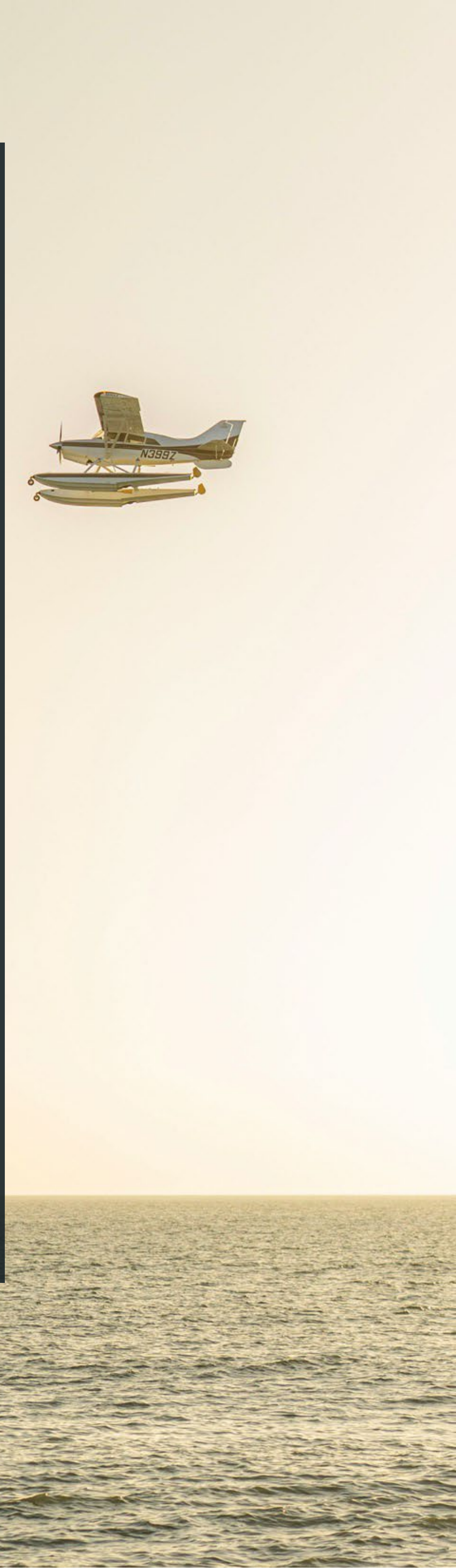
INVESTMENT STRATEGY STATEMENT | DECEMBER 1, 2023

Still Targeting a Soft Landing



by Joseph T. Keating, Pierre G. Allard, & Darren Hinshaw

Equity Markets

A November to Remember, Treasury Yields Fall and Stock Prices Rise

Following a rough three months for common stock prices, investors cheered a series of events in early November that pushed stock prices higher. First, investors seized on a normally overlooked event — the Treasury Department's quarterly announcement of its upcoming borrowing plans. Treasury not only announced that it would issue $2 billion less in longer dated securities than expected, but also suggested that it was willing to override informal guidelines for how much shorter maturity securities to issue, paring back on the amount of longer maturity Treasury securities it would normally issue.

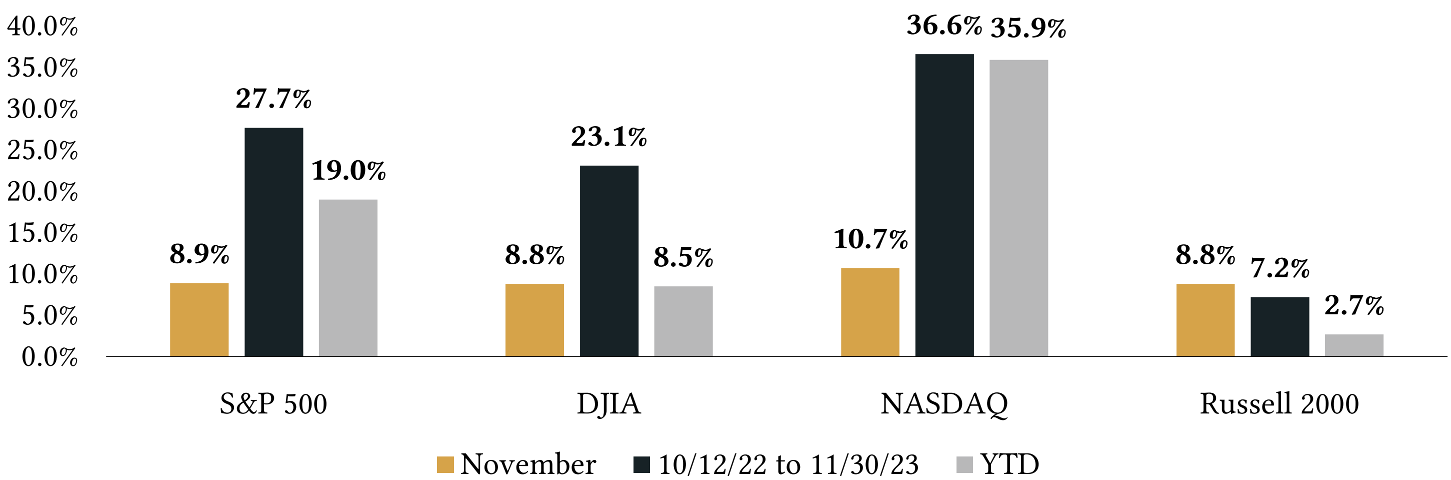
8.8% to 10.7%

Increase in Major Stock Market Indices during November

4.33%

Ten-Year Treasury Yield as of November 30

Major Stock Market Indices - Price Change Only



Source: Bloomberg

While the dollar amount between what the markets expected Treasury to issue in longer maturity securities and what it delivered was small, investors were encouraged by what they saw as the underlying message. Typically, Treasury attempts to hold "regular borrowing strategies," but now it signaled a willingness to adjust and be "more sensitive to the market." After briefly topping 5% on October 23 the yield on the ten-year Treasury fell to 4.48% on November 2, before ending November at 4.33%.

Also helping to ease the upward pressure on longer maturity Treasury yields were signs that the economy is coming off the third quarter boil.

Jobs data pointed to a labor market that is moderating, but not buckling, while the October purchasing managers' surveys showed the manufacturing sector remains in a mild recession and the service sector has cooled.

More fuel for the rally in stocks was provided by inflation reports which surprised to the downside in October and much softer readings on consumer spending. The CPI was unchanged month-to-month in October as gasoline prices fell -5.0%. Also helping to ease inflationary pressures were airline fares (-0.9%), physicians' services (-1.0%), used cars and trucks (-0.8%), and new vehicles (-0.1%). The year-on-year rise in the CPI dropped to 3.2% from 3.7% in September.

Indicator	Period	Change
Core CPI	Oct 2023 (month-to-month)	▲ 0.2%
Core CPI	Last 12 Months	▲ 4.0%
Core PCE Prices	Oct 2023 (month-to-month)	▲ 0.2%

3.5%

Core PCE Price Index

The core CPI rose 0.2% month-to-month in October and the year-on-year rise eased to 4.0% from 4.1% in September. Shelter costs — which have slowed over the past year but only filter into the inflation data with a lag — accounted for two-thirds of the monthly rise in the core CPI and 74% of the year-on-year rise in the core CPI.

In other words, if a real time shelter inflation measure was used in the calculation of the CPI, core inflation over the past 12 months would be roughly 1%, below the Federal Reserve's target of 2%. PCE prices were unchanged month-to-month in October, leaving headline PCE inflation at 3.0% year-on-year. Core PCE prices rose 0.2% in October and core inflation slowed to 3.5% year-on-year, below the Federal Reserve's most recent full year median projection for core PCE of 3.7%. Inflation is clearly coming down faster than the FOMC committee expected.

The best news in the PCE report was the six month annualized rate of change in core inflation decelerating to 2.5%— just a touch above the Federal Reserve's 2% target. The October inflation reports are consistent with the disinflation narrative in the economy being in full effect and offers incremental support for the Federal Reserve's rate hiking cycle being over.

Consumer spending softened notably in October, with retail sales falling -0.1% month-to-month following a strong 0.9% gain in September and robust gains earlier in the summer and the first drop since March. Real personal consumption expenditures also slowed in October to 0.2% from a 0.3% increase in September.

The spending data reflect a slowdown in consumers' willingness to spend after a blowout summer as credit card debt and delinquencies rose. The retail sales and real consumer spending data are likely a prelude to a further pullback in consumer spending in the months ahead as tighter credit conditions and higher borrowing costs take a toll. A slower pace of economic growth points to the next move by the Federal Reserve being a cut in rates, not a hike.

Additionally, the housing market is stalling under the weight of housing affordability that is near an all-time low.

> *All of these observations point to the economy's growth rate slowing to a range of 1% to 2%, with a negative quarter not out of the realm of possibility.*

The Federal Reserve also hinted that it could be finished raising rates at the conclusion of the October 31-November 1 FOMC meeting with the markets pulling forward the start of rate cuts to as early as May of next year.

With the data on the economy and inflation pointing to a soft landing for the economy, along with yields on longer maturity Treasury securities falling, common stocks posted strong gains in November with the major stock market indices higher by 8.8% to 10.7%. The major market measures are higher by 7.2% to 36.6% since the low in the S&P 500 back on October 12 of last year.

For the eleven months of 2023, the NASDAQ Composite has risen 35.9%, while the S&P 500 has gained 19.0%. The DJIA is higher by only 8.5% as a handful of megacap technology stocks continues to lead the advance in the major market measures so far this year. In light of that, the S&P 500 ex-technology, communication services, Tesla, and Amazon is higher by only 2.9% year-to-date, while the equal-weighted S&P 500 is higher by 5.0% and the Russell 2000 has gained 2.7%.

▲ **Russell 2000**	+2.7%	▲ **S&P 500**	+19.0%
▲ **NASDAQ**	+35.9%	▲ **DJIA**	+8.5%

YTD Index Performance as of 11/30/23

FOMC Committee "Proceeding Carefully"

The Federal Reserve kept rates unchanged at the October 31-November 1 FOMC meeting, leaving the target range of 5.25% to 5.5% for the federal funds rate in place. Chair Powell hinted the Federal Reserve might be finished raising rates but was careful not to rule out additional hikes. Mr. Powell said, "The Committee is proceeding carefully," during the press conference and said nothing to change the market's expectation that rate hikes are finished.

The policy statement was largely unchanged, only adding a nod to the rise in yields on longer maturity Treasury securities and the decline in stock prices to the end of October with the addition of "financial" conditions to previously noted credit conditions as factors weighing on household and business activity. Chair Powell implied that the increase in Treasury yields since July reduced the need for the Federal Reserve to raise the target range for the federal funds rate again.

Mr. Powell said the FOMC Committee is currently focused on one question, with two others next in line

> **"Is policy sufficiently restrictive to bring inflation down to the central bank's 2% target?"**

> **"How long should policy remain restrictive?"**

> The final question, which he said is not being discussed at the moment, is **"when and to what extent should rates be cut?"**

We think the transition from the first question to the second question is in process as we do not expect any additional rate hikes. The markets immediately responded positively to the Committee's decision to hold rates steady and Chair Powell's comments by pulling yields lower across the Treasury yield curve and pushing stock prices higher. Those responses had some legs as they persisted through November. The futures market has a roughly 75% probability of the first rate cut taking place at the May FOMC meeting.

Economy Remains on Track for Soft Landing

As we enter December and turn our attention to 2024, we view the backdrop for common stocks, as well as for Treasury and corporate securities, as being supportive of higher asset values.

01

The disinflation trend is well established on the back of easing supply conditions, lower oil prices, an increase in labor market supply from rising immigration and workforce participation, declining shipping costs and delivery times, decelerating rent increases showing up with a well-documented lag, and an easing of wage pressures.

Additionally, the disinflationary pressures arising from the expected retrenchment in final demand due to the higher borrowing costs resulting from the aggressive manner the Federal Reserve raised interest rates and the rise in Treasury yields is becoming more widespread. Anecdotally, retailers are warning of an aggressive pricing environment as the holiday shopping season unfolds.

02

The economy is slowing from the strong pace in 3Q 2023, but is maintaining forward momentum and is likely to hit on a soft landing with inflation declining to the 2% target without triggering an economic downturn.

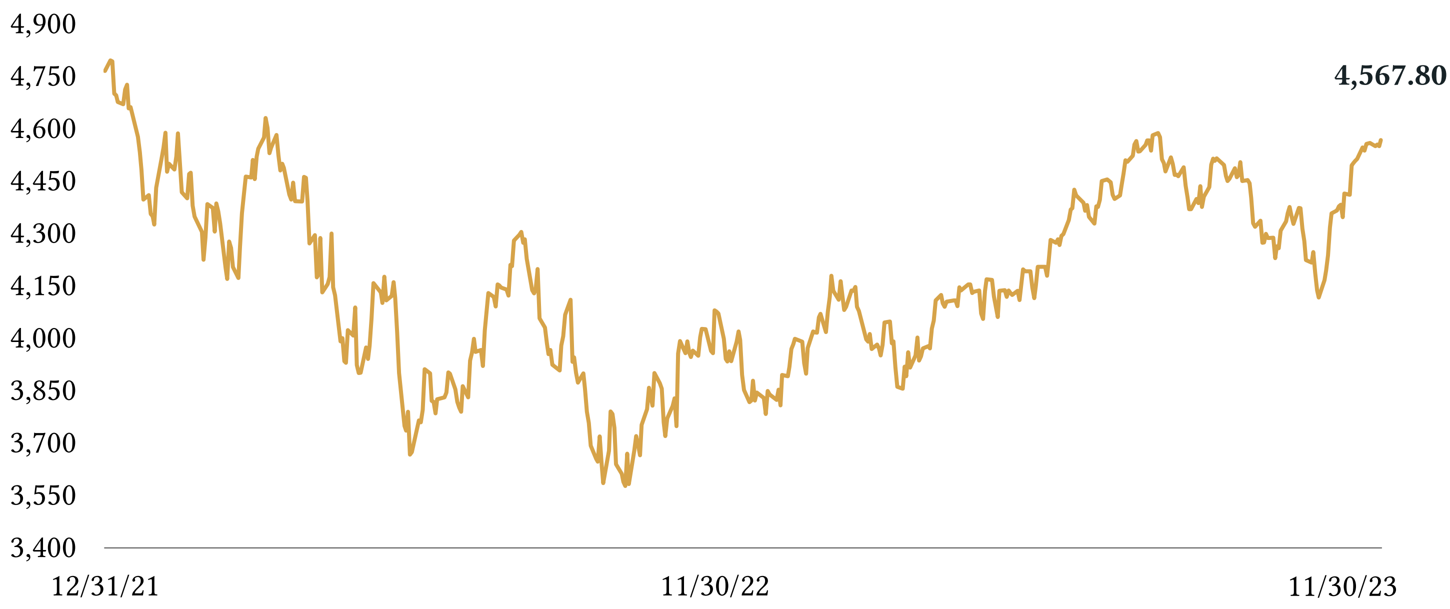
0.4%

Increase in Unemployment Rate Over 18 Months

We took the position during the summer of 2022 that the economy was likely to skirt a full-blown recession given the large number of open positions in the labor market in early 2022, which hit a record 12 million in March, representing two open positions for every unemployed worker. This set up a situation that as companies faced a softening level of demand from the Federal Reserve tightening monetary policy, the outsized number of open positions would largely absorb the bulk of the tightening, with employers likely to hoard suddenly dear workers.

Open positions have fallen by 2.5 million over the past 18 months, while the unemployment rate has only risen to 3.9% from 3.5%. It is important that open positions bear the brunt of the cooling in the labor market for the Federal Reserve to bring the economy in on a soft landing. If those 2.5 million open positions that evaporated had instead been lost jobs, the unemployment rate today would be 5.4%. The economy continues to add jobs, but at a slower pace than earlier in the year. The job gains and steady unemployment rate have supported consumer spending and kept the overall economy out of recession.

S&P 500 Price Index (12/31/21 – 11/30/23)



Source: Yahoo Finance

It is also clear that the economy is not nearly as interest rate sensitive as it was during previous business cycles as households and businesses locked in very low financing rates following the financial crisis through the end of the pandemic. However, consumers will be facing stiffer headwinds in the months ahead from the high level of rates on mortgages, motor vehicle, and installment loans and from the tightening of lending standards over the past 18 months.

Ongoing disinflation and a slowing economy increase the odds that the Federal Reserve is finished raising rates.

Chair Powell and other Federal Reserve officials have emphasized in their communications over the past few months the need to proceed carefully in assessing the extent of any additional policy firming that may be necessary. When all is said and done, the trends in the economy and inflation are nicely positioned as we look forward to 2024.

The former massive headwind of Federal Reserve policy is likely to become a tailwind as rate cuts come into play.

Additionally, institutions and investors have a record $5.7 trillion parked in cash-like money market funds. As short-term interest rates tick down over the next two years, a healthy portion of that cash should become a tailwind for both common stocks and fixed income securities as investors will increasingly fear missing out. Lastly, earnings continue to surprise to the upside. With 93% of companies reporting, operating earnings on the S&P 500 are on pace to grow 4.3% year-on-year in 3Q 2023 and are projected to grow 8.8% over the four quarters of 2023. Add in lower Treasury yields in 2024 and we look for solid returns from fixed income securities and common stocks in 2024.

Treasury Market

Treasury Yields Move Lower, Yield Curve Inversion Widens

We stated in last month's ISS that the significant jump in longer dated Treasury yields following the conclusion of the July 26 FOMC meeting was the major threat to the Federal Reserve being able to bring the economy in on a soft landing. The yield on the ten-year Treasury note ended October at 4.93%, 108 basis points higher than the 3.85% yield on July 26, with the ten-year Treasury yield briefly trading above 5% during October.

The rise in Treasury yields was particularly restrictive on economic activity as it was almost entirely an increase in real, or inflation-adjusted, yield as inflation expectations were largely unchanged from the end of July to the end of October. The 2.52% real yield on the ten-year Treasury was 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.

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
7/31/23	3.96%		4.88%		-92bp
9/29/23	4.58%		5.05%		-47bp
10/31/23	4.93%		5.04%		-11bp
11/30/23	4.33%		4.68%		-35bp

Source: Bloomberg

The current ten-year Treasury yield of 4.33% is 60 basis points lower than at the end of October. The best news for the economy is that about 76% of the decline in the nominal ten-year yield was a 46 basis point drop in real yields, from 2.52% to 2.06%, still high, but becoming less restrictive.

The current levels of nominal and real ten-year Treasury yields will keep financial conditions tight, helping to slow the economy and keeping downward pressure on inflation. However, the easing of yields raises the odds of the economy hitting that soft landing. To the extent the economy slows faster and in a more material manner than expected just a few months ago, the disinflation trend could accelerate with the Federal Reserve bringing rate cuts forward.

Despite the Federal Reserve holding rates steady for the past four months, the yield on two-year Treasury notes gave up some ground last month, ending November at 4.68%, 36 basis points lower than the end of October. Taken with the 60 basis point drop in ten-year Treasury yields over the month, the inversion of the yield curve widened back out to -35 basis points compared to only -11 basis pints at the end of October.

We continue to hold the position that the main message from the Treasury yield curve is that the current level of interest rates and bond yields cannot hold as the economy and inflation both cool. The set up looks good for yields to drop across the entire Treasury curve over the next year toward 4%.

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