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OUTLOOKS

October 2023

ECONOMIC OUTLOOK

Summary

In 2022, the Federal Reserve initiated the fastest start to a rate-hiking cycle in history with the objective of getting the Federal Funds rate into restrictive territory. A restrictive, or "tight," monetary policy should ultimately lead to a slowdown in economic activity and an increase in unemployment, which is typically the recipe needed to reduce inflation. This process works best in conjunction with "tight" fiscal policy, which can also slow economic activity by increasing taxes and/or reducing government spending. When both monetary policy (the Fed) and fiscal policy (the U.S. government) are in harmony, it may reduce the amount of monetary tightening necessary, improving the odds of escaping a recessionary outcome. However, when there is dissonance between the two policies, one will need to tighten more to offset the other.

Unfortunately, the latter is where we currently stand. Current fiscal policy is extremely expansionary as the government is spending significantly more than it is taking in. Due to pandemic-related stimulus, the Federal deficit ballooned to $3.13 trillion (tn) in fiscal year (FY) 2020, which was the largest in history. Though there was a slight decrease to the deficit in FY 2021, at $2.77tn it was still nearly double the pre-pandemic high. With the overnight rate at the zero lower bound and massive government spending in 2020 and 2021, in hindsight, it's not shocking we saw the substantial inflation experienced over the past few years. Even as the Federal Reserve began to rapidly tighten monetary policy in FY 2022, Congress continued to run a substantial deficit of $1.38tn, nearly double the five-year average deficit from 2015 to 2019. Additionally, the annual deficit for FY 2023 is on pace to increase back up to $1.66tn.

With monetary and fiscal policies acting as opposing forces, we are currently experiencing some economic anomalies. For example, we are almost 19 months and +5.25% into a rate-hiking cycle, yet the Atlanta Fed is projecting 4.9% GDP for the third quarter, which would be the highest level since the fourth quarter of 2021. Household net worth is at an all-time high and the unemployment rate remains historically low. With total U.S. debt outstanding at nearly $33tn and expected to increase to $52tn within 10 years due to continued deficit spending, it's no wonder the Fed is unsure how long they will have to maintain high interest rates.

Positives

Core PCE dipped below 4% for the first time in 26 months

Factory orders jumped back into positive territory and beat expectations (1.2% vs. 0.3% est.)

ISM manufacturing registered its highest level in 10 months

Negatives

Job Openings and Labor Turnover Survey (JOLTS) data showed job openings increase by 783,000 month over month

Producers Price Index (PPI) shows increased inflationary pressures (0.7% vs 0.4% est.)

Final GDP for the 2Q23 was revised lower by 0.1% (2.1%)

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EQUITY OUTLOOK

Summary

September lived up to expectations as a challenging month for equities with the S&P 500 falling 4.8%. The weakness in U.S. stock markets was fairly widespread in both style and size. The Russell 1000 Growth Index fell 5.4% while the Russell 1000 Value Index dropped 3.9%. The Russell Midcap Index and the small-cap Russell 2000 Indexes declined 5.0% and 5.9% respectively. Equity markets abroad held up better than domestic indexes in September. The developed MSCI EAFE index fell 3.4% and the MSCI Emerging Markets Index lost 2.6%.

One of the reasons U.S. markets in particular are struggling may very well be that two of the biggest market focuses in recent weeks are uniquely American. The United Auto Workers' (UAW) strike has now entered the third week with minimal signs of negotiation progress. Also, congress managed to avoid a government shutdown but really just kicked the can down the road with a temporary solution that will fund the government through mid-November. One could be encouraged the bill received bipartisan support but there still seems to be little appetite for long-term spending solutions.

There have been few recent catalysts to turn the momentum and the path of least resistance has clearly been lower over the past few months. As mentioned in recent publications, there have also been some negative seasonality factors at play. Historical seasonality considerations will turn positive later this month and companies will also begin reporting third quarter earnings mid month.

Eventually the UAW strike will end and Congress will ultimately land on a long-term budget solution. Corporate earnings have surprised to the upside the last two reporting periods. Those potential catalysts may line up with positive historic seasonality that could shift the market momentum back to positive for the balance of the year. October may get off to a difficult start but it could also see a swift reversal mid month.

Positives

- Federal Reserve nearing the end of hiking cycle
- Resilient corporate earnings
- Stocks are now entering near-term oversold conditions

Negatives

- Elevated crude oil prices
- Ongoing strikes and labor unrest
- Recession risks remain elevated
- Growing geopolitical tensions

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OUTLOOKS

October 2023

FIXED INCOME OUTLOOK

Summary

Nearly 19 months and 525 basis points (bps) after the Fed first began increasing the overnight rate from the pandemic zero bound, we are likely at, or very near the end of the rate-hiking cycle. For the second time in the past three meetings, the Federal Reserve's Open Market Committee (FOMC) passed on raising the overnight rate in September. As measured by the Fed Funds futures market, investors now apply slightly less than a 50% probability of one last hike, which is nearly identical to the expectations a month ago. Even with little change in the outlook for rate increases, yields moved sharply higher across the entire maturity spectrum. The 2-year Treasury yield increased by 18 bps to 5.04% while the 5-year added 36 bps to end September at 4.61%. On the longer end of the curve, 10-year and 30-year bonds increased nearly 50 bps to end at 4.57% and 4.70%, respectively. With little change in credit spreads, corporate bonds provided little buffer to the Treasury market carnage. Just when we thought the bond market waters were safe, September's returns were the worst since February and in the bottom 6% of all monthly observations over the past 32 years for most of the broad investment-grade benchmarks. The indexes that include longer-maturity bonds have now turned negative on a return basis for the year.

With longer-maturity yields increasing much more than near maturities, the yield curve inversion eased. Some forecasters have suggested this shift in the curve indicates the long-awaited, ever-evasive recession is on the horizon. While a scenario involving a significant economic slowdown can be crafted, most of the data simply does not support that outlook at this time. September's gangbusters payroll gains alone cast doubt on a slowdown. More likely, the sharper rise in longer-term yields was due to the market's readjusting to a "higher-for-longer" mentality. As mentioned, while not changing the outlook for near-term rate increases, investors have come around to believing the Fed when they project there may not be many rate cuts in 2024. As expectations of four or five rate cuts next year have shifted to two or three, longer yields reacted more aggressively as the path to the long-run neutral rate becomes more uncertain. Adding to these pressures, investors are increasingly concerned about the level of ongoing issuance of Treasury bonds. The current debt level of $33 trillion is expected to rise to more than $50 trillion in the next decade. Given the strength of the U.S. dollar, reduced holdings by China, and the balance sheet shrinking by the Fed, it makes sense to ask, "Who will buy all of these bonds?"

The market endured a lot of technical damage as the long end sliced through old highs with barely a pause. With oscillating sentiment, volatility in yields is likely to remain high in that part of the curve with shorter-maturity yields more stable. While the push higher could continue, the real, inflation-adjusted, yield is now above the projected rate of inflation. This means that more than half of the 10-year Treasury note's yield is real return compared to expected inflation. In the past, this metric has helped attract buyers which could then bring an end to this bear market for bond investors.

Positives

The Fed rate-hiking cycle is likely complete with one more at most

U.S. investment-grade corporate bonds yield more than 6%

Negatives

Significant government issuance with no budget discipline in sight

Disinflation is slowing as the path to 2% becomes more uncertain

Unknowns

Marginal buyer for U.S. debt as China reduces holdings

Russia/Ukraine war impact of commodity prices and inflation