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INVESTMENT STRATEGY STATEMENT | NOVEMBER 1, 2023

Easing Inflationary Pressures

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Equity Markets

Heavy Selling Pressure in September and October

The recent sharp selloff in common stocks is now three months old. It started rather innocently in August with light trading volumes, indicating more of a lack of buying interest rather than a rush by sellers to lower their exposure to stocks. Stock prices were also supported by Chair Powell's remarks in late August that the Federal Reserve was in a position to proceed carefully with its future policy moves, indicating that the rate hiking cycle was close to being finished, if not finished.

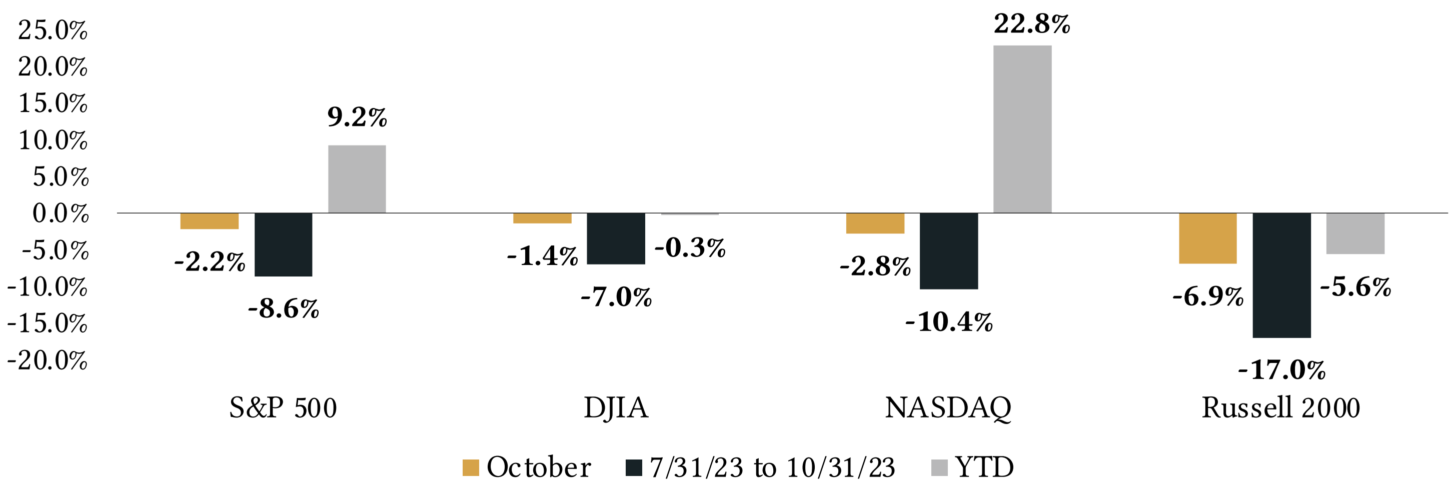
-4.8% to -12.5%

Decline in Major Markets since Aug.

July 31

S&P 500 and DJIA YTD High

Major Stock Market Indices - Price Change Only



Source: Bloomberg

Stock prices came under fairly aggressive selling pressure during September and October with the major market measures falling -4.8% to -12.5% over the two months. Investors' anxiety rose as the House of Representatives removed Kevin McCarthy as speaker, leaving the House effectively paralyzed until a new speaker was elected three weeks later.

Hamas's surprise attack on Israel raised fears of a broader conflict in the Middle East following an expanded Israeli ground invasion of Gaza, aimed at toppling Hamas. Investors worried about the risk of regional escalation, particularly if other groups like Hezbollah attack Israel or U.S. assets in the region. Should Hamas ally Iran get drawn into the conflict, stricter sanctions on Iranian oil exports could push energy prices higher. This new conflict comes on top of the ongoing war in Ukraine.

While wars and growing geopolitical risks definitely impacted investors' appetite for risk last month, we attribute most of the selling pressure during October to the persistent rise in longer maturity Treasury yields. Bond yields simply moved too high, too fast. Surprising strength in the economy, the Federal Reserve likely holding rates "high for longer," much larger amounts of Treasury supply than previously expected, and some regular large buyers stepping back from the market all have contributed to the upward pressure on Treasury yields.

Since the recent high on the S&P 500 and the DJIA on July 31, the major market measures have pulled back on the order of -7.0% to -17.0%. For the month of October, the major stock market indices were lower by −1.4% to -6.9%. While large cap technology stocks came under some selling pressure over the past two months, they are still distorting returns on a year-to-date basis, with the S&P 500 higher by 9.2%, while the NASDAQ Composite has gained 22.8%.

The S&P 500 ex-technology, communication services, Tesla, and Amazon has declined -4.0% year-to-date. Similarly, the DJIA is lower by -0.3% and the equal-weighted S&P 500 is lower by -3.8%, while the Russell 2000 index of small company stocks has fallen -5.6%.

▼ **Russell 2000**	-5.6%	▲ **S&P 500**	+9.2%
▲ **NASDAQ**	+22.8%	▼ **DJIA**	-0.3%

YTD Index Performance as of 10/31/23

Chair Powell Signals Rate Hike Pause to Stay in Place

In addition to developments noted below, also emphasized was the potential for the lags of monetary policy tightening to weigh on the economy in coming months and that the marked rise in yields on longer dated Treasury securities since early July has tightened financial conditions further, doing some of the work to slow the economy for the central bank.

The Federal Reserve will announce its next decision on interest rates at the conclusion of the October 31-November 1 FOMC meeting. *We do not expect the Committee to raise rates as communications from Federal Reserve officials over the past month have emphasized the need to proceed carefully in assessing the extent of any additional policy firming that may be necessary.* None of the speakers sounded in a hurry to raise rates further, pointing out that it is a sensitive period of risk management where the Federal Reserve will need to balance the risk of not having tightened enough against the risk of policy being too restrictive.

It is pretty clear that the majority of the FOMC committee members view the current level of rates and bond yields as more than restrictive enough to slow the economy over time.

However, Federal Reserve officials emphasized that the economic data needs to cooperate by displaying some further slowing, particularly in the jobs market, and inflationary pressures continuing to moderate. In other words, the data needs to talk the FOMC Committee out of the additional rate hike that was contained in the September Summary of Economic Projections. Ongoing restrictiveness was typically phrased by the Federal Reserve officials in terms of *longer, not higher.*

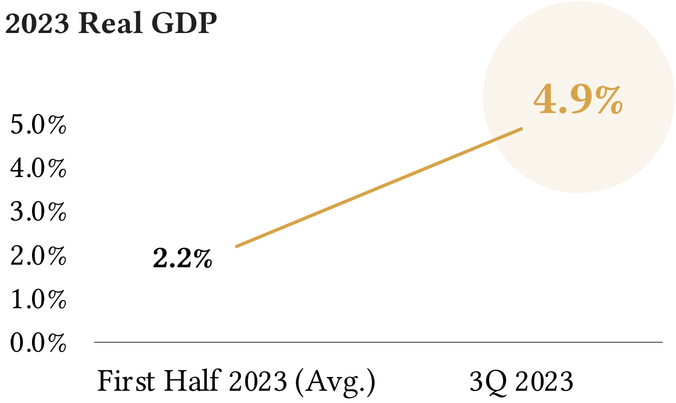
In a widely anticipated speech delivered to the Economic Club of New York mid-month, Chair Powell gave no indication that he was leaning toward a push for higher interest rates. He suggested that the swift rise in longer term Treasury yields has significantly tightened financial conditions and could slow the economy, effectively substituting for another rate hike if higher borrowing costs are sustained.

We stated last month that the odds leaned toward no further rate hikes this year as core inflation should surprise to the downside, and now we add that growth in the current quarter looks to come in on the weak side with financial conditions tightening further. That remains our position.

Strong Economy in 3Q 2023, Slower Growth Ahead

Real GDP surprised to the upside in 3Q 2023, growing at a 4.9% annual rate compared to an average of 2.2% over the first two quarters of the year. Digging into the data, the headline growth rate for the economy somewhat overstated the strength in the economy, however, the economy did post a solid, above potential pace of growth last quarter.

2023 Real GDP



01

The strongest private sector of the economy was consumer spending which advanced at a 4.0% pace vs. 0.8% in 2Q 2023.

Goods outlays grew at a strong 4.8% rate, with outlays for recreational goods and vehicles surging at a 15.8% pace as households splurged on experiences and travel. Furniture and appliances gained 7.1% as homebuilding posted a strong quarter. Spending on services was a touch slower at 3.6%, led by a 5.6% increase in food services and accommodations as travel was particularly robust over the summer months.

02

Despite mortgage rates pushing past 7% during the quarter, residential construction outlays rose at a 3.9% rate compared to negative readings over each of the previous nine quarters.

The rapid rise in mortgage rates has made homeowners reluctant to sell since that would require financing the purchase of their next home at much higher rates. This has helped support the construction of new homes since the extremely limited inventory of existing homes for sale has driven prospective buyers to purchase new construction as homebuilders are helping by buying down mortgage rates, shrinking square footage, and trimming amenities.

03

The weakest sector of the economy was business capital spending which was largely flat at -0.1% vs. +7.4% in 2Q 2023.

The rising cost of capital and a cautious attitude following the constant drumbeat of a looming recession led to a -3.8% decline in equipment spending compared to a gain of 7.7% in the previous quarter. Structures outlays slowed to a 1.6% pace after growing at a 23.0% annualized pace during the first half of the year due to a ramp in manufacturing plant construction that was supported by the Chips and Science Act.

04

A more realistic representation of the economy's growth rate last quarter was the 3.3% advance in real domestic private final sales—the sum of consumer spending, business capital spending & residential construction outlays.

This measure excludes the effect on real GDP of government purchases (8.0% increase in defense spending), a faster pace of inventory accumulation, and net exports which collectively accounted for two percentage points of the economy's 4.9% reported growth rate. The 3.3% pace is still a solid pace of growth, but closer to 3% rather than 5%.

05

Possibly the best news in the report was further progress on inflationary pressures continuing to ease, with core consumer prices rising at a 2.4% annualized rate vs. increases at 3.7% and 5.0% rates over the previous two quarters.

The disinflation narrative in the economy is in full effect given the Federal Reserve aggressively tightening monetary policy since March 2022 and tighter financial conditions arising from higher Treasury yields and lower stock prices.

We expect that the economy's performance last quarter will be difficult to repeat any time soon, with the economy's growth slowing over coming quarters. While jobs gains have supported household income, real disposable personal income actually decreased at a -1.0% pace last quarter after growing at a 7.1% rate during the first half of the year.

Consumers lowered their savings rate to 3.8% in 3Q 2023, compared to a 5.0% average over the first two quarters of the year and consumer credit outstanding rose at a 9.9% rate last quarter to help support consumer spending. Taken with the resumption of student loan repayments in October and the continued rise in mortgage rates and rates on car loans and installment loans, consumers will be facing stiffer headwinds in the months ahead. The percentage of subprime auto borrowers at least 60 days past due reached its highest level since 1994 in September, indicating the third quarter could have been a last gasp for strong consumer spending.

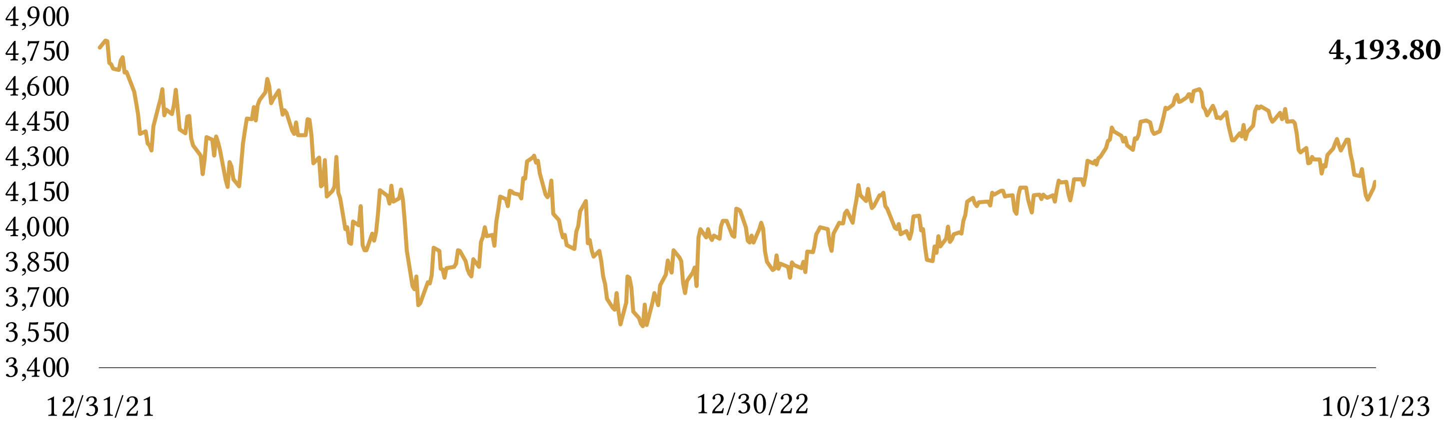
Also, consider that the increase in Treasury yields pushed thirty-year fixed mortgage rates over 8.0% during October, before ending the month at 7.95%, which has contributed to housing affordability approaching the all-time lows of the early 1980s. This will weigh on the recent rebound in homebuilding activity. The higher cost of capital will continue to weigh on business capital spending on equipment and structures as the required rate of return-on-investment capital has correspondingly increased.

We look for the economy's growth rate to be near 1% to 2% over the next few quarters, with a negative quarter not out of the realm of possibility.

Higher Treasury Yields Threaten Soft Landing

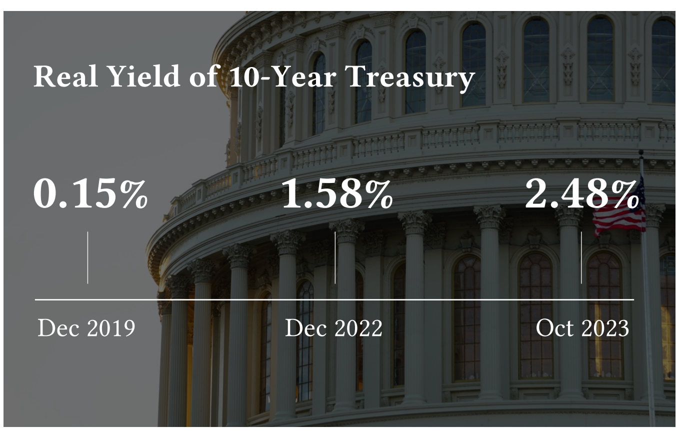
The jump in longer dated Treasury yields since the conclusion of the July 26 FOMC meeting is the major threat to the Federal Reserve being able to bring the economy in on a soft landing. The current ten-year Treasury note yield of 4.93% is 108 basis points higher than the 3.85% yield on July 26, however, the ten-year Treasury yield did briefly trade above 5% during the month.

S&P 500 Price Index 12/31/21 – 10/31/23



Source: Yahoo Finance

The rise in Treasury yields is particularly restrictive as it is entirely an increase in real, or inflation-adjusted, yield as inflation expectations are largely unchanged since the end of July. The 2.52% real yield on ten-year Treasury securities is 94 basis points higher than the 1.58% real yield on 12/30/22 and materially higher than the 0.15% real yield on 12/31/19—prior to the pandemic and the highest since mid-December 2008 prior to the Federal Reserve initially moving to a zero-interest rate policy on December 16, 2008.



Source: FRED

The move higher in longer dated Treasury yields has been so powerful that it has overwhelmed the usual safe haven bid that emerges during periods of global turmoil. The rise in Treasury yields this year is much different than last year's increase to a peak of 4.24% on October 24, which was driven by market expectations of higher short-term rates as the Federal Reserve tightened policy and by investors demanding additional yield to hold longer dated securities due to the ramp in inflationary pressures.

Neither of those factors appear to be driving higher Treasury yields now as the Federal Reserve's tightening campaign has come to a close (or is very close to an end), and the significant progress that has been made on lowering inflation and inflation expectations. The recent rise in Treasury yields has largely resulted from the unexpected strength in the economy, which has forced investors to price out the likelihood of a recession in 2023 and to accept that the Federal Reserve will likely hold rates "high for longer"—pushing out the timing of rate cuts and reducing the extent to which rates could be cut.

Investors have also come to the realization that the outsized supply of Treasury securities due to the massive budget deficits flowing from Washington and the unwillingness of our elected officials to address them will keep Treasury yields higher than what prevailed during the zero interest policies that dominated Treasury yields in the years following the financial crisis through the pandemic. It did not help that in early August, Fitch Ratings downgraded the U.S. credit rating to AA+ citing a worsening budget outlook and governance concerns, highlighted by the standoff over lifting the federal debt ceiling.

Additionally, some regular large buyers have stepped back from the market. The Federal Reserve is reducing its holdings of Treasury and mortgage-backed securities that it amassed in its earlier efforts to boost the economy. In the "quantitative tightening" program the Federal Reserve kicked off last year, it currently allows up to $60B of Treasury securities and $35B of mortgage-backed securities to mature each month without reinvesting the proceeds, effectively adding to the supply of bonds that other buyers must absorb.

The Federal Reserve's "Quantitative Tightening" Program includes:

$60B	$35B
Treasury Securities	**Mortgage-Backed Securities**

Banks are reluctant to buy more bonds given the embedded losses in their "hold to maturity" portfolios and the need to maintain liquidity in the current regulatory environment.

The two largest foreign holders of Treasury securities, Japan and China, may be less interested in additional purchases. In Japan, currency plays a role in its reduced appetite for Treasury securities. The yen is at a decades low and could appreciate as interest rates rise in Japan, which would cut into the yen value of its Treasury holdings. China's central government is taking more control of the country's finances at a time when the economy is slowing down, and Chinese leaders may use more of the government's own money to deal with its economic woes, particularly in the property markets, rather than purchase additional Treasury securities.

While the yield on longer dated Treasury securities has risen, the S&P 500 is lower by -8.6% since the end of July and the U.S. dollar has climbed 4.3% against a basket of foreign currencies. The resulting tightening of financial conditions is weighing on the economy's growth rate and weakens the case for the Federal Reserve to raise rates further.

We look for the economy's growth rate to slow in coming quarters with inflationary pressures continuing to ease.

While the recent tightening of financial conditions has slightly increased the risk of recession, we still expect the economy to skirt a recession, likely coming in on a soft landing. To the extent the economy slows faster and in a more material manner than expected just a few months ago, it is possible the Federal Reserve could bring rate cuts forward.

For common stocks to rally into year-end against a backdrop of investor sentiment being washed out, the third quarter earnings reports will need to remain at least better than feared, if not surprising to the upside, and the yield on longer dated Treasury yields must ease further, possibly approaching 4.5%. From a longer-term perspective, disinflation, along with solid, but moderating growth in the economy, and further gains in earnings with the Federal Reserve cutting rates some time in 2024 should support higher common stock prices over the next year.

A final thought. Now that Mike Johnson has been elected as speaker of the House, lawmakers can return to the business of the nation. The near-term concern is that the political dysfunction in the Republican conference in the House that removed Kevin McCarthy as speaker complicates the already complicated calculus surrounding the mid-November deadline to keep the federal government funded. Speaker Johnson needs to persuade the GOP House majority to advance federal spending bills needed to pass an annual federal budget and avoid a shutdown. Additional issues include aid requests for Ukraine and Israel and tighter border security.

Treasury Market

Treasury Yield Curve Steepens as Longer Maturity Yields Rise

We have been expecting the Treasury yield curve to steepen over the next several months from the significant inversion — yield on two-year Treasury notes above the yield on ten-year Treasury notes — of -92 basis points back on July 31. Indeed, the yield curve inversion declined to -11 basis points by the end of October, the smallest degree of inversion since July 2022.

However, we had expected the inversion to be washed away by the yield on the two-year Treasury note declining as investors anticipated the Federal Reserve would cut rates in 2024 as inflationary pressures eased toward the central bank's 2% target and the economy cooled following the tightening of financial conditions as the Federal Reserve raised rates.

Treasury Market Talks to Federal Reserve

	Ten-Year Treasury Yield	(minus)	Two-Year Treasury Yield	(equals)	Yield Spread
9/30/21	1.49%		0.28%		121bp
3/07/23	3.98%		5.07%		-109bp
5/03/23	3.35%		3.73%		-38bp
7/31/23	3.96%		4.88%		-92bp
9/29/23	4.58%		5.05%		-47bp
10/31/23	4.93%		5.04%		-11bp

Source: Bloomberg

Rather, the yield on the two-year Treasury note has risen only 16 basis points since the end of July, while the yield on the ten-year Treasury note has increased a whopping 97 basis points. We covered earlier in this ISS that yields on longer dated Treasury securities have been boosted by a pickup in the economy's growth rate during 3Q 2023, which has led investors to price out the likelihood of a recession in 2023 and accept that rates will be held "high for longer" with the timing of rate cuts pushed out and the extent to which rates could be cut reduced. Supply issues have also piled on because of massive budget deficits in Washington, while several regular large buyers of Treasury securities have stepped back from the market.

We also took the position that the inverted yield curve was signaling that the current level of interest rates cannot hold as the economy and inflation both cool. So, what do we say today?

To the extent the economy slows faster and in a more material manner than expected just a few months ago, it is possible the Federal Reserve could bring rate cuts forward. This will set the stage for yields across the entire Treasury curve to fall toward 4%.

Additionally, the central bank could be forced to cut rates to avoid a passive tightening of monetary policy if inflation eases further over the next few quarters which would lead to an increase in the real, or inflation-adjusted, federal funds rate if the nominal federal funds rate were held steady. Additionally, a 4.93% ten-year Treasury yield is attractive for investors needing income compared to core inflation running a touch above 2.0% on a three-month annualized basis and a 1.56% dividend yield on the S&P 500. Lower interest rates and bond yields are ahead of us, the path and timing remain unclear.

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