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Economic & Market Update

September 2023 Outlook

Global Economy

- After two quarters of effectively trend-like growth, the U.S. economy appears to have gotten off to a good start in the third quarter, as any pockets of weakness in production and housing have been rather mild while the consumer continues to spend at a healthy rate in the services and certain goods sectors. Higher rates may begin to impact spending by both consumers and businesses over the coming months, but this is more likely to lead to a slowdown as opposed to an economy-wide recession.

- The somewhat surprising strength of the economy this year may hinder to an extent the progress on moving inflation down to the 2% target. Headline inflation may increase a bit in coming months due to higher energy prices, but market participants will be more closely following core inflation which better incorporates wage inflation. The decrease in job openings and slowdown in jobs growth over the coming months should take some pressure off wage growth, although that last leg on the path to achieving the inflation target may be rather slow and arduous.

- Eurozone economic growth may be barely perceptible, but the Continental economy has so far avoided recession primarily due to the strength of the services-driven southern-tier countries that have benefited greatly from the global revival in services spending, particularly in the travel and leisure sector. Germany continues to be reliant on the growth of its key export destinations. The United States should be a reliable source of export growth, but concerns exist around China.

- With domestic spending expected to be muted for quite a while due to demographic headwinds, the Japanese economy will be reliant on exports of both goods and services (mainly travel) to both North America and Japan's Asian neighbors. This has been a surprisingly strong growth dynamic in 2023, which has been helped by a weak Japanese yen. The growth rate will likely slow but not stop given continued easy monetary policy.

- The disappointing growth of the Chinese economy has placed additional pressure on policymakers to construct a unified response that will help push gross domestic product (GDP) back to its longer-term growth rate. Government officials will be facing more permanent challenges of weakening demographics and continued trade tensions with the United States.

Monetary Policy

- Continued, albeit gradual, progress in reducing inflation and nascent signs of cooling in the hot labor market should convince the Federal Reserve (Fed) to keep rates steady at the September Federal Open Market Committee meeting and may lead to the end of the tightening cycle. Various Fed speakers have warned against expectations for rate cuts over the coming months, but success in the effort to bring down inflation should convince the Fed by early next year to retreat somewhat from what is now considered a restrictive monetary policy.
- The European Central Bank and Bank of England are also both near the end of their respective tightening cycles, although inflation is proving to be stickier at higher levels than seen in the United States. Expect at least one additional rate increase at each of these central banks, with further progress on reducing inflation allowing an end to rate increases by year-end.
- The Bank of Japan should finally begin to move away from its zero-percent interest rate policy as voting members become more convinced that inflation has become somewhat entrenched and deflation risks have dissipated. The bank would also likely want to control any further depreciation of the Japanese yen, which could lead to greater friction with trading partners.
- There should be continued pressure on the People's Bank of China to reduce rates in an effort to boost China's GDP growth. The central bank will be forced to move slowly to prevent substantial currency depreciation, which could lead to capital flight from the country.

Bond Markets

- The shift upward in the yield curve and increase in the 10-year U.S. Treasury yield above 4.0% have made bonds relatively attractive from a portfolio construction perspective. However, the forecasted economic growth environment of a "slowdown but no recession" should continue the rate normalization process, which is likely to put some additional upward pressure on yields in the intermediate to longer maturities.
- Expected progress on inflation should allow short rates to decline over the coming months, as market participants anticipate the end of monetary tightening and gradual easing of what may be an excessively restrictive federal funds rate. This combination of slowly declining short rates with stable to slightly rising longer rates should finally resolve the inverted yield curve.
- Yield spreads in the below-investment-grade bond space have remained rather narrow, as fears of an impending recession have dissipated. Refinancing pressures should accelerate in the high-yield market over the next few quarters, which should lead to widening spreads. Investors should therefore be cautious around investments in the asset class.

Equity Markets

- Although experiencing a slight pullback in August, U.S. large cap equities have delivered strong year-to-date performance, which has been driven solely by valuation multiple expansion as earnings have been declining over the first two quarters. With interest rates rising to higher levels, investors will be looking for earnings growth to be more of a driver of further appreciation. A resumption of earnings growth in the benchmark indices would also foster a greater breadth of participation in any further advance, as performance has so far been concentrated in several stocks in only a few sectors.

- European equities generally trade at meaningfully lower valuations than those in the United States, which is primarily driven by lower earnings growth rates in much more cyclically sensitive markets. To the extent the global economy can stay out of recession, equities on both the Continent and in the United Kingdom should be able to produce modest appreciation through year-end. A more definitive end to monetary tightening would remove an important headwind to these equity markets.
- Japanese yen depreciation and the relative strength of the U.S. export markets have helped drive very strong performance of Japanese equities, although for unhedged dollar-based investors, currency has subtracted roughly 10 percentage points from the return. As it does not appear that monetary policy is about to tighten meaningfully over the coming months, valuations should not be challenged, and the earnings growth of the exporters can drive some further equity price appreciation.
- Given the challenges of a weak property market and a pronounced slowdown in the export sectors, Chinese equities seem to need more fiscal and monetary policy support to enable a catch-up to the performance seen year to date in developed equity markets.

Commodities & Currencies

- Effective supply restrictions out of OPEC+ nations led by Saudi Arabia combined with better-than-expected demand growth have allowed oil prices to continue appreciating over the summer. There has been a distinct increase in supply coming out of the U.S. producers, as West Texas Intermediate oil prices remain above $80 per barrel. This supply should prevent any substantial spike higher in prices but not be enough to cause prices to fall given the anticipated maintenance of demand.
- Gold prices should remain in a rather narrow trading range until there is greater certainty that central banks are indeed at the end of their tightening cycles.
- A stronger economic growth rate compared to other developed market economies helped the U.S. dollar break above the upside of the trading range it had been mired in for most of the year. The earlier end of monetary tightening at the Fed compared to many other central banks should limit further appreciation except perhaps against the Japanese yen.

What This Means for Investors

The appreciation in prices seen so far this year in most global equity markets is leading to a general assessment that equities are fairly valued at current levels with further appreciation reliant on a resumption of broader earnings growth. Interest rates at current levels are now much more competitive with equities—and not only at the short end of the yield curve. The biggest risk to this rather stable environment appears to be excessive central bank tightening, which could provoke an unnecessary recession. The cooling of the hot labor market is the most important factor in more confidently predicting the end of central bank rate increases.

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