumer Discretionary, be mindful that the end of the "student loan debt jubilee" is near and this is likely to have a negative impact on purchasing power.
- In the Treasury space, we recommend beginning to extend duration if possible. Treasury Notes in the 2-year space are pricing firmly above 4.85% and the 3-year Note is firmly above 4.40%. Here we see opportunities to lock in risk-free rates ahead of potential cuts late in early 2023. We feel the 2-year Note is on the precipice of testing 5%, where it was before the regional banking crisis began in late March.
- In the Muni space. we still favor quality names and extending duration into the 3-year to 10-year space. We believe there are attractive opportunities there for yield pick-up, especially with continued volatility across the curve. We are actively staying away from Hospital and University paper, unless they are of superior quality and offer credit support. We continue to see very low new-issue volume, leading to slightly elevated prices resulting from lack of inventory.

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Disclosures

The Gross Domestic Product (GDP) is a comprehensive measure of U.S. economic activity. GDP measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.

All indexes referenced are unmanaged. The volatility of indexes could be materially different from that of a client's portfolio. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. You cannot invest directly in an index. Consult your financial professional before making any investment decision.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 1,382 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.

The U.S. Dollar Index (USDX) is a relative measure of the U.S. dollars (USD) strength against a basket of six influential currencies, including the Euro, Pound, Yen, Canadian Dollar, Swedish Korner, and Swiss Franc. The index was created in 1973, but remains useful to this day.

The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury note as a benchmark for the long-term bond market.

The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services (Source: U.S. Department of Labor).

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The "core" PCE price index is defined as personal consumption expenditures (PCE) prices excluding food and energy prices. The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

An exchange-traded fund (ETF) is a type of pooled investment security that operates much like a mutual fund. Typically, ETFs will track a particular index, sector, commodity, or other asset, but unlike mutual funds, ETFs can be purchased or sold on a stock exchange the same way that a regular stock can. An ETF can be structured to track anything from the price of an individual commodity to a large and diverse collection of securities. ETFs can even be structured to track specific investment strategies.

The NASDAQ Composite Index is a market capitalization price-only index that tracks the performance of domestic common stocks traded on the regular NASDAQ market as well as National Market System-traded foreign common stocks and American Depository Receipts.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The S&P SmallCap 600 Index is a stock market index established by Standard & Poor's. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index. To be included in the index, a stock must have a total market capitalization that ranges from $750 million to $4.6 billion.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.

The Dow Jones Industrial Average, or simply the Dow, is a stock market index that indicates the value of 30 large, publicly owned companies based in the United States, and how they have traded in the stock market during various periods of time.

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