

MARKET MATTERS: 2ND QUARTER 2023

June 30, 2023

"In the financial markets, hindsight is forever 20/20, but foresight is legally blind." – Benjamin Graham

TAKEAWAYS

- Stable economic indicators are pushing off a recession.
- Fundamentals have taken a back seat to headline risk.
- Sector-specific shocks and setbacks have not been broadly damaging.
- Look for opportunities in fixed income at or near peak interest rates.
- Though increased volatility is expected to persist, long-term consensus returns show measured reward for disciplined investors who stay the course.

MISSING THE FOREST FOR THE TREES

Whether the Fed's last decision is a "pause" or a "skip" is a matter of semantics. We are near the terminal point for interest rates, though we may not be there yet. Analysts forecast another quarter point of increase, with high confidence, after which we may be at the Fed's terminal rate. While we didn't get here without economic pain, we haven't seen an economic decline, and we may not see one any time soon. After 15+ months of rising rates, a pause in monetary policy is a nice breather to consider the question: **Where is the recession?**

The economy isn't firing on all cylinders, which creates the opportunity for headlines to steal the show. Regional banks saw a crisis in the first quarter. Major tech industry CEOs have announced multiple rounds of high-magnitude layoffs. The market for single-family residential real estate is in gridlock. Commercial real estate is entering uncharted territory with a triple threat of high interest rates, tighter credit standards, and high office vacancy rates. Globally, European economies are slowing and China's economy is growing less than expected. Zooming in on these has been distracting from the overall present stability of the U.S. economy.

The economic malaise stems from stubbornly high inflation and the central banks of developed nations raising interest rates. In the U.S. specifically, sector-specific drags aren't being directly caused by recessionary fundamentals. Offices aren't vacant because people are unemployed. People are continuing to work from home. They are still getting paid and spending money, keeping manufacturing and services sectors humming along. Home sales didn't plummet because people can't afford their current housing payments (mortgage delinquencies are historically low) or because lenders won't lend to them; people are staying put to avoid a higher mortgage rate if they can get away with it. With some geographical exceptions, the freeze is on the supply side, not lack of demand. Regional banks didn't fail because of fundamental economic recessionary forces, either. They failed in part because paper losses turned into real losses when deposits left their coffers for better use. Growth doesn't slow in isolation, so foreign factors will have domestic effects. However, the American consumer (i.e., U.S. private consumption) is almost 68% of the U.S. economy, measured by GDP. And the American consumer is still working, earning and spending.

RECESSION VS. RETRENCHMENT

The term RECESSION is used to indicate economic decline, but while there are clear times of booms and busts, there are also shades of economic gray. The economy speeds up, and it also slows down, sometimes without going into reverse. This reduction in economic activity, or general cooling off, might be called RETRENCHMENT. It may come prior to a recession, but a gradual slowdown alone doesn't predict one. The one thing that is synonymous with recession is unemployment, along with a prolonged period of negative growth. We aren't seeing clear signs of either. The slow-motion slowdown we are experiencing feels uneasy after numerous pronounced economic shocks, including the pandemic crash, inflationary bounce, accelerated interest rate spike, and near-crises in various economic sectors that have all kept us on edge.

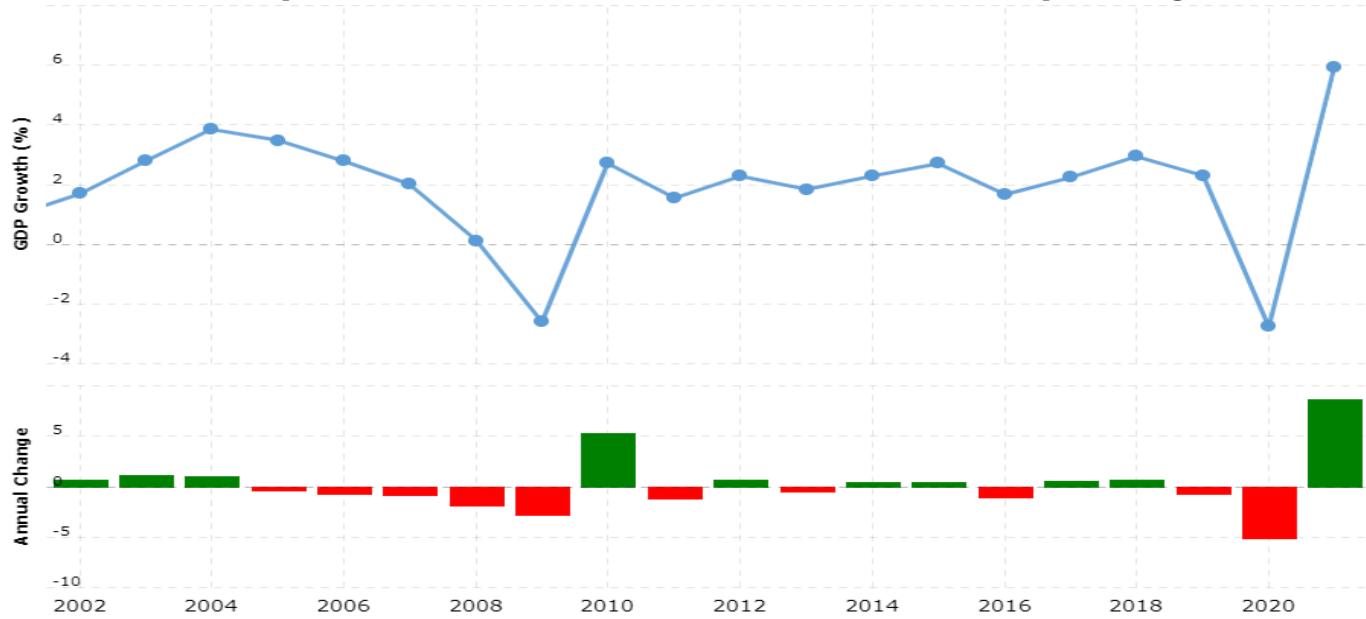


Exhibit 1: Annual GDP Growth and Change in GDP Growth

See above, exhibit 1: In 2009, the U.S. experienced negative economic growth and sharply rising unemployment (the “Great” recession). In 2010, growth was high (5.3%) as the economy accelerated. The next year showed a sharp relative drop. Between 2010 and 2020 we didn't see a recession, but we saw four years of negative annual change (slowing growth), which in and of itself did not lead to one. It may have done so eventually, but the pandemic recession in 2020 was exogenous.

Exhibit 2: U.S. Unemployment Rate

Sector-specific deterioration hasn't caused a pronounced decline for one main reason – U.S. unemployment is still historically low at 3.7%, and wages have seen decent increases over the past two years, raising consumer spending. A real estate crunch, a banking crisis, an over-bought and over-grown tech sector, and stubbornly high prices haven't tilted the retrenchment into recession. Will this cause the Fed to hike rates enough to throw the economy into negative growth and high unemployment? Many analysts and economists think this won't be necessary. The labor market is giving mixed signals, but is cooling overall. Workers are quitting less, there are fewer job openings and more jobless claims. Net additions to payrolls are slowing as companies slow hiring, and more workers have continued to come into the labor market off the sidelines since the post-pandemic recovery began.

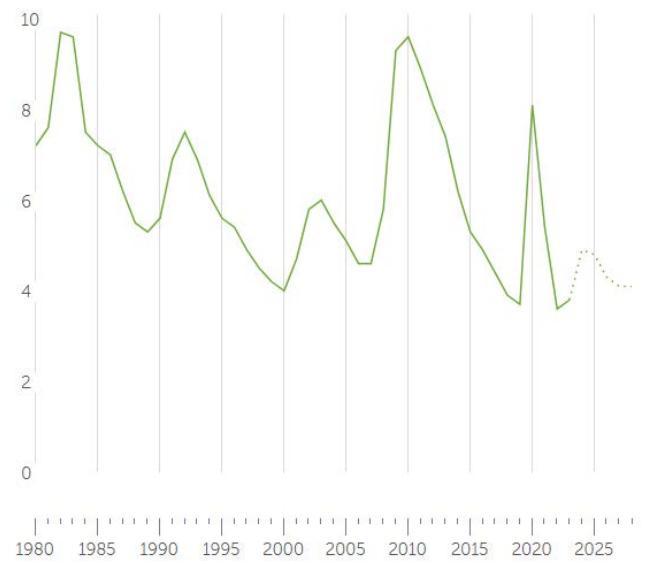
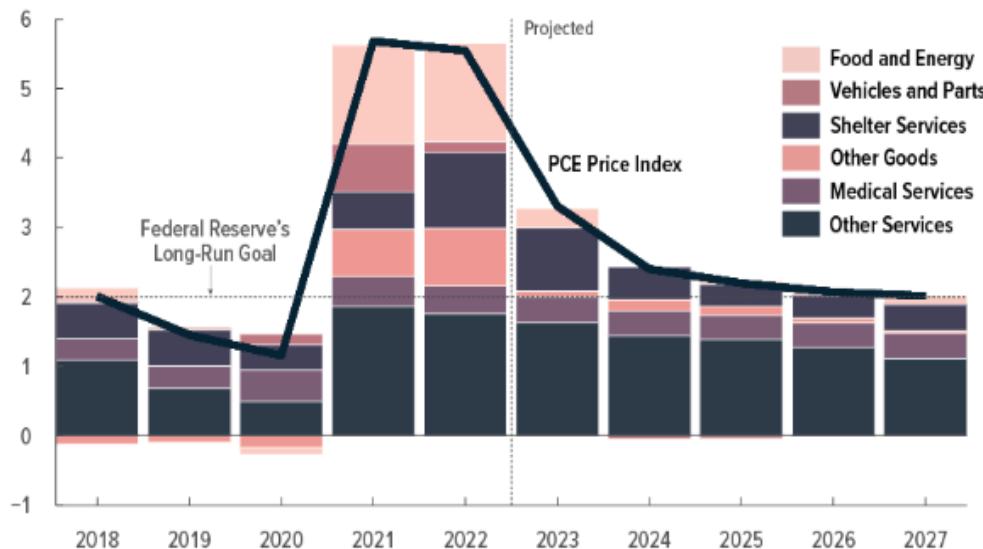


Exhibit 3: U.S. Inflation



The final battle with inflation may have yet to be fought, another rate hike (or two?) is in the cards, but the Fed is winning the war. Inflation peaked last summer at 9.1% (CPI). The last overall reading was 4% in May, and J.P. Morgan is forecasting a 3.3% reading in June. While that isn't close to satisfying the Fed's 2% target, and no one knows what the Fed will do next, the progress in the fight to get inflation to a low and stable level has been steady, and a wage-price spiral has not taken the reigns of the labor market.

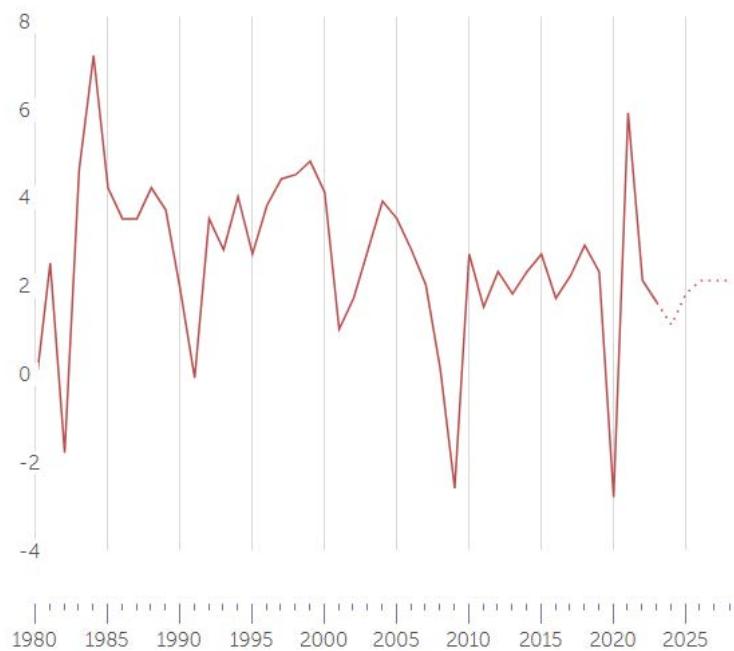
HEADLINE RISK: FOREST OR TREE?

Noisy headlines have grabbed our attention, but signaling from fundamentals is what matters. A few trees have fallen, but the forest hasn't been razed. Falling inflation and low unemployment are the two economic pillars that hold up the economy. The Fed has a dual mandate to keep the two metrics on target. Are we out of the woods? Don't count on it. The labor market is cooling, but is still relatively tight. Higher terminal interest rates could cause unemployment to climb through the end of 2024 to a forecasted ~4.8%, which would lead to a more pronounced economic slowdown and a mild recession. Wage growth is forecast to decline to 3.8% in 2024 and further from there. Spending is likewise slowing, but the factors underpinning income (the labor market) are stable. Many simply can't get over the feeling that the next piece of bad news will be the spark that starts a forest fire. While a downward catalyst isn't out of the question, the slowdown we are seeing is likely to lead to either a short-lived and shallow recession or the metaphorical "soft landing".

Exhibit 4: U.S. GDP Growth and Projection

Morgan Stanley's U.S. outlook now points to 1.2% GDP annual growth for 2023 and 0.8% in 2024. Bank of the West is forecasting 1.2% in 2023 and 0.5% in 2024. These numbers may include a couple of quarters of recessionary negative growth, but probably not a prolonged period of economic pain. What we are seeing in all of the accompanying charts looks more like normalization (or mean reversion) than a sharp decrease in economic activity.

Earnings, labor growth, spending and economic activity generally are slowing. For each tree, there will be a stage of sleep, creep and leap, and stagnating growth itself won't fell a forest. How soft the landing will be from the great inflation is unknown. For now, the chances that we are currently in a recession are minuscule.



In the next 12 months (to June 2024), Goldman Sachs estimates a 25% chance of a recession, while Bloomberg estimates 65%. Estimates are higher going out further. Even though forecasts vary widely, there seems to be a consensus that the economy is slowing, it may slow to the point of negative growth, and in the event that materializes it is likely to be mild and relatively short before growth picks up again.

STAYING THE COURSE: LONG-TERM RETURNS

In the long run, we'll see a recession eventually. It may or may not come from the current interest rate environment. Even if we had perfect foresight into the timing of economic decline, timing the market would still be a fool's errand. Economic foresight isn't enough to predict market behavior. While the stock market tends to recover ahead of the economy, whether a stock market recovery gets underway in advance of, just prior to, or during a recession is anyone's guess. Analysts at Morgan Stanley, among others, have commented that market cycles are getting hotter and shorter. Volatility is more pronounced, with bear markets and bull markets occurring at shorter intervals. The markets are more liquid, more efficient, and hold more information than ever before, and they are therefore more reactionary. This adds more noise to an already chaotic environment where investors are looking for signals.

| | 7 -Years MorganStanley | 10-Years Merrill Lynch | 10-Years JPMorgan | Average |
|-------------------------------|---------------------------|---------------------------|----------------------|---------|
| Investment Grade Fixed Income | 4.8% | 5.0% | 4.6% | 4.8% |
| Upper Tier High Yield | 7.1% | 6.4% | 6.8% | 6.8% |
| Private Credit | 9.3% | 8.4% | 7.8% | 8.5% |
| U.S. Equity | 4.9% | 9.8% | 7.9% | 7.5% |
| International Equity | 5.2% | 7.5% | 9.8% | 7.5% |
| Public & Private Real Assets | 6.3% | 7.3% | 7.5% | 7.0% |

Higher rates mean the opportunity to temporarily lock in higher yields. The best time to buy bonds is at the top of the hiking cycle, before the final interest rate hike. An eventual decline in rates will mean higher prices for bonds issued at current yields, increasing total return. Investors could do worse than clipping high coupons with more upside potential than downside risk at this point in the interest rate cycle. Cash offers attractive yields for now, but without any upside later.

Equities valuations have moderated, but overall U.S. equities remain expensive, especially in mega-cap growth (Tech and Communications). Other sectors look more fairly valued. International markets are sporting lower valuations, but pose higher risk. We could see a correction in equities before we experience a full recovery. Don't lose sight of the forest while in the midst of the trees. Don't let the trees obstruct your view of the forest. While putting capital to its best use given opportunities is always a good strategy, the old adage still holds: *Time in the market beats timing the market.*

| Asset Class | Opportunity Set | UW | N | OW | Change | Conviction | Description |
|--------------------|-----------------|----|---|----|----------|------------|--|
| Main asset classes | Equities | ○ | ● | ○ | ▲ | | Lower recession odds and more resilient growth suggest earnings downgrade cycle set to turn, positioning not stretched |
| | Duration | ○ | ○ | ● | Moderate | | Yields near top of range for most outcomes; risks from higher carry costs and persistent inflation reduce conviction |
| | Credit | ○ | ● | ○ | | | Spreads have tightened but still overcompensate for default risks; all-in yields attractive; prefer up-in-quality |
| | Cash | ○ | ○ | ● | Low | | Cash yields of around 5% are attractive and represent a carry hurdle for other assets; cash also useful as dry powder |

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