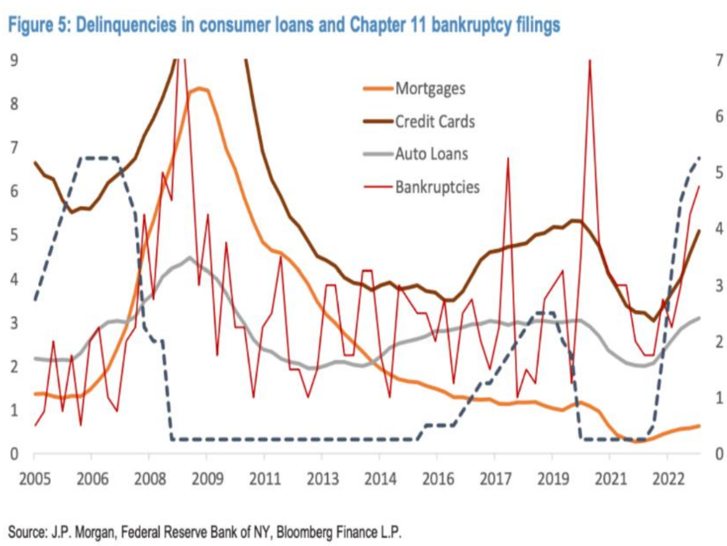
John's Market Outlook – September 28, 2023

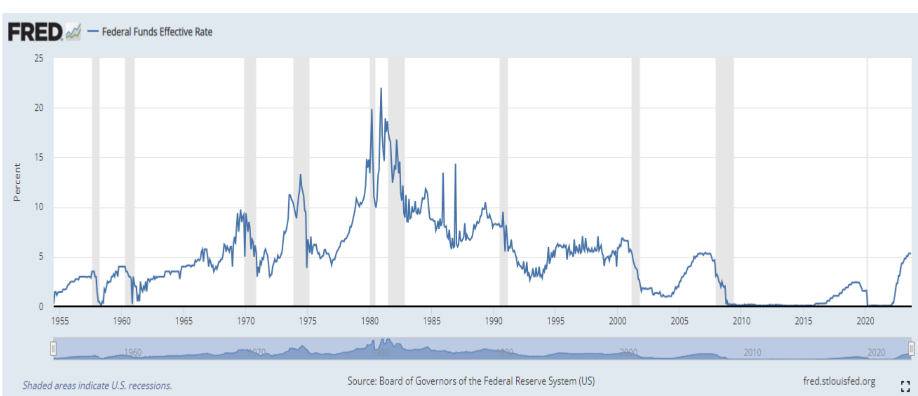
Let's start with interest rates. The Federal Reserve has paused rate increases to see if it has done enough to suppress inflation. For most consumers and many businesses, credit has become expensive. Prime mortgages and are near 8%, auto loans higher, credit cards nearly 30%. Small businesses are paying over 10% for credit. Companies who took "cheap" debt in 2020/21 face refinancing at twice the cost. The ten year Treasury yield has climbed to levels last seen in 2007.



Interest rates are pressuring the economy. Housing construction is down to pre-pandemic levels, house sales are near 2008/09 lows, office building values are falling, and commercial development activity is slumping. Industrial production is neither growing nor shrinking. Consumer spending is holding up, but consumer debt delinquencies and bankruptcy are rising (see chart; Fed funds rate is the gray dashed line).

Rising public spending in 2022 took the Federal deficit to $1TR/yr. Federal interest payments now exceed defense spending. Public spending will slow, removing that economic stimulus.

The economic picture remains on balance negative, with leading indicators down and yield curves inverted; see the Appendix for details.

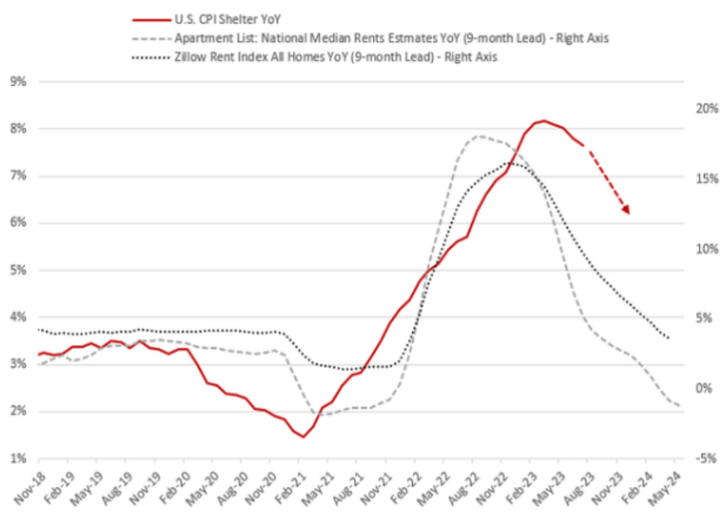


With inflation still twice its target, the Federal Reserve will keep rates "higher for longer". Rate increase cycles *usually* lead to recessions (gray bars in chart).

Whether this cycle will as well ("hard landing") or if progress on inflation allows the Fed to lower rates before causing a recession ("soft landing") is very uncertain.

For a while, investors partly ignored the economic picture. "Artificial intelligence" excitement drove a rally in several large technology stocks that lifted the S&P 500 back to mid-2022 levels; the index has since declined about -7%. Outside of those tech names, US stocks have overall been flat year-to-date. For the third consecutive year, long bonds are lower, as higher rates push their prices down.

There are positives. Inflation should continue declining. As the chart below shows, rent growth (gray lines) and house price growth (not shown) have fallen back to flattish, so housing aka "shelter" inflation (red line) is following. Housing is *35%* of inflation.



Sources: Apartment List, Zillow, Bloomberg, christope-barraud.com

S&P 500 earnings declines have been surprisingly modest, as revenue growth (inflation?) has offset declining profit margin. *If* consensus analyst forecasts are right, earnings may return to positive growth in 4Q23 and 2024.

Big tech is expensive, but mid and small-cap stocks are at historically low valuations, as are many S&P 500 stocks outside of tech.

Good short-term yields (about 5.5%/yr) are available from US Treasury bills. 2-year US Treasuries now yield over 5.0%; 10-year Treasuries over 4.5%. Investors are "paid to wait" during this uncertain period.

As for sectors and asset classes:

- The US remains the favored market. China's debt and growth dilemma has grown. Europe has made less progress in fighting inflation. Japan is emerging from its long deflationary slump and will soon raise interest rates; in Japan, higher inflation and rates are positive.
- The healthcare sector is increasingly inexpensive. Some investors think that anti-obesity drugs from Lilly (LLY) etc will reduce the need for other medical care; we are not so optimistic. Lower public spending is a risk for the sector.
- Energy, real estate, and consumer sectors remain cheap. OPEC is driving oil prices up for economic and political reasons, benefiting energy names like Shell (SHEL) and Total (TTE). Commercial real estate values are weak but, except for offices, rents are keeping up with inflation and occupancy is strong.
- High interest rates *should* bring down high valuations. We have moderate weights in high-priced big tech like Apple (AAPL) and Microsoft (MSFT), while adding overlooked tech names like Fortinet (FTNT) and Intel (INTC).
- We favor insurance names like Chubb (CB) and Arch Capital (ACGL) and Everest Re (EG), who are raising prices and benefit from higher interest rates, over banks facing higher capital requirements, weak commercial real estate (office) loans, and high deposit costs.

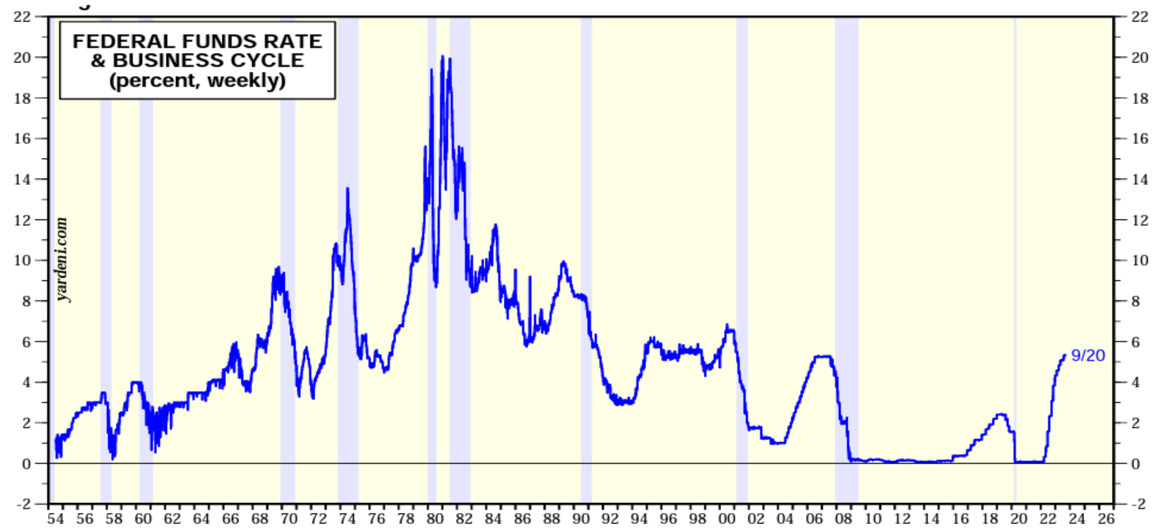
I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Thank you!

My opinions and best judgment as of the date written, not investment recommendations or guarantees.
For clients of Laurelhurst Asset Management, 1001 SE Water Ave Ste 217 Portland OR 97214.

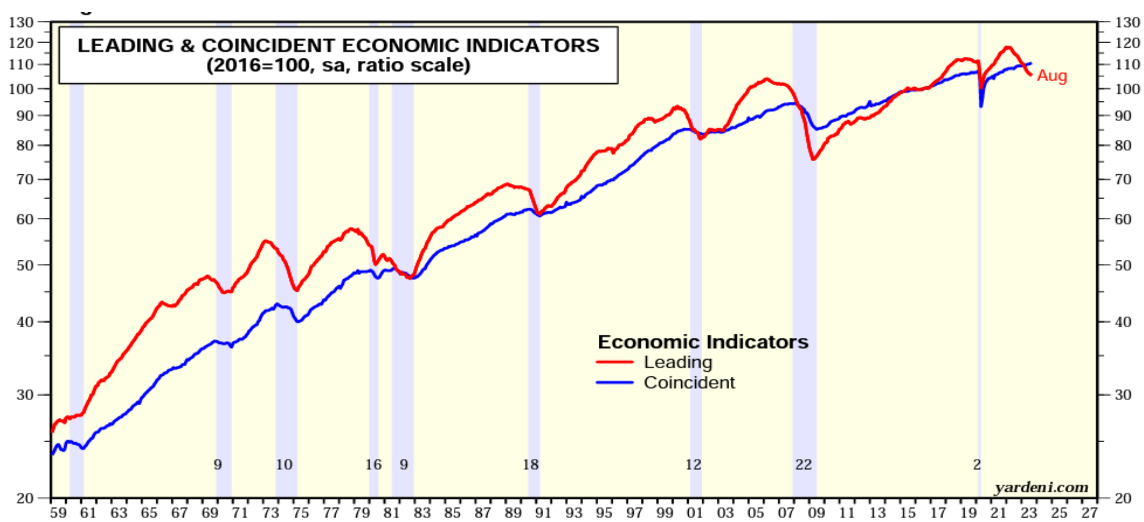
APPENDIX TO SEPTEMBER 2023 OUTLOOK – SELECTED CHARTS AND TABLES

The Federal Reserve raised the Fed funds rate to 5.25-5.50%. *It may raise again this year and expects to keep rates high next year.*



Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Federal Reserve Board.

Leading economic indicators (red) continue weakening. *Coincident indicators reflect the economy now. Leading indicators suggest the economy's future direction. Shaded periods are recessions.*



Note: Shaded areas are recessions according to the National Bureau of Economic Research. Numbers above timeline reflect number of months from peak of leading indicators to peak of business cycle.
Source: The Conference Board.

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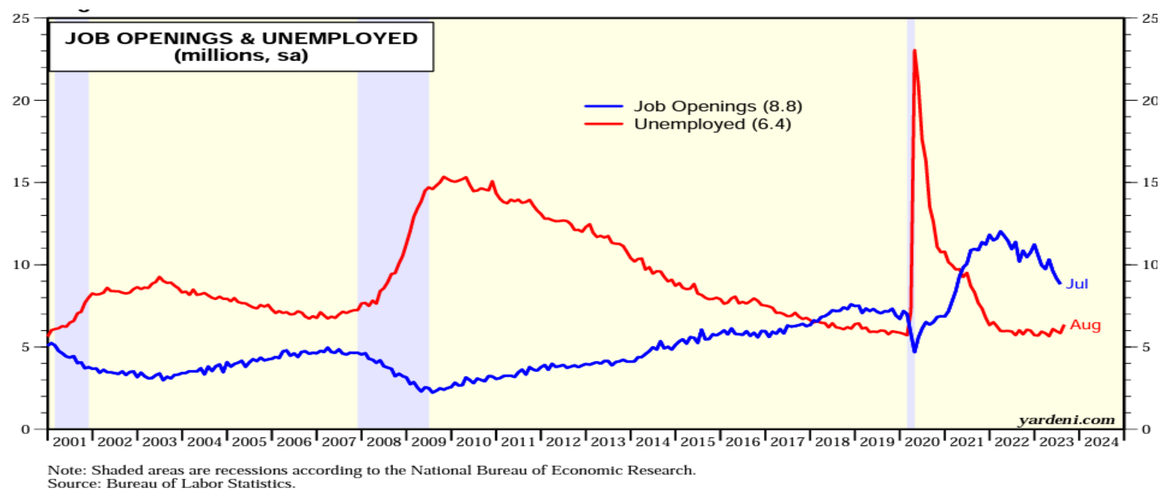
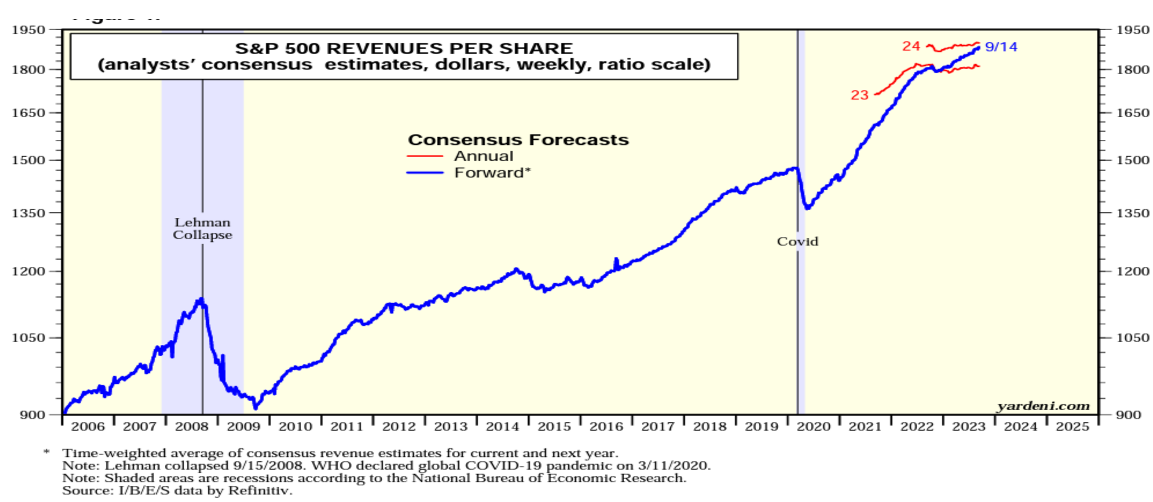
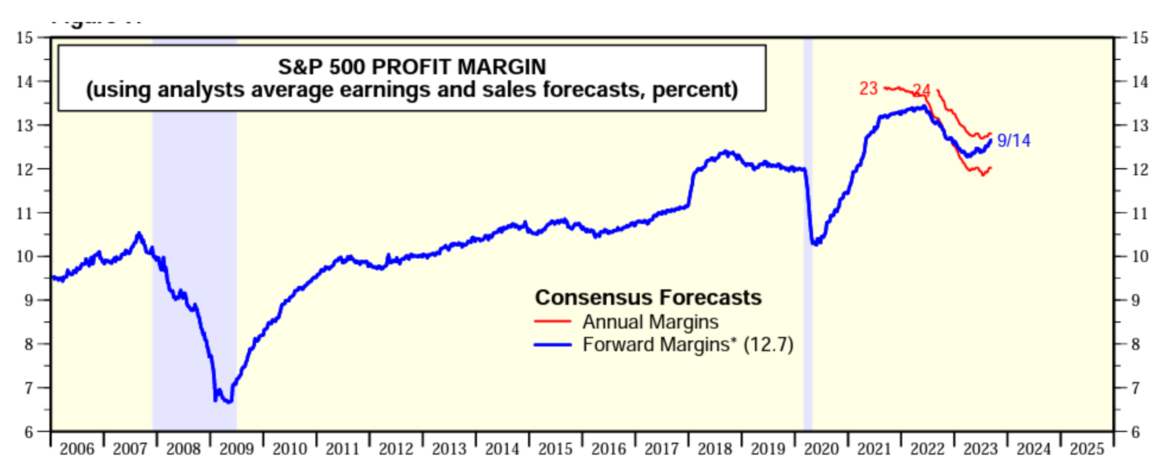
Job openings are declining. *The surplus of open jobs (blue) over unemployed persons (red) is shrinking.*



S&P 500 consensus forecasts are ticking up. *Red lines are forecasts for 2023 and 2024 revenue/share (slightly rising), blue is "next 12 months" forecast (consensus still has +5% growth in 2024).*



*S&P 500 profit **margins** fell sharply. 2023 and 2024 consensus is stabilizing, with recovery forecast in 2024.*



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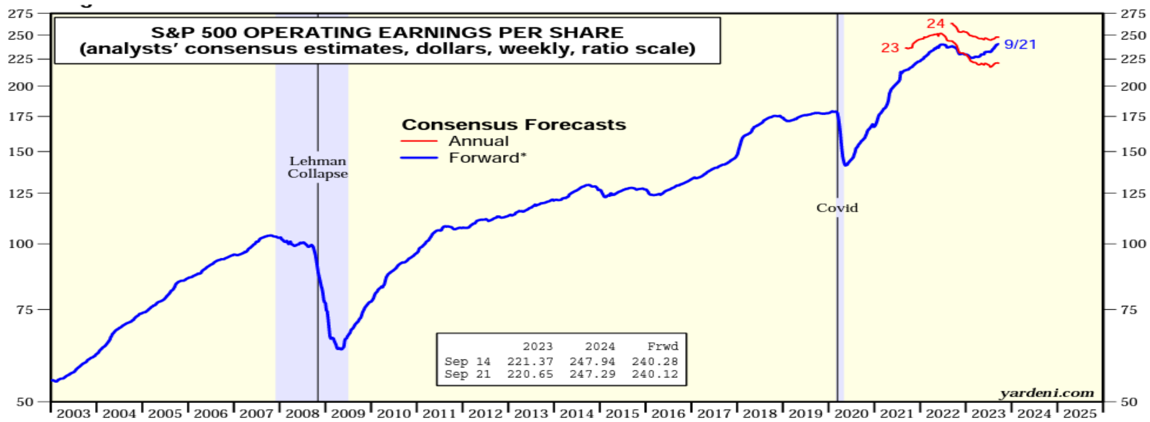
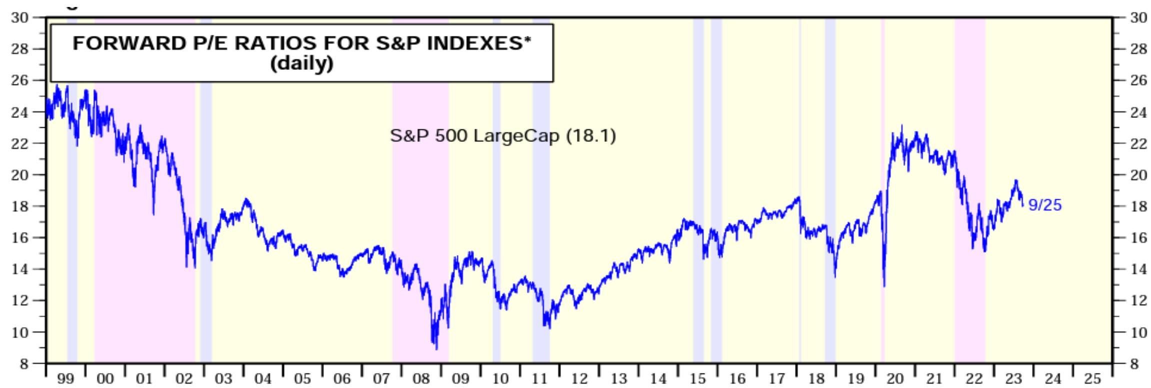
*Forecast S&P 500 2023 **earnings** are $220 and 2024 $247, implying +12% growth. Analysts do not expect a recession, when earnings typically fall -10% or more. Even a very mild recession usually sees earnings flattish.*



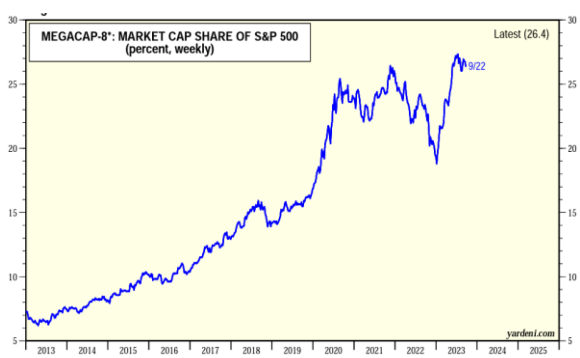
* Time-weighted average of analysts' consensus estimates for S&P 500 operating earnings for current year and next year.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Note: Lehman collapsed 9/15/2008. COVID-19 = WHO declares global pandemic on 3/11/2020.
Source: I/B/E/S data by Refinitiv.

S&P 500 price/earnings ratio in recent quarters has been 19X. *Large-cap stocks are expensive . . . ?*

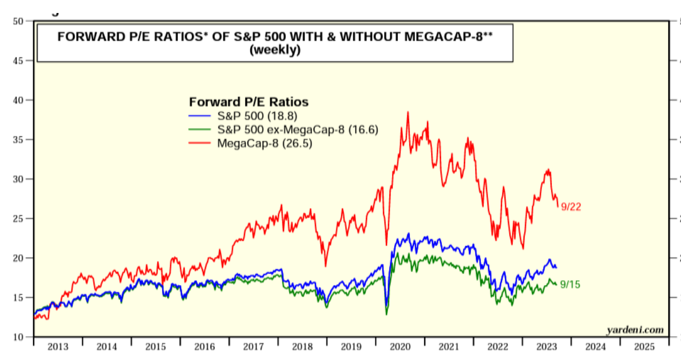


* Weekly stock price index divided by 52-week forward consensus expected operating earnings per share
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv and Standard & Poor's.

The "AI" rush drove the S&P 500 to a 27% concentration in the 8 largest tech names. Without them, the "S&P 472" price/earnings is a more reasonable 16-17X (green line, chart below).

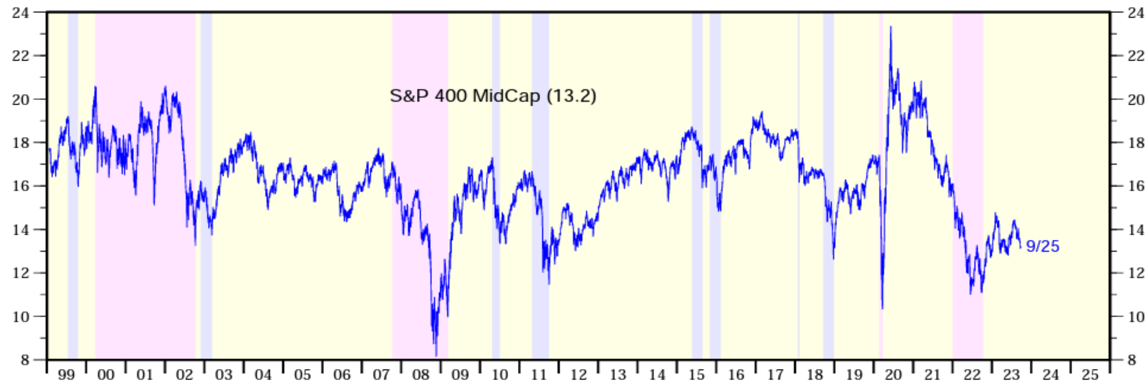


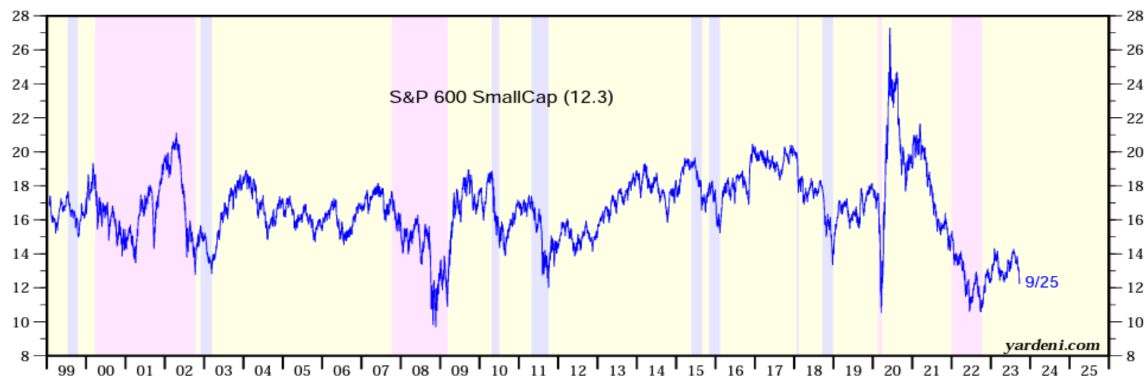
* MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included
Source: Standard & Poor's and I/B/E/S data by Refinitiv.



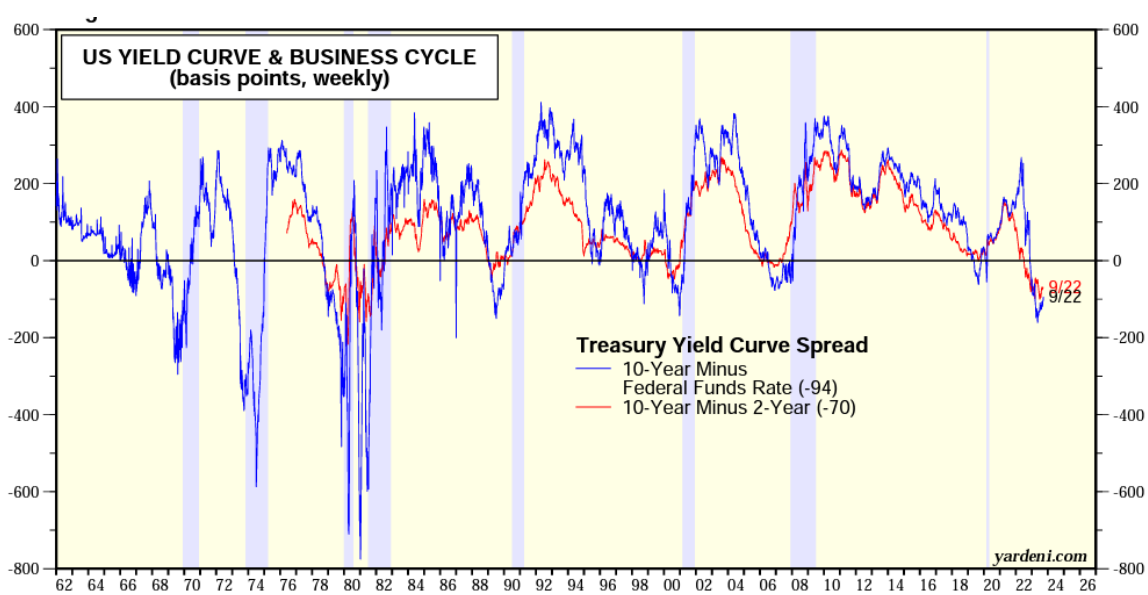
* Price divided by consensus forward earnings forecast.
** MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.
Source: I/B/E/S data by Refinitiv.

Mid/small-cap stocks (S&P 400 and S&P 600) price/earnings ratio are low. *Smaller stocks are inexpensive.*



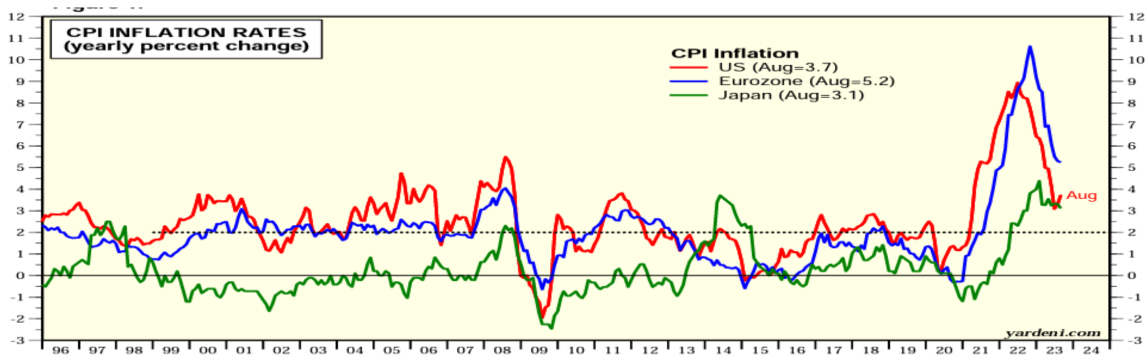


Yield curves remain inverted. *Inverted yields (long Treasury rates lower than short rates) are historically a reliable recession indicator* *<u>but</u>* *the "lag" from inversion to recession is long and variable.*



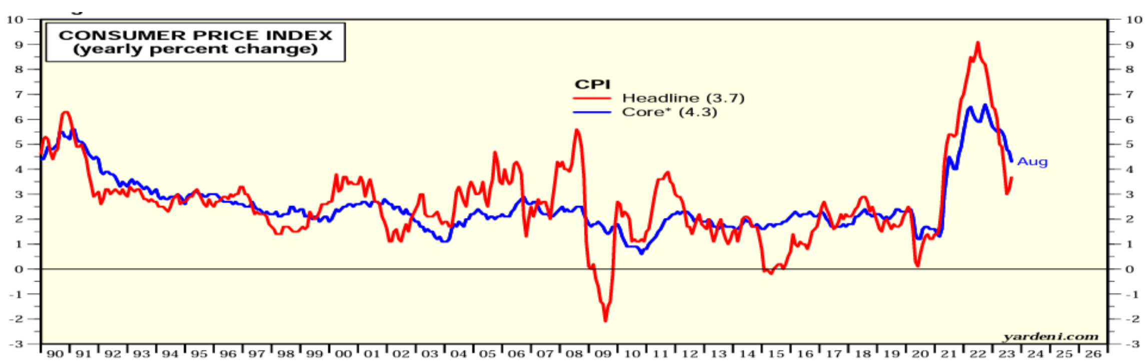
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Federal Reserve Board.

US inflation has declined but remains too high. *"Headline" CPI is under 4%, still well above the Federal Reserve's target of 2%. Europe has farther to go.*



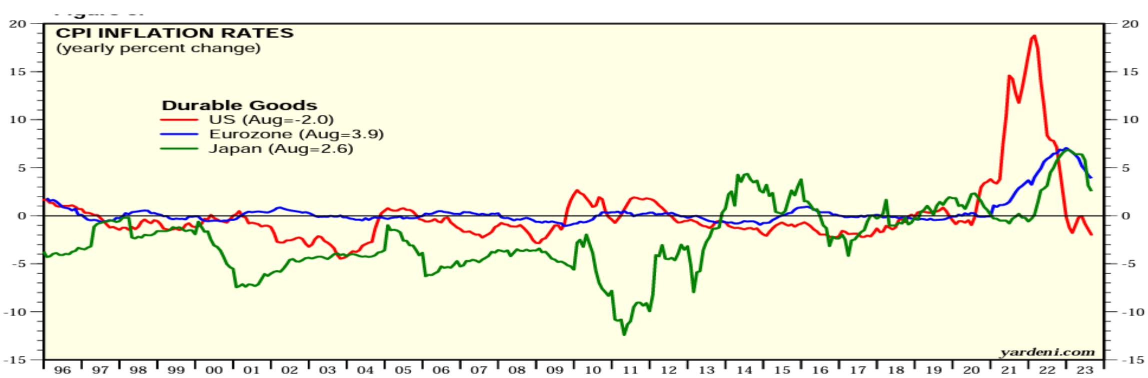
Note: Dotted line is the 2.0% inflation target of the Fed, ECB, and BOJ.
Source: Haver Analytics.

Consumers see "headline" inflation, but the Federal Reserve focuses on "core" inflation (blue line - excludes food and energy) which remains over 4%.



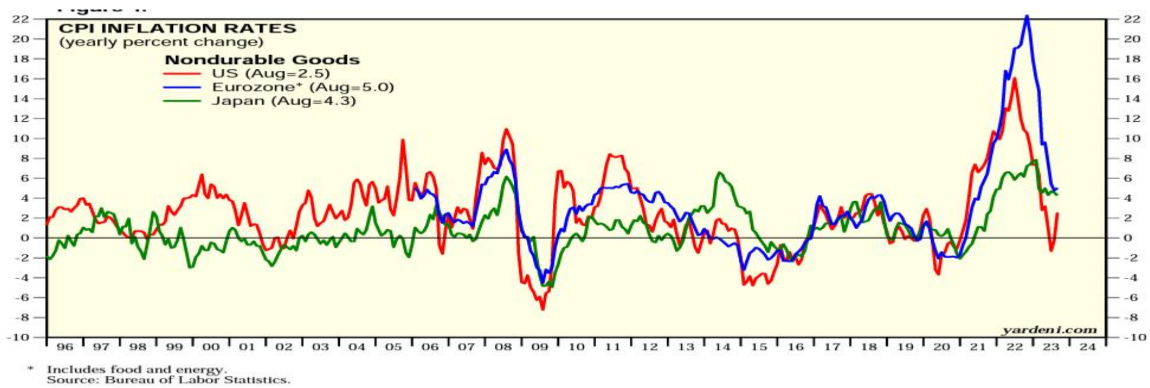
* Excluding food and energy prices.
Source: Bureau of Labor Statistics.

"Durable goods" (i.e. large purchases) inflation has fallen rapidly in the US and is following elsewhere.

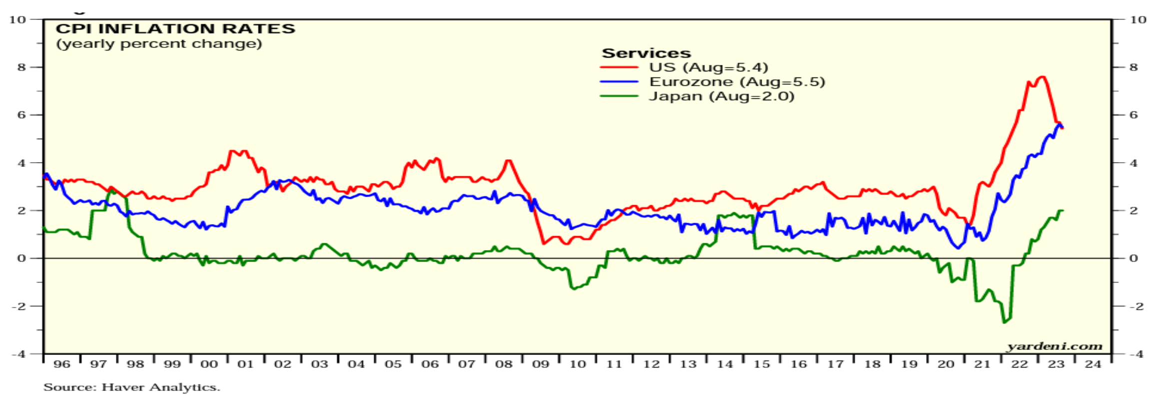


Source: Bureau of Labor Statistics.

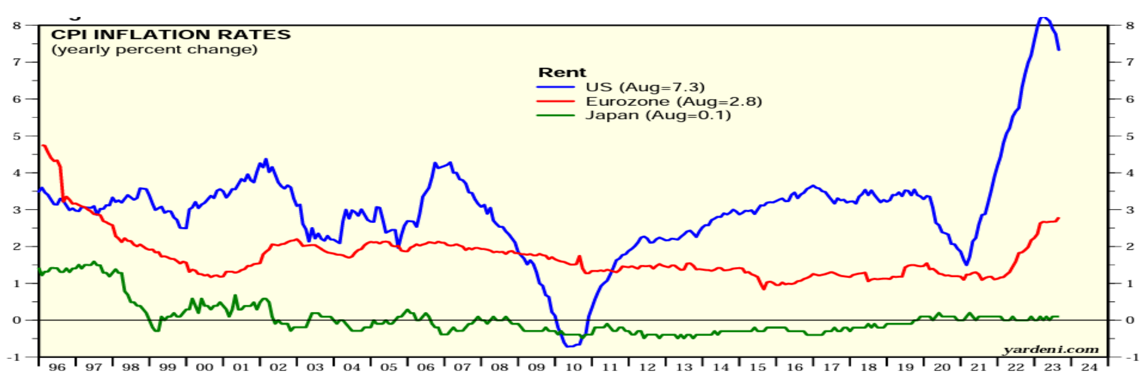
"Non-durable goods" (i.e. small purchases) inflation is also falling.



"Services" inflation has peaked in the US but is still rising elsewhere.



Housing services (here called "rent") is <u>35%</u> of total inflation. If prices/rents stay flat during 2024, US housing inflation should decline, pushing overall inflation down.



Charts and tables from reliable sources including FRED Economic Data and Yardeni Research, or prepared from primary data.