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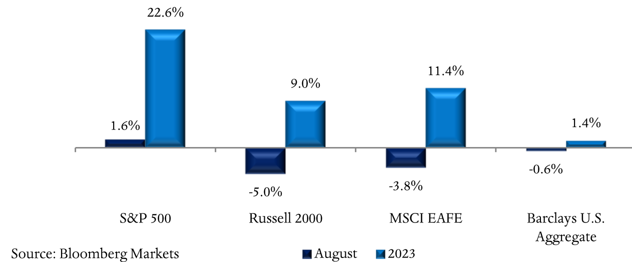
Markets

Investors witnessed a bout of financial market volatility in August, driven by decelerating macroeconomic data, jitters about China's property market, and an increase in global sovereign bond yields. Given this backdrop, stocks sold off, with the S&P 500 index declining -1.6% during August (+18.7% ytd), snapping a string of five positive monthly results. However, it was the more economically sensitive smaller capitalization stocks in the Russell 2000 index (-5.0% in August; +9.0% ytd) that bore the brunt of the selling. Overseas, the MSCI EAFE index retreated -3.8% during the month (+11.4% ytd). European equities in the Stoxx 600 index fell by -2.5% (+11.1% ytd). In Asia, Chinese economic worries led emerging market stocks down -6.1% (+4.8% ytd).

Credit rating agency Fitch downgraded the US government's credit rating from AAA to AA+, citing unsustainable debt and deficit trajectories as well as increased political dysfunction. Coupled with mixed economic data and large debt issuance post the budget ceiling impasse, the 10-year US Treasury yield rose 15 basis points to end August at 4.11%. These events led the benchmark US Aggregate bond index lower by -0.6% last month (+1.4% ytd).

Global oil prices remained in an uptrend (WTI benchmark $83.63/bbl, +2.2% in August; +4.2% ytd), reaching levels last seen in November 2022. OPEC+ production cuts persisted, counterbalanced by growth risks in China. Despite the European Union reaching its natural gas storage target well ahead of the November 1st deadline, local prices increased by 23% in August on the prospect of a possible strike at three liquefied natural gas (LNG) plants in Australia, which could disrupt up to 10% of the world's LNG supply. Gold declined -1.2% in August (+6.3% ytd), a solid showing despite headwinds from rising "real" rates and a rallying stock market.



Source: Bloomberg Markets

Geopolitics

US-China relations have become increasingly fraught as Beijing has become more aggressive in flexing its economic and military might. American officials view China as a security threat and have imposed a raft of restrictions aimed at crippling Beijing's access to technology that could be used to strengthen the Chinese military or security services. We found a recent New York Times guest essay entitled "China's Military Is Going Global" https://tinyurl.com/bddrzyhy to be quite informative. In an effort to maintain open lines of communication, the Biden Administration, last month, sent their fourth delegation of 2023 to China. US Commerce Secretary Gina Raimondo followed in the footsteps of John Kerry, the president's special envoy for climate change, Treasury Secretary Janet Yellen, and Secretary of State Antony Blinken. In an effort to strengthening business relations Raimondo came away agreeing to establish two working groups, one focused on commercial issues and a second governmental information exchange for export control issues.

United States

Overall US economic data has remained solid but showed signs worthy of attention. Labor markets are in a cooling phase yet still produced a respectable 187,000 payroll jobs gains in August. This compares to an average of 271,000 monthly hirings over the past 12 months. The unemployment rate ticked up to 3.8% (from 3.5%) as the labor force participation rate rose to 62.8%, a post

pandemic high, thanks to 736,000 people entering the workforce. Conversely, job openings decreased by 338,000 in July, to 8.8 million, reaching their lowest level since March 2021. Average hourly earnings came in slightly less than expected at 0.2% in August (4.3% year-over-year), compared to 0.4% (4.4% y/y) in July.

On the inflation front, the headline Consumer Price Index (CPI) increased slightly in July to 3.2% due to higher food and energy prices, while core CPI decelerated slightly to 4.7% from 4.8% in June. The Federal Reserve remain concerned about inflation, and has telegraphed that additional rate hikes may be necessary. This was echoed in Fed Chair Powell's Jackson Hole speech, where he indicated that the committee will remain data dependent, with a bias to tighten if necessary. Looking ahead, market pricing suggests the Fed could deliver one final interest rate hike before year-end, then commencing with cuts in the latter half of 2024. Meanwhile, the central bank's balance sheet has resumed its shrinkage, reducing financial liquidity by $90 billion per month via Quantitative Tightening. The Fed recently held $8.1 trillion of assets, the lowest level in two years, down $800 billion from its peak.

Emerging trends and data points are beginning to support the Fed's monetary policy efforts. Both businesses and consumers are being progressively affected by a combination of inflation and tightening credit. August's manufacturing PMI remained in contractionary territory for the tenth consecutive month. Consumer credit card debt has risen to a record high, over $1 trillion, with a current average 22.2% interest rate (also a record). Auto loan borrowers are being pinched by average interest rates of 9.5% on new car purchases, and 13.7% for used vehicles. As a result, credit card delinquency rates have hit 3.8% with auto loan delinquency rates at 3.6% (both reaching 10-year highs) according to Equifax. Further, after three years of deferments, student loan borrowers will soon have to start making payments on their $1.6 trillion in debt. Lastly, data indicates that households are running out of excess savings build up during the Covid-19 pandemic.

August 2023 Economic Statistics

	Aug-23	Dec-22	Dec-21
Federal Funds Target Rate	***5.25 - 5.50%***	***4.25 - 4.50%***	0 - 0.25%
Consumer Confidence Index	***106.0***	***108.3***	115.8
Manufacturing PMI Index	***47.6%***	***48.4%***	58.7%
Unemployment Rate	***3.8%***	***3.5%***	3.9%
JPY/USD	***145.53***	***131.11***	115.08
USD/EUR	***1.0841***	***1.0702***	1.1368
Gold/oz.	***$1,939.74***	***$1,824.40***	$1,828.39
Oil (WTI)/bbl	***$83.63***	***$80.26***	$75.21

Sources: see disclosure *

Europe

The euro-area economy has become the poster child of stagflation (stagnant GDP growth coupled with persistent inflation). Eurostat's GDP estimate showed that Q2 output grew by 0.1% quarter-over-quarter and 0.5% versus the second quarter of last year. Nevertheless European labor markets remain very tight, with unemployment dropping to 6.4% in June, the lowest level on record. EU business activity remained in contractionary territory, with the services PMI dropping to a 30-month low of 48.3% and the manufacturing PMI rebounding slightly to 43.7% last month.

Eurozone headline inflation remained flat in August at 5.3%, which was higher than expected. Core inflation, however, did fall modestly from 5.5% to 5.3% last month. While improving, inflation remains well above the European Central Bank's target and markets continue to price further interest rate increases (currently 3.75%) before the end of the year.

In the UK, the Bank of England hiked its policy rate by 25bps to 5.25% in August, further highlighting its intention to hold rates at restrictive levels for some time. Despite this tighter monetary policy, the UK economy surprised to the upside with Q2 GDP rising by 0.2% quarter-over-quarter vs. a consensus for no-growth. Headline CPI eased to 6.8% in July, down from 7.9% prior. Labor market data showed wage growth of 7.8% in Q2, the highest rate since records began in 2001. In this context, markets continue to expect further central bank interest rate increases this year (currently 5.25%).

Asia

In China, the post-pandemic economic activity has turned-out to be much weaker than expected, a combination of cyclicality from slowing growth in the US and Europe, coupled with the deflation of the country's housing bubble and deteriorating demographics. Retail sales missed expectations by a wide margin, growing at an annual rate of 2.5% versus expectations of 4.5%, a sign of dented consumer confidence. Low business confidence was also evident as private investment decreased at an annual pace of 2.3% in July. Real estate was the weakest sector, with an 8.5% fall in investment during the first half of 2023 compared to the same period last year. The financial distress of Country Garden and Evergrande, two of China's largest property developers, showcase some of the country's malinvestments. On the inflation front, CPI turned negative in July at -0.3% year-over-year, while producer price deflation continued for the tenth month in a row. Reacting to stimulate the economy, the People's Bank of China lowered its benchmark interest rate twice in August. Beijing also took several initiatives to support financial markets, such as halving the stamp duty on stock trading. Despite these measures, the subsequent demand for credit and market response has been muted.

The Japanese economy expanded by a robust 6.0% quarter-over-quarter in Q2 on the back of a strong contribution from trade. Activity indicators such as the Tankan index point to a continuation of this strong momentum in coming months. It could be that Japan is turning the page on decades of deflation, with latest core CPI reported at an annualized rate of 4.3% in July, as spring (Shunto) wage negotiations led to the biggest wage increases in 30 years.

Outlook

Macro-economic data points have begun to indicate the need for vigilance. Housing is in a recession, new orders have collapsed (ISM down for 11 straight months), and corporate profits are contracting (-4.1% in Q2 for the S&P 500 index, a third straight down quarter). "Strong" employment, typically a lagging indicator, should follow suit, typically within 24 months, as companies react to a challenging environment. Yet, with sentiment near 2008 low levels, the consumer continues to spend, and the stock market moves higher. Certainly a confounding set of data points. From a monetary policy perspective, achieving the Federal Reserve's goal of stamping out inflation may herald one additional interest rate increase in the latter half of 2023, followed by an extended period of peak interest rates. This leaves us with a greater than even chance of economic recession in 2024 as the Fed guides the economy towards its mandate of "maximum employment, stable prices, and moderate long term interest rates."

In this context we continue to believe that investors should remain conservative while paying attention to valuations. US Mega Cap stocks, which have been driving this year's returns, include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla appear to be sharply priced at 27.7x expected earnings. The S&P 500 Large Cap index is trading at 18.9x profits, well above historical average. Meanwhile the S&P Mid and Small Cap indexes trade at more reasonable 14.0x and 13.8x ratios, respectively. Rest-of-world price-to-earnings valuation multiples also appear attractive (EU: 12.0x; Japan: 14.3x; UK: 10.3x; Emerging Markets: 12.0x) even when adjusted for differentials in growth rates.

Exposure to alternative asset classes, especially given the current uncertain environment, should provide ballast to traditional portfolios through diversification and non-market correlation. Credit opportunities continue to offer investors equity-like returns, while residing higher in the capital structure. Energy and agricultural related commodities stand to benefit from cyclical tailwinds stemming from underinvestment and the potential for scarcity and supply shortages, amid geopolitical instability. In the real estate sector we are seeing interesting special situations stemming scarcity and secular regional growth. Finally, we are seeking to benefit from disruptive trends in the defense, edu-tech and cybersecurity sectors.

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*Sources: Reuters, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Institute for Supply Management, MSCI, Russell, Standard & Poor's, Financial Times and the Wall Street Journal.