Ayco Personal Financial Management

SEPTEMBER 2023

Summer Review, Fall Preview

July was a strong month across risk assets, supported by resilient US economic data largely in support of a soft-landing scenario. US equities, as measured by the S&P 500 index, were up five consecutive months through July. Despite falling -2% in August, US equities are up 19% year-to-date and have outperformed most major economies. Meanwhile, bond yields trended higher overall in August.

As we look ahead to the rest of the year, the key focus areas for investors continue to be US economic data, Fed policy, and the risk of recession. In our Summer Review, Fall Preview we recap key economic and financial market news from the summer and outline the Investment Strategy Group's (ISG) expectations for the rest of the year on the US economy, fixed income, and equities.

Summer Recap: Review of Financial Markets in July & August

Highlights From July...

July was a strong month across risk assets. Resilient US growth gave the market increasing confidence in the possibility of a soft-landing scenario. This led to an increase in risk appetite across the board.

The S&P 500 gained 3.2% for the month, with the MSCI EAFE and MSCI EM indices following suit, rallying 3.2% and 6.3% respectively. This marked the fifth consecutive monthly gain for the S&P 500, buoyed by the excitement around Artificial Intelligence (AI) and its potential boost to productivity.

On the other hand, fixed income markets faltered in July. Both the US Federal Reserve (the Fed) and European Central Bank (ECB) hiked interest rates by 25 basis points, respectively. The ISG base case is that this will be the final rate hike for both the Fed and ECB in this cycle, with no cuts until at least the second quarter of 2024.

Across commodity markets, oil stole the show. Supply cuts and an ongoing global demand recovery led WTI and Brent to rally in July by 15.8% and 14.2%, respectively.

US economic growth continued to surprise to the upside. The first estimate of Q2 GDP came in much stronger than expected, rising by 2.4% (quarter-on-quarter, seasonally adjusted annual rate). Note, the second estimate of Q2 GDP in August was revised down to 2.1%, which is still above the consensus forecast prior to the first estimate of 1.8%.

Non-Farm Payrolls (NFP) for June came in at +209k (and was subsequently revised down to +185k), the softest print since December 2020, though unemployment ticked down by a tenth to 3.6% from 3.7% a month prior.

On inflation, the Consumer Prices Index (CPI) dropped to 3% year-over-year (YOY) in June and core inflation slowed to 4.8% YOY driven by reductions in used vehicle prices and shelter inflation.

Highlights From August...

Following strength in July, major equity markets fell in August. The S&P 500 ended the month -2%, with the MSCI EAFE and MSCI EM down -4% and -6% respectively. Bond yields moved higher in the first half of the month. Assets in China struggled amid ongoing headwinds from the outsized property sector. The policy response from Beijing has been tepid (so far), with only minor interest rate cuts.

Non-Farm Payrolls in July were mixed, with the headline figure coming in below expectations (+187k) with negative revisions to prior months, though unemployment again edged a tenth lower to 3.5%.

Regarding inflation, CPI came in at 3.2% YOY in July, below consensus expectations of 3.3%—but marginally increasing compared with June due to base effects.

The minutes of the July Federal Open Market Committee (FOMC) meeting contained no major surprises. Members remain open to more rate hikes but expect a moderation in economic activity over the second half of 2023 will help ease price pressures.

In the euro area, activity data such as PMIs and consumer confidence surprised to the downside in August. This weak economic data increases the risk of a recession in the euro area, according to ISG.

At the end of August, at the 2023 Jackson Hole Economic Policy Symposium, Chair Powell noted that the FOMC will "proceed carefully" when deciding whether to hike or hold the policy rate constant at future meetings. Powell was slightly more hawkish on risks to the outlook than at the July press conference, saying the FOMC is "attentive to signs that the economy may not be cooling as expected." Meanwhile, ECB President Christine Lagarde spoke about inelastic supply chains and tighter labor markets as potential risks to long-term inflation.

What is the Jackson Hole Economic Policy Symposium?

The Federal Reserve Bank of Kansas City's Economic Policy Symposium in Jackson Hole, Wyoming, is one of the longest-standing central banking conferences in the world. Over its 35-year history, the event has brought together central bankers, economists, financial market participants, academics, public officials and the news media to discuss long-term policy issues of mutual concern. Past symposiums have focused on topics such as inflation, labor markets and international trade.

Fall Preview: Expectations for the Rest of the Year

US Economic Outlook

Growth

Overall, economic data in the US has come in ahead of expectations during the first half of this year. There is also positive momentum in economic activity going into Q3. As a result of these developments, ISG have raised their expectations for 2023 US GDP growth from 1.4% to 2.1% (annual average rate).

Nevertheless, ISG expects growth will gradually slow in the second half of this year and will remain below potential going into 2024. Contributing factors include:

- An easing labor market (implying lower wage growth and thereby a deceleration of disposable income growth)
- High real rates
- The resumption of student debt payments in October. Student loan payments have been suspended since March 2020 when they were first paused as part of the pandemic relief measures

Recession Odds

Resilient economic data in the first half of 2023 has pushed out recession fears across the street into late 2023 or 2024. In July, ISG lowered their odds of a US recession over the next 12 months from 45-55% to 30-40% to acknowledge:

- More resilient than expected US economic data
- A diminishing headwind from the Fed's monetary policy tightening
- Less than feared drag from credit tightening sparked by the regional banking turmoil

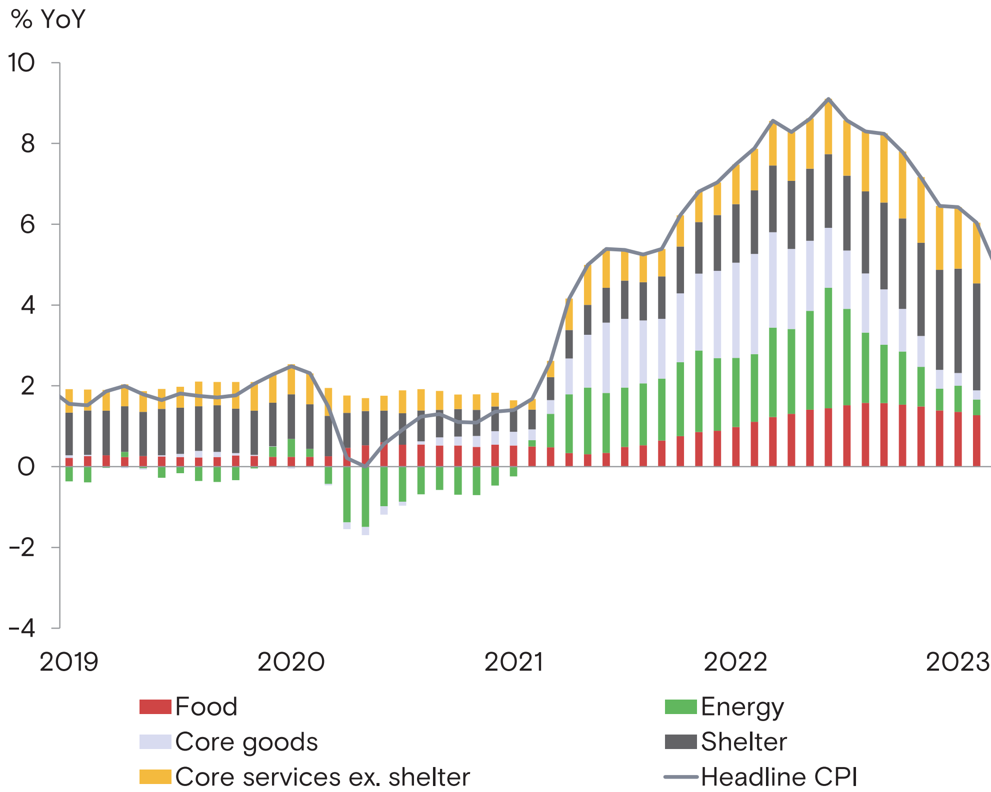
Even so, ISG notes several recession indicators continue to flash red.

Finally, there are a wide range of US recession probabilities across the economic forecasting community. Goldman Sachs Global Investment Research (GIR) reduced their estimated 12-month US recession probability to 15% on September 4, down 5% from their prior estimate, due to continued positive inflation and labor market news. They point out that their recession odds are far below Bloomberg consensus, which remains at 60%.

Inflation

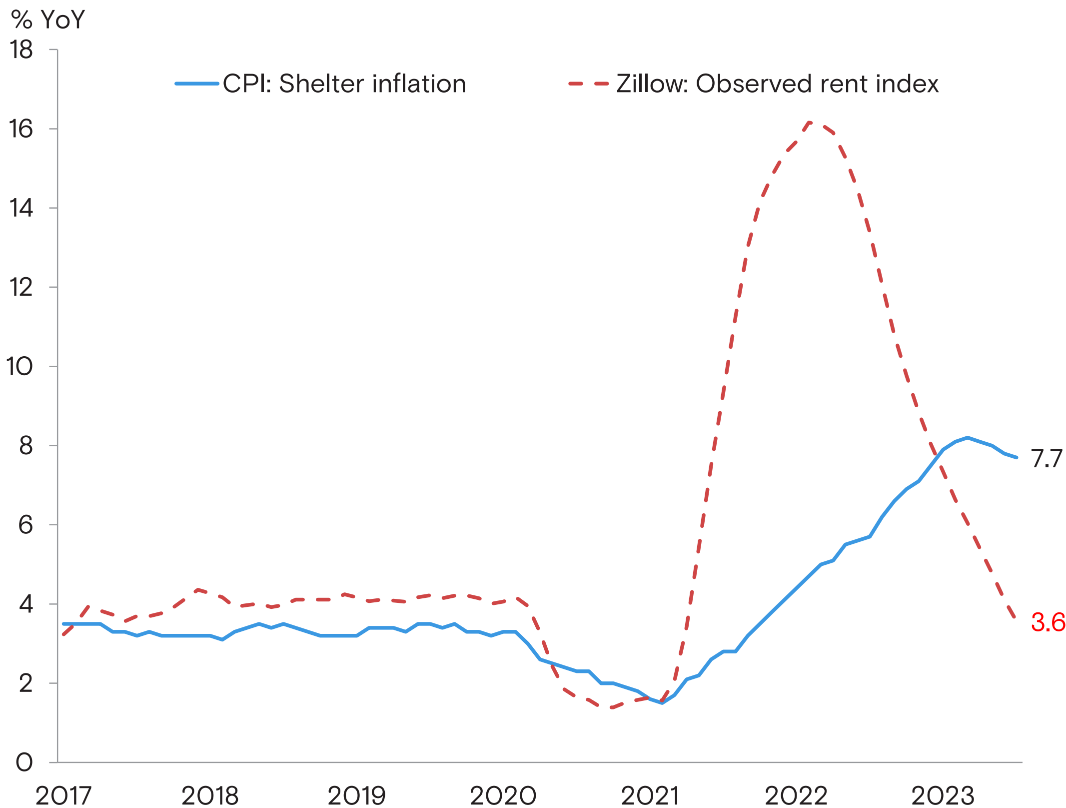
Inflation has eased since peaking in the summer of 2022. Falling oil prices and easing global supply bottlenecks have pushed energy and core goods prices lower (**Exhibit 1**). However, shelter inflation— which represents about 44% of core CPI—has been stickier, having fallen only 0.5% from its March peak of 8.2%.

Exhibit 1: Consumer Price Index (CPI) – Contributions to Headline Inflation – Through July 2023



Source: Investment Strategy Group, Haver Analytics

Exhibit 2: US Market Rents and Consumer Price Index (CPI) Shelter Inflation – Through July 2023



Source: Investment Strategy Group, Haver Analytics

ISG expects a more meaningful moderation in shelter inflation going forward. Market-based rent indexes have shown recent weakness (**Exhibit 2**). Historically, it's taken ~12 months for movement in these indexes to impact CPI. When coupled with reduced supply constraints and a gradual easing of the labor market, it points to further moderation in overall inflation for the second half of this year.

That said, ISG anticipates headline and core inflation will remain well above the Fed's 2% target going into 2024. Given US economic resilience this year, ISG sees risks to inflation tilted to the upside.

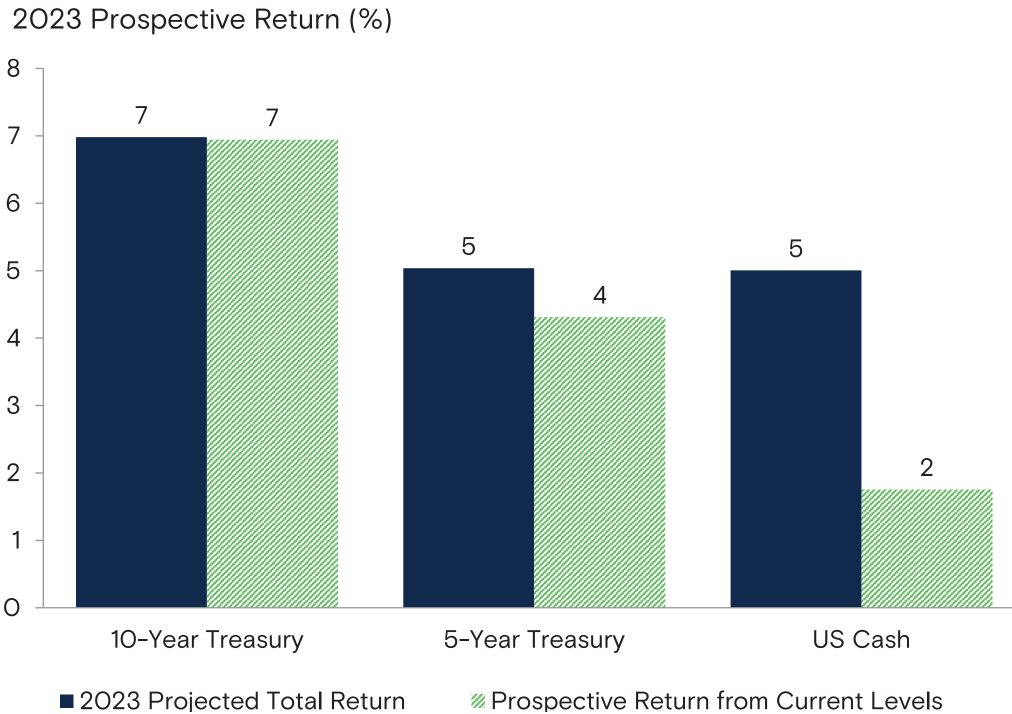
Monetary Policy

Inflation and employment data since the previous July FOMC meeting have been broadly in line with expectations—showing progress toward moderating inflation and an easing of the labor market. ISG's base case is that the July hike was the last in this hiking cycle and the FOMC will remain on hold through the rest of the year. The FOMC could seek to prevent financial conditions from easing prematurely and there remains the chance of an additional 25 basis point hike in September or November. Even absent an additional hike, their communications will likely continue at a hawkish bias to maintain restrictive financial conditions.

US Fixed Income Outlook

Against a backdrop of better-than-expected economic data and lower odds of a recession, ISG recently increased their 2023 year-end forecast for 10-year US Treasury yields to 3.25-3.75%. Elevated recession odds have placed increased importance on the role of duration in fixed income portfolios. Although prospective returns for cash and intermediate Treasuries are similar in ISG's base case, fixed income provides superior expected returns against negative growth shocks (**Exhibit 3**). In fact, high-quality fixed income is the only asset class that has effectively hedged against deflationary shocks in the past. As such, ISG continues to suggest that client portfolios be at their strategic duration benchmark—which is four years for a US taxable moderate portfolio.

Exhibit 3: ISG 2023 Projected Total Return and Prospective 2023 Returns From Current Levels – As of August 31, 2023



Source: Investment Strategy Group, Bloomberg

Forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change.

US Equities Outlook

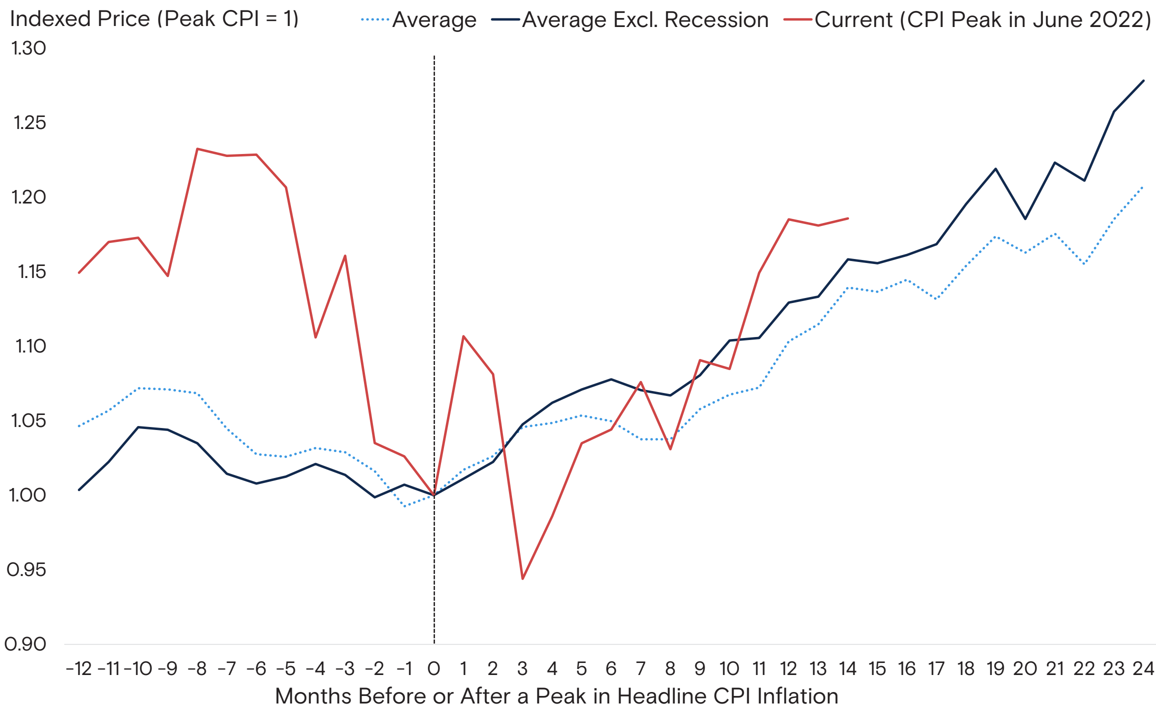
At the outset of 2023, ISG's good-case scenario for the S&P 500 was 4,800 by year-end. They recently increased the probability of this outcome to 30% from 25%. At the same time, ISG revised their 2023 bad-case scenario up to 3,850 and reduced the likelihood from 25% to 20%. The current level of the S&P 500 exceeds ISG's base case range of 4,200 to 4,300 for year-end—which has been above consensus for the year. The difference between the base case range and current trading levels of the S&P 500 is well within normal equity volatility and does not undermine ISG's recommendation that clients stay invested.

ISG's base case year-end target for the S&P 500 assumes above-consensus earnings growth (mid-single digits vs. consensus implying 1.5% growth YOY). Recent Q2 results came in better than feared and support ISG's view that profit margins should stabilize. Several factors should help support profit margins moving forward (just as they weighed on them over the last year), including improving supply chains, easing input costs, the decline of the US dollar from last year and moderating wage costs.

Despite the year-to-date gains, there is still scope for further US equity upside.

- A peak in inflation has historically been favorable for equity returns, and the gains seen this year are representative of what has transpired following past inflation peaks. **Exhibit 4** shows the average S&P 500 price return has been favorable in the 24 months following a peak in the inflation cycle (blue lines). The current cycle (red line) broadly maps the average.

Exhibit 4: S&P 500 Indexed Price Return in the Year Before and After Past Peaks in Consumer Price Index (CPI) Inflation* – Through August 31, 2023



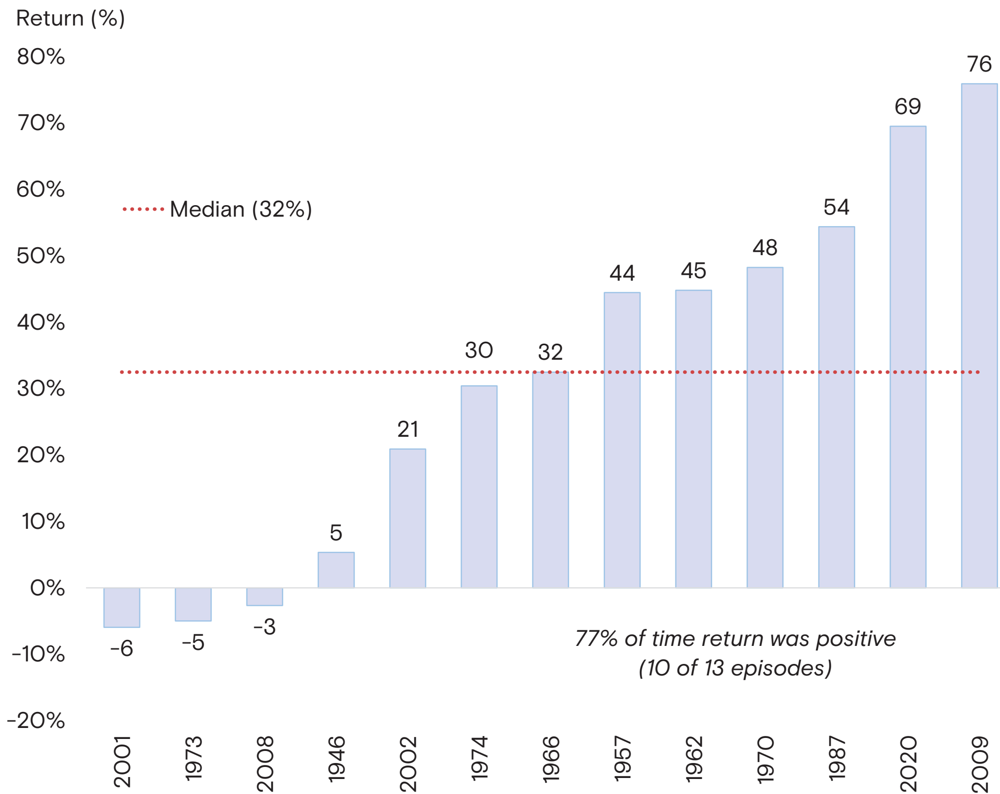
Source: Investment Strategy Group, Bloomberg

*Historically, the CPI reading comes out after a median of 11 days after month end (using data since 2002), and hence ISG measures performance of the S&P 500 in the 24 months following a start date 11 business days after month end to adjust for this. Data computed using 14 historical episodes of peak CPI YoY growth since 1945.

Past performance is not indicative of future results, which may vary.

- In the two years after past bear markets—defined as an equity decline of greater than 20%—the median return for the S&P 500 is 32% (**Exhibit 5**). The S&P 500 fell into a 'bear market' on June 13, 2022 when it closed below 3,837. If the S&P 500 were to recover by the historical median from its trough, that would imply a close above 5,000 on June 13, 2024.

Exhibit 5: S&P 500 Return in 24-Months After 20%+ Pullback in Calendar Year



Source: Investment Strategy Group, Bloomberg

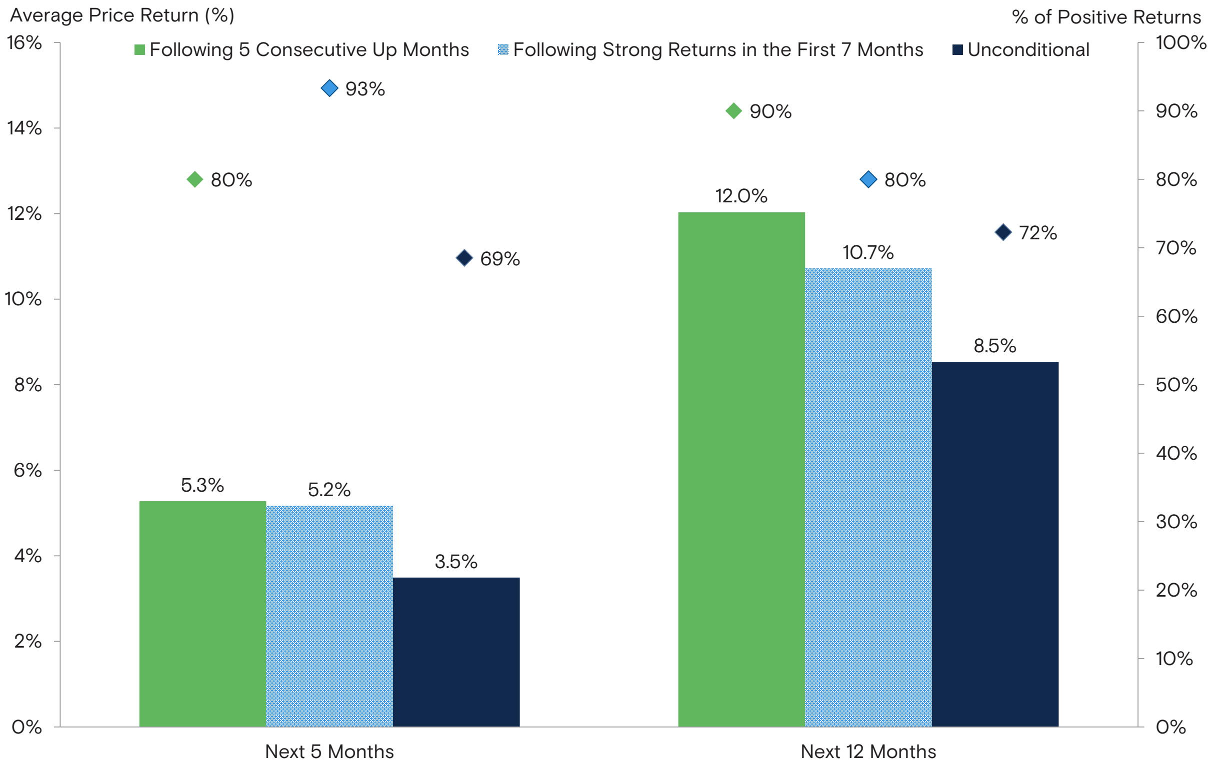
Past performance is not indicative of future results, which may vary.

The Benefits of Taking a Long-Term View When It Comes to Investing

US equities have rallied this year—with the S&P 500 now up 19% through August 31, 2023. There is a natural tendency for investors to worry that strong gains—such as those year-to-date—are at greater risk of being forfeited than more modest increases over the same time.

However, history suggests otherwise (as shown in **Exhibit 6**). When looking at past periods where the S&P 500 experienced a price gain of over 15% (similar to this year) over the first seven months of the year (January to July) or five consecutive monthly increases, the balance of the year has been associated with above-average returns—with 93% and 80% odds of a positive return, respectively.

Exhibit 6: S&P 500 Returns Following Similar Gains Through July Each Year*



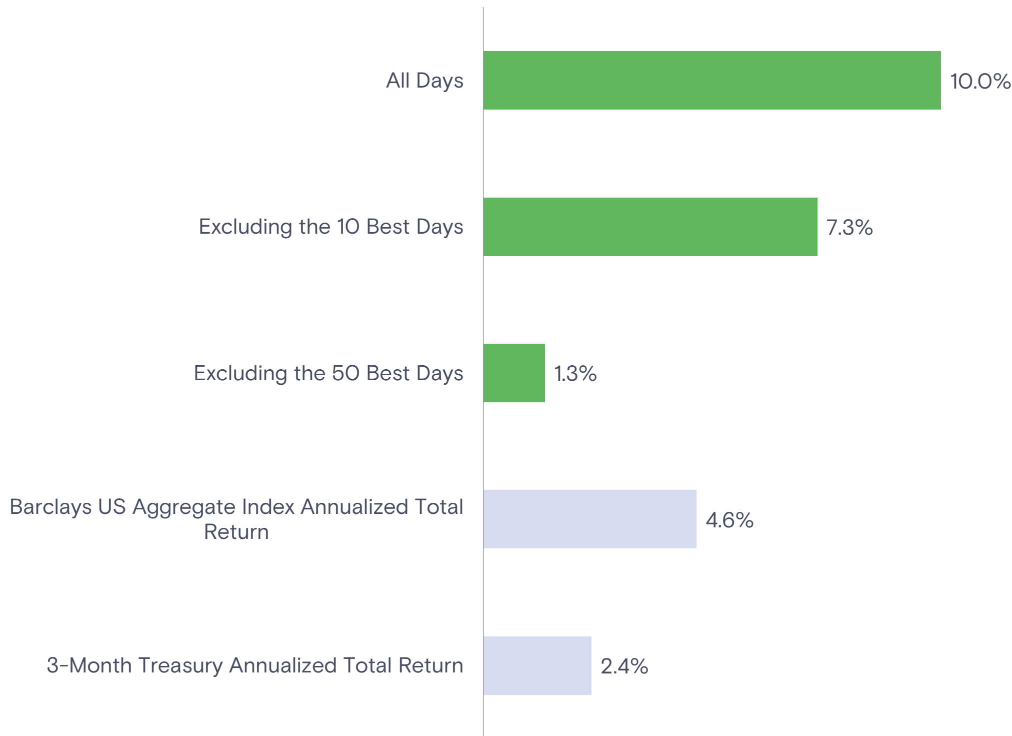
Source: Investment Strategy Group, Bloomberg

*A strong return in the first 7 months Is defined as an over 15% price gain from January to July. The studies reflect post-World War II data.

Past performance is not indicative of future results, which may vary.

ISG emphasizes the importance of being a long-term investor and recommends clients stay invested at their customized strategic asset allocation. As shown in **Exhibit 7**, the best 10-50 days of the S&P 500 represent a small percentage of overall trading days. It's difficult to time the market and the opportunity cost of missing their cumulative returns has a significant impact on index returns. The cost of taxes incurred when realizing capital gains of assets is also an important factor to consider for investors who pay taxes. The market must decline significantly to make up for the cost of taxes, and the timing for exiting and then re-entering the market must be excellent.

Exhibit 7: S&P 500 Annualized Total Return: December 31, 1991 to June 30, 2023*



Source: Portfolio Advisory Group, Bloomberg

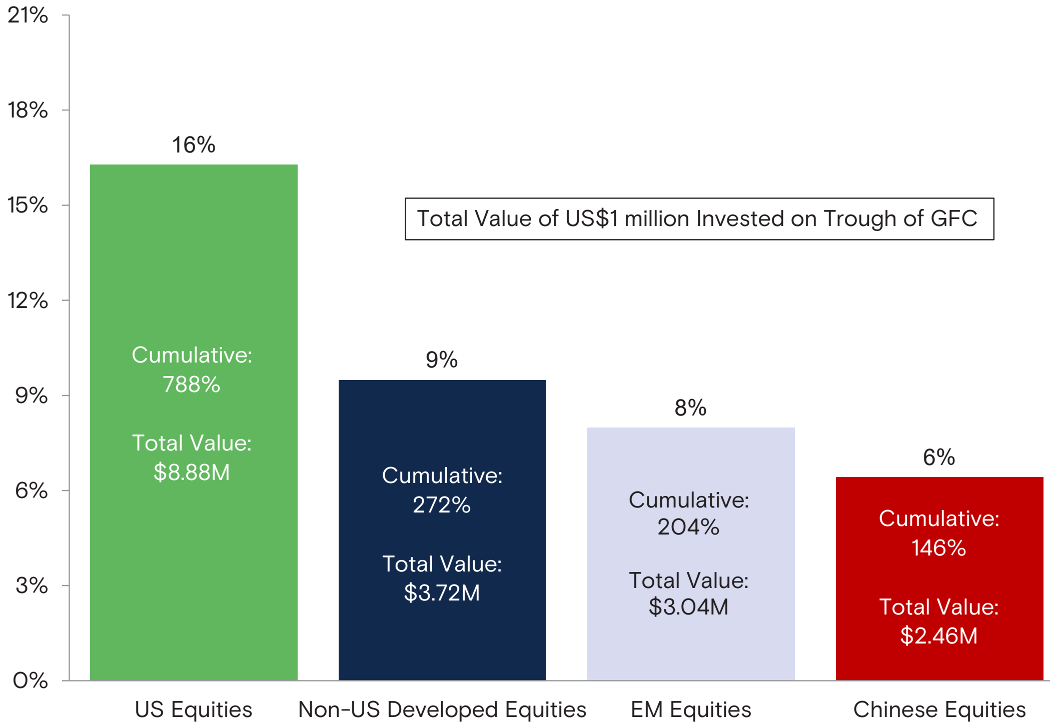
*Excluded days assume a 0% return. "Total Days" refers to open-market days.

Past performance is not indicative of future results, which may vary.

For those who are underinvested, ISG sees occasional market pullbacks (that can happen at any time and are normal even in bull markets) as providing an opportunity to scale into one's equity allocation.

ISG continues to recommend an overweight to US assets given their long-standing view of US preeminence—a view they have held since the inception of the group in 2001 and have re-underwritten even more strongly post the Global Financial Crisis (GFC). Since March 2009, US equities have outperformed other regions, with an annualized return of 16% (**Exhibit 8**).

Exhibit 8: Annualized and Cumulative Asset Class Returns Since March 9, 2009 – As of August 31, 2023



Source: Investment Strategy Group, ICI, Bloomberg, Returns based on: US Equities: S&P 500, Non-US Developed Equities: MSCI World ex. US, EM Equities: MSCI EM($), Indian Equities: MSCI India ($), Chinese Equities: MSCI China($), Bonds: Bloomberg Barclays Multiverse Total Return Index Value Unhedged USD

Past performance is not indicative of future results, which may vary.

Risks

In addition to the risk of recession in the US, discussed previously, there are geopolitical and other risks that could change ISG's outlook or lead to volatility. It is important to remember that financial market volatility and occasional pullbacks are normal, even in bull markets. ISG recommends portfolios be positioned at their customized strategic asset allocation, where they are designed to ride out volatility and provide staying power in the event of market disruptions or declines.

Conclusion

ISG recommends clients stay invested in a well-diversified portfolio at their long-term strategic asset allocation consistent with their risk tolerance.

ISG also continues to recommend an overweight to US assets given their long-standing view of US preeminence. According to ISG, the drivers that underpin US preeminence are intact, including the resilience of US institutions, economic strength supported by abundant natural resources, human capital advantages, and a vibrant, innovative, and efficient private sector.

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