Market Strategy
by STRATEGAS A BAIRD COMPANY

Year-end Market Outlook

September 12, 2023

A SNAPSHOT AND AN OUTLOOK

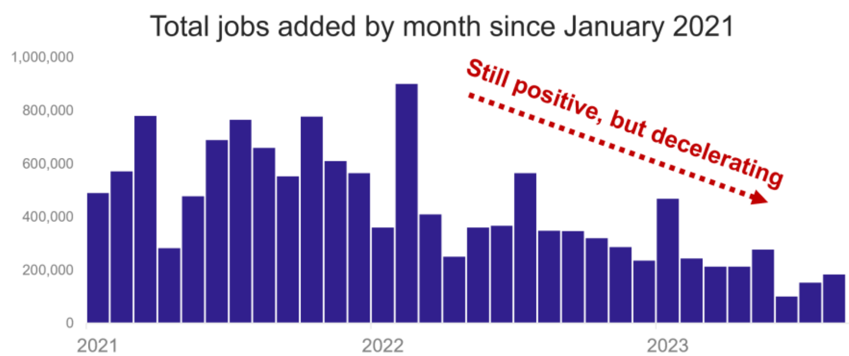
At Strategas, we look at the markets and the economy from several angles. Periodically, we round up these separate research areas into one picture that serves as a snapshot of where we are today and an outlook for the months ahead. As we ramp up toward the end of 2023, here is a summary of our firm's current thinking on interest rates, inflation, the job market and more (including the likelihood—and likely impact—of a government shutdown in October)

ECONOMICS: DON RISSMILLER, CHIEF ECONOMIST

The labor market has been holding the U.S. economy together, and since the U.S. economy has been a bright spot relative to other places in the world, the domestic labor market has really held the global economy together. Today, there are still two views of the US economy: a recessionary view that highlights the Treasury yield curve and a non-recessionary view that looks at the stock market. The yield curve remains inverted, which has been a good leading indicator of recession in the past, and yet the stock market's performance this year is inconsistent with an economic downturn (for more on Treasury yields, see the Fixed Income Strategy section below).

The way to resolve these two views is to look at inflation. If core inflation (excludes energy and food) continues downward, interest rates can head lower, and equity valuations can find support. **The debate is whether inflation comes down with or without slowing wages and rising unemployment.**

While payroll employment was still up an adequate 187,000 jobs in August from July, we're starting to see cracks in the labor market. There has been a worrisome trend of the initially reported payroll numbers from previous months being revised lower. Temporary employment has weakened, the unemployment rate rose to 3.8% in August, job openings fell sharply in July, and layoff announcements were up in August. **These cracks in the labor market are where the risk of economic downturn comes from.**

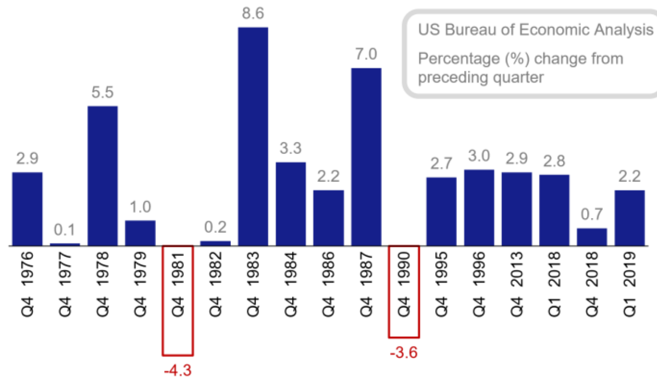


WASHINGTON POLICY: DAN CLIFTON, HEAD OF POLICY RESEARCH

After a relatively quiet period following the debt ceiling debate in June, Washington is set to bring more headlines to investors. The House of Representatives returns this week, and **we are stumbling into a scenario similar to what we saw with the government shutdown in 2013.** Conservatives upset about spending levels and the growing debt/deficit are unlikely to approve a continuing resolution to fund the government unless their demands are met. But permanent policy changes on a temporary budget are unlikely to fly. **The shutdown is likely to happen right around October 1.** Sure, Congress can avoid it if Speaker McCarthy cuts a deal with Democrats on some of the procedural votes, but he's unlikely to do that as it would probably lead to a motion to vacate the speakership.

During the debt ceiling debate in June, we advised that there would be headline risk for the markets, but the issue would ultimately be resolved. This time, we think a shutdown is much more likely to occur, but the economic risk is lower. **In fact, in the last six government shutdowns, GDP has been positive.** We don't think a shutdown is likely to impact the S&P 500 too much either. The government will probably reopen within a couple of weeks, and the outcome will probably be more of a timing difference in spending rather than less spending. A shutdown could actually lead to higher spending, as was the case in 2013 when a bipartisan deal to reopen the government relaxed some previously scheduled spending cuts. So, it runs counter to what the conservatives are trying to do. But once you get that shutdown out of the way and reopen the government, it clears the way for more spending.

Real GDP growth rate during past government shutdowns



While a shutdown will dominate headlines, we are more interested in the debt servicing cost of the United States. **This is the first time in 35 years that the cost of servicing the US debt is increasing.** Net interest costs as a percent of tax revenues hit a key inflection point of 14% of tax revenue in July. And there is no obvious path to get that interest cost under control. The paradox here is that Fed Chair Jerome Powell is trying to keep rates high to squeeze inflation, but by doing so, he's putting upward pressure on the funding cost of the US government, which then begins to squeeze some of the entitlement spending and pulls forward the solvency question around Social Security. At some point, there will be political pressure on Powell to relieve the burden this increasing financing cost puts on the Treasury Department. That's going to become a much larger fiscal issue moving forward.

INVESTMENT STRATEGY: JASON TRENNERT, CHIEF INVESTMENT STRATEGIST, CHAIRMAN

Regardless of the probability of a recession, we don't believe that the risk/reward for the stock market today is particularly favorable. **Taking the 2024 consensus estimate for S&P 500 at face value**—and combining it with a price-to-earnings ratio consistent with 0-2% inflation—**results in an S&P 500 price level of roughly 4,600** (i.e., that's $247 x 18.5)**.** That's not a lot of upside from here. During a recession, on the other hand, the median earnings decline is about 20%. If we see a downturn, the risk/reward would be flipped and expectations would change dramatically. In the next section, we discuss our own estimates for corporate earnings in 2023 and 2024, which are still below consensus expectations after we recently raised them.

ASSET ALLOCATION: NICHOLAS BOHNSACK, HEAD OF PORTFOLIO STRATEGY

We continue to rely on a simple three-part scaffolding for getting more constructive on equities. One, **"Have we arrested inflation back to acceptable levels?"** Investors and consumers have probably accepted a shift higher in price at this point, but policymakers seem to think there's more work to be done.

Two, **"What stock market valuation is appropriate for an environment of ongoing margin pressure and higher-for-longer interest rates?"** Jason mentioned the median decline of corporate profits in recessions, and frankly, we expected more weakness in earnings. I think we underappreciated the resilience of the consumer and the labor market. We've now taken our expectation for earnings to $214 (from $200) for 2023, and to $209 (from $187) for 2024. This new forecast sets an important baseline heading into 2024 following a year when, despite unexpected strength, aggregate corporate profits have run (effectively) flat. That strength has only curbed the downward progression of corporate profits, which is interesting given how bullish many investors are on the economy. We think more profit margin pressure is to come.

Finally, **"What are the organic drivers of growth that might spur capital off the sidelines?"** Is the AI push strong enough to forestall a significant pullback in economic activity? Is there something else out there? We haven't seen the one that really charms us yet, and that keeps us cyclically cautious even as we upgrade our earnings estimates.

TECHNICAL STRATEGY: CHRIS VERRONE, HEAD OF MACRO AND TECHNICAL STRATEGY

One of the things we feel strongest about is that, amid a very split market (barely 50% of S&P 500 stocks are above their 200-day moving averages), the Energy sector has emerged as clear leadership. **What began as a subtle market leadership change in May or June has become more overt and, ironically, Energy has been far and away the best performing sector since investors celebrated June's allegedly benign 3% CPI print.** Compared to the overall market earlier, 96% of the Energy sector is above its 200-day moving average right now. Nothing else rivals it in that sense. Oil & gas service names are already at new cycle highs, the refiners remain strong, and even many of the global names have held up. Within the small cap world, Energy is the only sector at a new cycle high. At the same time, while investor dollars flowing into Energy-linked investments are up modestly in the last few weeks, the trend would hardly be considered aggressive. So, it's a favorable sentiment picture as well. Ultimately, I think all of this is punctuated by this big turn for crude oil, which we expect to continue higher, and which has rallied even despite the rising US dollar. Intellectually, this might be tough to explain (Is it supply? Is it demand? Is it expectations of a China reacceleration?) but the fact remains: Energy has reclaimed leadership in this market, and I think that's been underappreciated by investors.

FIXED INCOME STRATEGY: TOM TZITZOURIS, HEAD OF FIXED INCOME RESEARCH

Treasury yields are caught between a long-term secular uptrend and a short-term cyclical downturn. That is, we have two competing dynamics in place today. One is the long-term secular trend of higher highs and higher lows for interest rates that we believe is in place for this business cycle and possibly the next. The second is the shorter-term component that suggests the US economy is in the later stages of the cycle, with financial conditions set to tighten further and inflation on a cyclical downturn.

This means that the Federal Reserve is probably done tightening policy at this point and shorter-term Treasury bill yields should be stable for the rest of the year. But yields between one and two years should be moving lower on any signs of economic weakness. If a recession materializes by the end of the year, 2-year yields could be significantly lower (100+ basis points). Even in a scenario where the US labor market stalls but no recession materializes, 2-year yields should still finish the year ~25 basis points (0.25 percentage points) lower than where they are today. Altogether, we expect yields to remain tighter at the shorter end of the Treasury curve no matter what the economic outcome is between now and year-end.

The story changes a bit as we shift out to the belly of the curve. In our opinion, 10-year yields still haven't normalized for what's likely to be years of sticky inflation in a structurally rigid labor market. Furthermore, the notes curve faces higher Treasury supply for at least the next three years, as well as competition from higher corporate refinancing activity. And on top of all of that, we know that Fed balance sheet runoff (i.e., quantitative tightening) is going to persist at least until the US hits a recession (and some within the Fed would like to see it persist after recession too). **So, the longer it takes for a recession to arrive, the more opportunity we have for 10-year yields to normalize.** To us, that means reaching a level consistent with the long-run nominal growth trend of the economy.

Now, a conservative estimate of that long-run nominal growth trend might be 5%, and the historical norm is for 10-year Treasury yields to trade within 50 basis points of that number. So, if a cyclical downturn in the economy does not arrive soon, 10-year yields are likely to make a move toward 4.5% or even higher. In contrast, if a recession does materialize this year, the normalization is likely to be temporarily interrupted with a large reversal lower in 10-year yields. But unlike 1- and 2-year Treasurys, which could easily see 200 bps of yield decline in a recession, we believe the floor in 10-year yields should be somewhere around 3.25% to 3.50%, a much shallower drop from current levels. And that is in part driven by those structural forces that are raising the floor on yields irrespective of the near-term economic outlook.

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