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Economic & Market Update

November 2023 Outlook

Global Economy

- The U.S. economy has grown faster over the first nine months of 2023 than any forecaster predicted, led by the flush and well-employed consumer. The savings rate has declined to 3.4%, so consumption will no longer be driven by the spending of excess savings; however, job and wage growth should allow for continued growth in consumer spending, albeit at a lower rate. Business spending will remain muted as inventories are drawn down. Confidence among supply managers about future demand is improving to the extent that any manufacturing recession this year should prove to be short and shallow. The services economy should be the next sector to slow as travel demand has been generally sated and rising costs begin to have an impact.
- The steady decline in the inflation rate seen since it peaked in the summer of 2022 stalled somewhat over the summer. That "last mile" of the journey toward the 2% target established by the Federal Reserve (Fed) is proving rather difficult, as stubborn services inflation has largely offset the success in eliminating goods price inflation. The tight labor market has kept wage inflation high, and the recent settlement between the major auto manufacturers and United Auto Workers is an indication that negotiating power may be tilting toward the side of labor.
- Europe remains on the precipice of recession as the manufacturing-driven northern economies led by Germany struggle with waning domestic goods demand, higher energy prices and weaker growth among some of their key Asian trading partners. Continued services expansion, particularly among the southern-tier countries, has helped the larger region avoid recession but that growth is expected to slow over the coming quarters.
- In Asia, Japan has produced higher-than-anticipated growth year to date on the back of net trade. The weaker Japanese yen has been helpful in boosting exports and muting imports while overall domestic demand remains rather tepid. We expect the economy to slow through the rest of the year into 2024, but continued easy monetary policy will keep the country out of recession.
- Chinese economic growth will continue to be negatively impacted over the long run by weak population demographics and ongoing trade and political tensions with the United States. However, in the near term, government fiscal expansion should help the country achieve its 5.0% growth target for 2023.

Monetary Policy

- While the Fed will continue to jawbone about remaining vigilant in the fight against inflation, it is likely finished with its rate tightening campaign, as ongoing balance sheet reduction and higher rates across the yield curve are creating sufficiently tight monetary conditions. Any decrease in the federal funds rate will be contingent on meaningful progress in bringing the inflation rate closer to the 2% target, which is not likely to occur until the middle of next year.
- Despite inflation being generally higher in Europe than currently seen in the United States, both the European Central Bank and the Bank of England are also likely finished raising rates due to their weakening economies.
- The Bank of Japan is still resisting the tightening trend evident among the other developed market central banks. The policy rate remains slightly negative and relaxation around the yield curve control bands has been only slight. Resulting pressure on the yen should soon lead to the solidified inflation environment that the government has been seeking. We should see more tightening of policy by the first half of 2024.
- Monetary policy in China is expected to complement fiscal policy in providing stimulus to economic growth, but the People's Bank of China will be limited in its ability to help by the potential for unwanted currency depreciation and capital flight.

Bond Markets

- The stronger-than-expected economic growth environment continues to exert upward pressure on Treasury yields across the maturity spectrum. Additional supply of Treasury securities to finance the growing fiscal deficit is adding additional upward pressure now that the Fed has left the intermediate maturity market.
- With growth expected to slow and inflation expected to decline over the coming months, intermediate maturity yields have likely peaked. The inverted yield curve is slowly correcting itself but will not fully return to the more normal upward slope until inflation moves closer to the Fed's target.
- Interest rate spreads in the high-yield sector of the market have finally begun to widen—more of an indication of a slowing economy as opposed to any more pronounced weakening. While wider, the spreads are not currently wide enough to compensate investors for the credit and refinancing risks that appear on the horizon.

Equity Markets

- The sharp increase in interest rates has challenged equity valuations at a time when corporate earnings have flattened. This led to a 10% correction from the highs achieved in the U.S. equity markets over the summer. Third quarter earnings should be slightly positive when all the reports are in but accompanying the reports have been some warnings by corporations of a revenue slowdown. Fortunately, input costs are declining so margins may expand slightly as an offset. Positive earnings growth is expected in the fourth quarter and throughout 2024, although the magnitude of growth expectations is likely to be revised downward as revenue growth slows.
- Slower economic growth and heightened geopolitical risk made the correction in many of the European bourses worse than that in the United States. Valuations are cheaper in Europe, which is likely warranted by lower expected economic and earnings growth. As earnings for large cap European equities are heavily reliant on the state of the global economy, continued growth in the United States and China will lead to some earnings growth, which should be a catalyst for a resumed advance in equity prices.
- The countertrend maintenance of extremely loose monetary policies helped the Japanese market outperform other markets

in their local currency, but the sharp decline in the yen has stripped much of that outperformance for unhedged foreign investors. The eventual end of zero interest rates and yield curve control may be viewed as a positive sign of normalization, which could attract more capital into Japanese equity markets.

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- The countertrend maintenance of extremely loose monetary policies helped the Japanese market outperform other markets in their local currency, but the sharp decline in the yen has stripped much of that outperformance for unhedged foreign investors. The eventual end of zero interest rates and yield curve control may be viewed as a positive sign of normalization, which could attract more capital into Japanese equity markets.
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Commodities and Currencies

- Crude oil appears to have settled into a range between $80–$90 per barrel for West Texas Intermediate, as the concerns about disrupted supply out of the Middle East are offset by better production out of the United States and slowing global demand. Any breakout of this range is likely to be through the upper end in this tense geopolitical environment.
- Restrained domestic consumption growth in China and an inventory glut of electric vehicles should prevent any sharp appreciation in industrial metals, with prices remaining stable to trending downward through year-end.
- Gold has been quite volatile over the past few months as the headwind of rising rates has given way to its value as a haven asset when geopolitical risks rise. It will be difficult for gold prices to break much higher given the current level of global rates, with little chance of meaningful monetary ease until the middle of next year.
- Outsized U.S. economic growth, which will prevent the Fed from easing in the near future, has helped push the U.S. dollar higher. With the U.S. economy expected to slow in the fourth quarter and into 2024, the dollar should stop appreciating, but it is hard to identify the catalyst for any other global currency to meaningfully appreciate against the dollar until the Fed strongly signals a decrease in the federal funds rate.

What This Means For Investors

- Now that equities have corrected to more reasonable valuation levels given the rise in rates, corporate earnings in a still-positive economic growth environment should be the driver of appreciation as we approach year-end and move into 2024. Risks abound in these markets that will further restrain any valuation-driven advance. Interest rates have normalized and should not move much higher as inflation continues to decline. This makes fixed income relatively attractive for the first time in quite a while.

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