# Quarterly Economic Update

## September 7, 2023

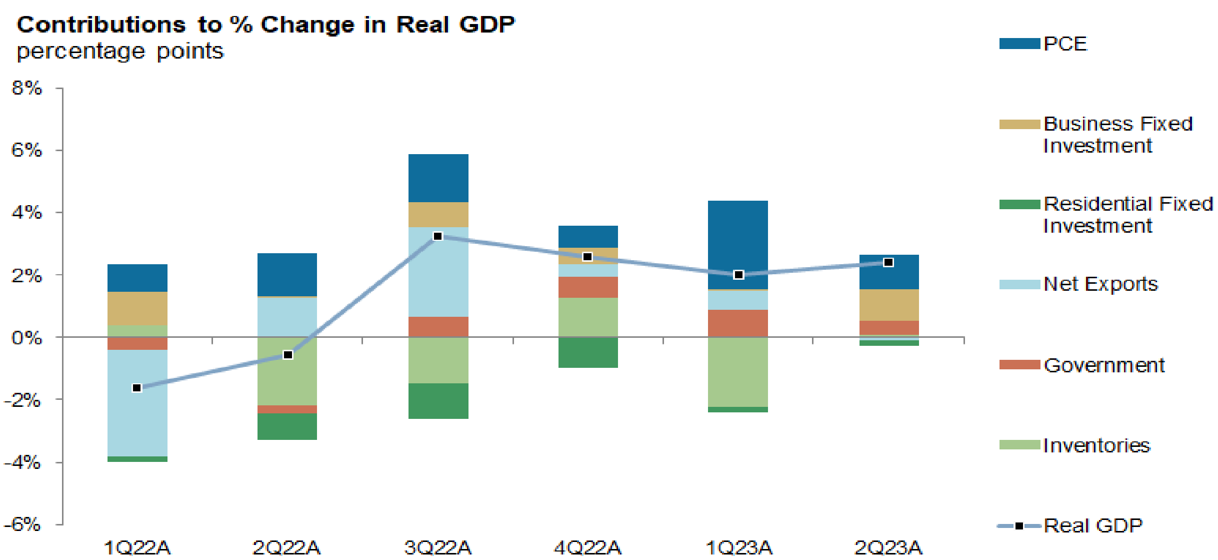
## *MACROECONOMIC COMMENTARY*

# Economic Outlook

***By Bobby Long***

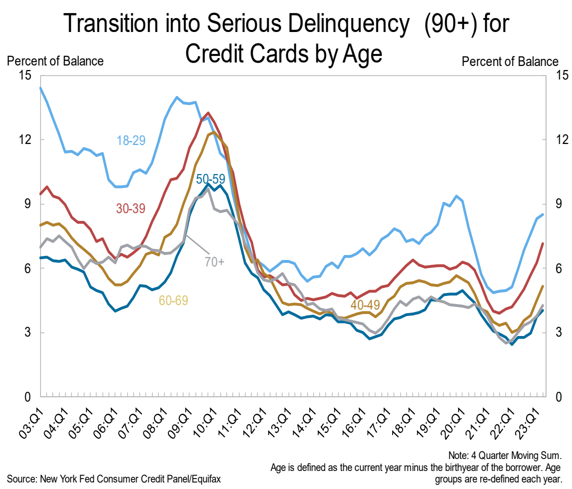
We began the 2023 calendar year with a large number of economists forecasting weaker economic activity and highlighting the elevated risk of conditions slipping into a recession. Economic data has largely shrugged off these concerns and surprised markets with activity that has proved more resilient than expected. There has been some mixed data and pockets of weaker activity, but overall conditions have broadly skewed to the positive despite increasing headwinds over the past several quarters. The fact that activity has continued to come in strong under less supportive conditions argues favorably for the overall health of economic conditions. Despite this healthy level of activity, higher interest rates, contracting money supply, and tighter lending standards will likely challenge these conditions over the next several quarters.

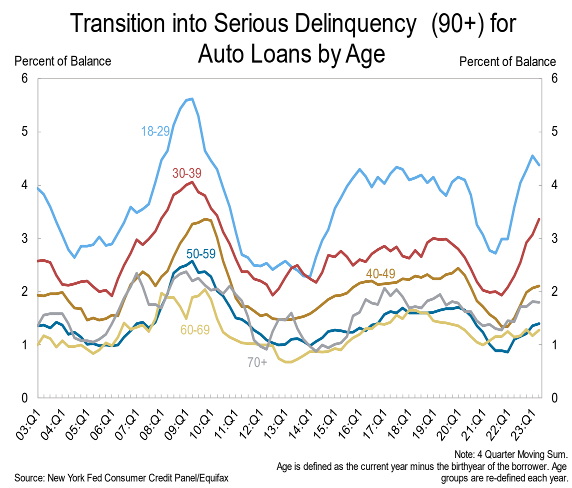
Second quarter real Gross Domestic Product (GDP) grew at an annual rate of 2.1% over the prior quarter. Personal consumption expenditures (PCE) grew by 1.7%, a slower pace but positive with growth across both goods and services. This was supported by stronger spending on recreational goods and energy consumption, while motor vehicle and clothing purchases were both weaker over the quarter. Spending on services grew broadly across most categories. Nonresidential fixed investment grew 6.1%, supported by growth across equipment, structures, and intellectual property products. Residential fixed investment continued to be a modest drag, declining 3.6%. State and local government spending positively contributed to the quarter's growth.




Source: Morgan Stanley Research

While consumer spending has shown some weakening trends, consumers have continued to spend at healthy levels that remain supportive to economic growth. Retail sales increased 0.7% in July over the prior month, with core retail sales increasing 1.1%. Strong Amazon Prime Day spending and early back-to-school spending look to have contributed to the stronger monthly growth. Restaurant sales for the month remained strong, signaling the consumers continued willingness to spend on services and entertainment. Underlying spending trends do point to a weaker consumer. Big ticket merchandise spending has been declining. The spending mix has also been shifting away from discretionary categories such as home furnishings, electronics, and apparel, with a greater share directed towards non-discretionary consumables. A noticeable spending shift towards value and discount retailers portrays a less healthy consumer as well. Higher debt service costs and lower availability of credit will likely weigh on spending over the remainder of the year. The resumption of student loan payments will also have an impact on discretionary spending levels. An additional headwind is the consumer savings rate has been trending higher. While that carries positive attributes for the consumer balance sheet and their capacity to spend, it comes at the expense of actual spending. There has been an uptick in both credit card and auto loan delinquencies. These are not at alarming levels but are more pronounced for younger borrowers and are trends that should be watched. A continued rise in delinquencies would be a sign of increasing consumer stress and, if combined with weaker labor trends, could potentially signal a deeper contraction in personal spending.

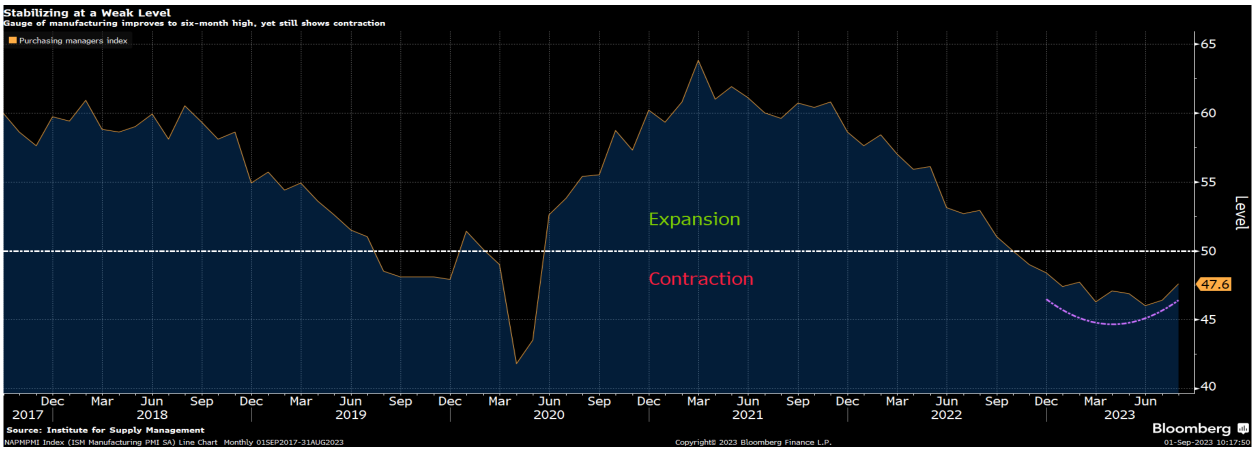



Gasoline prices fell from elevated levels through the back half of 2022 but have been trending higher this year. Prices have risen 19% since the beginning of 2023, with a sharp 8% increase since the beginning of July. This has shown signs of moderating over the past couple of weeks and may reflect elevated summer demand. Still, if it continues to move higher, it would be felt by consumers and negatively impact spending.

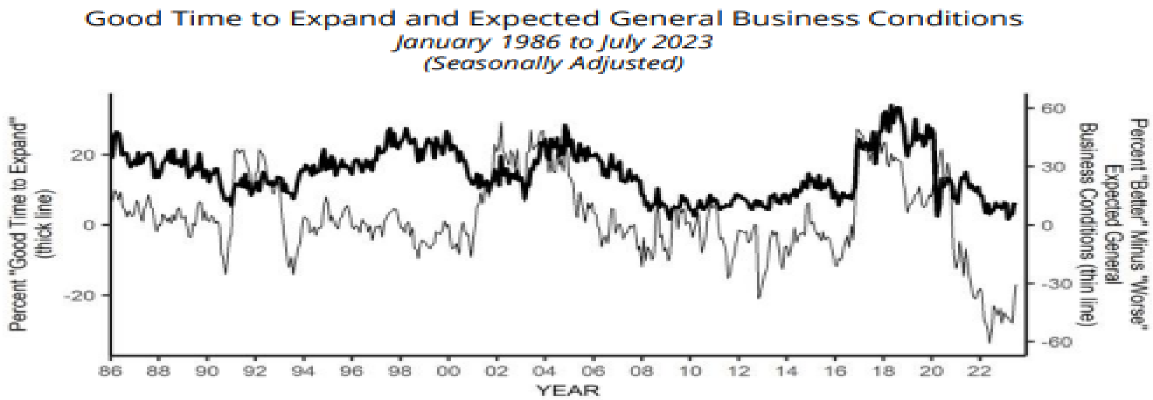
Stronger business investment over the second quarter was a positive surprise following a weakening trend over the past several quarters. Nonresidential investment rose 6.1% over the prior quarter. After strong growth over the prior two quarters, nonresidential structures investment rose at a slightly lower but still healthy rate of 11.2%. Equipment investment increased 7.7% after contracting over the previous two quarters and was supported by stronger investment in transportation equipment. Investment in intellectual property products has been decelerating for several quarters now and increased a more modest 2.2%.

Manufacturing activity continues to be weak. The Institute of Supply Management's Manufacturing PMI Index for the month of August was 47.6%, remaining firmly in contraction territory where it has been for the past ten months. The index has improved over the past two months, indicating some signs of potential stabilization.




S&P Global's U.S. Manufacturing PMI Index also remains in contraction territory. Regional manufacturing surveys have been mixed but are still broadly weak. Service activity has been stronger, reflecting the broad shift in demand for services over goods. ISM's Services PMI has remained in expansionary territory. The rate of growth has been decelerating, but the most recent Services PMI report indicated a continued broad expansion with 14 of the 18 industries reporting growth.

The National Federation of Independent Businesses (NFIB) has reported that its business surveys have indicated deteriorating sales trends, with an increasing number of its members reporting lower sales over the past three months compared to the previous three months. Earnings have also trended lower, with members attributing the decline to lower sales volumes and increased costs. The outlook for general business conditions has improved over the past few months but is still historically negative, and this may be keeping expansion and capital spending plans down. Despite the lower spending expectations, actual expenditures have been okay, and the lower expectations may reflect a higher degree of uncertainty around general economic conditions.



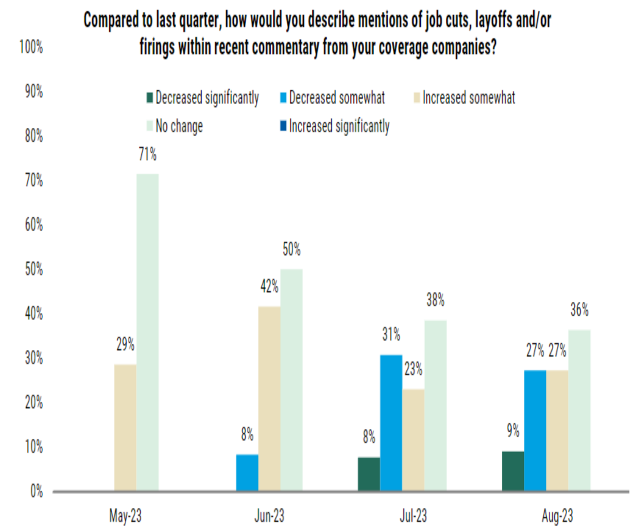

Source: National Federation of Independent Businesses

Evercore ISI's weekly company surveys provide relatively real-time feedback across economic industries and are useful to identify shifting trends. Their company survey average has ticked down some over the past several weeks but has largely moved sideways over the past couple of months. Breadth has deteriorated more recently after improving in July and early August, moving back into negative territory. Retailer sales recently moved lower after several weeks of improvement; however, this may reflect seasonal trends. Restaurant sales have also been trending lower and may reflect some increasing caution around spending habits that should be monitored. As shown in the chart below, the company surveys have been broadly moving lower since the beginning of 2020, reflecting slower growth trends but still positive and above recessionary levels.


Labor conditions remain healthy, with demand for labor outpacing labor supply. These tight conditions have loosened more recently as labor demand pressures have eased. Nonfarm payroll employment has continued to expand; however, job gains have been increasing at a slower pace over the past year and have run below 200,000 over the past three months, well below the average monthly payroll gains of 271,000 over the prior twelve months. The most recent payrolls report added 187,000 jobs for the month of

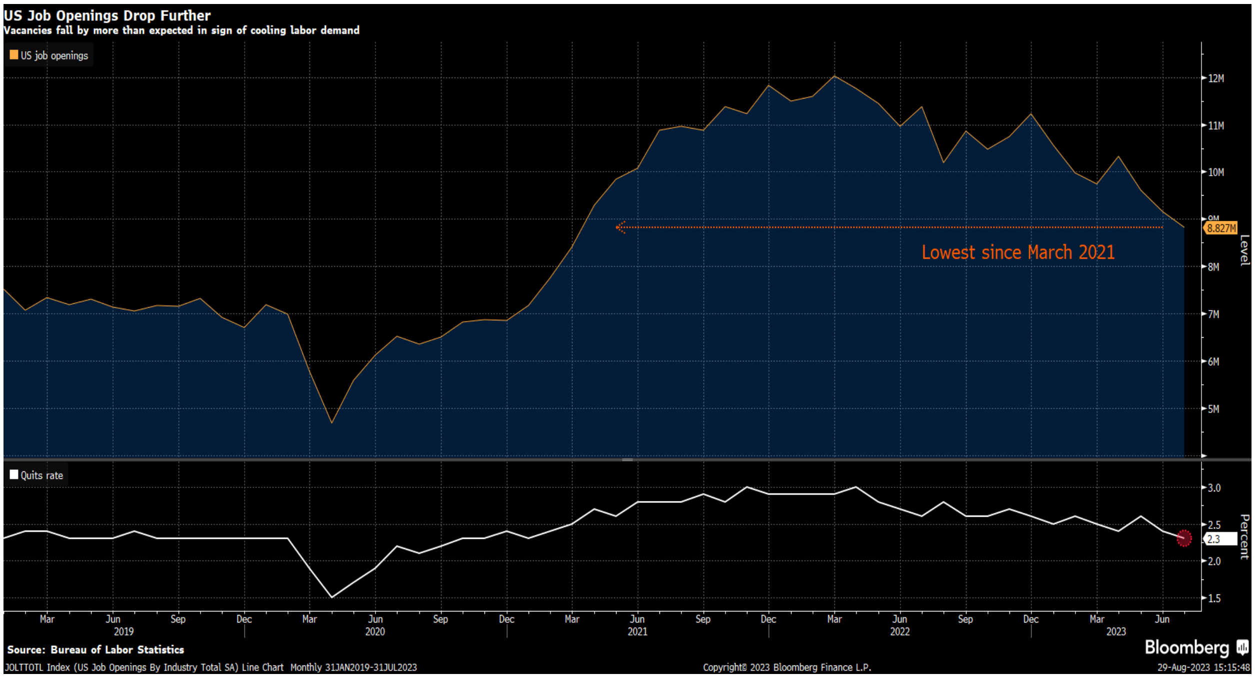
August and revised the prior two months significantly lower. July payrolls were lowered by 30,000, reducing the monthly gains to 157,000. June payrolls were lowered by 80,000, down to 105,000 additions for the month. Employment growth has been concentrated in service-providing industries. Recent strength in payroll gains has come from healthcare, social assistance, insurance-related and real estate leasing financial services, and wholesale trade. When excluding education and healthcare services, private payroll gains have been much weaker. Leisure and hospitality gains have also slowed through the year. The August unemployment rate was reported at 3.8%, continuing to run at a low rate but up 0.3% from the prior month. Labor force participation increased for the month to 62.8%, up 0.2% from the prior month, as additional workers joined the workforce.

Initial jobless claims ticked up earlier this summer, and there were some concerns this could signal the beginning of a more worrisome trend; however, claims have ticked back down and trended sideways since mid-June. The uptick in layoff announcements earlier in the year has also faded. Morgan Stanley surveys their industry research analysts across economic sectors to measure layoff commentary by management teams. While there was a slight increase in the number of analysts reporting that job reduction mentions had increased somewhat in August, the chart on the right shows a number of analysts have reported a decrease in mentions since May.



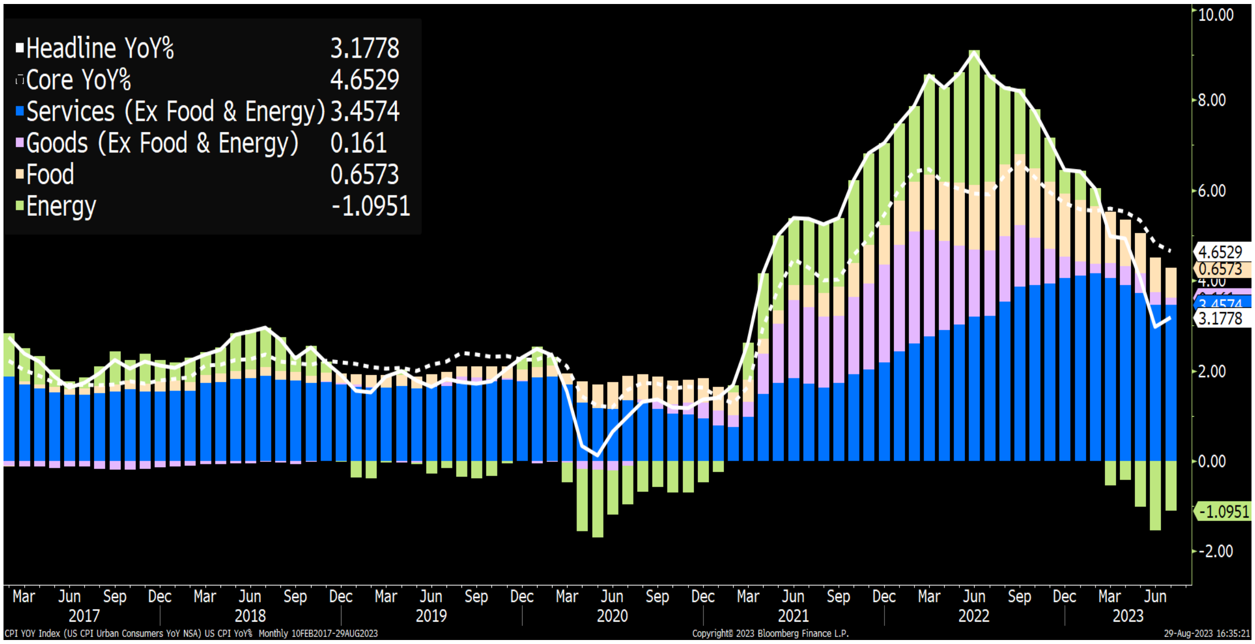

Source: Morgan Stanley Research

A measure of tightness in the labor market is the number of job openings relative to the number of unemployed workers. This gap has been elevated, creating an imbalance between labor demand and labor supply that has placed upward pressure on wages. Over the past few months, job openings have moved down more substantially, as shown below. This reflects some weaker employment trends and indicates that labor demand is cooling. The quits rate reflects worker confidence in finding another job. This has also declined, implying weaker labor conditions.




While the declining ratio of job openings to available workers implies weaker labor conditions, the contracting imbalance is relieving wage pressures. Wage pressures have clearly eased as conditions have loosened, but the data is mixed on the direction from here. There have been some big headlines around union workers capturing significant increases in wage contracts. American Airlines pilots are said to have negotiated a 46% cumulative pay raise in wages and benefits over a four-year contract term. UPS workers have also made headlines with significant increases for drivers and part-time workers getting a 48% increase over their five-year contract. On the other side of the ledger, there have also been headlines indicating some employers are now reducing wages paid to new hires as demand has eased. Overall, wage growth is decelerating from elevated levels; however, it is still elevated, with both average hourly earnings and the employment cost index remaining at historically high levels well above 4%. This will continue to weigh on profit margins and fuel broader inflationary pressures unless it declines further.

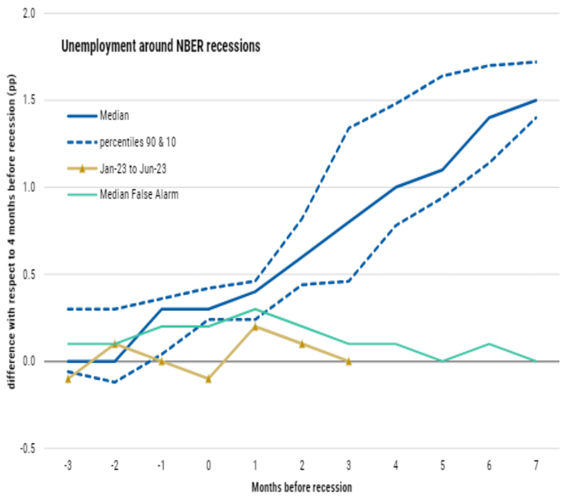
Inflation has declined further, with most measures having retreated substantially from their highs. PCE inflation for the month of July was reported at the year-over-year annualized rate of 3.3%. Core PCE was 4.2%. These were slightly higher than the prior month's report, but the monthly increase for both held steady at 0.2%, showing no acceleration in the monthly increase. The Consumer Price Index (CPI) also increased slightly for the month of July, increasing to 3.2% over the prior twelve months. This was 0.2% higher than the June report of 3.0% after trending lower over the past year. CPI excluding food and energy was 4.7%. The headline number has fallen faster than the core number. Food inflation has been a stickier component and lower energy prices have helped move the headline number lower. Energy prices have been moving higher more recently, which will put upward pressure on headline CPI. Inflationary pressures in food and services continue to run higher and have only modestly declined. The chart below shows how CPI and its components have trended over the past several years.

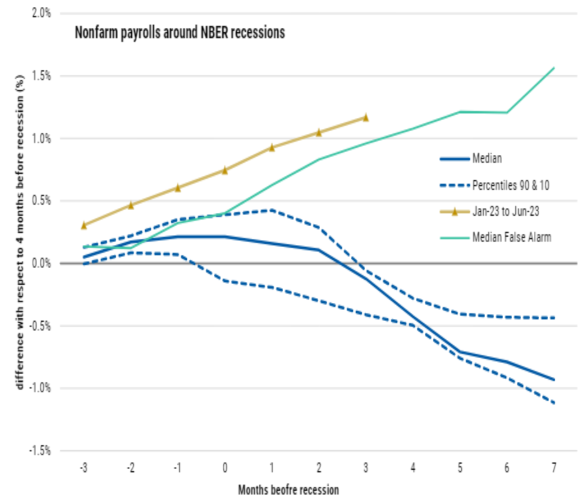



Consumers are not feeling much relief with this sticky inflation still elevated and rising energy prices are only going to squeeze them further. With inflation moving lower real incomes are rising; however, most consumers would likely tell you they do not feel any relief. Inflationary pressures persist in these stickier components, representing a large percentage of the average consumers' non-discretionary expenses. Consumer sentiment had shown some improvement but remains weak and moved back lower in the most recent report.

Since the beginning of the calendar year, a wide range of economists have shifted their views away from an impending recession and more enthusiastically embraced the potential for a soft landing. Economic strength in the face of persistent inflation and tighter monetary policy has proved stronger than anticipated. Morgan Stanley economist Ellen Zentner recently compared the change in the unemployment rate and payrolls numbers leading into previous recessions with several periods that ended up being false alarms. These periods all marked conditions in which the ISM manufacturing index had been in contraction territory for some time, and initial claims had increased. She defines recessions as periods of depressed economic activity that trigger dislocations in labor markets, causing upswings in unemployment rates and negative payroll prints. Her findings show the unemployment rate has historically increased 20bps before the median recession starts, then payrolls begin to decelerate, and both measures continue to deteriorate further. These historical trends are marked by the blue lines in the charts below, with the dotted lines representing the variance across the 90th and 10th percentiles of the periods measured. The green line represents three episodes starting in November 1991, May 1995, and June 1998, which proved to be false alarms. Current conditions, represented by the yellow line, are tracking much closer to the periods where leading indicators were false alarms.

## Path of Unemployment Rate and Nonfarm Payrolls around NBER Recessions




Source: BLS, NBER, Morgan Stanley Research

Despite the sustained strength of economic conditions, activity is clearly slowing on multiple fronts in the face of increasing headwinds. The modified table from Evercore ISI on the right shows how some conditions have changed over the past three years. Monetary policy has become much more restrictive, with the Federal Funds rate rising and the Fed balance sheet declining.

| | | August | |
|---|---|---|---|
| | 2021 | 2022 | 2023 |
| Federal Funds Rate | 0.25% | 2.50% | 5.50% |
| Yield Curve | +100bps | +50bps | -125bps |
| Fed Balance Sheet Y/Y | +19% | +6% | -8% |
| M2 (Money Suppy) Y/Y | +14% | +4% | -4% |
| | | | |
| Mortgage Rate | 3.10% | 5.90% | 7.60% |
| Credit Card Rate | 15% | 15% | 21% |
| | | | |
| CPI Y/Y | +5% | +8% | +3% |
| Nominal Consumer Spending Y/Y | +15% | +9% | +5% |
| Payroll Employment 3-Mo Avg | +648k | +432k | +218k |

Money supply is now contracting, and lending is becoming more restrictive. Mortgage and consumer interest rates have significantly increased, and the higher debt service will eventually impact discretionary spending. Employment growth is losing momentum and if job losses do surface, consumers would most likely pull back harder on spending habits. GDP growth is historically positive in quarters leading into a recession before it turns sharply negative. Economic conditions may be strong enough to fight through the headwinds of tighter policy and avoid a recession. The odds of this scenario have increased over the past several quarters; however, the current economic strength may have just simply pushed out this negative scenario into next year. Current activity supports another strong quarter of GDP growth. The Federal Reserve Bank of Atlanta's GDPNow forecast estimates 5.6% growth for the third quarter as of the end of August. If we are not heading towards a recession, negative measures like the ISM Manufacturing index should move back up out of contraction territory. Inflationary pressures may also be difficult to bring down further without additional tightening from the Federal Reserve. The U.S. economy may be strong enough to avoid tipping into a recession; however, we continue to believe restrictive policy is likely to slow the rate of growth over the next year, with an elevated risk of weaker economic conditions developing.

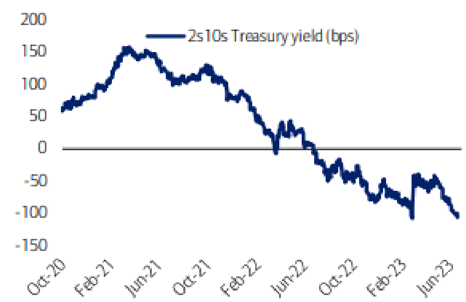
# *RSA PORTFOLIO STRATEGY*

## Fixed Income Strategy

***By Lance Lachney***

At our previous economic update in mid-June, regional bank volatility and the drama surrounding the debt ceiling had finally come to pass. The expected “hawkish pause” at the June Federal Open Market Committee meeting came to fruition, ending the stretch of ten consecutive rate hikes. Economic data during this time continued to show resiliency. The Fed forecasted two additional rate hikes for the remainder of the year within its Summary of Economic Projections (SEP) as core domestic inflation persisted at an uncomfortable level. However, the lack of concern regarding long-term inflation provided a lift to risk assets, with equities and high-yield debt leading the way. Spread levels for investment-grade corporates tightened by approximately 13bps and were able to eke out a relatively small monthly return. Strong economic data, coupled with the hawkish stance from monetary policymakers, resulted in a significant bear flattening of the curve. Front-end treasury yields rose approximately 50bps, while the 10yr benchmark increased by roughly 20bps. The 30yr treasury bond showed no movement at all. The yield curve, which has remained inverted for well over a year, fell even further with the 10yr note yielding 105bps less than its 2yr counterpart. Treasuries were the worst-performing asset class in June, losing .75% on the heels of a negative 1.15% return in the prior month.

**Figure 1: 2s10s Treasury yield curve has reached cycle lows**
2s10s Treasury yield curve flattened to -106bps by the end of June, similar to -108bps prior lows in March.




**Source:** Bloomberg
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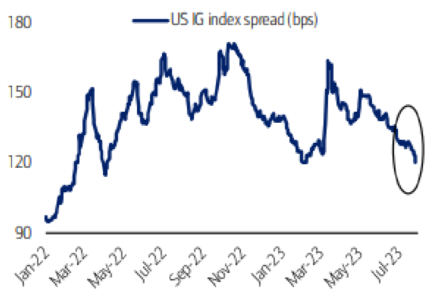
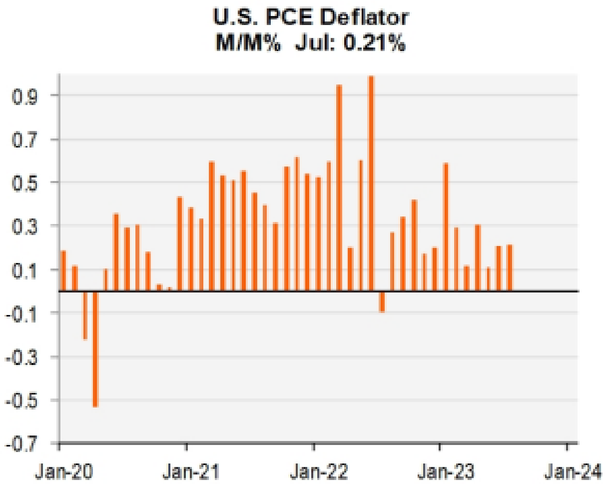
The upward move in treasury yields accelerated during the first week of July as the ADP employment report revealed that half a million jobs were added in June. While the more reliable Nonfarm Payroll account provided a more subdued total a couple of days later, the market began pricing in a near-certain rate hike at the end of the month. The economic outlook due to the strength of the labor market pushed treasury yields higher, led this time by the long end of the maturity spectrum. Interest rates reversed course quickly thereafter as the June inflation report (CPI) showed a deceleration in the cost of consumer goods and a lower-than-expected rise in core services. Despite the progress made on the inflation front, fed fund futures remained adamant in pricing in another 25bp move in late July. Risk assets performed in much the same way as they did in June due to the continued strength of the economy, solid corporate earnings, and a more favorable outlook on inflation. Investment grade spreads tightened once again, nearing levels reached earlier in the calendar year. The yield curve bear steepened during the month, with short-term Treasury yields relatively stable and the back end moving higher by approximately 15bps. Of note, the Bank of Japan tweaked its policy of yield curve control (YCC) by allowing its 10yr reference security to move incrementally higher. However, the BOJ remains a willing buyer to ensure this happens at an acceptable pace. The Fed followed through with the market's expectation of a 25bp increase at the July FOMC meeting.

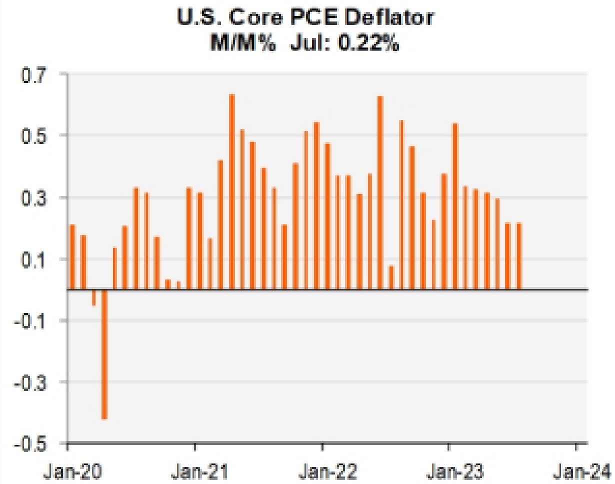
**Figure 7: IG spreads are back to YtD tights**
US IG index spread has tightened to 120bps, matching the earlier tights from February 2023.




Source: ICE Data Indices, LLC

The month of August has provided market participants with a sizable amount of information to digest. Fitch Ratings stripped the U.S. government of its AAA status ahead of the Treasury's refunding announcement, where it released details on its $1 trillion borrowing estimate for the third quarter. The downgrade from the rating agency cited the "expected fiscal deterioration," the "growing general government debt burden," and the "erosion of governance" in its reasoning for removal. The initial market reaction was higher treasury yields, especially in the longer end of the curve. Treasury yields received a small bit of reprieve at the end of the week thanks to a softer-than-expected payrolls report. Nevertheless, the spread differential between 2yr and 10yr treasuries collapsed approximately 20bps. Interest rates moved higher across all maturities the following week with the belly of the curve receiving the brunt of the punishment. For the third consecutive week, yields on government securities increased, headlined by a solid retail sales number for July. At this point, the investment community had begun to adopt the view that a modest slowdown instead of an outright recession was in the cards. Projections for economic growth in the third quarter have also risen as of late. Chairman Powell's speech in Jackson Hole was relatively tame compared to last year, but he did reiterate that "two percent is and will remain our inflation target". Despite the pain he envisioned a year ago in order to bring inflation down sufficiently, growth remains adequate, and the unemployment rate has barely budged. Government bonds have rebounded over the last week or so, with yield levels pulling back a bit after the rapid rise during the first half of the month. The job openings data released earlier this week showed an improving supply/demand imbalance in what remains a tight labor market. Second-quarter GDP was also revised slightly lower to 2.1%. Headline and core PCE inflation for the month of July increased by .20% mom, but in line with current expectations. The Bloomberg Aggregate, a diversified basket of fixed income securities, posted a negative return of .64% in August, recovering a sizable portion of the 2.25% of losses experienced in the first three weeks of the month.




PIPER SANDLER

Trading activity within the portfolio has been fairly active since our last meeting. A sizable amount of the purchases has been made within the Treasury and mortgage-backed asset classes. The fund has participated in a couple of new corporate issues, purchasing securities in areas of the curve where it has limited exposure. Within treasuries, the fund took advantage of interest rate surges over the last two months to add exposure to its underweight positioning. Its most recent addition was buying March 2027 and May 2028 notes and coupling those purchases with a block of May 2043 paper. This provided a yield in the neighborhood of 4.45%, a 25bp pickup relative to a bullet with similar duration. The purchases within the mortgage-backed sector have been made at healthy spread levels relative to other high-quality alternatives. The fund has been adding safer assets to the fixed income portfolio during this time as it believes it is prudent to do so given the uncertainty of the economic outlook and the relatively tight spread levels of investment-grade corporate debt.

**Table 1: Summary of jobs data (most recent 6 months)**

Nonfarm payrolls have increased by an average of 194k over the last six months

| | Aug | Jul | Jun | May | Apr | Mar |
|---|---|---|---|---|---|---|
| **Establishment survey** | | | | | | |
| Nonfarm payrolls | 187k | 157k | 105k | 281k | 217k | 217k |
| Private payrolls | 179k | 155k | 86k | 255k | 179k | 157k |
| Construction | 22k | 16k | 29k | 25k | 11k | -9k |
| Manufacturing | 16k | -4k | 4k | -4k | 9k | -12k |
| Government | 8k | 2k | 19k | 26k | 38k | 60k |
| Average weekly hours | 34.4 | 34.3 | 34.4 | 34.3 | 34.4 | 34.4 |
| Avg hourly earnings (mom %) | 0.2% | 0.4% | 0.4% | 0.3% | 0.4% | 0.3% |
| **Household survey** | | | | | | |
| Unemployment rate | 3.8% | 3.5% | 3.6% | 3.7% | 3.4% | 3.5% |
| Participation rate | 62.8% | 62.6% | 62.6% | 62.6% | 62.6% | 62.6% |
| Labor force | 736k | 152k | 133k | 130k | -43k | 480k |
| Household Jobs | 222k | 268k | 273k | -310k | 139k | 577k |
| Employment to pop. ratio | 60.4% | 60.4% | 60.3% | 60.3% | 60.4% | 60.4% |

**Source:** Bureau of Labor Statistics

BofA GLOBAL RESEARCH

Going forward, the Fed appears to be on hold for the time being and is not expected to alter rates at its September meeting. The jobs report provided a clear picture of deceleration in the hiring process over the last few months. However, there is very little evidence of sizable job loss, just a slow normalization of a tight labor market. Consumer spending continues to be healthy due to low unemployment, accumulated savings, and the growth in employees' wages. There are a few signs of caution coming from comments made by management teams within the retail sector, as well as the personal savings rate dropping to 3.5%. The market is currently pricing in a one-in-three chance of an additional rate hike at the November FOMC meeting. While it is difficult to forecast accurately over a long period of time, capital markets expect at least four interest rate cuts by the end of next year. The global economic picture must be accounted for as well, with China attempting to stimulate growth through rate cuts to bolster its housing and banking issues while the European economy continues to struggle with stagflationary pressures. The fund is positioning itself for a gradual normalization of the yield curve over the next year. How we arrive at that destination is best articulated by the Fed itself, proclaiming it to be “data dependent.”

# Domestic Equity Strategy

***By Kevin Gamble***

Revisiting the top 5 reasons for optimism from our domestic equity strategy piece at the turn of the calendar year, it is clear the post-midterm election year dynamics (Year 3 of the Presidential cycle) have once again carried the day for the U.S. equity market thus far in 2023. Specifically, the debt ceiling was suspended in June through the end of the presidential election, which has given politicians the ability to continue to run wartime budget deficits in a full employment economy. The removal of the debt ceiling and subsequent excessive government spending is an effort to “prime the pump” of the economy ahead of the 2024 presidential election. To be specific, the U.S. national debt has grown by close to $1.35 trillion in less than 3 months since the suspension of the debt ceiling and is now approaching $33 trillion dollars! With eight months of calendar 2023 now in the books, we remain on track for both positive equity returns as well as GDP, which has been the case in each post-midterm election year since World War II.

In addition to the strong post-midterm election dynamics holding true, inflation has continued to trend in the right direction throughout the year. While we have yet to reach the Fed’s ideal 2% target, we are well below the unacceptable high single-digit inflation rate that was present as we turned the calendar year. This declining trend has allowed earnings multiples on the U.S. equity market to remain somewhat elevated and equity investors to avoid the multiple compression that would have likely resulted should inflation have remained sticky at much higher levels.

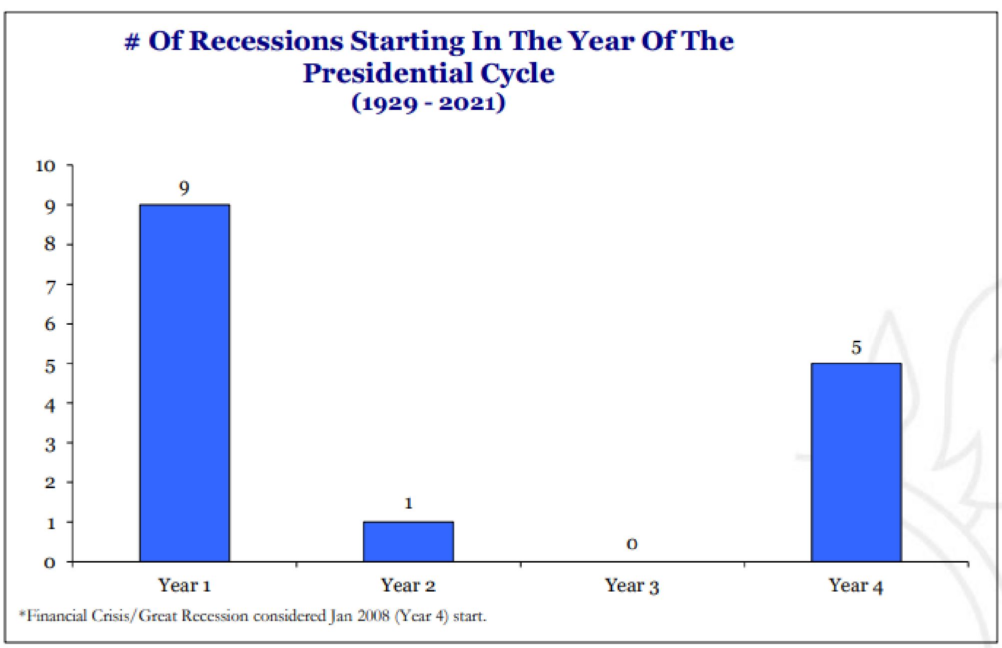
The other three reasons for optimism have largely held serve and have not deteriorated. Divided government has continued to put pressure on the politicians for compromise, and geopolitical concerns have largely remained consistent. While investor sentiment has oscillated throughout the year with the month-to-month market movements, it remains somewhat muted relative to the strength of the gains we have seen in the U.S. equity markets.

Are we out of the woods with clear sailing ahead as we enter the most dangerous two months of the year? Of course not, but we should all be grateful for the strong fiscal year-to-date gains which have allowed equity investors to retrace much of what was lost in 2022.

## Exhibit 1: Fiscal 2023 S&P 500 Performance

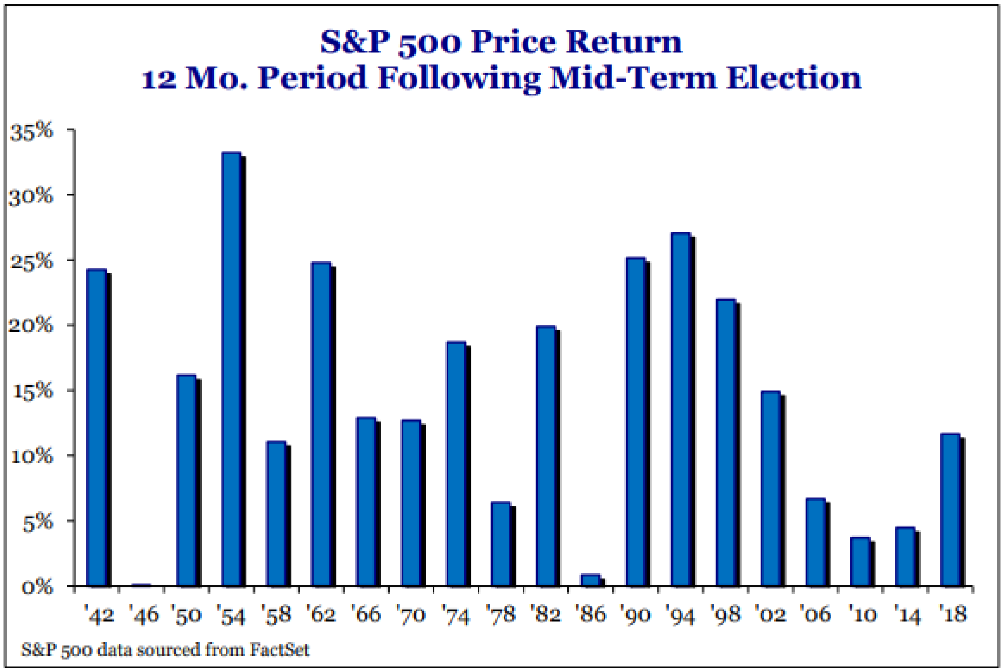

Source: Bloomberg

## Exhibit 2: Recessions and the Presidential Cycle



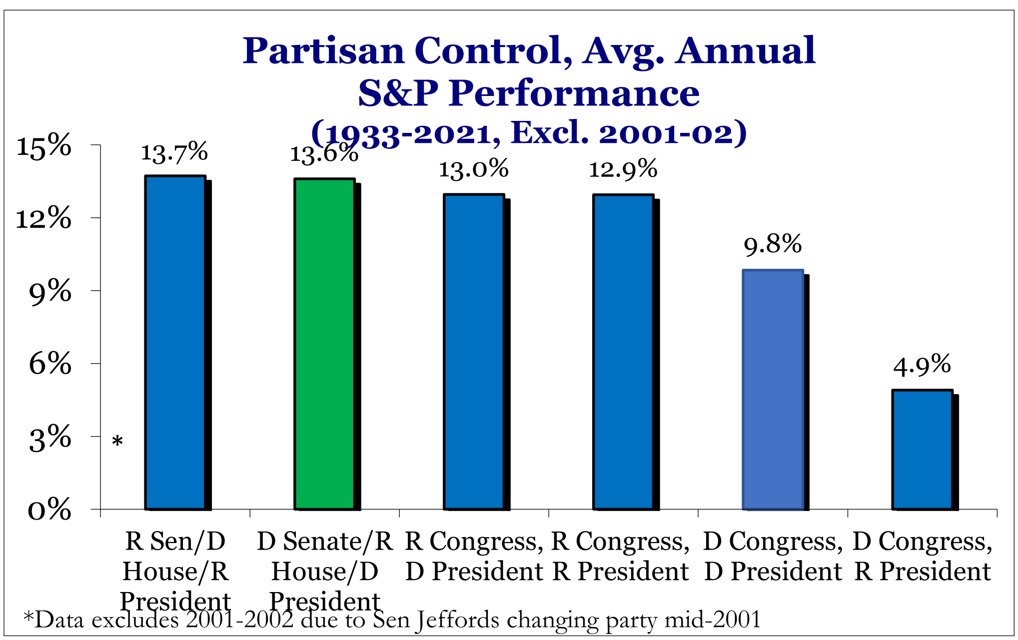

Source: Strategas

**Exhibit 3: Post Midterm Election (Year 3 Presidential Cycle) S&P 500 Returns**



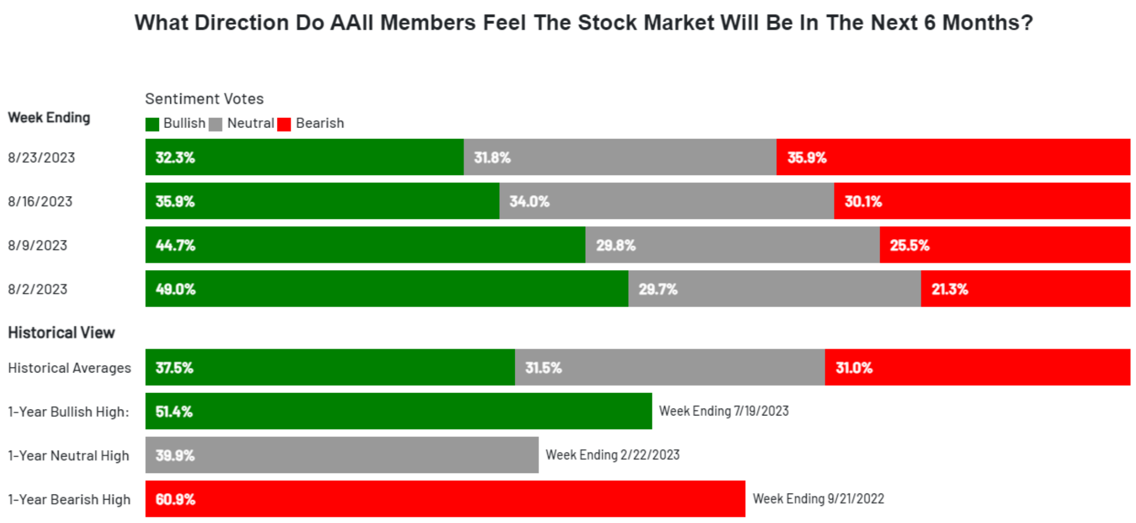

Source: Strategas

**Exhibit 4: Divided Legislative Branch Has Led to the Best Investor Outcomes**



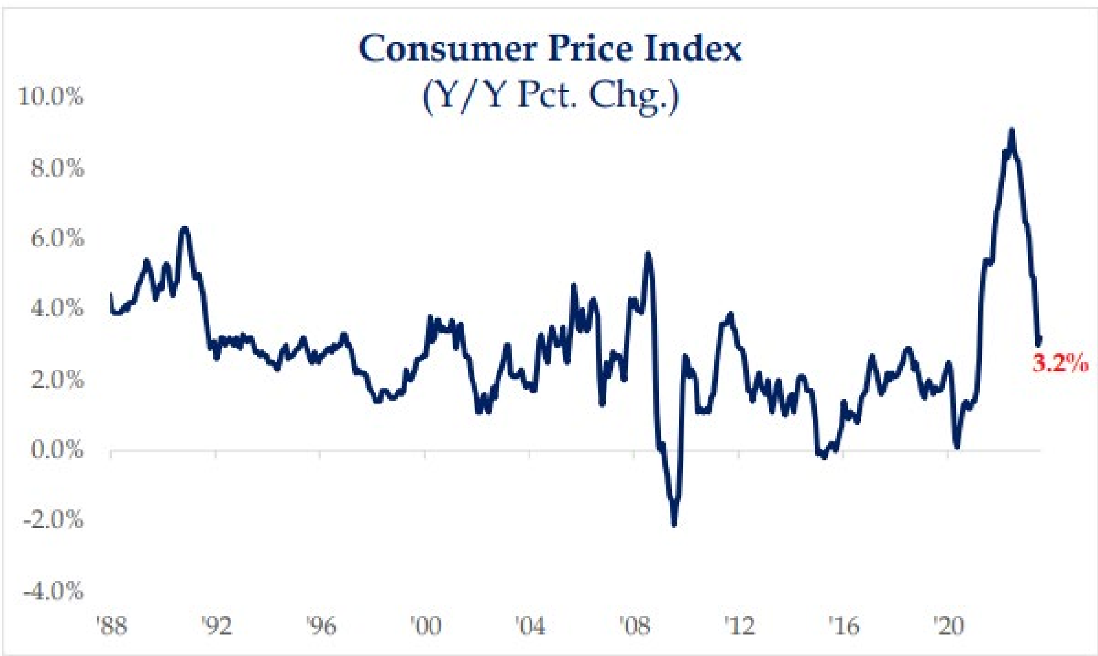

Source: Strategas

## Exhibit 5: Current AAII Investor Sentiment Survey




Source: AAII Investor Sentiment Survey

## Exhibit 6: Consumer Price Index (CPI)



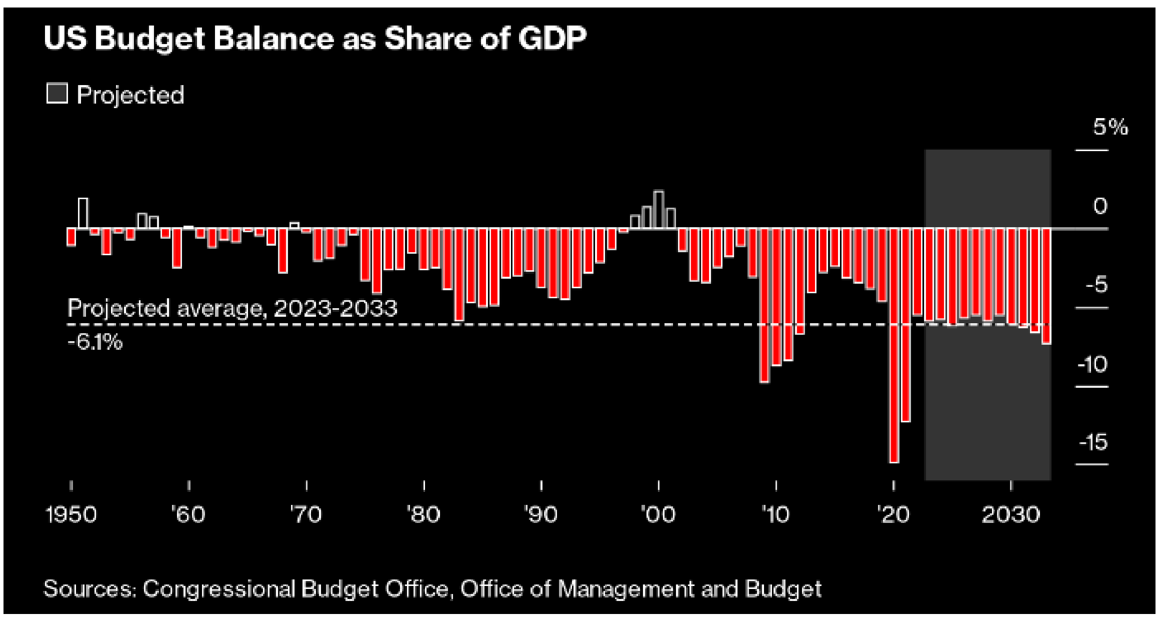

Source: Strategas

## 10 Concerns to Monitor Closely Moving Forward

**1) Are we approaching a fiscal crisis as annual U.S. interest expense is on pace to surpass our annual national defense spending? Where is the money going to come from to finance these deficits moving forward in the absence of Q.E.?**

The U.S. Treasury has indicated they will be in the market to issue close to $1.9 trillion dollars between now and the end of 2023 to finance the large U.S. budget deficits we are running as far as the eye can see. In the recent past, such large issuances have been monetized by central banks and their Q.E. programs. With this option no longer on the table due to the inflationary pressures, where is the money going to come from to buy the treasuries and finance the deficits? Will interest rates have to continue to rise to attract buyers? Does this money ideally need to come out of the stock market and into the bond market?

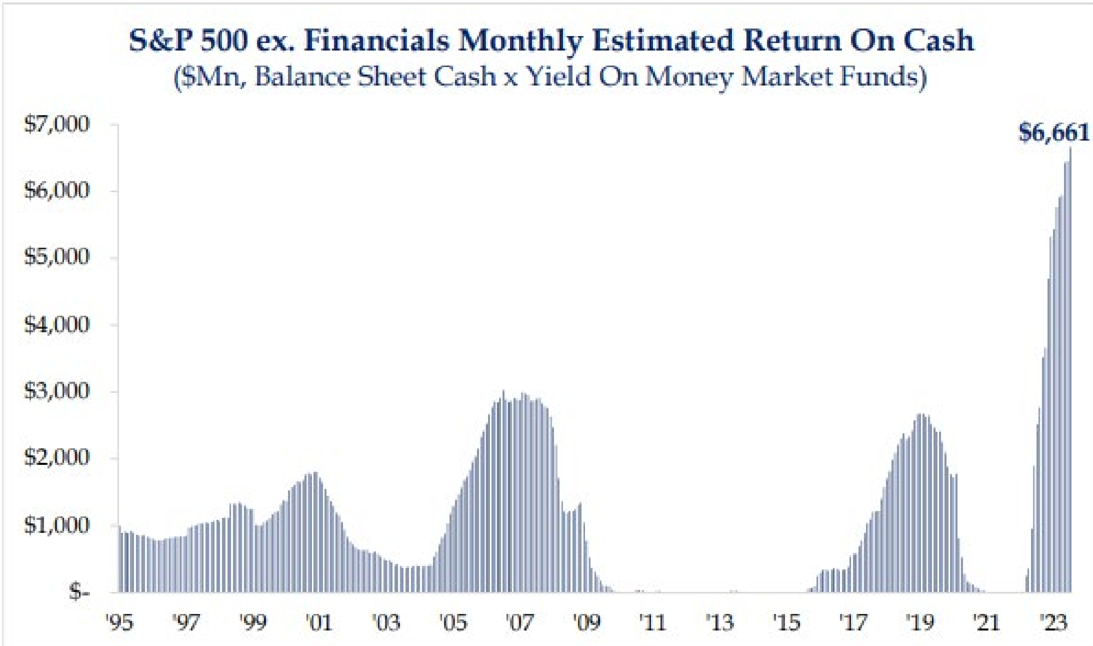
**Exhibit 7: U.S. Budget Balance as Share of GDP**




Source: Congressional Budget Office

It should be noted that there is a pro-cyclical aspect to the rising government interest expense that we must consider as the interest expense to the U.S. government is income to many other parties, including treasury investors such as pension funds, high-end consumers, corporations, and states! As an example, Alabama's Treasury and General Fund have seen great investment income gains due to the rising short-term government bond yields, which is obviously a big positive for the state.

**Exhibit 8: Corporate Earnings from Cash**




Source: Strategas

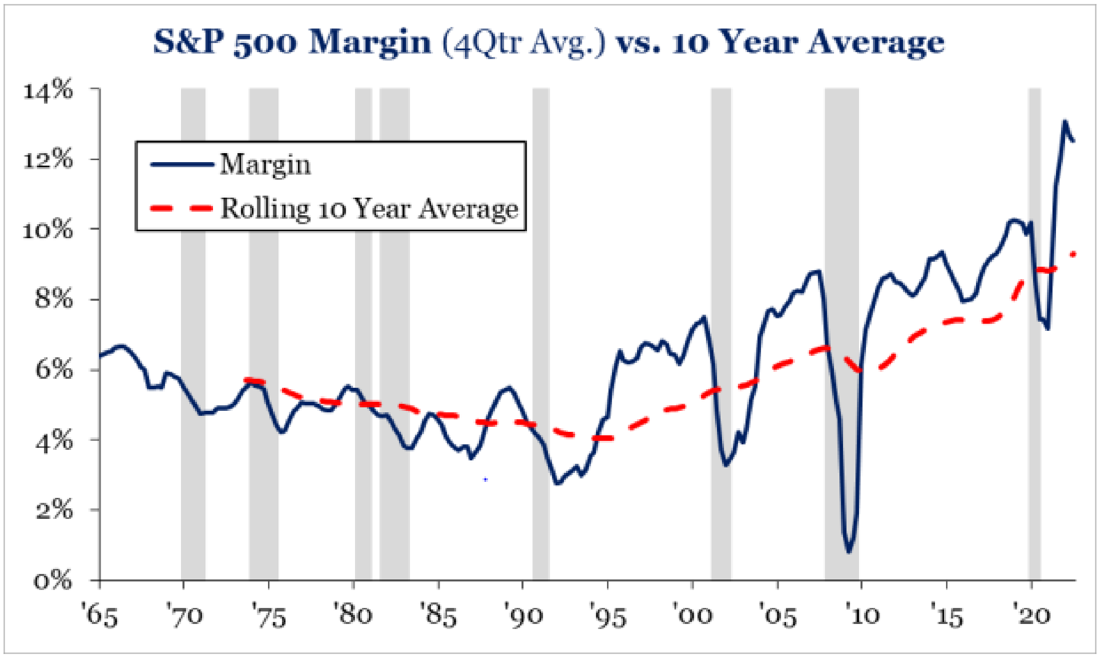
## 2) Profit Margin Tailwinds Have Turned into Headwinds

The big 4 trends that have driven profit margins on the S&P 500 to record highs over the last 2 decades have now all reversed.

1) Globalization to de-globalization
2) Falling interest rates to rising interest rates
3) Contained labor costs to rising labor costs
4) Just-in-time inventory to supply chain issues and the need to retain inventory

Importantly, large labor unions are now flexing their muscles and trying to prove their salt to their constituents. These labor unions are not seeking small wage gains, but rather 40%+ wage gains as well as reduced work weeks in the case of the UAW negotiations! These auto negotiations follow pilot unions successfully securing large wage gains over the coming years for skilled pilots in the 40% range and the Teamsters securing large wage gains for its UPS workers. It is all over the Internet that UPS drivers will make up to $175,000 a year in the coming years, which now has everyone questioning their own pay (from skilled labor with educational requirements to unskilled labor). These significant wage pressures simply must be passed on in the form of inflation to consumers or must be eaten by corporate profitability in the absence of tremendous productivity gains!

**Exhibit 9: S&P 500 Profit Margin vs. 10 Year Average**




Source: Strategas

### 3) Yield Curve is Still Very Inverted - Recession ahead?

An inverted yield curve has historically been the best leading indicator for a recession to come. Monetary policy works with "long and variable lags," and the Fed has a plan to continue to raise short-term rates if needed despite this recent inversion, which certainly introduces the risk that they will go too far. We are basically looking at the potential for an equal and opposite restrictive reaction to counter going too far on the expansionary front during the pandemic. This potential overly-restrictive policy stance (should the Fed stay tight too long) increases the risk of a "hard landing" in the economy and much lower S&P 500 earnings moving forward.

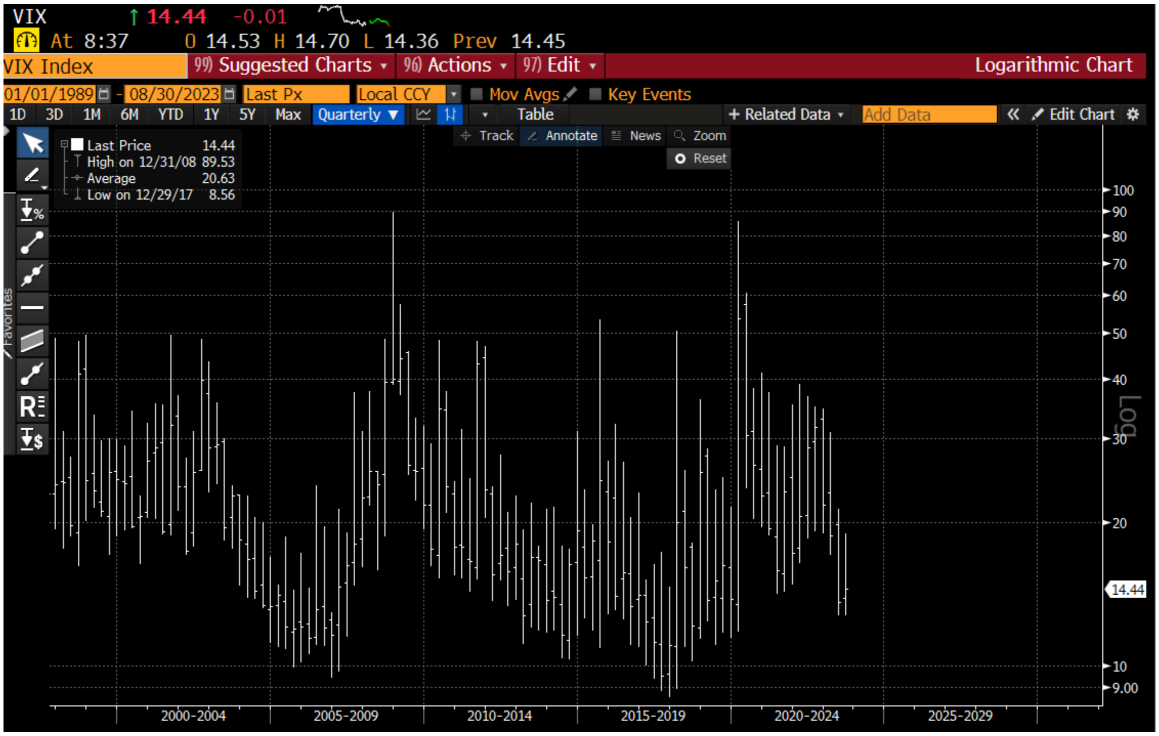
**Exhibit 10: U.S. Yield Curve (10-Year Minus 2-year)**


Source: Strategas

### 4) Record High Use of 0 DTE options has suppressed volatility. Could someone eventually get hurt on a large, unexpected intraday move?

Use of 0 DTE options hit a record high in August as large market players continued to sell options to capture premium and take advantage of the suppressed volatility in intraday stock moves. While this strategy generates significant daily income so long as the market is contained, it does make one wonder who stands to eventually get hurt badly when there is an unexpected intraday market move due to a significant event. These options fall into the category of things that work until they don't, and when they don't, somebody really gets hurt! This day has not happened yet.

**Exhibit 11: VIX – Volatility Index Has Stayed in Contained Range in 2022**




Source: Bloomberg

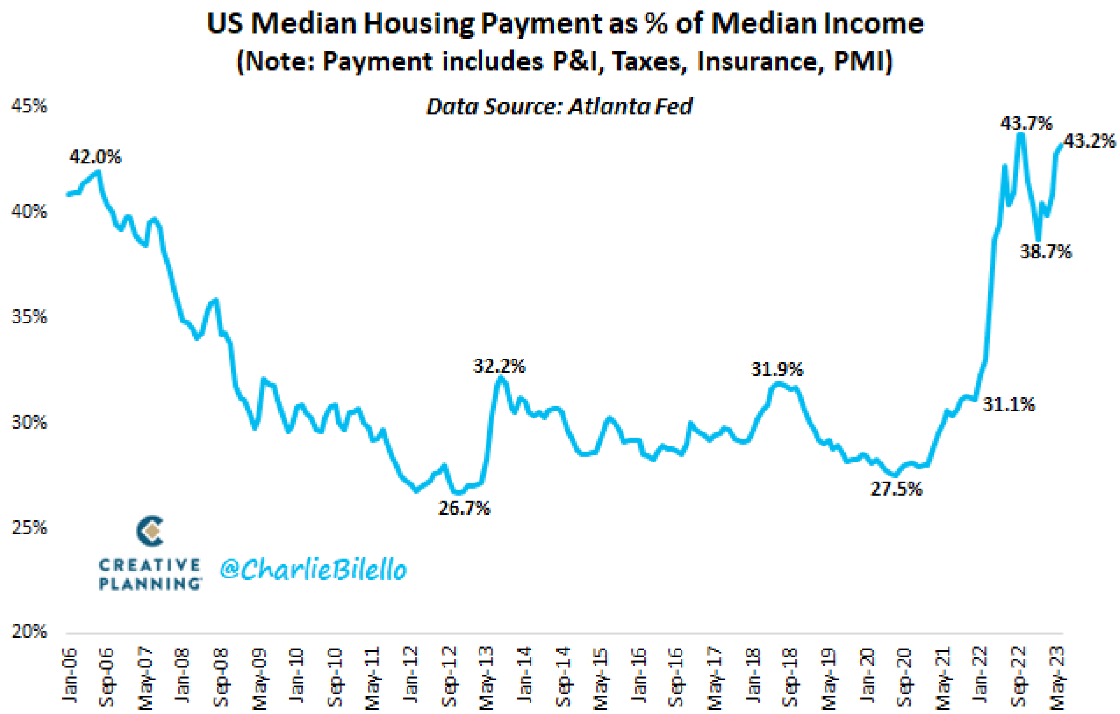
## 5) Bond vigilantes – TINA to TARA

While fixed income has not provided much competition for equity dollars in recent history (idea of TINA, or there is no alternative to equities), it should be noted that the higher yields now present in the marketplace do provide some competition for equity dollars moving forward as asset allocators now have something to contemplate (TARA or there are currently reasonable alternatives to equities). While shorter-duration bonds have a nice yield and are attractive, it should be noted that longer-duration bonds have suffered losses going on three years running due to rising rates and the associated duration risk.

## 6) Housing Market is Currently Broken

The housing market is currently broken on many fronts. While home builders are creatively taking advantage of the situation to sell new homes, the existing home market continues to be plagued by high prices relative to median incomes, existing homeowner mortgage rates that are well below current mortgage rates for new buyers, and a lack of supply due to this unusual backdrop. In addition, large institutional buyers of rental properties have pushed up rents, and there is currently a bubble in Airbnb properties owned by investors.

**Exhibit 12: U.S. Median Housing Payment as % Median Income**

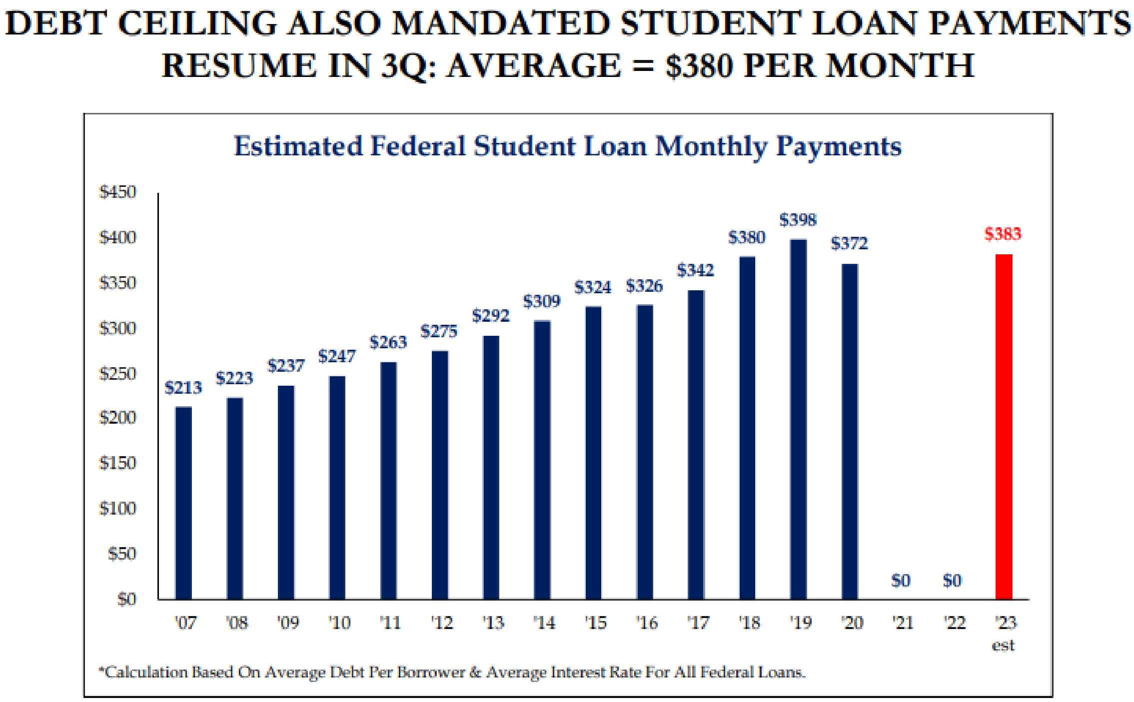



Source: Atlanta Fed and Creative Planning

## 7) U.S. Consumer Showing Some Early Cracks w/Student Loans Coming Back

Recent earnings reports from Dick's Sporting Goods to Macy's have shown a weakening consumer backdrop with the added insult of "shrinkage" or stealing as we used to call it. In addition, student loan payments are scheduled to resume next month, which should further take money out of the consumer's discretionary wallet in the future.

**Exhibit 13: Estimated Federal Student Loan Monthly Payments**




Source: Strategas

## 8) Geopolitics

Geopolitics is certainly something that could break in either direction, and given the ongoing war in Ukraine and the deteriorating relationship with China, it is certainly possible that events will spread in a negative direction. Vladimir Putin's standing with President Xi at the recent Beijing Olympics prior to the invasion of Ukraine seems to be a relevant historical event potentially ushering in a Cold War 2.0 geopolitical backdrop. In addition, the recently imposed U.S. semiconductor export restrictions to China are a big threat to Chinese ambitions and their *Made in China 2025* agenda to be a leader in artificial intelligence, 5G wireless, and quantum computing. Taiwan is incredibly important as the global hub for semiconductor manufacturing and thus in the geopolitical crosshairs and warrants close monitoring.

## 9) Equity Valuations Are Full

Valuations across the U.S. equity market vary by sector but can certainly be considered full in the aggregate given the current level of interest rates.

## Exhibit 14: S&P 500 NTM P/E with Long-Term Average


Source: Strategas

### 10) Where Are We in Ed Hyman's Maturing Business Cycle Dance?

**Exhibit 15: ISI Maturing Business Cycle Dance**

Here We Go,
Economy Good,
Rates Go Up,
Earnings Go Up,
Rates Go Up,
Economy Better,
Rates Go Up,
Economy Great,
Rates Go Up,
**NEW ERA THINKING!**
Yield Curve Inverts
No Problem!
Bear Market Starts
RECESSION
The End

Source: ISI

Over the years, we have often cited Ed Hyman's framework for helping us assess where we are in the maturing business cycle. Bull markets rarely peak on the early rate hikes, and this cycle has been no different. However, we are now 10+ rate hikes into the tightening cycle, we have a very inverted yield curve, and now have a market that believes in a soft-landing scenario combined with a new era belief in A.I. technology. Given this backdrop, we must be on the lookout for a market peak. As of this writing, the January 2022 level of just over 4800 on the S&P 500 remains the market high of this cycle.

### Equity Strategy Moving Forward

Given the uncertain macro environment, we continue to focus on improving our micro equity selection, which includes owning quality companies with strong balance sheets, resilient business models, dividend yields, and positive cash flows. Against a tightening liquidity backdrop, we want to continue to actively avoid "zombie" companies which need access to the capital markets to stay afloat given their lack of cash flow.

We continue to see value-oriented equities as relatively attractive versus the longer-duration growth equity assets. Growth equity assets had a strong 14-year relative performance run, which likely peaked with massive Q.E. and negative real interest rates present during the pandemic. While it won't be a straight line, we think the relative leadership likely now resides with more value-oriented equities for the foreseeable future.

Following the strong absolute equity performance out-of-the-gate this fiscal year, we executed several put spread collar legs, which give us a healthy amount of put spread protection through the remainder of our fiscal year should we see a September equity correction, which has unfortunately happened so often in the past.

Our active funds continue to underweight the very top of the S&P 500 given the top-heavy nature of the index. While this stance can hurt active returns in very top-heavy years, it makes great sense from a diversification standpoint across our total domestic equity portfolio, given we have significant long exposure to these heavyweight names through our large, market capitalization-weighted S&P 500 index holdings. Almost 1/3 of the S&P 500 index is now made up of the "Magnificent 7"!!! In other words, index funds are no longer as diversified as one might think or ideally desire as a conservative investor. These top 7 companies include Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta.

# International Equity Strategy

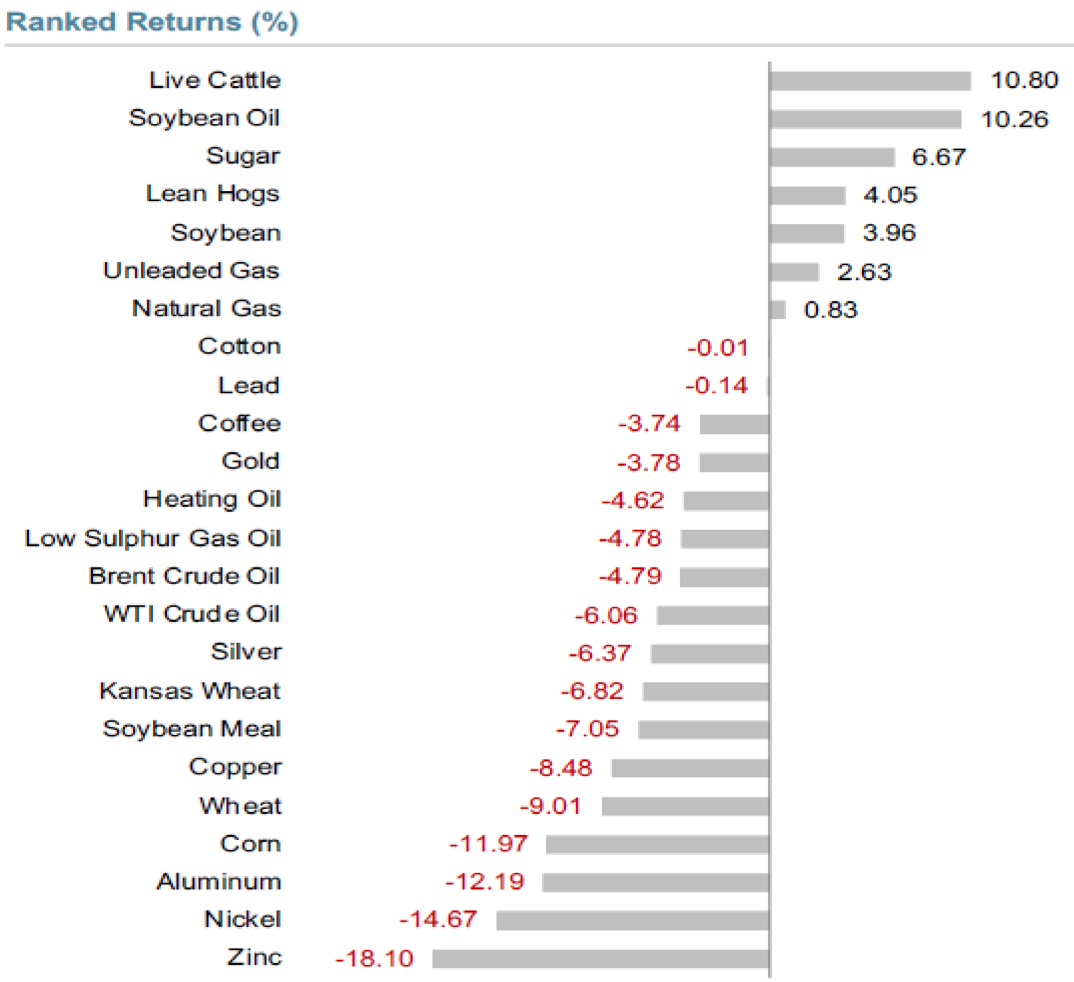
***By Steve Lambdin***

The global equity markets kept their recent momentum as the second quarter provided the third straight period of market gains. Inflation continued to trend lower as several global central banks signaled an end to the tightening cycle as significant progress has been made in the inflation fight. This was enough to push global markets higher, especially in the U.S. In fact, many of the global equity markets are near multi-year highs. Global technology equities continued to move higher as developments in artificial intelligence (A.I.) are fueling a new investment cycle theme. European financial stocks staged a rebound as higher interest rates could boost the earnings of these institutions. Growth stocks continued to work much better than value stocks, as one would expect in the current economic and investment environment. This led to more chatter of a “soft landing” or a “push-out” of a recession in the U.S. economy. Japanese equities were very strong as the economic recovery gained traction, and corporate governance reforms are beginning to take hold. These reforms even brought renowned investor Warren Buffett to the region as his investment arm took several large stakes in Japanese companies in the quarter. Global employment remained strong across most of the developed world as workers remain in high demand. However, we did see China’s post-COVID recovery stall out a bit as growth has not been as strong as expected. The real estate sector remained a source of weakness. This made for jittery investors as China’s equity market fell over -9% in the quarter. Also, many key economic data points continued to deteriorate across the Eurozone, the U.K., and the U.S., forcing the International Monetary Fund (IMF) to keep its outlook for growth flat in 2024. On the geopolitical front, Ukraine’s counter-offensive continued to grind at a slow pace as territory gains have been hard to manage. Tensions between the U.S. and China over Taiwan remain high but have not worsened lately as U.S. Secretary of State Blinken traveled to Beijing to cool down recent rhetoric between the two countries. Through the first nine months of our fiscal year, global equity market returns remain quite impressive.

| | June 2023 | | Q2 2023 | | YTD 2023 | |
|---|---|---|---|---|---|---|
| Equity index returns (%) | US dollar | Local currency | US dollar | Local currency | US dollar | Local currency |
| S&P 500 | 6.6 | 6.6 | 8.7 | 8.7 | 16.9 | 16.9 |
| MSCI ACWI | 5.8 | 5.4 | 6.2 | 6.6 | 13.9 | 14.0 |
| MSCI ACWI ex USA | 4.5 | 3.6 | 2.4 | 3.4 | 9.5 | 9.7 |
| MSCI World | 6.0 | 5.7 | 6.8 | 7.1 | 15.1 | 15.1 |
| MSCI Emerging Markets | 3.8 | 3.4 | 0.9 | 1.7 | 4.9 | 5.6 |
| MSCI EAFE | 4.6 | 3.6 | 3.0 | 4.3 | 11.7 | 12.1 |
| MSCI Europe | 4.8 | 2.4 | 2.7 | 1.8 | 13.6 | 10.5 |
| MSCI Pacific | 4.1 | 5.9 | 3.5 | 9.5 | 8.4 | 15.6 |

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +3.0% and +.90%, respectively, during the second quarter of 2023 vs. +8.70% for the S&P 500 Index. Investors rushed to the technology megacap names in the U.S. market as the A.I. movement took centerstage. The U.S. dollar rose 1.3% in the period, which hurt returns for unhedged U.S. investors in the MSCI EAFE Index and, to a lesser extent, investors in the emerging markets. The Asian region was stronger than the European region as the Japanese equity market was very strong as investors embraced the changes expected to come in corporate governance. Seven of the eleven sectors of the MSCI EAFE Index posted positive returns, with technology, consumer discretionary, and industrials leading the way. Real estate and communications sectors were the relative losers in the quarter. Once again, commodity prices fell in the period as the Bloomberg Commodity Index fell -2.56%, led by aluminum, nickel, and soft commodities.



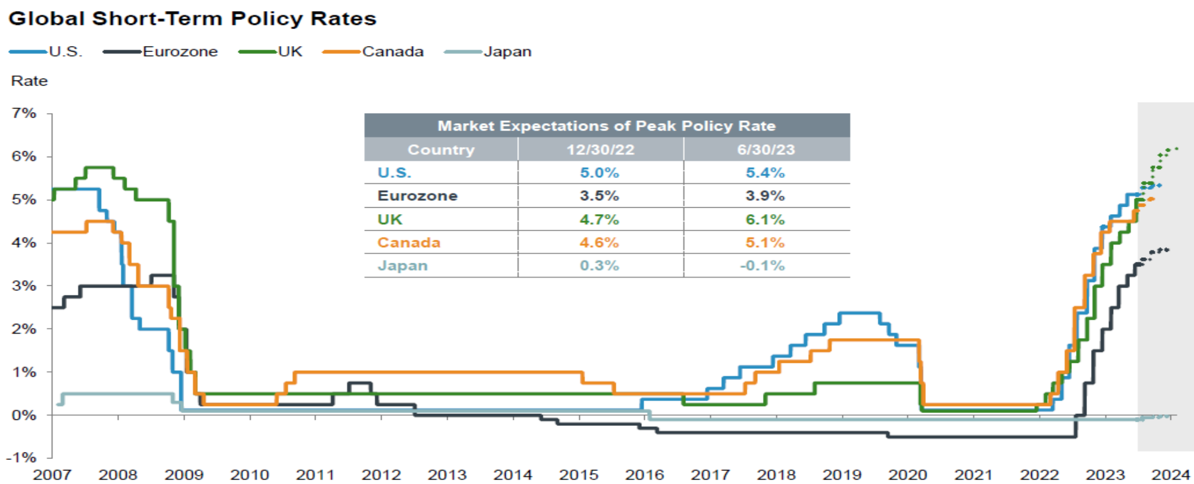

Sources: Arcadia Wealth Management

Quarter-to-date through the end of August, the global equity markets have been near flat as rhetoric around the direction of future interest rates and global growth dominate investor headlines. We will see how these issues affect the final month of our fiscal year. The MSCI EAFE Index and the MSCI Emerging Markets Index are down -.68% and -.32%, respectively, while the S&P 500 Index is up +1.57%. Barring a September equity market collapse, we are poised to post excellent returns across our equity portfolios this fiscal year!

Below is an update to what we see as the current issues in the marketplace, which could set the direction of equity markets over the next few months.

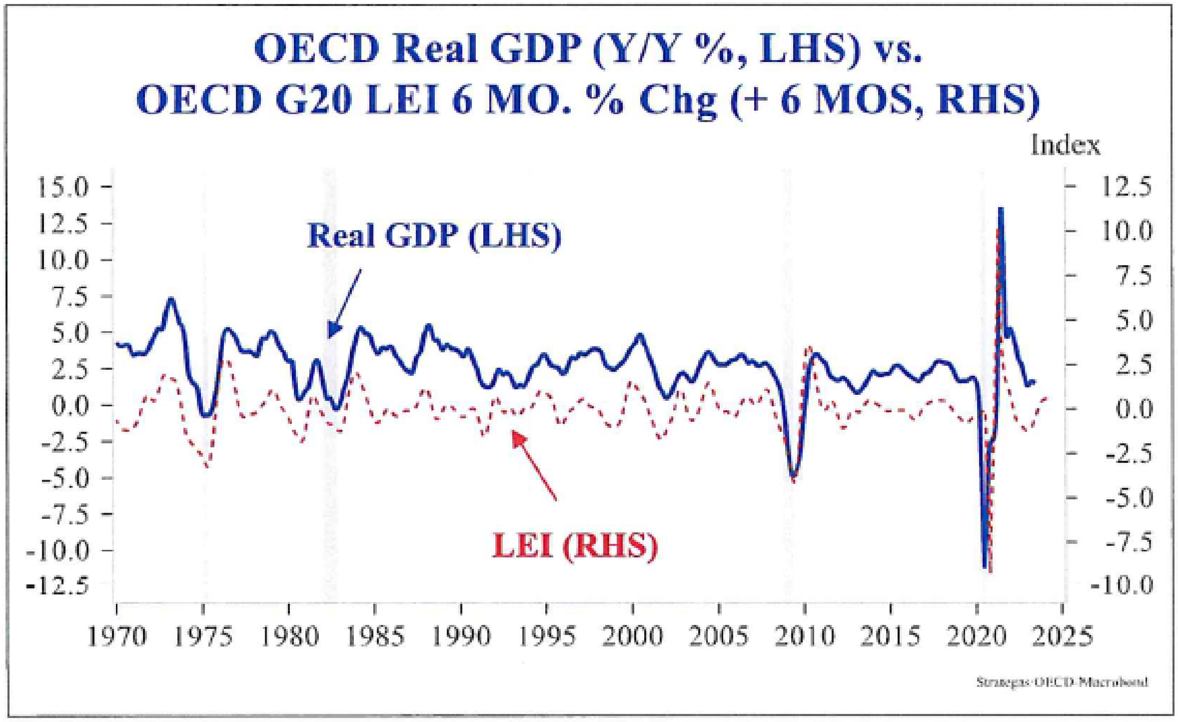
**Issues/Points:**

**Central Bank Policy/Inflation** – Investors are currently grappling with where interest rates are heading in the coming months. The U.S. Federal Reserve (FED), the European Central Bank (ECB), and the Bank of England (BOE) are all playing a delicate game of taming inflation while avoiding a recession. Past interest rate increases by the ECB and the BOE have brought down headline inflation from record levels several months back. However, most of this has been the result of falling energy prices across Europe. Core inflation has been stickier than expected and will take more time to tame. With this in mind, we still expect the ECB and the BOE to hike rates further in September. Many expect the BOE to continue to hike over the balance of 2023. Investors will be on edge as any sharp changes in expectations can move equity markets quickly in any direction.




Source: FED, ECB, BOJ, BOE, Haver Analytics, Bloomberg, Fidelity Investments

**Recession or a Soft Landing? –** Investor discussion has really heated up on this issue over the last couple of months. Many economic data points indicate a clear slowing pattern, while others seem to have a bullish tone to them. How soft will the landing be, or how deep of a recession will we have? It's our best guess at this point that a recession has at least been pushed to the right in the U.S. and not a very deep one in Europe. At the same time, we see the Japanese economy marginally improving while China's growth is slowing. All in all, we view this as positive news for the global equity markets and a big reason for the performance we have seen over the last several months.




Source: Strategas, OECDs

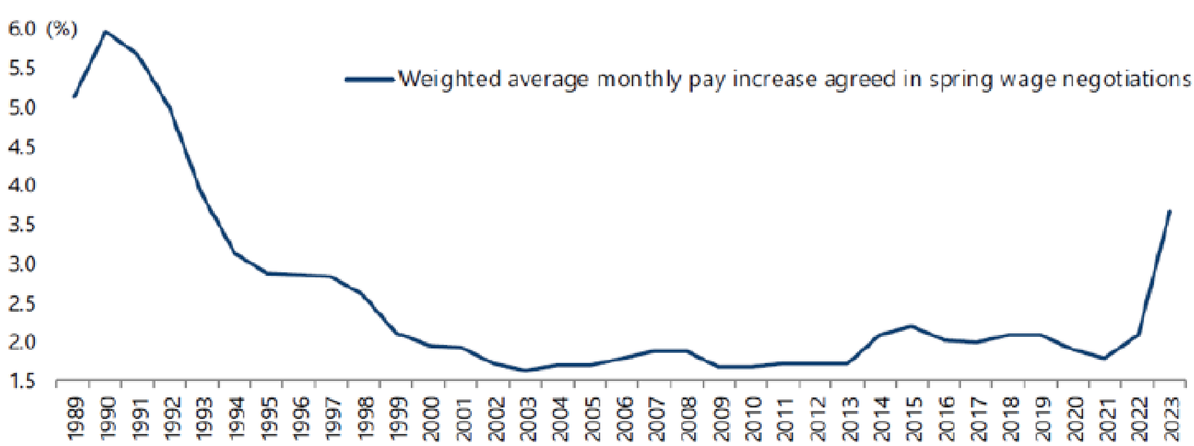
**China Economic Growth** – What investors thought would be a very positive driver for global growth this year has turned into something well below expectations. The China re-opening has lost a lot of steam. Weakness in the real estate sector has turned into a full-blown property crisis event. In addition, a slowing Eurozone economy has dampened exports to the region, pushing weakness in manufacturing. As a result, unemployment among the young has risen dramatically over the last few months. However, government officials have moved quickly with measures to stabilize the region and push households to spend. We believe these measures will help on the margin and be just enough to maintain growth at the targeted level of 5% for 2023.

Net % expecting stronger Chinese economy in 12 months


Source: B of A Fund Manager Survey; Fisher Investments

**Japan Finally? –** Japanese equities have performed very well in 2023 as investors have taken notice of substantial corporate governance changes. Many companies are making moves with their significant cash positions on their balance sheets. This has been highlighted by Warren Buffet taking large positions in six companies in this market. This should attract more investors and could push equity markets higher as many investors are underweight Japan. In addition, this economy is one of the few large economies around the globe that will post better growth in 2023 vs. 2022. Inflation is running above +3.0% and putting to rest any talk of deflation. This has led to the best wage growth in 30 years, as wage hikes are in the +3.0% to +4.0% area. We could see consumption being a bigger driver of economic growth over the next year. Perhaps this equity market will continue to surprise investors to the upside.

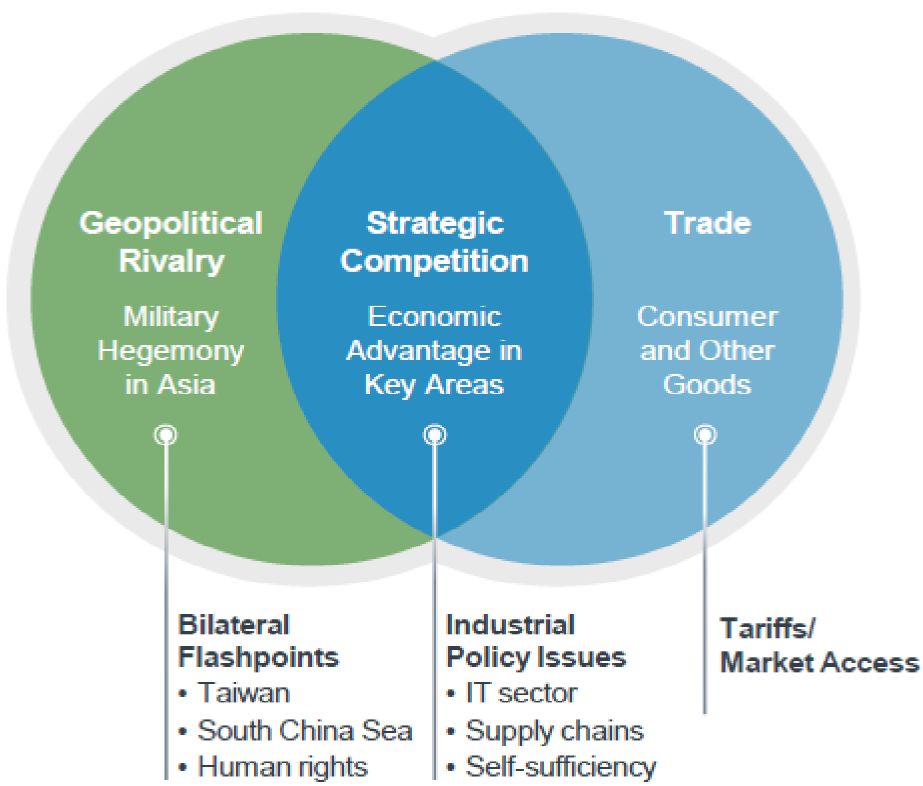
Japan Weighted Average Monthly Pay Increase Agreed In Spring Wage Negotiations




Source: Japanese Trade Union Confederation, Eagle Global Advisors

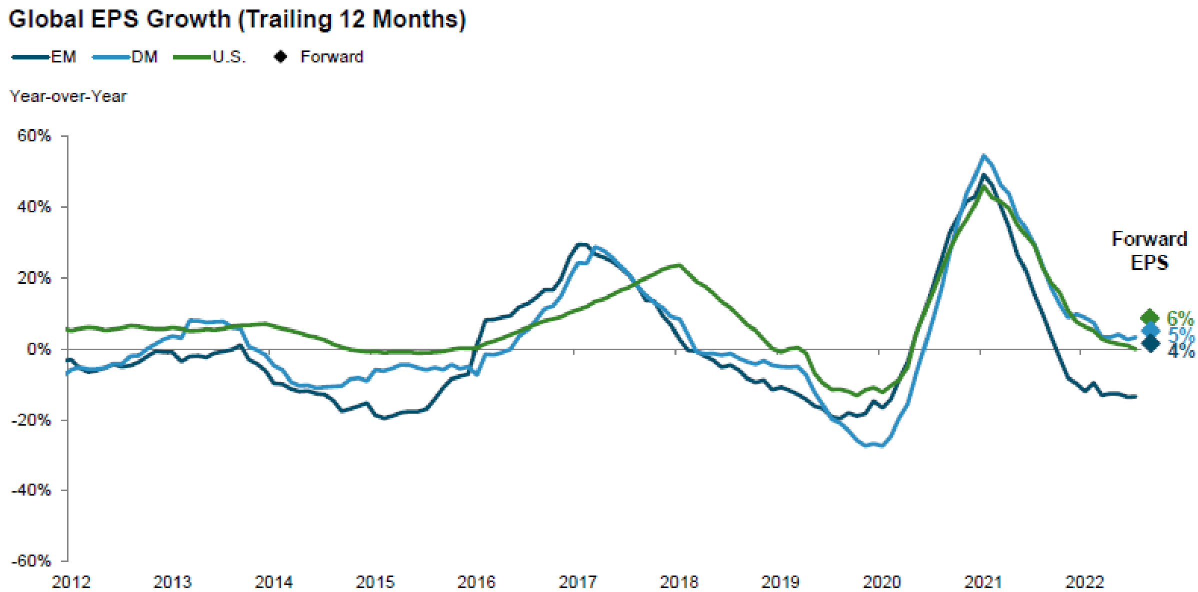
**Geopolitical tensions still running high** – As mentioned in previous outlooks, this remains an area that can change in a hurry and have significant ramifications for global equity investors. The war in Ukraine continues with no progress toward any peaceful negotiated settlement. Ukraine's recent counter-offensive is only making marginal progress while coming at a high price. As long as Western aid continues to flow to Ukraine, we see a stalemate that could continue until a change of leadership happens inside Russia. In addition, China/U.S. relations over Taiwan have cooled just slightly over the last couple of months as high-level dialog between the countries has taken place. However, the issues between the countries remain miles apart with no meaningful solutions on the near-term horizon.

## U.S.–China Relationship




Source: IMF, World Bank, Haver Analytics, Fidelity Investments

**Earnings Growth –** Investors have been keeping a watchful eye on future earnings growth as many economic data points around the globe have begun to weaken. While some regions are experiencing earnings contractions more than others, overall, we have not seen a brutal downdraft in earnings expectations. We will see how this plays out over the next few quarters.




Source: MSCI, Bloomberg, Fidelity Investments

**Debt Distress** – Investors have been keeping a watchful eye on borrowing costs for developing and emerging economies alike. As borrowing costs rise this begins to choke out spending for other areas in the economy. A recent IMF report put the share of developing and emerging economies with sovereign credit spreads above 1,000 basis points at 25% vs. only 6.8% a couple of years ago. This is worth watching and could push equity markets downward if this worsens.

## Final Thoughts/Summary

As we think about the next few months, we see economic growth for the rest of 2023 set to slow down as the effects of the monetary tightening cycle begin to take a firmer hold on the global economy. The growth forecast looks paltry for the U.S. and the Eurozone economies but better in some of the Emerging Markets. However, we believe we have passed peak headline inflation readings in these economies, even if core inflation remains sticky. This should push several of the central banks to keep short-term rates at current levels. In addition, we see the possibility of a moderate to deep global recession as being less of a possibility than a few months ago. We could see global corporate earnings come in a bit stronger than anticipated over the balance of this year, in addition to a very strong global employment outlook as joblessness remains at historic lows and wage growth has been very strong. This could be good for consumer spending and keep investors very engaged in the equity markets for the balance of the year.

We continue to sell a few out-of-the-money calls on the Emerging Markets Index to bring in some income, as well as selling some exposure into rallies. Premiums remain attractive in the current equity market. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.1% of total assets and approximately 11.9% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 15.0%. This is close to our target allocation within our investment policy statement. *(Credit is given to the following entities for charts provided: Strategas, MSCI, Bloomberg, Fidelity Investments, IMF, World Bank, Japanese Trade Union Confederation, Fisher Investments, B of A Fund Manager Survey, Eagle Global Advisors, OECD, FED, ECB, BOJ, BOE, Haver Analytics, Arcadia Wealth Management, RIMES, Capital Group)*

# Fiscal and Monetary Policy

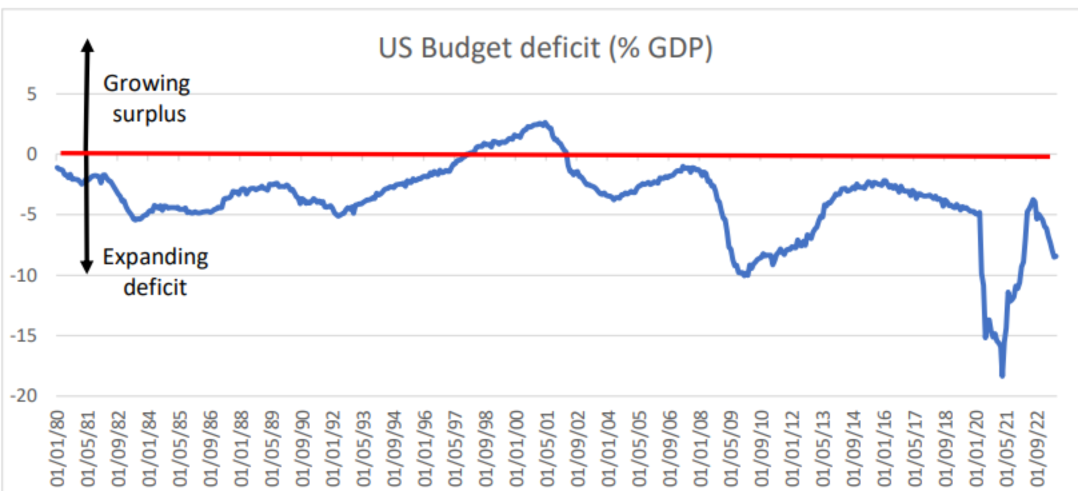
***By Michael McNair***

**Introduction**

Recent developments in U.S. fiscal and monetary policy have set the stage for growing divergence between the U.S. economy and other major global economies. Loosening fiscal policy and tightening monetary policy have created powerful dynamics that should support U.S. dollar strength going forward. This report will provide an in-depth analysis of these policy shifts and their implications for currencies, bonds, equities, and commodities in the U.S. and abroad.

*U.S. Fiscal Expansion amid Tightening Monetary Policy*

The U.S. federal budget deficit expanded dramatically from 4% to 8.5% of GDP over the past year. This fiscal loosening provided substantial stimulus to an economy experiencing historically tight labor market conditions, with unemployment at multi-decade lows. The massive deficit spending is over 5.5% of GDP, accounting for 5/6ths of total GDP growth over the past year.

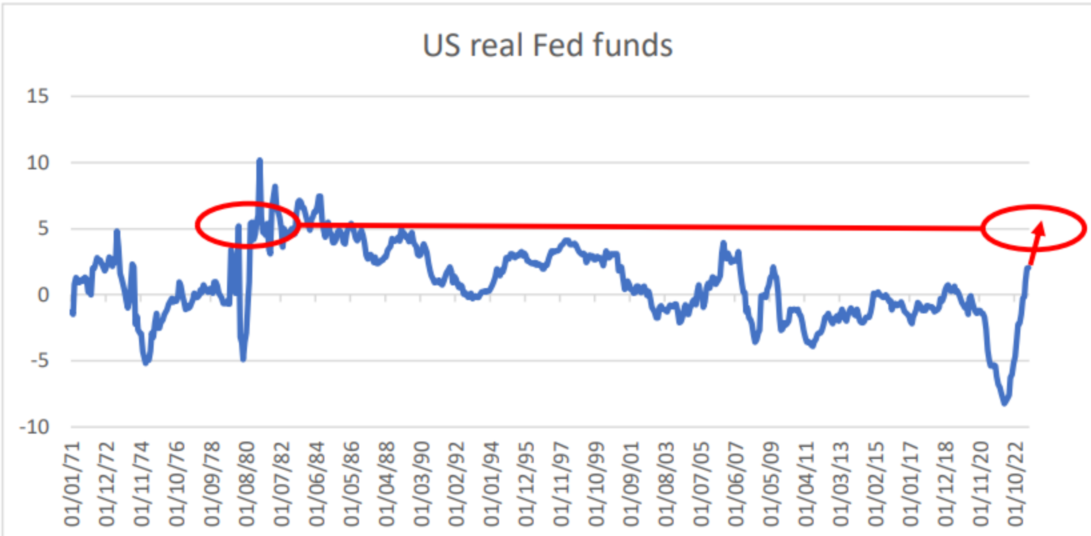


Source; Bloomberg

Subsequently, the Federal Reserve has been aggressively tightening monetary policy, taking real Fed funds rates to levels not seen since the 1980s. After keeping rates near zero through 2021, the Fed began raising rates in March 2022 and has lifted the fed funds rate range to 5.25 – 5.5% currently.

Real Fed funds (the Fed Funds Rate – inflation rate) have returned to high levels, not seen since 1987. With headline inflation at 3.2%, real rates adjusted for CPI sit at 2%. However, alternative inflation measures indicate real rates are much higher. In particular, real rates should account for rental inflation, which lags policy changes by around 12 months. Adjusting for contemporaneous rent inflation shows core PCE already near zero.

Similarly, adjusted for rents, real fed funds likely sits around 5% currently – similar to the early 1980s when the U.S. dollar began its huge bull market run.



Source; Bloomberg

This combination of surging fiscal stimulus and tight monetary policy is creating powerful dynamics reminiscent of the early Reagan years. The divergence between loose fiscal policy and tight monetary policy, results in capital inflows into U.S. dollar assets and reduces capital outflows from the U.S.

*Evidence the U.S. Neutral Rate Has Risen*

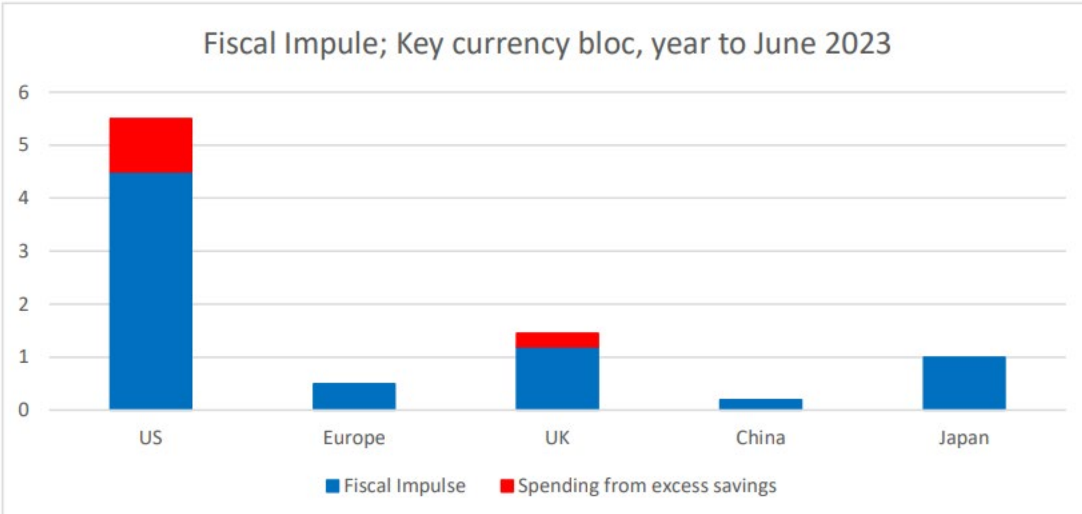
Several factors indicate that the neutral rate of interest (r*) has risen significantly for the U.S. versus other major economies. R* represents the level of real interest rates consistent with full employment and target inflation.

Key reasons pointing to a higher U.S. r*:

- Onshoring: Efforts to reshore production and shorten supply chains are supporting investment in U.S. manufacturing capacity. This raises demand for capital.
- Surging fiscal stimulus: The huge deficit requires significant private financing. Higher borrower demand raises equilibrium rates.
- Excess savings drawdown: Households accumulated over $2 trillion in excess savings during COVID lockdowns. Spending this savings influx adds to demand.
- Aggressive Fed tightening: The Fed liftoff and ongoing hikes also signal rates must rise to reach neutrality.

Overall, these factors suggest the U.S. neutral rate has increased both cyclically and structurally compared to the last decade. This diverges from countries where r* remains low, such as Japan and Europe.

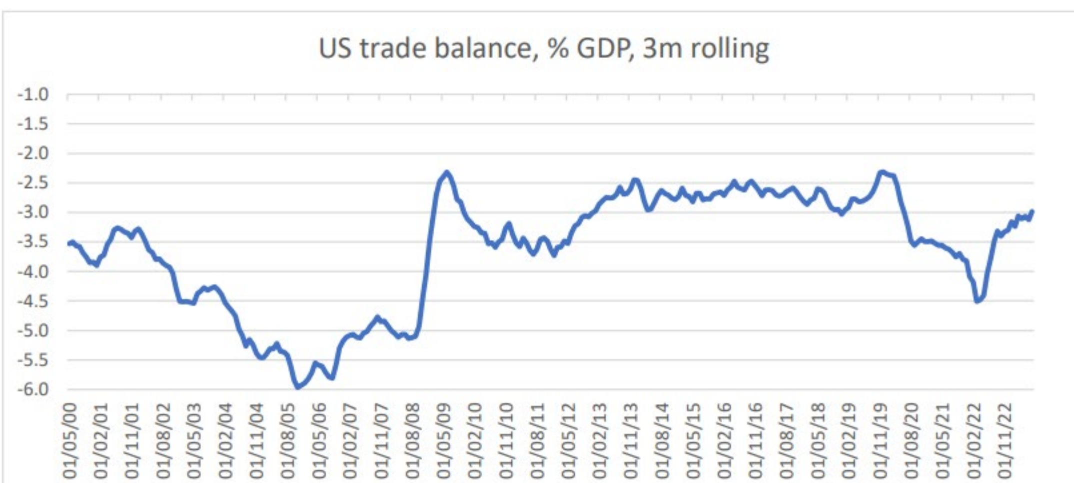
The higher r* for the U.S. versus abroad attracts foreign capital to U.S. dollar assets in search of higher returns. It also reduces incentives for domestic capital to flow abroad. These shifts reinforce dollar strength.




*Falling Trade Deficit Reflects Capital Flow Impact*

Despite the huge expansion in federal borrowing, the U.S. trade deficit has declined in 2022. This highlights the impact of underlying capital flows. The capital account surplus, driven by higher U.S. rates, is now outweighing budget deficit.

In particular, the deficit in goods and services trade fell from $859 billion in Q1 2022 to $741 billion in Q2. Higher domestic demand has been met by rising U.S. production rather than imports.




Source; Bloomberg

*Implications for Europe*

U.S. monetary tightening has exposed fault lines in Europe's economy. The ECB has only raised rates by 425 basis points so far versus the Fed's 550 basis point hike. With the Fed signaling more tightening, the rate differential continues to expanded.

This situation poses challenges for Europe:

- Lack of fiscal stimulus leaves the economy reliant on household spending and private investment. But consumption is being squeezed by high inflation and the energy crisis.
- Excess savings accumulated during COVID have already been eroded by rising prices. Unlike the U.S., these cannot cushion the economy.
- Energy price spikes and shortages resulting from the Russia-Ukraine war and aggressive green energy policies are forcing energy rationing. Energy-intensive industries are scaling back activity.
- Green policies like carbon taxes and renewable energy mandates raise costs for consumers and industry. This contributes to inflation and erodes competitiveness.

We forecast a recession in Europe within the next 6 months, at which point the ECB will likely shift toward rate cuts to combat deflationary forces. This dovish pivot would weigh on the Euro.

Additionally, European inflation may be less “sticky” than in the U.S., as rents are a much smaller component of European inflation measures. Therefore, European inflation will rapidly converge toward deflation as growth slows, while U.S. inflation will lag due to rental stickiness. This may allow the Fed to keep tightening even as the ECB eases. This policy divergence would accelerate capital flows to U.S. dollar assets.

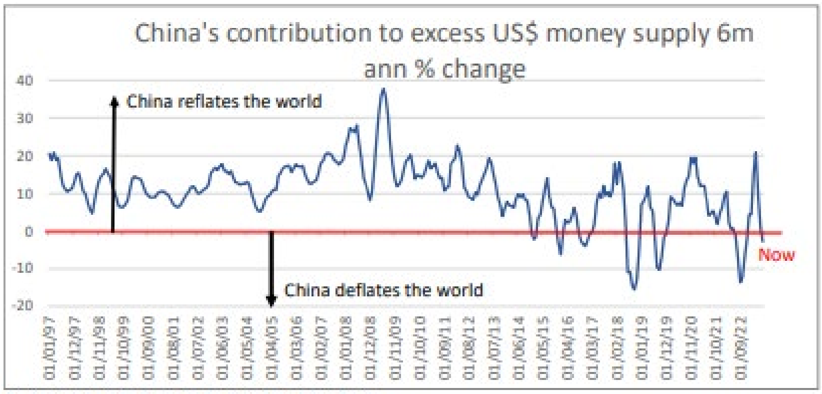
*China Caught Between Deflation and Currency Collapse*

China faces an imploding property bubble that poses risks of deflation and currency devaluation. The property sector is burdened by $7 trillion in debt and has over 35 "Manhattans" worth of unfinished properties. With presales and shadow bank financing evaporating, the entire sector is now distressed.

Knock-on effects could require bailouts of shadow banks, banks, and local governments equivalent to 60-70% of GDP, based on historical recovery rates. With most household and corporate savings tied up in real estate and related assets, government debt issuance of this scale risks crowding out the economy and spiking interest rates.

These constraints limit the ability to pursue bailouts without worsening the currency or deflation risks. The likely result is a managed property sector deleveraging that spills over into broad-based renminbi (RMB) weakness.

Already, signs of deflation are evident in the rapid decline of Chinese money supply in U.S. dollar terms. As the PBOC prints RMB for bailouts and stimulus, these translate into fewer dollars. This dynamic is exporting disinflation from China to the global economy.



Source; The MacroStrategy Partnership, Bloomberg

*Japan - Running Out of Options*

The Bank of Japan has maintained its yield curve control policy even as the Fed began aggressively tightening. This policy pins short-term rates near zero and caps long-term bond yields.

But with Japan's inflation rising to over 3%, YCC now forces the BOJ to print money at the wrong stage of the economic cycle. This threatens to exacerbate inflation and weaken the currency.

If Japan exited YCC, it would allow rates to rise and likely trigger a recession given high debt levels and reliance on cheap money policies. Yet this would strengthen the Yen.

As a result, Japan faces no good options. The most likely path is allowing gradual Yen weakening to import disinflation while avoiding disruptive rate spikes. Regardless, Japan's policy dilemma means it will export disinflation amidst a weakening Yen.

**Asset and Currency Outlook**

The macro environment outlined above has major implications for currencies, bonds, equities, and commodities:

- The U.S. dollar should strengthen significantly against the Euro, Yen, Sterling, and Yuan on widening rate differentials and respective economies moving into recession and/or deflation.
- U.S. Treasuries should benefit as economic weakness causes yields to decline. Bond prices and yields move in opposite directions.
- U.S. equities face risks from higher interest rates, margin compression, and likely earnings declines. Stocks and other risk assets would confront valuation headwinds.
- Industrial metals like copper are vulnerable to China's slowdown and global growth headwinds. Prices could revert toward 2020 lows.

*Key Scenario Risks*

Several alternative scenarios could disrupt the baseline outlook:

- Perceived Fed pivot: If ongoing labor market resilience is interpreted as flexibility that allows the Fed to cut rates, it could spark short-term U.S. dollar weakness and equity strength. This appears to be a key risk investors are positioning for.
- Treasury supply glut: Heavy U.S. Treasury issuance to fund the large deficits could overwhelm demand and cause yields to spike higher. This could offset disinflationary forces from growth weakness.
- Resilient U.S. economy: U.S. growth could continue due to productivity enhancing investments, climate policies, and onshoring tailwinds. This may allow both equities and bonds to rally despite Fed hikes.

However, the balance of risks lies with the baseline outlook for now. The Fed remains strongly committed to lowering inflation regardless of growth headwinds, while global growth is clearly slowing into 2023, weighing on earnings.

## Conclusion

Diverging U.S. fiscal and monetary policies have driven capital flows and a U.S. economic divergence versus the rest of the world, which support U.S. dollar strength going forward. Deteriorating outlooks for Europe, China, and Japan will likely spill over into global disinflationary forces. With risks tilted toward the downside, the dollar and bonds should outperform as stocks and commodities confront valuation headwinds. If global weakness triggers a Fed pivot, all assets could rally initially. But structural factors suggest long-lasting U.S. dollar superiority compared to other major currencies as the 2020s progress.