GALLIARD
Capital Management, LLC
ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

THIRD QUARTER 2023

October 4, 2023

Quarterly Key Points

- Perhaps the biggest story of the quarter is the precipitous selloff in interest rates that started right around the Fed meeting in July. It feels counterintuitive that rates are selling off in such a fashion along with the Fed nearing the end of a tightening cycle. Although recession probabilities remain elevated, primarily due to the shape of the yield curve, forecasts calling for near-term recession have been virtually eliminated.
- The Fed is signaling that it will likely hike another 25 bps before year end and then keep rates elevated through next year with perhaps a couple of cuts along the way as inflation normalizes. The market is pricing in one more hike in November but then an extra cut or even two in addition to what the Fed is projecting as the economy cools and inflation fades.
- Broadly speaking, inflation measures continue to trend lower after peaking in 2022. Inflation expectations are largely unchanged since the end of the second quarter. In our view, the stability of inflation expectations is consistent with the market view that the Fed is almost done with monetary policy tightening.
- The labor market remained strong throughout the quarter; however, there are early signs of a correction taking place and measures of consumer sentiment are struggling to break out. Some believe the resumption of Federal student loan payments will push consumers over the edge. At a minimum, it will be a jolt to budgets that have become accustomed to not making payments.
- Meanwhile, the deterioration in businesses activity seems to have bottomed out. The ISM Manufacturing PMI has been in contractionary territory since November 2022, but has improved recently. The ISM Services PMI has been a bright spot in business activity, generally hovering around 55 for most of the past year.

Our View

- Market expectations are harmonizing around a “no landing” scenario. Although rate hikes are likely nearing the end, an extended period of restrictive monetary policy means liquidity will continue to be a concern and volatility in risk assets could return, reflecting fatter tails and the risk of unintended consequences.
- Portfolios are fully invested and we are comfortable with positioning given the market environment. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

3Q2023 – "NO LANDING" SCENARIO GAINS FAVOR

In 2022, the Federal Reserve (Fed) launched the most aggressive attack on inflation in 40 years. By the beginning of 2023, the policy rate was 4.25% (425 basis points (bps)) higher, the odds favored a recession starting as soon as mid-year, and expectations were for the Fed to start cutting rates by the end of the year. The deeply inverted yield curve predicted that a rather “hard landing” could emerge. However, as labor markets stayed firm and inflation slowly rolled over, expectations evolved and a “soft-landing” with only a mild recession (thanks to resilient consumers and nimble monetary policy) seemed more likely. Fast forward to today and the outlook now calls for a “no landing” scenario where the economy sheds toxic inflation but avoids a recession altogether. It seems too good to be true.

Perhaps the biggest story of the quarter is the precipitous selloff in interest rates that started right around the Fed meeting in July. Short rates sold off only marginally (prices lower, yields higher), reflecting that interest rate hikes are nearing conclusion; however, the 10-year Treasury sold off by a whopping 73 bps by the end of the quarter. More interestingly, the bulk of the selloff was in real rates and not inflation expectations: 10-year real rates increased by 60 bps whereas 10-year breakeven inflation only increased by 13 bps. With the 2-year Treasury increasing by just 15 bps, the curve became less inverted, leaving the 2s vs. 10s curve inverted by 48 bps at the end of the quarter.

It feels counterintuitive that rates are selling off in such a fashion along with the Fed nearing the end of a tightening cycle. Historically, interest rates tend to go the other direction when the Fed signals the end of rate hikes. Several narratives have emerged to explain the curve and particularly the increase in real rates, including: 1) upward revisions to economic growth forecasts leading to a higher neutral policy rate; 2) larger budget deficits requiring increased Treasury issuance colliding with reduced investor demand; 3) a dysfunctional government leading to continued U.S. sovereign credit rating downgrades; 4) Bank of Japan yield curve control tweaks; and 5) Fed signaling that quantitative tightening (QT) could extend beyond the timing of the first rate cut.

Most likely a combination of these narratives is at work on the yield curve. Regardless of the reasons, the signal is somewhat perplexing. Inflation expectations have remained in a tight range between 2.25% and 2.35% since last spring, suggesting that the market believes the Fed will ultimately win against inflation. At the same time, whatever the reason for the rate selloff, higher real yields should reverberate through risk assets. Yet here we are with the S&P 500 up ~11% through the third quarter and the Nasdaq up over 25%. Real assets like housing are proving remarkably resilient despite mortgage rates over 7%. Commercial real estate is showing some signs of stress, but cap rates have not reset to the degree we would have expected. It is almost as if asset values assume a return to the low real yield levels of the previous decade. Something feels out of synch. The big questions in our minds are whether the Fed can beat back inflation without breaking labor markets or asset values, and, if so, can it then slowly bring interest rates back down in a controlled fashion as inflation subsides. Anything is possible, but we are reminded of the observation that policy rates go up the staircase and down the elevator.

For the time being, the economic outlook remains robust. 2Q GDP growth measured 2.1% q/q annualized, with personal consumption and private fixed investment increasing 0.8% and 5.2% q/q annualized, respectively. Overall, these numbers indicate the economy did better than expected in the first half of the year. 3Q GDP growth is expected to be 2.5%-3.5% q/q annualized with full-year 2023 now in the 2.0% range, slightly higher than previously projected. Although recession probabilities remain elevated, primarily due to the shape of the yield curve, forecasts calling for near-term recession have been virtually eliminated.

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GOVERNMENT & CENTRAL BANK UPDATE

The ink was barely dry on the debt ceiling resolution last spring when talk turned to a possible government shutdown heading into fiscal year end (September 30). In the waning hours, Congress passed a 45-day stop gap funding bill as a temporary solution. Unfortunately, this does little more than kick the can down the road to mid-November. With none of the 12 appropriations bills passing through the House, the shutdown is still a very real possibility later this fall. Importantly, government shutdowns do not result in all services being cut off. Essential services like the Treasury, Post Office, Social Security, and Medicare continue to function. Furthermore, the economic impact of previous shutdowns has been limited because furloughed government workers typically receive back pay for time lost. At the margin, estimates of real economic impact are 0.1% to 0.2% per week in the quarter realized. Longer term, evidence suggests the economic loss is minimal.

In the wake of the debt ceiling showdown, Fitch downgraded the U.S. Government sovereign rating to AA+ in early August. The primary reasons were rising budget deficits alongside an "erosion of governance." The ongoing possibility for a government shutdown is evidence that Fitch's analysis hit close to the mark. Indeed, Moody's issued a statement on September 25 indicating that a shutdown would "demonstrate the significant constraints that intensifying political polarization put on fiscal policymaking" and that such an event would be a credit negative for the U.S. Government.

The Fed slowed policy rate hikes to 25 bps per meeting throughout the spring before leaving rates unchanged in June, despite a general lack of data supporting a pause. The Fed suggested that a short breather was warranted considering the aggressive pace of policy tightening over the past year, the "long and variable lags" associated with such tightening, and the unknown impact of recent bank failures on credit creation. However, the Fed increased rates by another 25 bps at the July meeting commensurate with stronger economic data. The official statement was virtually unchanged, and Chair Powell was non-committal at the post meeting press conference stressing that policy decisions going forward will be data dependent.

As expected, the Fed kept rates unchanged and resumed a holding pattern at the September meeting. More importantly, Powell's message at the post-meeting press conference remained hawkish despite the policy rate pause, reinforcing that "[the Fed] is prepared to raise rates further if appropriate, and we intend to hold policy at a restrictive level until we are confident that inflation is moving down sustainably toward our objective." The Summary of Economic Projections (SEP) updated at the September meeting once again included several upward revisions. The median Fed projection for full-year 2023 GDP growth now stands at 2.1% versus 1.0% in June, the median projection for the year-end unemployment rate is 3.8% versus 4.1%, and the median core PCE inflation projection is 3.7% versus 3.9%. Even more interesting, the upward revisions extended into the future with projected GDP growth of 1.5% for 2024 and 1.8% for 2025, suggesting the Fed believes in a "no landing" scenario. The median Fed Funds rate projection at year-end 2023, as illustrated in the dot plot, was unchanged at 5.625%, but the projected rates for 2024 and 2025 were both revised up by 50 bps, commensurate with a stronger economic outlook.

Putting it all together, the Fed is signaling that it will likely hike another 25 bps before year end and then keep rates elevated through next year with perhaps a couple of cuts along the way as inflation normalizes. The market is pricing in one more hike in November but then an extra cut or even two in addition to what the Fed is projecting as the economy cools and inflation fades.

INFLATION FINALLY COOLING OFF?

Broadly speaking, inflation measures continue to trend lower after peaking in 2022. More recently, the trend in aggregate inflation measures has flattened out and even reaccelerated towards the end of the summer leading to some concern about inflation heating back up. On the other hand, when the aggregate numbers are picked apart into subcomponents, some forecasters find underlying trends pointing to a favorable drop in inflation that is expected to continue. In our view, we can only say that inflation remains well above the Fed's 2% target. The next six months will be revealing.

Encouragingly, core CPI continued to march lower, increasing by 4.8% y/y in June, 4.7% y/y in July, and 4.3% y/y in August. On a month-over-month basis, core CPI jumped up slightly to 0.3% m/m in August after falling to 0.2% m/m in both June and July. The PCE inflation

numbers show an almost identical pattern. Core PCE continued to trend lower, coming in at 3.9% y/y and only 0.1% m/m in August after increasing 4.3% y/y and 0.2% m/m in both June and July.

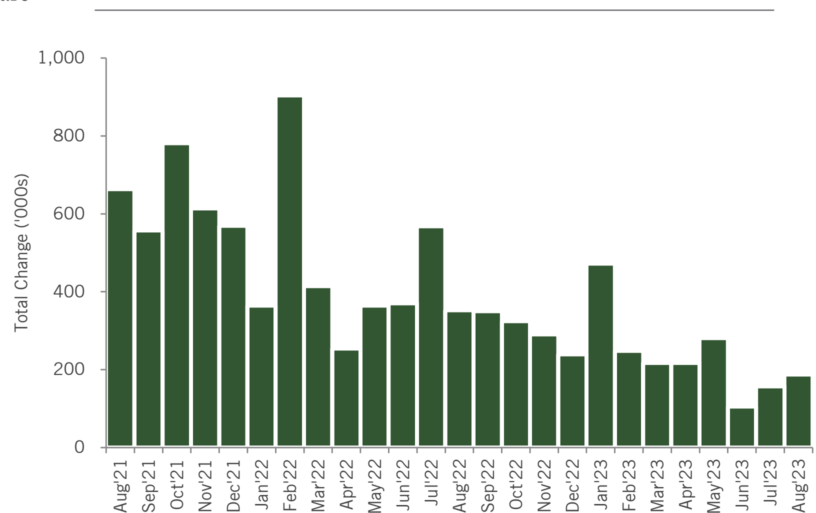
Inflation expectations are largely unchanged since the end of the second quarter. 2-year breakeven rates started the quarter at 2.11% and ended at 2.05%, the 5-year breakeven went from 2.19% to 2.25%, and 10-year breakeven rates increased slightly from 2.23% to 2.34%. Highlighting the effects of the marginal increase in the 10-year breakeven, the 5-year, 5-year forward breakeven increased from 2.22% to 2.43%. In our view, the stability of inflation expectations is consistent with the market view that the Fed is almost done with monetary policy tightening. Therefore, the selloff in rates throughout the quarter was primarily the result of real rates increasing and not due to an uptick in inflation expectations. Should inflation expectations turn higher, we would expect additional monetary policy tightening to enter the picture.

KEY INDICATORS SIGNAL A SLOWING ECONOMY

The labor market remained strong throughout the quarter; however, there are early signs of a correction taking place. For example, there were only 105k, 157k, and 187k jobs added in June, July, and August, respectively, marking the lowest 3-month series since the start of the pandemic (Figure 1). Furthermore, every single monthly jobs number this year has been revised downward in the following month. Additionally, after grinding down to 3.5% in July, the unemployment rate jumped up to 3.8% in August after 736k workers entered the labor force. Job openings turned sharply lower in July with only 8.9 million jobs available but then ticked up to 9.6 million again in August. Meanwhile, the quits rate has retreated to only 2.3%. Many are looking to the job openings number as a canary in the coal mine that labor markets are beginning to correct.

Still, with inflation trending lower, nominal wage gains are translating into real wage gains. After turning positive in May for the first time since early 2021, year-over-year real hourly earnings came in at 1.3% y/y in June, 1.1% y/y in July, and 0.5% y/y in August. Month-over-month real hourly income growth had been positive in every month since February but turned negative once again at -0.5% m/m in August. Despite this, measures of consumer sentiment are struggling to break out. The University of Michigan Consumer Sentiment Index has crept up to ~70, which is the highest reading in almost two years; however, this is considerably lower than it was in the years leading up to the pandemic.

FIGURE 1: NON-FARM PAYROLLS[1]

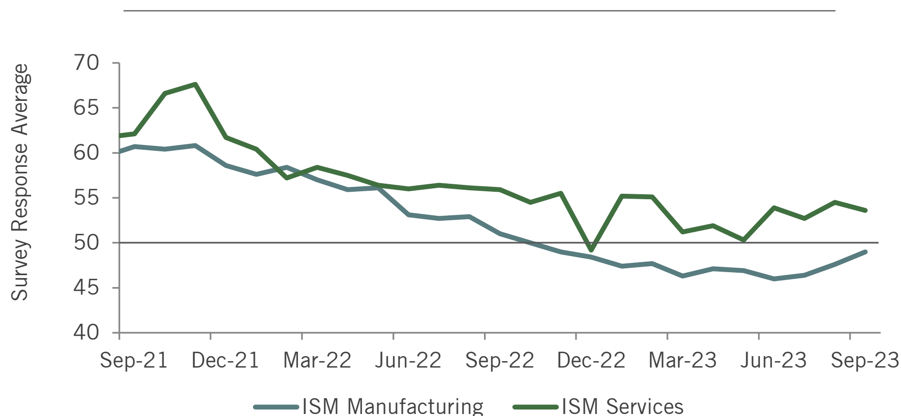


Personal consumption expenditures (PCE) are downshifting after increasing nicely during the early summer months. Nominal PCE growth slipped back to 0.4% m/m in August after increasing 0.9% m/m in July, whereas PCE core dropped back to 0.1% m/m in August following 0.3% m/m and 0.6% m/m readings in June and July. The personal savings rate, measured as a percentage of disposable income, has turned south once again measuring only 3.9% in August. Personal savings had climbed back up to over 5% earlier this year after plummeting in 2022 to the lowest point in 17 years, and consumer revolving credit has consistently grown at a double-digit annualized rate over the past one year. The most recent measurement in July came in at ~9% m/m annualized and ~11% y/y. The Federal student loan payment moratorium that started three years ago in the early days of the pandemic ended on October 1. Approximately 40 million borrowers will resume making payments. Some believe the resumption of payments will push consumers over the edge. At a minimum, it will be a jolt to budgets that have become accustomed to not making payments.

[1]Source: Bloomberg

Meanwhile, the deterioration in businesses activity seems to have bottomed out. The ISM Manufacturing PMI has been in contractionary territory since November 2022, but has improved with recent readings coming in at 46.4, 47.6, and 49.0 in July, August, and September, respectively. The ISM Services PMI, on the other hand, has been a bright spot in business activity, generally hovering around 55 for most of the past year, and most recently registering 54.5 in August and 53.6 in September (Figure 2). The U.S. Durable Goods New Orders Index turned sharply lower in July registering -5.6% m/m and then rebounded to only 0.1% m/m in August. These are the lowest numbers since last winter. However, construction spending continued expanding at a healthy pace of 0.5% m/m, 0.9% m/m, and 0.5% m/m in June, July, and August, respectively. After ending last year slightly lower, industrial production and capacity utilization have both gained steam, almost getting back to the highs of early 2022. Industrial production is back up to 103.5, matching the post-pandemic high point, whereas capacity utilization is hovering just below 80%.

FIGURE 2: ISM MANUFACTURING AND SERVICES[2]



As a result of higher mortgage rates and home prices that remain near all-time highs, housing activity remains muted, particularly in existing homes. Existing home sales volume remains anemic, coming in at only a 4.0 million unit annualized pace in both July and August. This is a very low level of existing home sales, matching the low point reached at the beginning of the year and the lowest level since the fall of 2010 in the aftermath of the GFC. Despite transaction volumes plummeting, existing home supply remains exceptionally low at ~3 months; barely higher than the historic low point reached in early 2022. Many point to the low level of existing home supply as evidence of a strong lock-in effect. Essentially, existing homeowners with low mortgage rates are unwilling to move because they have "locked-in" extremely low financing. New home sales had been on a strong upward trend since mid-2022 before falling back considerably in August to 675k units. The supply of new homes remains elevated at ~8 months of supply, well above pre-pandemic levels.

LOOKING AHEAD

With interest rates selling off and the curve re-shaping, narratives abound as to why this is happening, casting doubt on the recession predicting power of an inverted yield curve. Benign forecasts reflecting continued economic resilience, higher neutral real rates, and supply-demand imbalances in Treasury markets driven by a larger budget deficit are all possible explanations. Only a few quarters ago, a sharp drop in output sat on the horizon. Today market expectations are harmonizing around a "no landing" scenario. We find this a bit too Pollyannaish. It is not a stretch to imagine labor markets cracking and a subsequent dearth of financing throwing cold water on the broader economy. Or perhaps re-emerging inflation brings the Fed back to life. And what about asset valuations? Are they immune to increasing long-term real rates? Something is amiss.

Although rate hikes are likely nearing the end, an extended period of restrictive monetary policy means liquidity will continue to be a concern and volatility in risk assets could return, reflecting fatter tails and the risk of unintended consequences. Generally speaking, portfolios are fully invested and we are comfortable with positioning given the market environment. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

800 LaSalle Avenue, Suite 1400 | Minneapolis, MN 55402-2054 | **www.galliard.com** | 800-717-1617

[2]Source: Bloomberg

GALLIARD Capital Management, LLC

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