Big Picture Market Thoughts:

September 19, 2023

Our belief is that the equity market most likely reached a cyclical peak in January 2022 due to historic levels of overvaluation, extremely bullish investor sentiment and positioning, and the acceleration in inflation that brought about the most aggressive Fed tightening cycle in the past 40 years.

The rally in equity markets from October of last year through July of this year coincided with falling inflation, hopes of a timely reversal of Fed policy, and economic data that turned out to be more resilient than was generally anticipated. The rally was more powerful and longer lasting than we expected given the compelling alternative that fixed income securities provide today. If there is no economic hard landing, there is little reason for the Fed to reverse the rate increases of the past year, leaving fixed income yields quite attractive relative to the dividend and earnings yields generated by equities at today's prices. If there is a recession, earnings and equity prices should materially decline due to the contracting economy.

Aggressive Fed tightening cycles of this magnitude have ***produced a recession in every instance*** in the post-war period, although it often takes a year or more for the change in monetary policy to fully affect economic conditions. We have yet to experience the full effect of the Fed's tightening cycle.

As of today, the yield curve from 3-month T-bills to 10-year Treasury bonds has been inverted (meaning short term yields are higher than long term yields) for a record 225 trading days as of this morning. The only prior experiences of inversions persisting this long occurred prior to the deep recessions of 2007-2008, 1981-1982, and 1973-1975. ***There is no precedent*** for the yield curve to invert for this duration without a recession occurring. In addition to the inverted yield curve condition, there is ***no historical precedent*** of the Fed lifting the funds rate by the magnitude it has this cycle (5.25%) without a recession following. The record level of leverage in today's economy works to increase our conviction that the historical precedent is likely to be followed, and the severity of the likely recession potentially enhanced.

A number of non-monetary indicators suggest the likelihood of recession in the coming quarters remains high as well. Those include: 1) the sharp tightening in lending standard amongst banks; 2) the persistent decline in the index of leading economic indicators and; 3) recent weakening in forward looking indicators for employment.

The sharp increase in deficit spending over the past fiscal year has worked to support economic growth, but that effect should wane going forward. The sharp drop in tax receipts over the past year is the result of poor capital gains receipts over the past year, but if it persists it should be viewed as a sign of economic weakness.

In the near term, there are a number of events that could quickly shake the soft-landing narrative. Household savings rates have fallen to low levels in recent months just as gasoline prices have risen again and student loan repayment requirements are set to return. Consumer confidence and real disposable income

growth remain weak, so it may not require a huge shock to result in consumer retrenchment, and with that a material weakening in the overall economy and labor market.

While fiscal policy has been strongly supportive of economic growth over the past couple of years – in fact it has been overly supportive and has been a meaningful contributor to the inflation surge – the fiscal policy backdrop is unstable due to the current large budget deficit and the accumulation of federal debt over the past few years. That led to a credit ratings cut by Fitch for the US government earlier this year. While government shutdowns due to budget stalemates are not typically major market moving events, the polarization today suggests a compromise could be allusive. Republicans will seek to extract spending reductions. Democrats will resist that avoid fiscal contraction in an election year that may hobble reelection chances. It is not coincidental that the last 3 recessions have been in close proximity to the presidential election years of 2020, 2008 and 2000.

Finally, **global conditions** abroad are not particularly supportive of the US growth outlook. The eurozone and U.K are both in the midst of significant rate cycles as well, although in the case of the U.K. inflation has not moderated to the extent it has in the US and Europe. Japan is lagging the other economic blocks in terms of the rate cycle, though inflation has risen and the Bank of Japan may begin moving interest rates higher by early next year.

China is moving the other direction by lowering interest rates and reserve requirements to head off serious problems in its property markets and amongst property developers. The Chinese economic model of exporting labor intensive goods, investing to support export industries, and recycling capital into the property sector with leverage while trying to move up the economic food chain by granting foreign companies access to its market in exchange for technology has probably run its course. China is not likely to be the contributor to global economic growth that it has been for the past couple of decades. Economic and other tensions with China are likely to rise further in the coming years.

Inflation has peaked in the wake of the Fed's tightening cycle but remains well above the Fed's 2 percent objective on a core basis. Housing costs in the inflation reports, which are based on actual and imputed rents, should move materially lower in the coming months. The labor market has become more balanced as job growth has slowed, job openings have declined materially, and wage growth has slowed but nevertheless remains above levels consistent with the 2 percent inflation objective. Labor in general appears to have garnered greater bargaining power as evidenced by significant gains by UPS and airline pilots in recent contract negotiations and the recent UAW strike against the big 3 auto makers. If this is sustained it implies a much more difficult road to returning inflation to 2 percent and also implies profit margin pressure for the corporate sector. The bottom line is that, cyclically, inflation has peaked and is likely to continue moving lower, perhaps meaningfully so in a recessionary environment. Money growth has contracted at a rate not seen since the 1930s. However, the trends toward de-globalization, the swinging of the pendulum back toward labor from capital, and excessive indebtedness by the government present the risk of a more pervasive and destructive inflation down the road.

Interest rates sit near their high point of the cycle today for both short- and long-term maturities. The Fed has most likely completed its rate hiking cycle but will continue to leave open the possibility of future hikes with inflation remaining above its objective and unemployment remaining low. Overall inflation will likely

move higher in the near term as oil prices have risen due to supply restraints and low inventories, but the trend in inflation should remain downward in the coming year. Economic growth has been surprisingly resilient through the first 3 quarters of the year. We expect growth indicators to meaningfully deteriorate in the coming quarters, which should push longer term interest rates lower in the coming quarters, and eventually lead the Fed to begin reversing the rate hike cycle. That sets the stage for a very solid return outlook for Treasuries, while credit and equities will have to contend with what is likely to be a contracting economic and earnings environment.

CHART 1: Investor Sentiment and Equity Markets Move Together Over the Past 21 Months.

Sentiment was more bullish in July than at the market peak last January, and it remains very bullish today in relative terms.

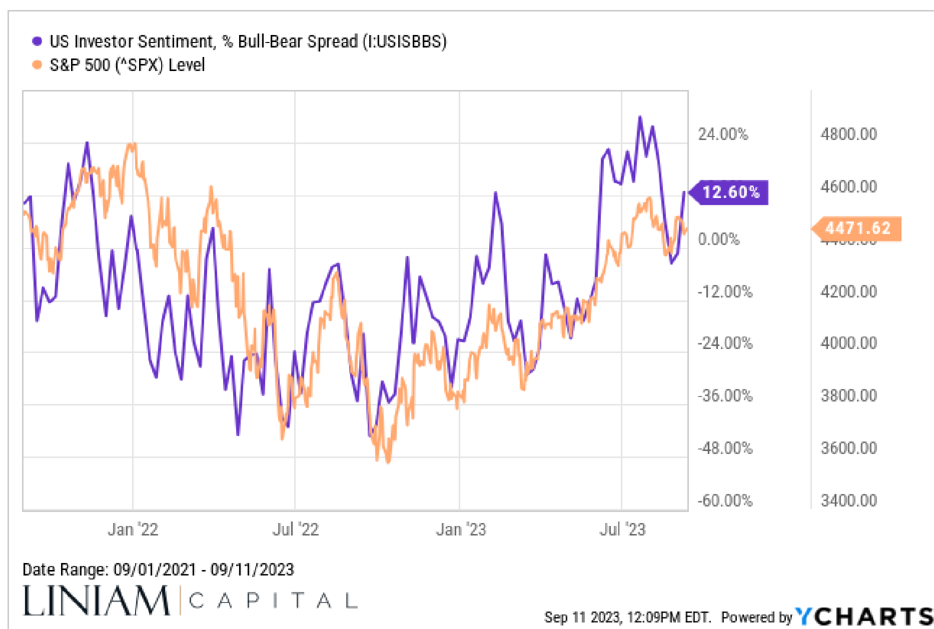


Chart 2: Equity Valuation Remains Historically High

Many measures show the equity market is historically expensive. The chart below shows dividend income relative to yields at the lowest levels that preceded the 2000 and 2007 bear markets.

Chart 3: Fed Funds rate Up by 5.25% since the rate cycle began in February of last year.

The funds rate has moved up more this cycle than in any other rate cycle since the 1980s. There is no precedent for an economic "soft landing" following a rate cycle of this magnitude.

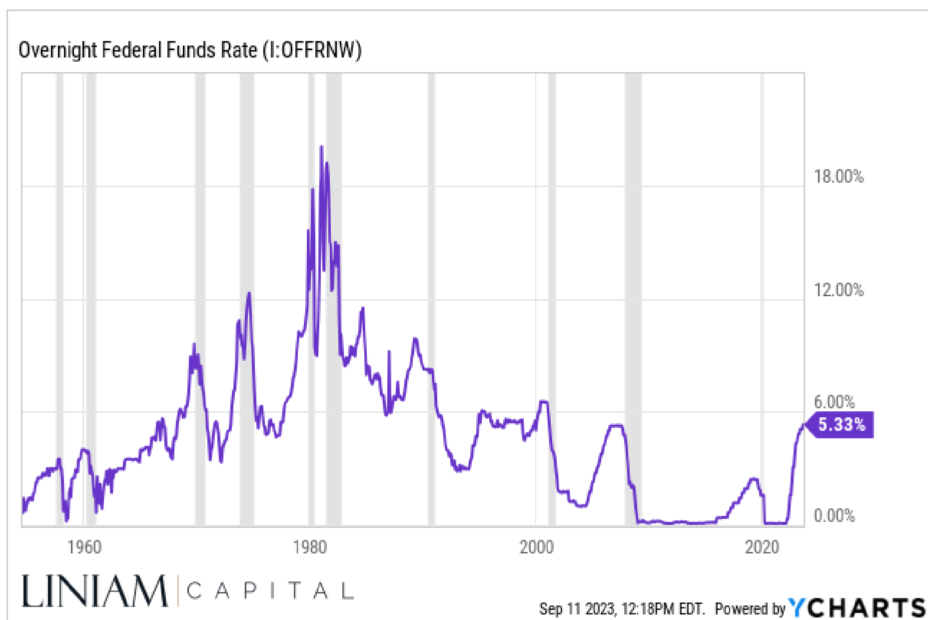


Chart 4: Recession probability over the next 12 months is very high.

Similar to the extended duration of the inverted yield curve today, we have not seen a recession probability reading this high without a recession occurring.

Chart 5: CPI Down Sharply on a Year over Year Basis

Core inflation should continue to moderate as rents and wage growth slows in the coming quarters. Higher oil prices will lift inflation in the near term, but the downward trend should persist.

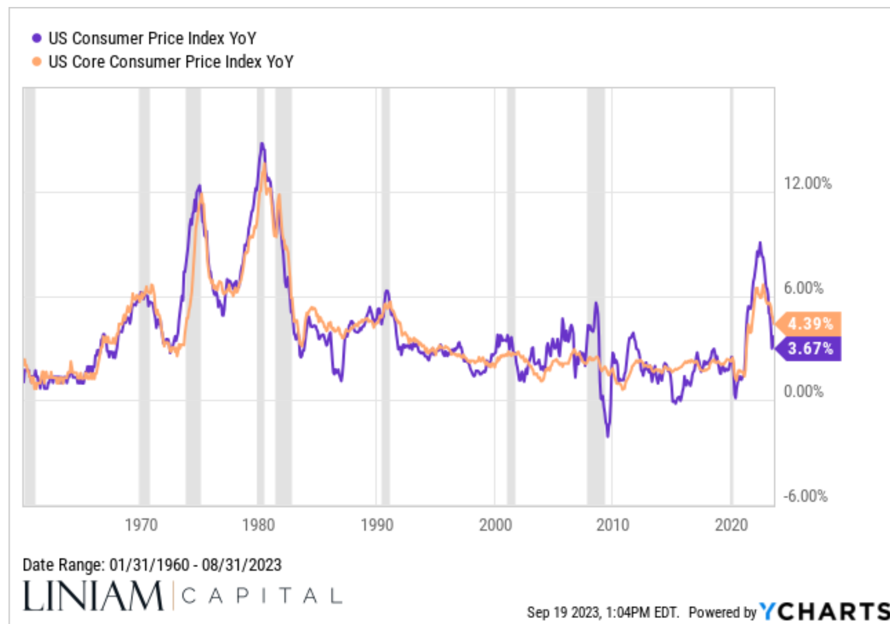


Chart 6: Money Supply Growth Contracting After the Pandemic Related Surge

The surge in inflation during the past couple of years reflected a surge in money supply, borrowing and deficit spending at the Federal level. The excess in money creation is being corrected.

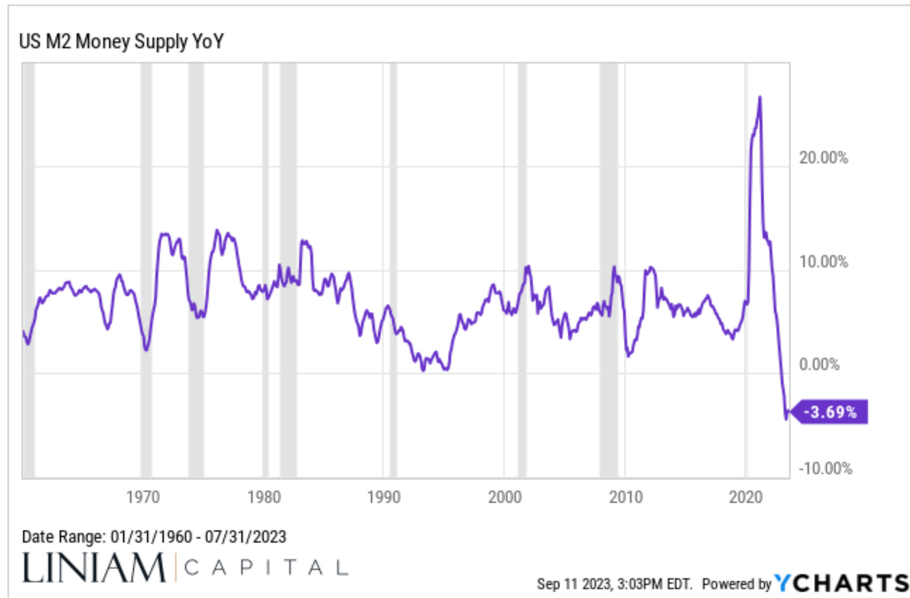


Chart 7: Job Openings Down but Still Elevated

The labor market remains tight and job opening elevated, but openings have been falling at sharp rate and job growth has meaningfully slowed in recent months. These trends should continue.

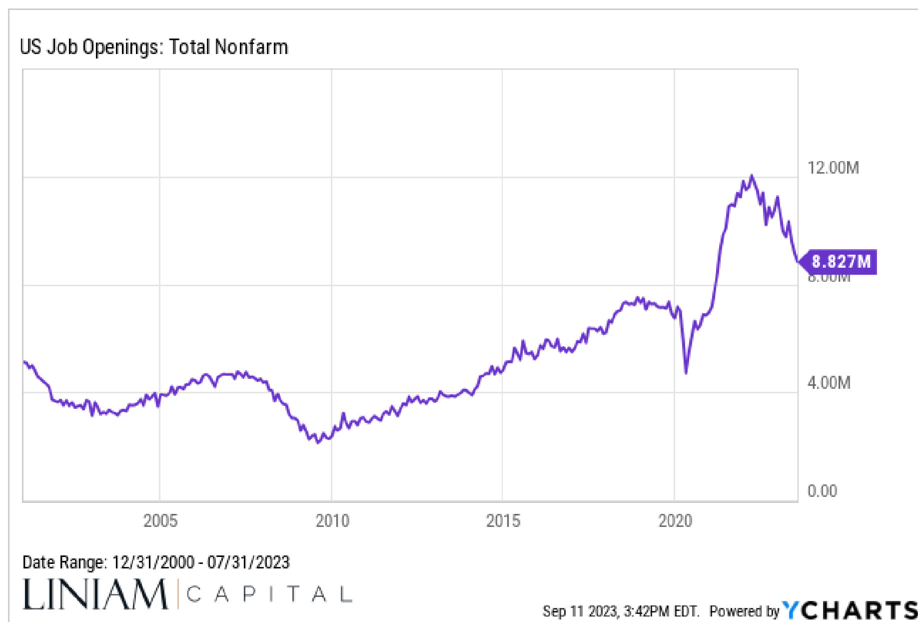


Chart 8: Wage Growth has Slowed but Remains Elevated Relative to Pre-Pandemic Levels

Wage gains have moderated but will need to slow further to be consistent with a stable 2 percent inflation environment. A weaker labor market is likely needed for that to occur.

Chart 9: Interest Rates at Cycle Highs for Short- and Long-Term Maturities

The Fed likely concluded the rate hiking cycle with a move to 5.25% - 5.50% in July. Long-term yields have risen since that time as the Fed has pushed back on expectations of a quick reversal to lower rates.

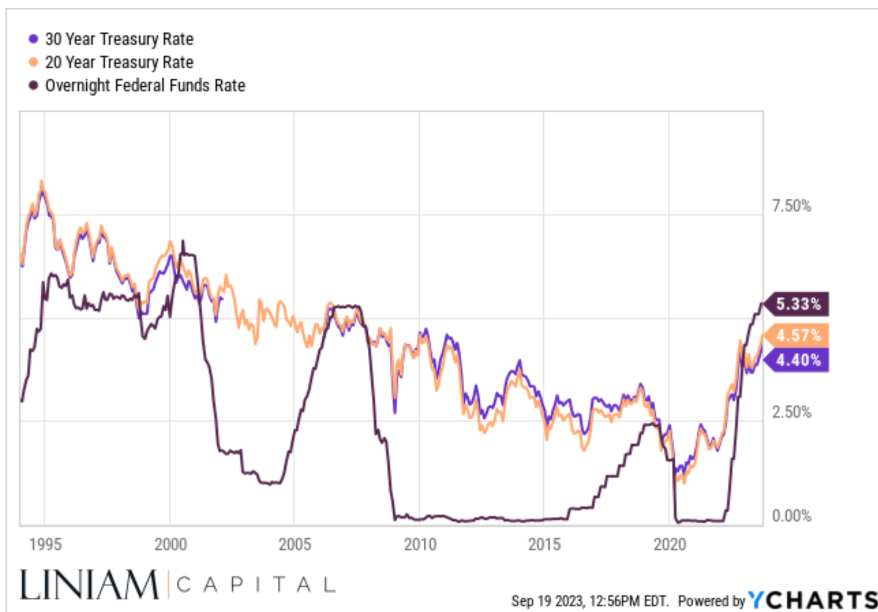
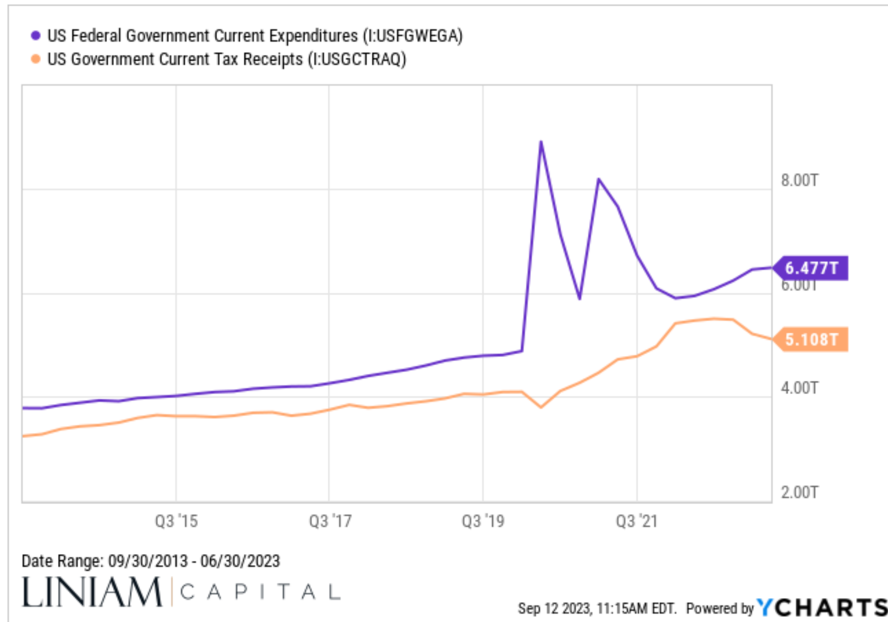


Chart 10: Budget Deficit Up Sharply on Elevated Spending and Declining Tax Revenue

The fiscal deficit is currently running at greater than 5 percent of GDP at the same time the economy is at full employment, contributing to inflation and higher interest rates.



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