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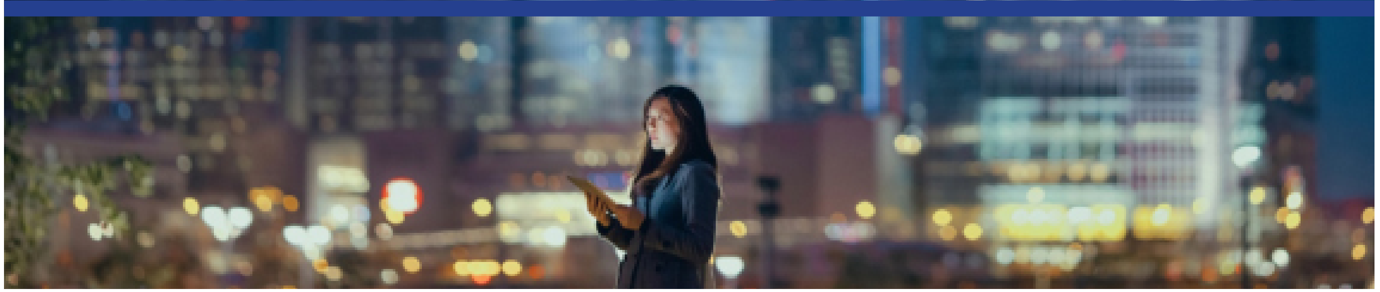

July 23, 2023

CIO Strategy Bulletin

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Looking Toward the Beginning of the Next Cycle: *Understanding Where We Are in Markets and the World Economy*

- We see evidence that the resilience in markets parallels the actual resilience of the economy in the face of Fed tightening. The resilience in markets also reflects numerous meaningful differences between bearish expectations and not-so-bearish realities. And the arrival of a game-changing shift in technology that promises increased productivity and profitability catalyzed investors. All of these factors have contributed to a shift in investor sentiment that should propel markets into 2024.
- The "simple rules of thumb" for how the economy will perform are inadequate to understand the current environment. We do not see a V-shaped collapse in everything, everywhere, all at once. Rather, we see a rolling recession of below-trend growth globally that ends some time in 2024.
- A significant source of recent market optimism comes from a major drop in inflation. Not only have headline US consumer prices slowed to 3% from a peak of 9% a year ago, but the most troubling components of core inflation are moderating in a similar way.
- Aside from the AI-infused indices, most of the remainder of world equity markets are not expensive. Mid-cap growth shares are "cheap for no reason" at 14.5X. Similarly, many shares in emerging markets will have stronger long-term returns starting at 11X EPS. Equities accrue the gains of both technological advancement and global economic development, generating higher returns in the process.
- Real yield opportunities could reach 4% above inflation over the next five years. Therefore, buying bonds in lieu of cash is advisable.
- If you're wondering now if you should invest after the "rally is over," you have missed the point of this Bulletin. Markets are looking to the beginning of the next cycle. There is more to come in 2024, 2025 and beyond with many geographies, themes and sectors that have significant positive return potential.

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Explanations and Probabilities

Did anyone expect that global equities would be up 17% year-to-date while short-term Treasuries were offering rich yields? We did not. So, how did we get here and what is different now than what we expected? What do our current circumstances portend for the next 12-18 months?

As we entered 2023, equity and debt markets had come off their worst combined performance since 1931. There were only two previous years of combined US stock and bond market declines in the past century. The investor experience of this rare event is best summed up by the phrase "nowhere to hide." Diversification across asset classes vanished and the inverted yield curve signaled a material V-shaped recession was just ahead. With the unanimity of pessimism, investor positioning in equity markets was more bearish than in any other period we can measure.

Markets last year had priced in a lot of bad news heading into 2023. Given the Fed's extraordinary rise in rates, all historical data suggested the likelihood of a major recession was high as we entered 2023. High interest rates, asset price declines, strained budgets due to higher rates, more savings and less investment, persistent inflation and geopolitical tensions pointed to an economic contraction. We expected labor markets to fade, leading to rising unemployment. We feared Europe would suffer a severe and lasting energy supply shortage. We also expected China's economy to boom following a Covid reopening.

While we thought otherwise, most investors expected inflation would remain sticky and come down very slowly until the Fed caused the economy to collapse. They expected consumer sentiment would reflect the harsher environment and accelerate downwards.

Huge negative impacts on the housing market and real estate more broadly were clear (see our May 5 CIO Bulletin). And we saw that rates created holes in bank balance sheets, with mark-to-market losses on loan portfolios estimated at $600 billion as of year-end 2022. After runs on lenders including Silicon Valley Bank, the Fed created an emergency lending facility to help banks hold these bonds to maturity and access liquidity.

Nonetheless, US equity markets rallied 6.2% in January and have gone up in five of the last six months.

As we look back, we see that the resilience in markets parallels the actual resilience of the economy in the face of Fed tightening, Quantitative Tightening and negative money supply growth. The resilience in markets also reflects numerous meaningful differences between bearish expectations and not-so-bearish realities. And, finally, the resilience of markets reflects that just as there can be unexpected calamities, like Covid, there can be game-changing shifts in technology that promise increased productivity and profitability, like the introduction of AI. All these factors have contributed to a shift in investor sentiment that should propel markets into 2024.

A Rolling Recession Is Still a Recession

The US and world economies appear to be contracting and growing in different places at the same time. Significant parts of the world economy and particular industries that were expected to have a recession are, in fact, in recession. There is booming demand for travel this summer, even as we see recessionary conditions in manufacturing and housing.

The offsetting contraction and growth of sectors within the economy reflect a below-trend 1.5% year/year GDP growth in the year through 2Q, above our prior estimates for about 1% growth. With some parts recovering and others moving lower, we expect tepid growth to continue in the US in 2024. In our view, however, this sustained period of slow growth is compelling evidence of a rolling recession.

Both US and China trade data show significant goods export contractions, close to a double-digit pace in May and June, respectively (**Figure 1**). Even worse, US housing investment shank 19% in the year through 1Q. While the decline has been mild thus far, US industrial production peaked nine months ago as manufacturing orders have contracted for 10 consecutive months, according to the Fed and Institute for Supply Management data.

Looking at nominal consumer services spending, we see a healthy 8.0% yearly pace. While still strong, this is the weakest rate of growth since the reopening of the economy that led to a services boom beginning in 2021.

As we look closely, we can see that goods inventories are declining, a necessary precursor for a later recovery from recession. There's evidence of this in the single-family construction sector, where unsold inventories are falling despite high mortgage rates (**Figure 2**). And some industries that had supply issues over the past three years are already enjoying a refreshed (and disinflationary) expansion. Autos is a particularly clear example of this development (**Figure 3**).

All this data suggests that a traditional V-shaped recession lasting six to nine months is unlikely and that the present broad malaise in the US and world economies results in a shallow and longer recessionary period – but no collapse.

Inflation Way Down

A significant source of recent market optimism comes from a major drop in inflation. Not only have headline US consumer prices slowed to 3% from a peak of 9% a year ago, but the most troubling components of core inflation are moderating in a similar way. US services inflation, excluding housing, has slowed from an 8% pace to about 3%, as well.

The drop in headline inflation is boosting US consumer confidence and real incomes (**Figure 4**). And disinflation is very likely to be global (**Figure 5**). The end of the post-Covid spending boom in services is likely to be a larger contributor to disinflation than many anticipate. Finally, the known long lag between housing developments and measures of shelter price inflation suggests a sharp slowing in the US core CPI in the year to come.

Ahead of a likely rate hike in the coming week, the Fed's policy rate has risen above the unemployment rate. Assuming disinflation continues, the employment outlook is particularly material for the Fed. What would the central bank do if inflation continues to fall and the labor market decelerates? The Fed knows that a restrictive monetary policy interacts with labor markets. If employment weakens, the Fed isn't likely to want to contribute to job declines without an inflation problem to cite.

There Is No Reason to Wait for a Future Collapse

In our rolling recession scenario, a sustained period of slow growth is unlikely to generate high levels of unemployment. And in the absence of a hard landing, markets can look through the end of 2023 and see a brighter period of recovery ahead.

With inflation abating and very modest overall growth, the timeframe for Fed easing has been pushed out until March of 2024 based on the forward rate curve. Given term premiums for longer-duration bonds are normally positive, we think the combination of below-trend growth, a tight Fed and falling inflation should allow 10-year Treasury yields to grind lower to 3.5% around the end of 2023. We previously had expected a bigger drop in yields.

AI Matters

AI technology is likely to drive output growth by powerfully redirecting labor resources in the years ahead. It appears to be both a more promising and disruptive technology than we've seen in decades. Even as new users embed AI, it is unlikely to lift equity prospects as rapidly as has been experienced by initial market leading winners. Investing in new technology now comes at a price. Much of the promised profits will need to materialize in the years to come to justify current enthusiasm.

Determining which shares under- or overprice AI optimism will be a task for investment managers for many years to come. As broad asset allocators looking to protect and grow wealth, we are happy to keep equity portfolios exposed to this key technological breakthrough. We wouldn't seek an even larger exposure than benchmarks at this moment.

The Forward Path for Equities

The seemingly impossible mix of tight US monetary policy and rising share prices continues for a ninth month. Some signs are building that investors may be getting carried away by the unexpected good fortune of markets. Positive price momentum has led investor sentiment and positioning. And fear of any bad news is being "priced out" of options market premia for equities (**Figures 6-7**). This suggests some near-term caution.

For equities during the early months of 2023, the bull market was very narrow. Seven US tech mega-caps contributed 45% of the entire world equity return in the year to date. In our view, a broader market improvement lies ahead, but with less robust gains for both the "magnificent seven" and the S&P 500, which has benefited from its AI leaders.

For most of the *remainder* of world equity markets, no such grand optimism is priced in. Even ordinary growth should be rewarding. Nasdaq is "expensive for a reason" at 27X expected EPS. Mid-cap growth shares are "cheap for no reason" at 14.5X. Similarly, many shares in emerging markets will have stronger long-term returns starting at 11X EPS.

If staying invested in equities requires short-term loss avoidance strategies, by all means, hedge. The S&P 500 VIX has fallen back toward the zone of record lows. Risk-mitigation steps can offer either immediate yield or unusually cheap costs for hedge buyers.

Markets Looking Toward the Beginning of the Next Cycle

Covid and the huge government fiscal/monetary policies to counteract its economic destruction were without precedent. The massive injection of income to families and corporations drove spending and savings higher in unusual ways, straining supplies and distorting prices. Credit was plentiful with rates at zero, and huge amounts of refinancings occurred through mortgage refinancings and bond issuance. The spigot of government support was then turned off as abruptly, amid unfilled demand for goods and services. For a while, short-term interest rates were below inflation as real wages normalized. With personal, corporate, government and bank balance sheets full, spending and investment carried on.

After the turmoil, inflation is falling and the convalescing economy is healing many imbalances. Asynchronous contractions in some sectors and growth in others has become an accepted fact, but is unlikely to persist.

In the face of all this, the rise in markets in 2023 was unexpected. While there is likely to be a consolidation in US equity markets sometime this year, 2022 may have been the “collapse” everyone feared. A rolling recession is replacing the V.

Investors can’t expect this “relief rally” to continue forever, but that’s not the point of having a core portfolio that grows and preserves wealth. Real yield opportunities could reach 4% above inflation over the next five years (**Figure 8**). Therefore, buying bonds in lieu of cash is advisable. Equities accrue the gains of both technological advancement and global economic development, generating higher returns in the process (see our Mid-Year Outlook). That’s true even when markets aren’t racing from one extreme to another.

So, if you’re wondering now if you should invest after the “rally is over,” you’ve missed the point of this Bulletin. Markets are looking toward the beginning of the next cycle. There is more to come in 2024, 2025 and beyond with many geographies, themes and sectors that have significant positive return potential.

Figure 1: US and China: Merchandise exports Y/Y%

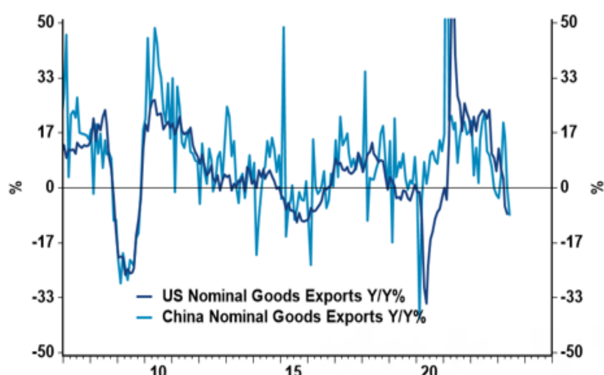

Figure 2: US residential investment and single-family home inventories Y/Y%

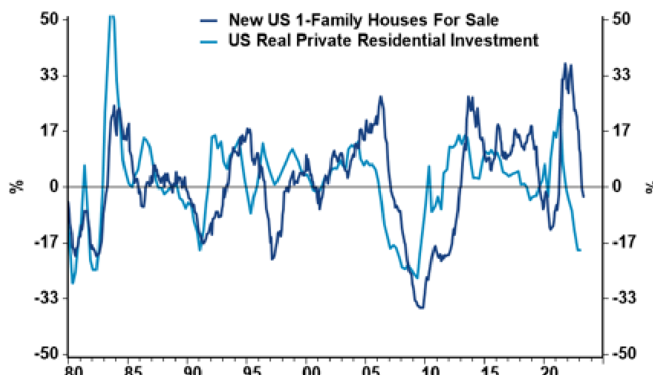

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Figure 3: Autos rising in 2023 after 2022 drop: US domestic car and truck sales and production

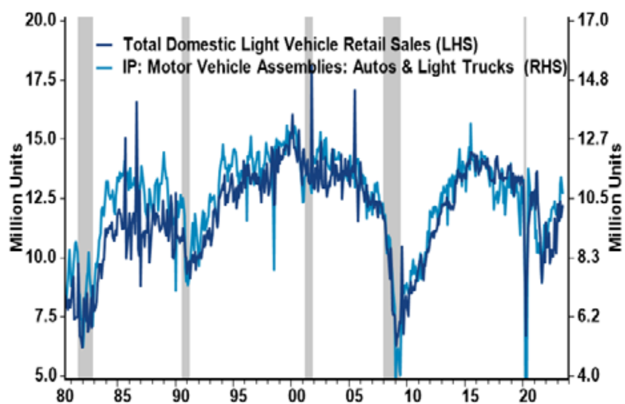

Figure 4: US real disposable income Y/Y%

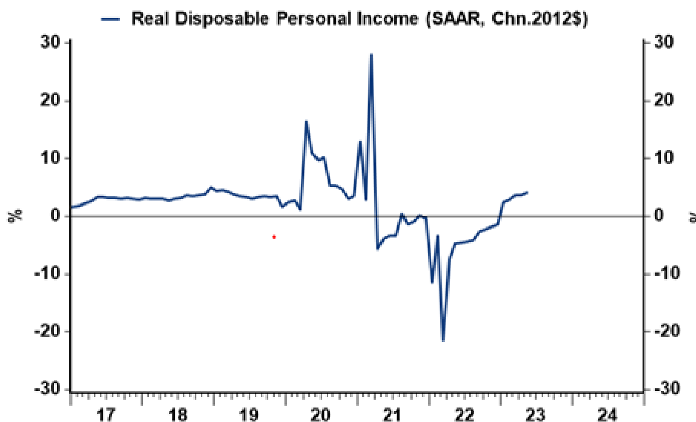

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Figure 5: US, UK EU CPI Y/Y%

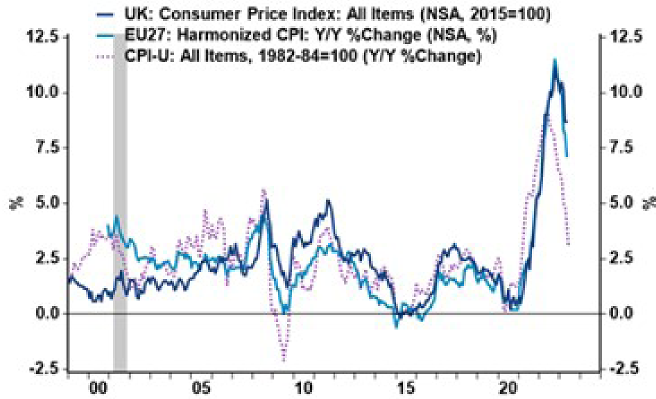

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Figure 6: Market rally pulls investor sentiment higher: AAII poll of bullish less bearish investors vs S&P 500

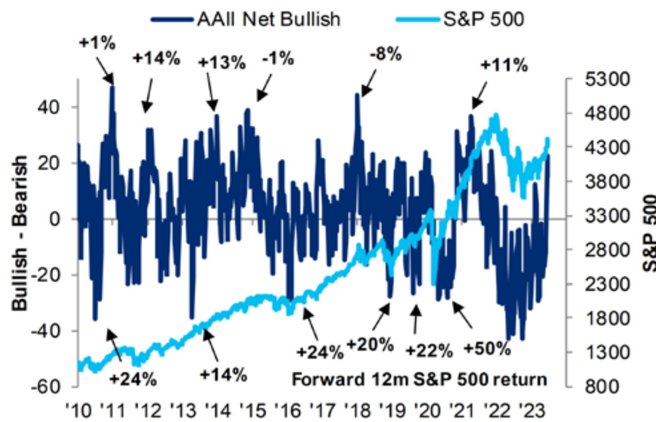

Figure 7: US equity vs fixed income implied volatility

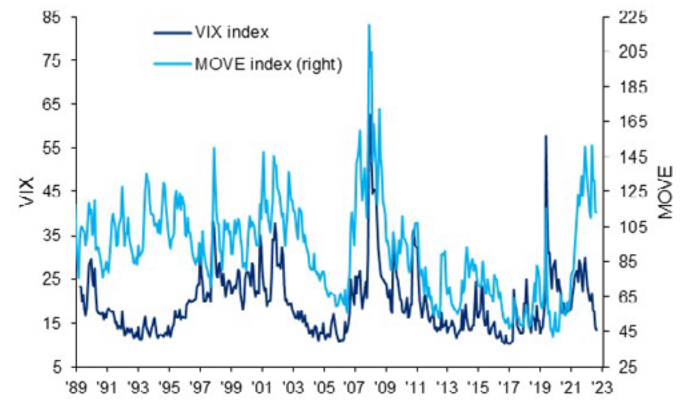

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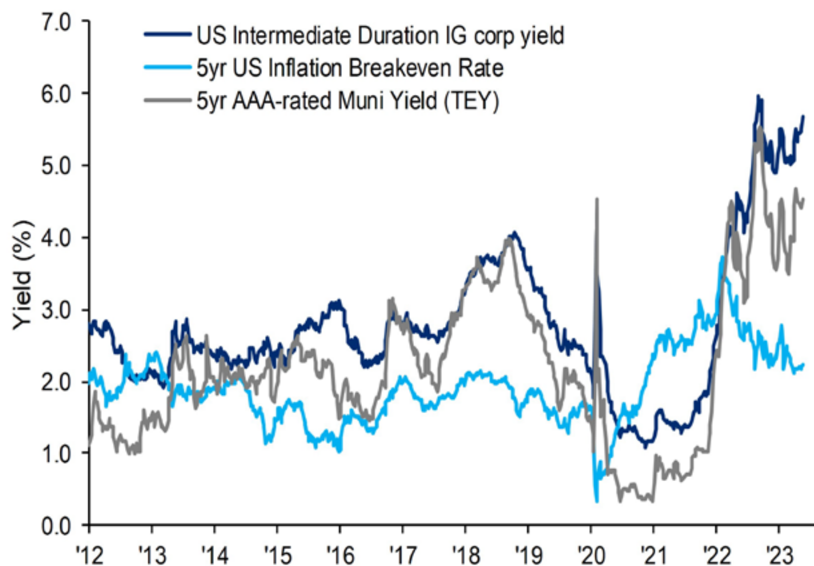
Figure 8: US 5-year IG corporate yield, muni yield and TIPS expected inflation



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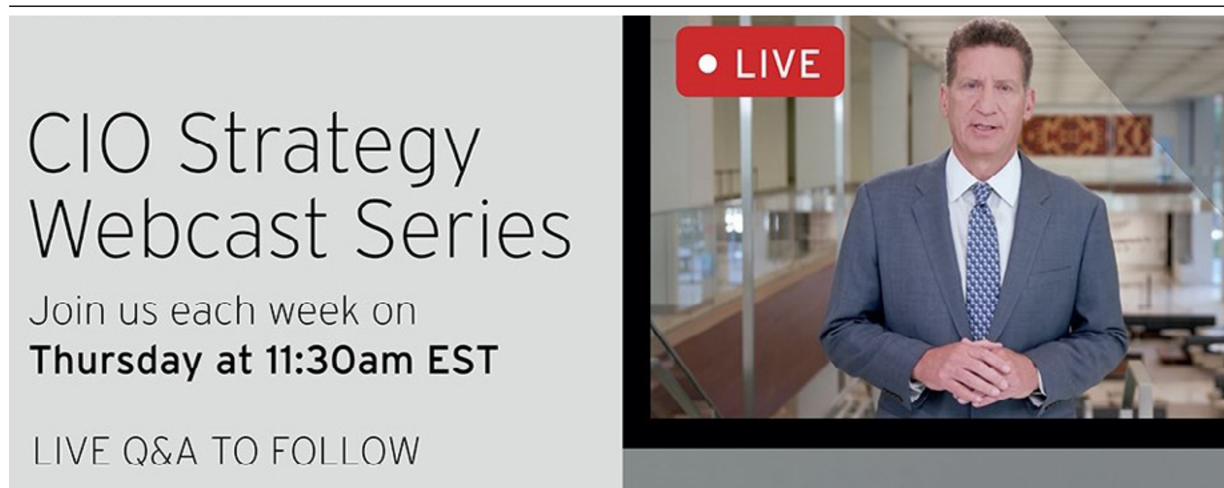

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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