Economic & Market Update

Third Quarter 2023 Review & Forecast

Review of the Quarter

With three months left in the year, most U.S. recession forecasts have been postponed to 2024. A Fed hiking cycle, a troubled regional bank sector, an anemic housing market, and an unstable fiscal and political outlook have failed to pull Gross Domestic Product (GDP) growth much below trend, let alone below zero. After growing at 2.2% in Q1 and 2.1% in Q2, Q3 looks even stronger and should come in at around 2.5%. Underpinning this economic resilience is a still-flush consumer that has a job with a growing wage and continues to spend. Real (inflation-adjusted) Personal Consumption Expenditures continue to chug along at year-over-year rates north of 2%, with particular strength in the service sector. It will be difficult to see any recessionary scenario without a material slowdown in service spending, which makes up roughly half of U.S. GDP. Beyond some potential cyclical headwinds such as dwindling pandemic savings, and resuming student loan payments, we see new structural consumption tailwinds emerging as the baby-boom generation continues to retire. This growing population of retirees is wealthy, insulated from labor market dynamics, and may pick up some slack if younger generations begin to cut back on spending.

The housing sector may be trying to bottom out but is struggling to recover in the midst of declining affordability. Average 30-year mortgages returned north of 7% to beat their October 2022 highs, further locking in current homeowners now paying lower rates. This has had a notable dampening effect on existing home sales. Despite higher mortgage rates, tight supply still seems to be keeping the housing recession from pulling prices down too far. After briefly dipping into slight year-over-year losses, the S&P/Case-Shiller U.S. National Home Price Index turned positive again, rising 1.0% in July. Seeing resilient prices and low inventories, homebuilders are beginning to step in as the marginal supplier. Building permits and single-unit housing starts have been steadily climbing this year. On the other hand, multifamily housing starts, which were strong in 2022, plunged 41% year-over-year in August. Developers may be reconsidering the viability of new projects given new supply, a cooling rental market, and a difficult financing environment. A prolonged pullback in this space without improvement on the single-family side could mean that things get worse before they get better in the housing sector.

The overall European economy continued to skirt a recession in the quarter, but growth is anemic with Germany likely in recession due to the pressure of higher energy prices and disappointing growth in China, an important export destination. The southern tier countries, which tend to have stronger services economies, are beginning to feel the impact of high inflation with consumer spending slowing throughout the quarter. The Japanese economy has been boosted by exports to the U.S. and a weaker yen, which declined another 2.5% during the quarter and helped boost exports.

Chinese growth is struggling to return to trend after a disappointing re opening from harsh pandemic restrictions. With debt-laden developers struggling to make interest payments, activity in the property sector, which accounts for an outsized portion of GDP in China, continues to suffer. On the consumer side, negative wealth effects from falling home prices (the source of most wealth in China) are impacting consumer confidence and holding spending below expectations. Falling demand for exports from Western economies also hasn't helped. The Chinese government has held off meaningful deficit spending to meet its 5% growth target, preferring a series of smaller, more targeted fiscal measures and monetary easing that it hopes can boost confidence without increasing corporate or government debt burdens.

The quarter saw an impressive return to strength in the energy markets. West Texas Intermediate (WTI) crude oil rose from $71 on June 30th to $91 at quarter-end on the back of continued production cuts from OPEC+, led by Saudi Arabia and Russia. Higher production from non-OPEC countries (U.S., Brazil, Canada) is softening the blow, but the U.S. Energy Information Administration still predicts that global crude inventories will have flipped from surplus to deficit in Q3 for the first time since Q4 2021.

Higher oil prices are showing up in headline inflation, with the Consumer Price Index (CPI) rising by 3.7% year-over-year in August from June's low increase of 3.0%. Meanwhile, 12-month core CPI continues to march lower, from 4.8% in June to 4.3% in August. Core inflation is down from its September 2022 peak of 6.6% but it remains well short of the Fed's 2.0% inflation target. At this point, inflationary concerns are primarily in service prices, with inflation in durable and nondurable goods prices having returned to trend, if not outright deflation. On the service-sector side, shelter inflation was still running hot at 7.2% year-over-year in August, but it is expected to fall as the official figure absorbs more of the recent normalization in house price appreciation and rent growth. Wage inflation, the main input to non-shelter service inflation, continues to abate, but it remains above the Fed's target levels.

Concerns about sticky wage inflation have kept the Fed focused on the tight labor market. The central bank's goal of reducing job openings and employee turnover, rather than forcing layoffs, seems to be working so far. This should help curtail the elevated "job hopping" that has shown itself to be a driver of big pay bumps. Wage growth has indeed begun to roll over without an accompanying increase in the unemployment rate, keeping soft landing hopes alive. Even as nominal wage inflation slows from its peak, consumer price inflation has mostly been falling at a faster rate, which implies higher real disposable incomes that allow for continued strength in consumer spending.

After raising the fed funds rate by 25 basis points in July, the Federal Open Market Committee (FOMC) held rates steady at the 5.25%–5.50% target range in its September meeting. A revised Summary of Economic Projections revealed a median estimate among Fed members of one more hike this year, and two cuts next year (down from four in the June release). GDP growth for 2023 was revised up to 2.1% from 1.0% while the year-end unemployment rate was revised down from 4.1% to 3.8%. Additionally, the estimate for 2024 unemployment rate was ratcheted down to 4.1% from 4.5%, as GDP is expected to grow 1.5% in 2024. In its accompanying statement to the FOMC meeting, the Fed said job gains were "slowing" as opposed to the "robust" characterization coming out of the July meeting. The Fed re-emphasized its commitment to the 2% inflation target despite some calls to adjust the target higher to reflect some of the more permanent effects of deglobalization that has occurred so far this decade.

After a very strong first half of the year, U.S. equity markets lost some steam in the quarter. The S&P 500 Index fell by close to 4%, reducing its year-to-date performance down to a still strong 12%. Value stocks outperformed growth stocks as the energy sector emerged as a clear market leader, while the previously dominant "magnificent seven" (Meta, Alphabet, Amazon, Apple, Microsoft, Nvidia, Tesla) took a step back. Developed international equity markets were down in the quarter, but outperformed US equities as they tend to be more exposed to the value or defensive sectors of the market. Emerging market equities declined as the Chinese market struggled with a slower than expected rebound after the removal of severe Covid restrictions and acute pressure on its property sector.

The corporate earnings picture for 2023 doesn't seem as bad as anticipated at the beginning of the year, possibly forming a trough in Q2 at around -9% year-over-year. This "earnings recession" has been mainly due to compressing margins, as nominal revenue growth slowed from its peak but remains strong at almost 10% year-over-year. Companies are still seeing last year's inflation spike work its way through their input and labor costs and are apparently hitting limits in their ability to pass these costs along to consumers, which is a good sign for inflation going forward. S&P 500 forward earnings estimates have begun to stabilize near $220 for 2023 and $245 for 2024, implying near-zero growth for this year, but double-digit growth expectations for next year.

The surprisingly strong economic activity fueled fears of sticky inflation, causing another push higher in interest rates. Ten-year Treasury yields marched past their previous peak of 4.25% in October 2022 to reach 4.70%, higher than at any point since before the Great Financial Crisis. The sell-off in 10-year Treasuries helped contribute to some correction of the inverted yield curve, with the inversion between 2-year and 10-year yields closing by half from above -1% at the beginning of the quarter to roughly -0.50% by its end.

Outlook for the Fourth Quarter and into 2024

Higher interest rates, higher energy prices, and a potentially protracted United Auto Workers strike will likely exert some downward pressure on the U.S. economy in the fourth quarter. The resilient U.S. consumer will be tested, but job and wage growth over the coming months should continue to support spending. With the economy experiencing more of a rolling recession than an economy-wide decline, the housing market downturn, which began last year, appears to be bottoming — though mortgage rates will impede a near-term recovery. The manufacturing sector may be in recession moving into the fourth quarter as businesses work down excess goods inventories accumulated at the end of the pandemic. However, the manufacturing recession should be short and shallow as the inventory overbuild was rather mild. This leaves the service sector, which continues to grow at impressive rates through three quarters of the year. While higher interest rates and higher prices may reduce demand slightly, robust consumer income should prevent a meaningful downturn.

Some longer-term secular trends support the economy and may cushion a slowdown. The millennial generation, which put off having families for much longer than any recent generation, is finally starting families and buying houses. The demand skew is at lower price points, but it should keep builder production steady unless mortgage rates rise sharply. The notable trend of U.S. companies bringing manufacturing closer to home is leading to a distinct increase in commercial and industrial construction, and this should help stabilize an employment downturn — if in fact one appears. Finally, the baby- boom generation continues to retire in large numbers and is in much better health than its predecessors and has more accumulated wealth. As a result, this demographic bracket is likely to spend at higher rates than previous retirees, particularly during the first decade of retirement.

The Fed did not increase rates at either the June or September meetings after raising rates by 25 basis points in July. It may have moved into a tightening cadence, where it targets every other meeting. The odds of a tightening at the November meeting (there is no meeting in October) stand at around 50% moving into the fourth quarter. With a government shutdown averted for now, the six-week period between the September and November meetings should provide enough economic data points to convince the Fed to remain on hold as core inflation, particularly wage inflation, continues to trend down toward its 2% target. If the Fed skips another meeting, it is likely done with the rate tightening cycle while continuing to reduce its balance sheet. However, the possibility of further hikes makes excessive tightening into an already slowing economy the biggest risk to markets as we approach year end.

Although inflation in Europe is higher and proving more stubborn than in the U.S., there is little accord between members of both the Bank of England and European Central Bank (ECB) for further tightening and potential eases. It appears there is growing acceptance among central bankers of the limitations of monetary policy in fighting supply driven inflation. In this view, raising rates puts undue pressure on consumers and businesses. With the Continental economy already on the brink of recession, the ECB should be near the end of its tightening cycle. The Bank of England has increased rates as aggressively as the Fed and more aggressively than the ECB, so it too should be nearly finished, unless inflation stalls in its downward descent.

In Asia, the Bank of Japan (BOJ) remains the lone holdout among developed- market central banks in maintaining its zero-interest rate policy. This has helped produce the inflation the Japanese government has been seeking for years, but it has also caused a sharp fall in the yen, which may rankle trading partners. Look for the BOJ to begin serious discussions and provide previews about implementing a tightening cycle early next year. The Peoples Bank of China has room, and likely a reason, to ease policy rates to achieve better economic growth, but it will proceed carefully to prevent currency depreciation and capital flight.

Greater than anticipated economic growth along with rising energy prices have driven yields higher across the maturity spectrum. The inverted yield curve should continue to correct through a combination of higher intermediate and longer rates and a Fed that can soon begin to reduce the fed funds rate as inflation declines closer to target. Spreads on high- yield debt narrowed further during the third quarter, leaving the asset class rather expensive given expectations for slower economic growth through the next few quarters. The concern in this space is less about sharply rising default rates due to declining revenue growth than the refinancing risk from having to reissue matured debt at much higher interest rates.

The pullback in equity markets at the end of the third quarter was driven primarily by higher interest rates as valuation levels came under pressure. Second-quarter earnings results and company guidance for the second half of the year were both incrementally higher than expected. Our forecast for continued economic growth in 2024, though at lower rates, should lead to top- line revenue growth. A decline in input prices in an improving inflation environment should help margins expand somewhat. This should lead to a resumption of earnings growth after a few quarters of year-over-year declines. With no expectation of multiple expansion in this higher interest rate environment, the onus will be on earnings to drive equity- price appreciation back to levels not seen since early 2022.

European equities are cheaper than U.S. on a valuation basis. However, European economies are growing slower and are closer to recession. Ending the tightening cycle would increase confidence in the economy and future earnings growth. The combination of relatively low rates and positive earnings growth should lead to multiple expansion in the market.

Japanese equities have been very strong performers in their local markets, but the substantial yen depreciation against the dollar has reduced a good portion of that performance for dollar-based investors. Policies to stabilize the yen, even if it entails a degree of monetary tightening, should be received favorably by international investors, who generally invest on an unhedged basis. Positive world GDP growth moving into 2024 should support Japanese export sectors, while some wage inflation should boost domestic sectors.

A rebound in Chinese equities will be needed for the emerging markets space to match returns expected from developed markets. In addition to further policy support from both the fiscal and monetary authorities, Chinese markets need some relief from stresses in the property sector.

Latin American markets should be supported by higher energy prices — though other commodity markets important to the region have not experienced similar appreciation. The end of dollar strength should be supportive of these markets with the reshoring (or near-shoring) trend and additional longer-term support.

Worry about stalled disinflation led Fed members to forecast additional tightening and fewer fed funds rate reductions in 2024. The dollar appreciated notably in this environment during the third quarter despite energy- price increases. With relative economic growth rates and interest rates generally favorable for the dollar, we do not expect the dollar to decline notably from current levels, but any confirmation that the Fed is ending its tightening cycle should prevent further protracted advances.

WTI crude oil prices may reach $100 a barrel by year-end, but shouldn't break too much above those levels as OPEC+Russia supply reductions are set to expire by then, and non-OPEC production has begun to ramp up. Demand growth beyond current levels will depend on China's success in boosting its economic growth. Industrial-metal prices are also very much a function of world economic growth, but particularly growth in China with its historically voracious demand. With supply now sufficient for most underlying commodities in the space, metals like copper should remain in a tight trading range through coming months. A rising rate environment is usually a difficult one for gold prices as the yellow metal has no yield and does better when central banks are easing policy. Further declines are likely until the market gains more clarity as to the timing of easing policies in the developed economies.

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