September Market Update: Mixed Messages & The Path Forward

October 10, 2023

The Israel-Hamas conflict is a terrible tragedy that has caused pain and suffering. While the situation remains deeply challenging, it is important to remember that we stand by the principles of freedom, human rights, and the pursuit of a just and lasting peace. It is our hope that dialogue, diplomacy, and international cooperation will eventually lead to a resolution that respects the rights and aspirations of all people, bringing an end to the cycle of violence and ensuring a brighter future for everyone.

Before we begin, we want to revisit the market landscape and address key developments since our midyear outlook. We acknowledge the existing risks and aim to provide insights into what lies ahead through year-end, as well as our expectations for 2024. Looking forward, we anticipate short-term turbulence due to mixed economic data, geopolitical uncertainties, contributing to stock market volatility. The resurgence in oil prices has led to rising inflation and a mixed outlook. However, we observe improvements in earnings, the Federal Reserve nearing the end of its tightening cycle, a growing economy, and low unemployment rates.

While we believe that the markets are taking a temporary breather, our outlook for the remainder of the year remains positive. It's important to note that the second half of the year will not resemble the first, as higher interest rates are poised to bring about changes, potentially leading to new market leadership as consumers reduce their spending. Just as we have in the past, we will guide you through these uncertain times. We see better days ahead, and it's important to remember that policy matters, not politics.

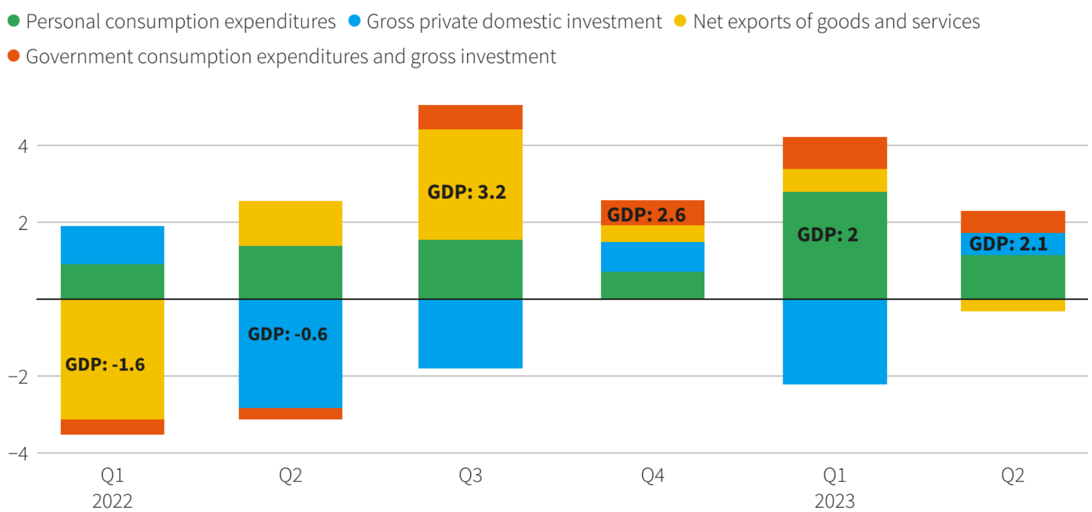
Expect Turbulence in the Short-Term

Global bond yields have climbed to their highest levels since 2008, raising concerns and drawing attention. Currently, U.S. household debt doesn't set off alarm bells. However, potential stressors include the resumption of federal student loan payments, reduced savings, and the Federal Reserve's expectations of a softer labor market due to rate hikes. As of now, loan delinquencies do not indicate significant economic stress, as both unemployment rates and initial jobless claims remain relatively low.

Consumer spending is likely to slow in the coming months for various reasons. However, as long as the unemployment rate remains low, it won't become a major issue for the economy. A robust job market is vital for a soft landing, and it significantly affects a borrower's ability to manage debt. Despite the 11 rate hikes by the Federal Reserve since March 2022, the economy has continued to grow, with real GDP growth exceeding potential in the second quarter at 2.4%. The Atlanta Fed's GDPNow model estimates real GDP growth in the third quarter at 5.4%.

A year on from "recession," economy keeps growing

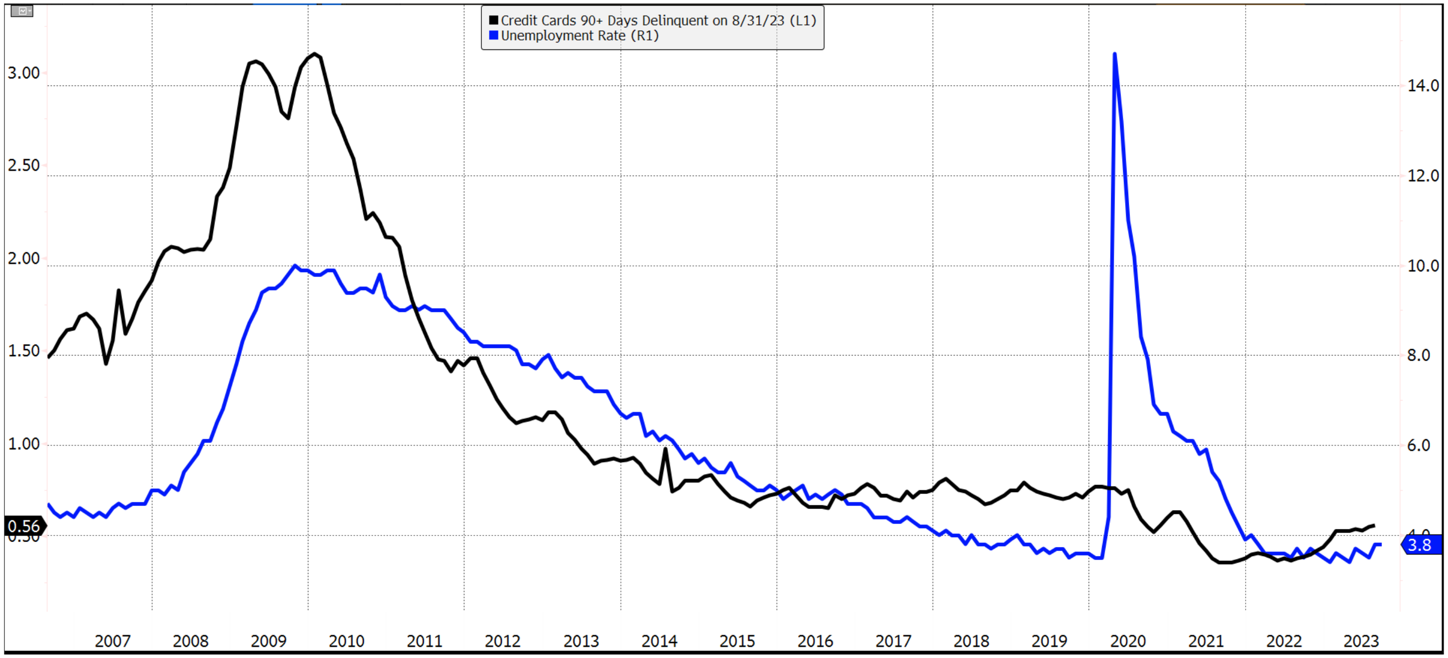
The U.S. economy shrank over the first six months of 2022, amplifying predictions of a coming recession. It hasn't happened.



Note: Percentage point contribution to quarterly growth in gross domestic product, annualized.
Source: Bureau of Economic Analysis

How will Higher Interest Rates for Longer Affect you?

Treasury yields have continued to rise, with the U.S. Treasury 10-Year Yield reaching its highest level since 2007. Higher interest rates have increased minimum payments on variable-rate debt and installment payments on fixed-rate loans. Credit card debt has surged past $1 trillion, marking a 30% increase in the last two years. Notably, the average credit card interest rate now exceeds 20%. This situation is impacting company profits and may lead to upward pressure on wages. If this trend persists, the Fed might opt to maintain its current rates, allowing time for higher rates to influence the market.



Will Labor Strikes Impact the Economy?

The consumer landscape faces challenges, but it hasn't yet reached alarming levels due to one key factor: a low unemployment rate. While we do expect more labor strikes and bankruptcies, they are less concerning when employment income is stable. An unemployment rate near a 54-year low at 3.5% has been instrumental in sustaining economic stability. However, if unemployment were to rise, loan delinquencies would increase, lenders would tighten lending standards, and economic activity could slow down. Managing debt payments becomes more difficult when employment income dwindles or when individuals accumulate excessive debt relative to their income. As companies unable to refinance go bankrupt, it leaves room for other companies with stronger margins to emerge.

Personal Savings as % of Disposable Income

What Does History Tell us about a Government Shutdown?

Historically, government shutdowns have had minimal negative impacts on the U.S. stock market, with the S&P 500 Index gaining an average of 4.4% during such events. Shutdowns may cause only modest losses in gross domestic product (GDP). Despite the 2018-2019 shutdown affecting federal workers, the following quarter saw only a slight decrease in GDP. On average, government shutdowns have lasted just over a week, and government agencies and staff receive back pay once a budget is approved, mitigating broader economic effects.

Consumer-Led Earnings and Profit Margins

Corporate earnings are expected to turn upwards in the 4th quarter and grow strongly through 2024. Wall Street analysts anticipate a modest drop in earnings during the third quarter, followed by a significant increase in the fourth quarter and beyond. Improvements in profit margins, driven by higher prices and unique borrowing strategies by large U.S. companies, have contributed to this trend.

Reshoring and Friend-shoring is Just Beginning

Over the past decade, U.S. companies have shifted toward reshoring and nearshoring initiatives, particularly accentuated by supply chain disruptions during the pandemic. Economic uncertainties and reduced dependence on China are ongoing drivers for reshoring efforts, aided by government grants and tax incentives. Job growth from this trend has doubled in five years, although access to skilled labor may be a limiting factor. The trend away from China benefits Mexico and Canada, leading to potential industry shifts that could impact various market segments. The Infrastructure Super Cycle remains a compelling investment opportunity, focusing on digitalization, decarbonization, and deglobalization.

Charting a Path Forward

The stock market experienced a strong first half of the year, primarily driven by mega-cap stocks. However, the road ahead may prove more challenging. Expectations are higher, earnings multiples are stretched, interest rates have risen, and concerns about the economy's response to prior rate hikes are mounting. This uncertainty creates a choppy trading environment. While the future remains uncertain, the market's technical foundation remains solid, though it may experience near-term consolidation following a rapid ascent.

Down the road, we anticipate significant industry shifts as the economy transitions toward better-than-expected growth and more persistent inflation. We foresee a moderate global growth recovery, benefiting SAM Strategies.

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