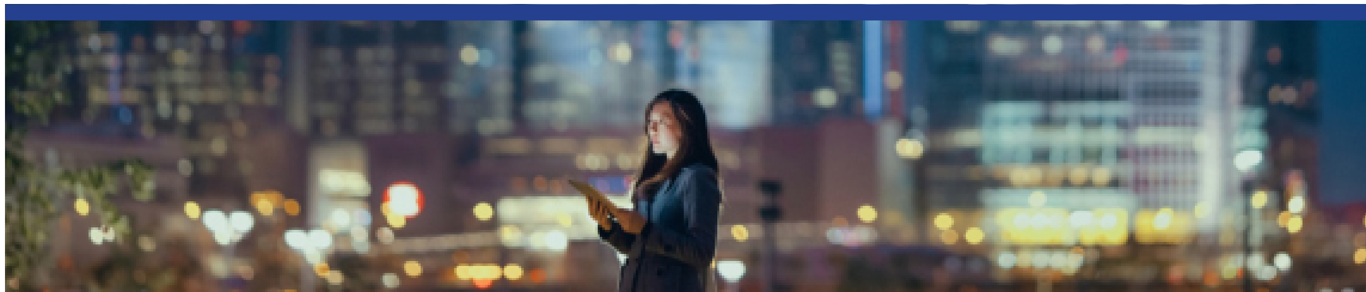

November 5, 2023

CIO Strategy Bulletin

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A Turning Point

There is no way to be certain this is THE turning point for financial markets. However, we are seeing data that suggests our view for the direction of markets in 2024-25 is sound. We believe:

- Inflation is coming down.
- Employment growth is slowing.
- Corporate profits are rebounding.
- Expectations for global growth are very modest.
- Wage growth – even in services – is moderating.
- Most equity valuations are more reasonable than many investors believe.
- High short-term interest rates today are unlikely to be available tomorrow.
- High rates are constraining certain economic sectors, but the economy has been more resilient that most expected.
- Market timing is a bad strategy. It is a really good time to have a diversified portfolio.

- **On October 18, the Global Investment Committee (GIC) raised the allocation to global equities from neutral to overweight. This is our first such move since early 2020 (Figure 1).** We did this in the face of falling share prices.
- The evolving macro environment suggests that equity price appreciation will broaden in the US, then globally. The largest US tech-related shares (the "Magnificent 7" [2]) have driven nearly the entire return in global equities in 2023. Now, we expect that profitable small and mid-cap growth shares with solid balance sheets will see renewed interest.
- We expect no synchronized economic collapse and no "V-shaped" rebound. The economy is going through a series of "rolling recessions" as we head into 2024. But these will "roll out" in the coming year.
- With a 2% overweight in global equities, we are not taking a high-risk posture thus far. As inflation and interest rates fall in the process, we will likely increase and broaden our global equities overweight.
- We believe fixed income offers compelling returns at this time. Four-year duration US Investment grade corporate bonds yield near **6.25%** (please see our most recent CIO Bulletin).
- We see "Security" as a theme with strong prospects. For example, cyber-security software, defense industry shares, tech supply chain expansion opportunities and energy producers will likely see growth as geopolitical risks stay elevated.
- Beware market timing. Many investors appear to be awaiting "a catastrophe" which collapses share prices before adding to equity holdings. This is even as corporate profits have begun to grow again. Remember, the US economy has grown in 87% of all months since the end of WWII.[1]

[1] Based on the S&P 500 operating EPS T.he 87% is the National Bureau of Economic Research's measure of expansion months as % of total months.

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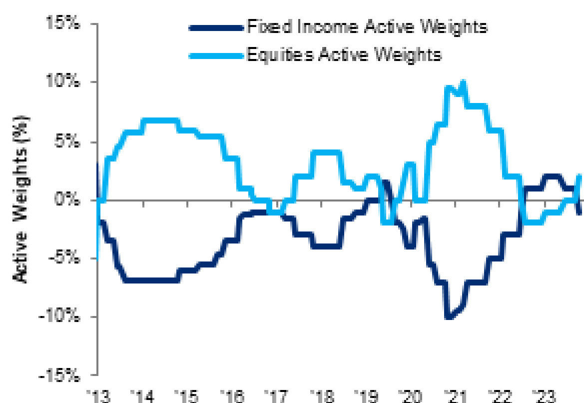
Consider Equities in Anticipation of "Rolling Recessions" End

The rolling recessions suffered in 2023 across many industries will not be repeated in 2024. In fact, they will likely "roll out" in the year to come. That is just one reason we believe investors should consider adding to equity allocations.

Excluding the "Magnificent 7"[2] US tech shares, the MSCI World Equity Market Total Return index is down 12% since end 2021. At its recent low, the S&P 500 price lost 14% over the same period. Compared to the roughly 50% losses of the 2008/2009 Global Financial Crisis period and the unwinding of the great tech bubble from 2000-2002, the drop in equities since 2021 has not been catastrophic – but it has slowly eroded investor confidence.

More recently, from July 31 to October 27, US equities dropped 10%. But there has also been a far broader correction in world equities than the S&P 500 and Nasdaq 100 might suggest. Just 15% of stock markets globally are trading above their 200-day moving average.

Figure 1: CGW Global Investment Committee Tactical ; Overweight/Underweight: Equities vs Fixed Income



Source: GIC and Bloomberg as of November 1, 2023.

A Sigh of Relief for the Bond Market

On a risk-adjusted basis, the valuation reset in the US bond market since late 2021 was far worse than the equity declines over the same period. Bonds suffered their largest drawdown in a century in 2022.

Now, after US 10-Year Treasury yields topped out at 5%, the bond market finally "exhaled" last week. Fed Chairman Powell ended his second straight FOMC meeting without increasing rates. That is just one reason we would suggest that investors consider adding to their bond allocations and away from cash.

Despite an exaggerated bounce in US GDP for the third quarter, data in the past week continue to show a slowing economy. US manufacturing activity continued to contract for a 12th month. This is despite a steady pace of consumer goods spending as firms attempt to reduce inventories. US employment growth has slowed. Most convincingly, wage growth is decelerating. This does not happen in an overheating labor market.

Wealth Creation Opportunity of Fully Invested Portfolios

The gains for the bond market accelerated after Fed Chairman Powell appeared to set a fairly high bar for further interest rate hikes. He said that *if* there was a reversal of the easing in labor market conditions or *if* it appeared that the slowdown in inflation were stalling, it would call for additional policy tightening. Powell pointed to decelerating wage gains and stable inflation expectations in data recently reported. Notably, these signs of moderating price pressures have been accomplished *without* any loss of employment. [3]

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[2] The Magnificent 7 are seven US Tech-related firms that have generated 54% of this year's global equity return and trade at 36X expected EPS. These seven firms have also grown their profits at nearly 3X the pace of the S&P 500 over the past five years.

[3] FOMC press conference, Bloomberg November 1, 2023

We have a high level of confidence that core inflation measures will slow in the coming year. Lagging components of the CPI are only beginning to moderate **(Figure 2).** If labor demand does slow markedly as we expect, the Fed will not want restrictive monetary policy to drive the economy into a full stall (**Figure 3**). This is why Fed forecasts and market estimates both embed rate cuts before 2024 ends.

Figure 2 CPI Core Ex-Shelter vs CPI Shelter Year-over-Year%

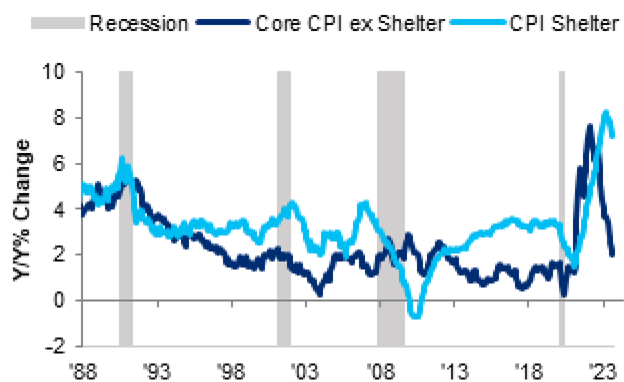
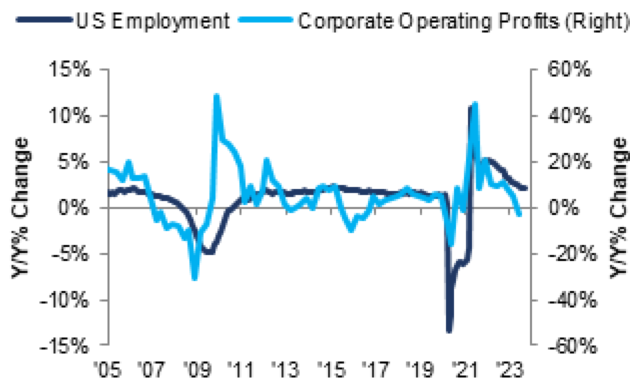


Figure 3 US National Corporate Profits and Employment



Source: Haver Analytics as of November 2, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Corporate Profits Could Rise Even as the Economy Slows

Corporate profits have begun to improve following declines over the past year. EPS for the S&P 500 over the past two quarters have risen from their trough at the start of the year. Measured over 12-months, EPS grew in the third quarter following a full year of modest declines (**Figure 4**). A tracking estimate of firms reporting 3Q results is running about 6% above our conservative estimates.

Uncharacteristically, labor demand has been growing much more strongly than profits, and we expect that this will reverse over the coming two years. With the performance of most shares weak and profits recovering, we believe it bodes better for equity returns in the year ahead.

And assuming bond yields fall and credit markets ease – still “ifs” – these circumstances may suggest a substantial gain for US equities in the coming year.

Figure 4: S&P 500 Operating EPS Year-over-Year% (3Q is Current Reporting Season, Tracking 4Q is Consensus)

Source: Factset, Bloomberg as of November 2, 2023.Consensus is from Bloomberg. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Market Timers Beware: Growth is the Norm

Historical data analysis has gotten much faster, but this does not explain why there are many striking values available to investors. While we see undeniable valuation discrepancies and potential growth opportunities, others claim to be able to predict the “perfect moments” to enter and exit investments.

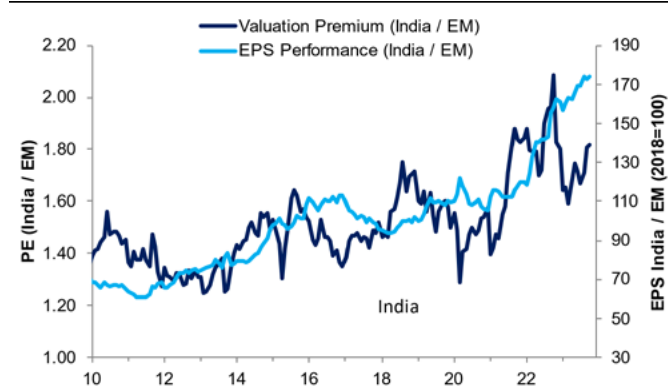
The history of equity market timing continues to show a bleak record. Growth is normal. Since World War II, the US economy has expanded in 87% of all months. While volatile month to month, US equity returns have been positive in 78% of all years over the same period.

With fear of recession and fear or loss driving investors to the sidelines as we end 2023, we remind investors that betting against equity market progress has historically been unprofitable.

Global Equities May See Better Performance, Too

A slowing US labor market, falling inflation and lower bond yields remain what we believe to be the most likely outcomes. If these views prove to be accurate, the news would likely weaken the US dollar after a surge based on expectations that the Fed would stay “higher for longer”. If so, our present over-weights in a few Asian Emerging Markets such as India may benefit (**Figure 5**). And this would enable us to broaden our over-weights further across the world. Passing the peak of monetary tightening and trade weakness in 2024 should yield stronger corporate profits globally in 2025.

Figure 5: MSCI India/EM Relative Valuation and EPS



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Finally, a Time to Emphasize Potential Thematic Opportunities

For nearly three years, the GIC has maintained an overweight in cyber-security software firms given their critical role in protecting governments and firms from the dangers of cyber-crime and the misuse of AI. Equity performance has been strong, but earnings have delivered more than share prices, making valuations more attractive these days (**Figure 6**)

We see the world grappling with a wider range of security risks. These include technology supply chain security, defense against wider military conflicts and energy security. These are not “optimal” investments for a perfect world. But they are quite visible and potential areas of growth.

Figure 6: Cyber Security Forward P/E

Source: Bloomberg as of October 30, 2023. The Cyber Security proxy is the Nasdaq Cybersecurity Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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