THE PRIVATE CLIENT GROUP

BALANCING LIFE & WEALTH

ECONOMIC & MARKET

INSIGHTS

An Executive Summary for July 2023

July was a strong month for equity markets while fixed income markets were essentially unchanged. The S&P 500 continued to post positive returns led by Energy, Communications, and Financials. Yields on U.S. Treasuries nudged higher as the 10-Year Treasury rate rose to 3.97% from 3.81% and the 5-Year U.S. Treasury rate ended at 4.2% up from 4.1%. Bond indices were virtually unchanged with the Bloomberg Aggregate Bond Index declining slightly, while corporate bonds and Muni bonds rose modestly.

The Federal Reserve raised the Federal Funds rate by 25 basis points bringing its target rate to 5.25% - 5.50%. It was the Fed's 11th hike since March 2022 and Chair Powell indicated that rates are finally in 'restrictive territory'. The Fed Funds rate now exceeds inflation as measured by a variety of methods, including CPI Headline (3.0%), CPI Core excluding food and energy (4.8%), PCE Headline (3.8%) and PCE Core (4.1%). Historically, on average, real rates above 50 to 75 basis points have been considered restrictive.

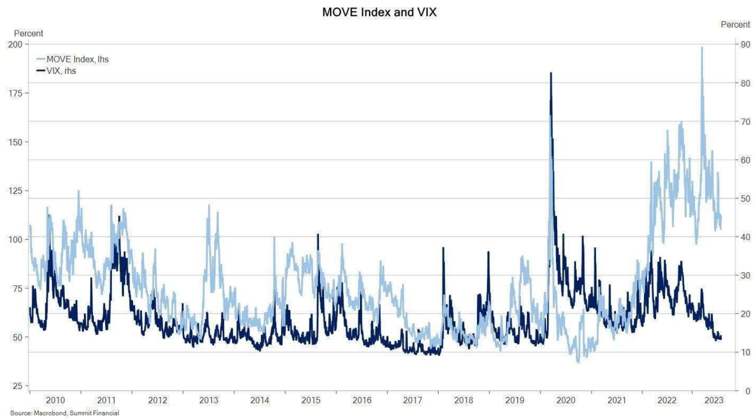
The key question now is how long will the Fed maintain its restrictive stance. The Fed's own forecasts call for one further rate hike this year. On the other hand, market forecasts, as measured by the CME Fed Futures, indicate a low probability of further rate hikes. The expectation is that the Fed will not cut rates any time soon, and will remain at this level into Q1 next year. In order to cut rates, the Fed will need to see clear evidence of core inflation heading back towards its target of 2% which equates to consistent monthly readings near 0.2% to 0.3%. June's reading, at 0.2%, was the first in the past seven months to reach the target level.

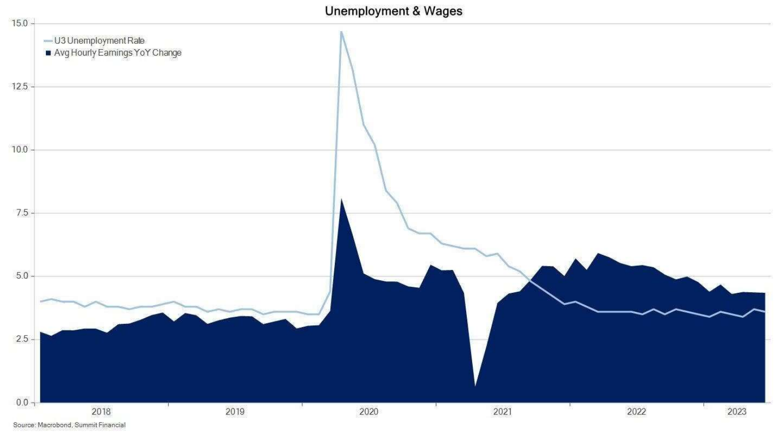
Looking forward, Powell confirmed that "reducing inflation is likely to require a period of below trend growth and some softening of labor market conditions". Unfortunately for Fed policymakers, U.S. economic growth was not below trend in Q2. The GDP reading, released in late July, showed the U.S. economy grew at 2.4%. Increases in consumer spending, federal and state spending, nonresidential fixed investment, and private investment all contributed to the broad-based growth. Only residential investment and exports were offsetting. For policymakers, the news was somewhat better on the employment side, as the Conference Board's Employment Trends Index showed a decrease of 3% year-on-year in June, indicating that pressures in the labor market are easing. Further beneficial news on inflation came via the second quarter Employment Cost Index report which showed costs decelerating across wages, salaries and benefits versus the prior quarter and the prior year. The Fed likely pauses here as it awaits the lagged effects from credit tightening to slow the economy and further reduce inflation.

Globally, official Chinese growth estimates remain at 5% for this year. GDP growth for the second quarter was 6.3% year over year, though it came in below forecasts of 7%. With inflation near 0%, concerns about deflation and slow growth continue to pressure officials to either increase government spending or cut rates. Europe reported economic growth of 0.3% in the second quarter, led by Ireland, France, and Spain. The growth, while meek, was above first quarter's 0% and fourth quarter's slight decline. European growth forecasts remain muted and overall credit demand is declining. The Bank of Japan, in order to combat rising inflation, began exiting its yield curve control policy allowing rates on long dated Japanese Government Bonds to rise. This may be significant for U.S. rates as Japan is the largest foreign holder of U.S. treasury bonds and, given the high cost of hedging, Japanese investors may reallocate towards their own sovereign bonds.

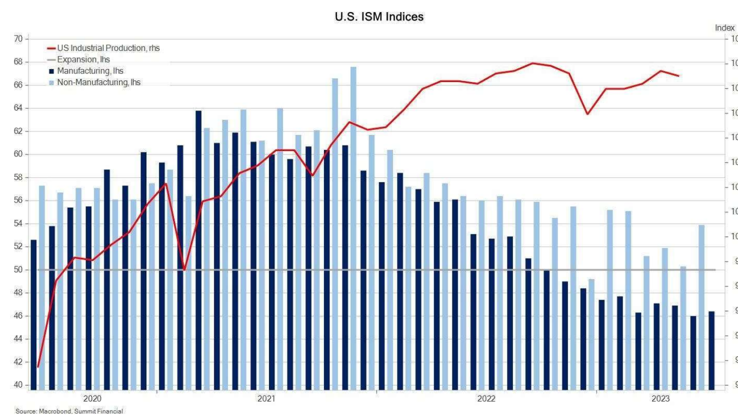
Within fixed income markets, yields are up across the board. Long-run expectations for inflation, as measured by five-year breakeven rates, are above the Fed's target at 2.4%. This is a key indicator for the Fed and one that will likely trigger concern if it rises much higher. Nonetheless, with the Fed most likely at the end of its rate hiking cycle, extending duration especially for investment grade bonds and Treasury Inflation Protected Securities (TIPS), provides a reasonable risk reward trade-off.

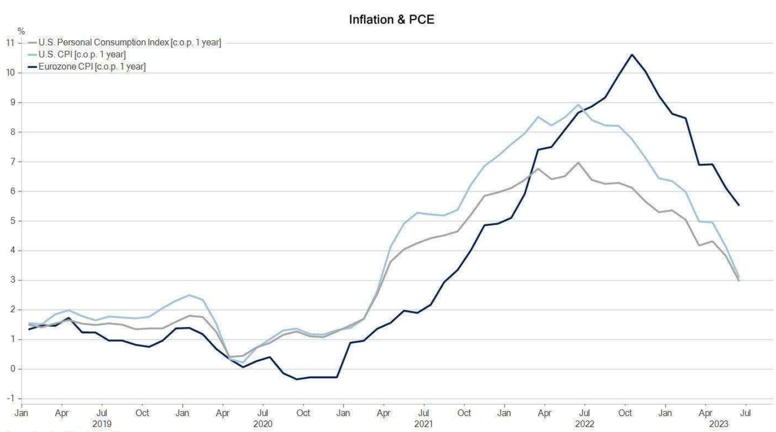
Halfway through Q2 earnings season, S&P 500 firms are reporting a decline in growth rate year over year. Positive growth from Communications and Consumer Discretionary has been more than offset by flat growth in Technology and negative growth from Energy, Materials and Healthcare. Per Factset, Q3 growth is forecast at 0.2%, and Q4 growth at 7.5%. Analysts are forecasting 12.6% earnings growth for CY 2024. Future equity returns will likely be closely tied to the rate of earnings growth, with a sensitivity towards any downward revisions.

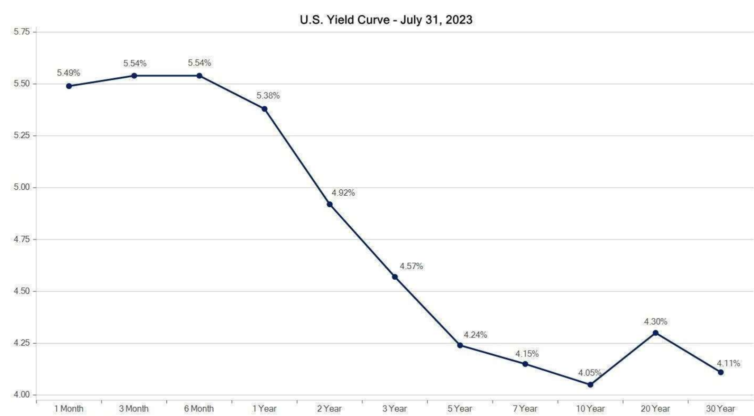

MOVE Index and VIX
Percent
Percent
MOVE Index, lhs
VIX, rhs
Source: Macrobond, Summit Financial


Unemployment & Wages
U3 Unemployment Rate
Avg Hourly Earnings YoY Change
Source: Macrobond, Summit Financial


Price to Earnings (Estimated Consensus EPS)
U.S.
EAFE
Emerging Markets


U.S. ISM Indices
Index
US Industrial Production, rhs
Expansion, lhs
Manufacturing, lhs
Non-Manufacturing, lhs
Source: Macrobond, Summit Financial


Inflation & PCE
%
U.S. Personal Consumption Index [c.o.p. 1 year]
U.S. CPI [c.o.p. 1 year]
Eurozone CPI [c.o.p. 1 year]
Source: Macrobond, Summit Financial


U.S. Yield Curve - July 31, 2023
5.49%
5.54%
5.54%
5.38%
4.92%
4.57%
4.24%
4.15%
4.05%
4.30%
4.11%
1 Month
3 Month
6 Month
1 Year
2 Year
3 Year
5 Year
7 Year
10 Year
20 Year
30 Year
Source: Macrobond, Summit Financial

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