Q2 2023 MARKET COMMENTARY

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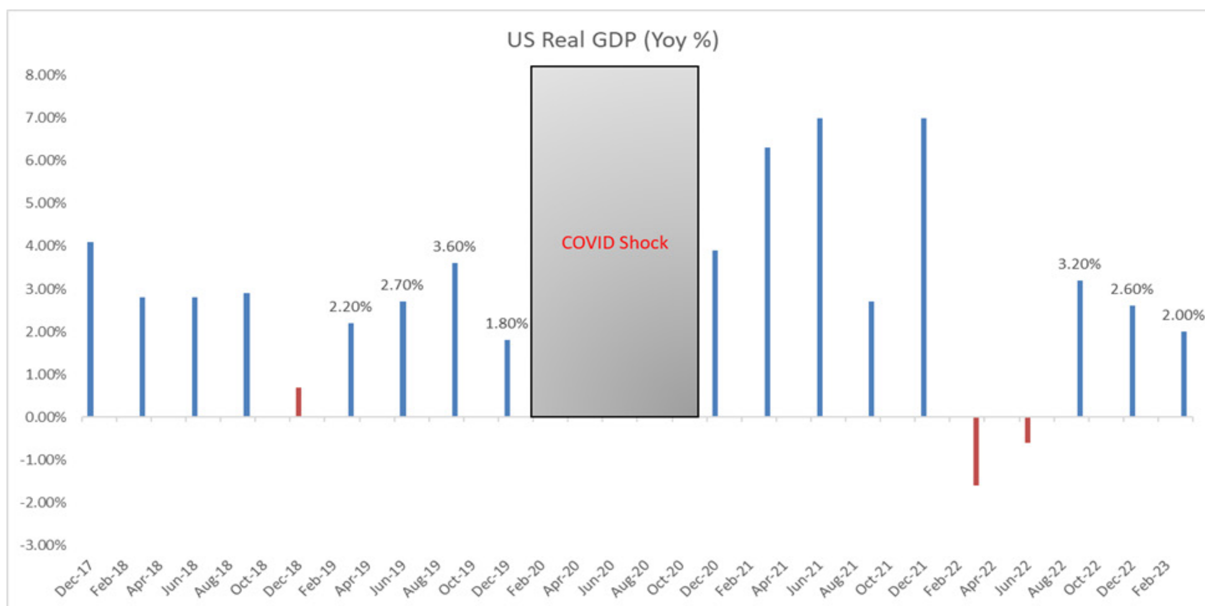
Macro drivers (inflation, recessions, interest rates, and investor sentiment) have had the greatest influence on markets in the first half of 2023 while company fundamentals have somewhat been overlooked by investors (further details explaining this phenomenon later in the commentary). Afterall, macro factors were the main drivers of declining stock prices last year. In 2022, stock prices sold off with the expectation that the economy would dip into a recession as the Federal Reserve and inflationary pressures generated headwinds on the economy. Fast forward to June 2023, a recession has thus far been avoided, the economy is showing signs of resilience, and valuation multiples have expanded once again- with investor optimism surging due to the future economic prospects of the Artificial Intelligence (AI) "revolution". Consequently, markets have recouped most of last year's losses, with the S&P 500 down only approximately -5% since December 2021.

Although we are in a better place today than what many had expected, risks and challenges remain plentiful, especially if the recessionary scenario is not avoided but rather delayed. Markets have re-priced for the economy to experience a "softer landing" indicative in this year's market rally. The basis of a soft landing is predicated on stronger economic data being released thus far, which in our opinion is a double-edge sword. On one hand, it could indicate that the economy is in fact very resilient, with its ability to power through many of the macro headwinds and avoid a recession. On the contrary, this could be the last leg of a very strong post-COVID recovery but renders the Fed to take more drastic restrictive actions, potentially exacerbating a naturally slowing economy, and tipping it into a recession. Regardless, investors stand at a crossroads today, with economists, market experts, and professional investors divided on the future outlook. This is something that we find encouraging, especially as fundamental active investors because it paints a very supportive environment for us to uncover alpha if we navigate it right.

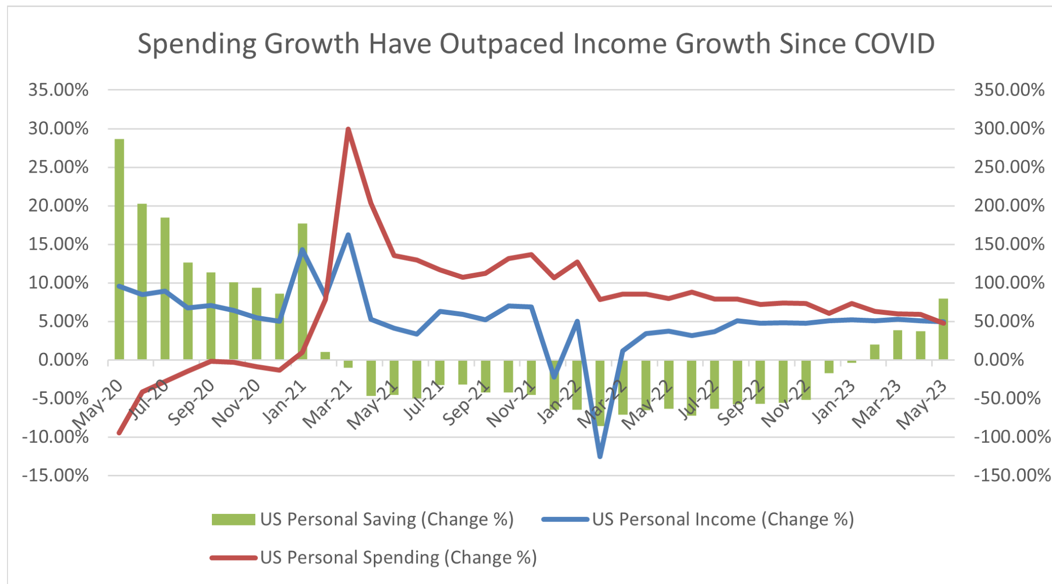
Recession...? What Recession?



Source: Bureau of Economic Analysis (BEA), Liberty One 2023

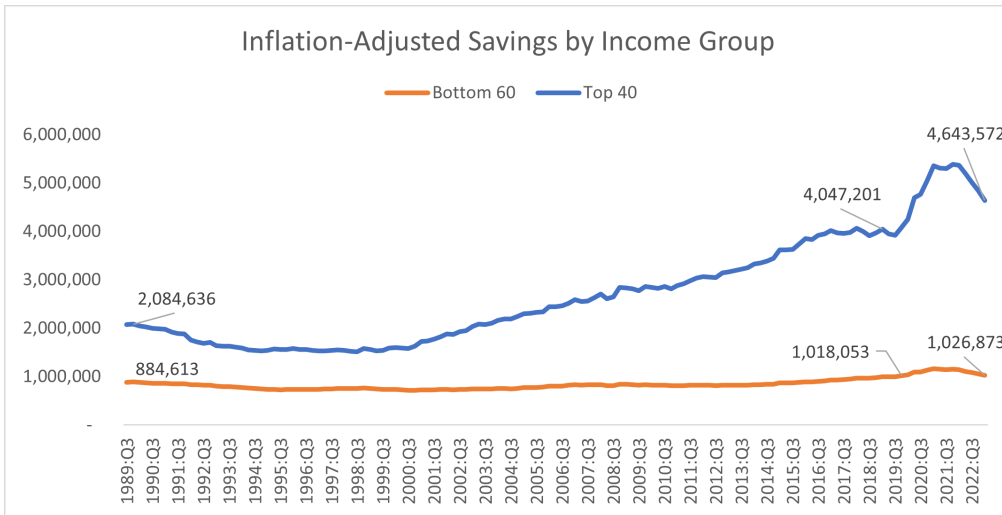
Economic output continues to surprise to the upside, evident in the Q1 2023 GDP numbers- reflecting its continued upward revision from its first estimate of 1.1%, second estimate at 1.3%, and now most recently revised upward again to 2% year over year. (Note: we removed the impact of the COVID shock from the graph to illustrate a comparison post-Covid to pre-Covid) The strength in our GDP numbers have primarily been influenced by the US consumers, with spending on both good and services contributing to almost all of the economic growth in the first quarter of 2023. Given that consumption spending makes up approximately 70% of our economy, such strong consumption behavior has been key in keeping our economy together.

Consumers Have Been on a Spending Spree



Source: Bureau of Economic Analysis (BEA), Liberty One 2023

Historically, spending growth and personal income growth have stay relatively close to one another. However, the COVID shock that led to built up excess savings and changing consumer behaviors in the post-COVID recovery have resulted in a historic level of spending growth. Spending growth has outpaced income growth for all of post-COVID recovery period. In fact, aggregate personal savings ballooned from $1 trillion to over $6 trillion during the height of the pandemic, driven by a combination of factors which included social distancing (limiting consumer's ability to spend) and fiscal stimulus checks to both businesses and households (which increased personal incomes and savings). Within a period of 24 months, most US consumers spent down that historic level of excess savings. Total savings within the bottom 60 percent of Americans income group have fallen back to its pre-COVID levels, indicating that excess savings accumulated by most Americans have been exhausted.



Source: Bureau of Economic Analysis (BEA), Liberty One 2023

It is important to note that excess savings held by lower-income households have a greater multiplier effect on the economy than savings held by higher-income households. Given that lower-income households typically hold very little liquid wealth, an increase in excess savings can be used to pay down debts, as a down payment for a home, or used to invest in other financial assets, instead of keeping them as liquid assets. This reallocation of excess savings results in higher net worth and stronger balance sheets, which have continued to support spending and credit performance.

The high level of spending growth is mainly supported by excess savings and a strong labor market, both of which supports the consumer which has helped our economy avoid a recession thus far. However, spending growth that is outpacing income growth is unsustainable over the long-term as simple logic dictates that eventually, excess savings will be depleted, and consumers will simply run out of money to spend. Spending and income growth have started to converge recently as consumers are starting to run out of excess savings which limits their spending potential.

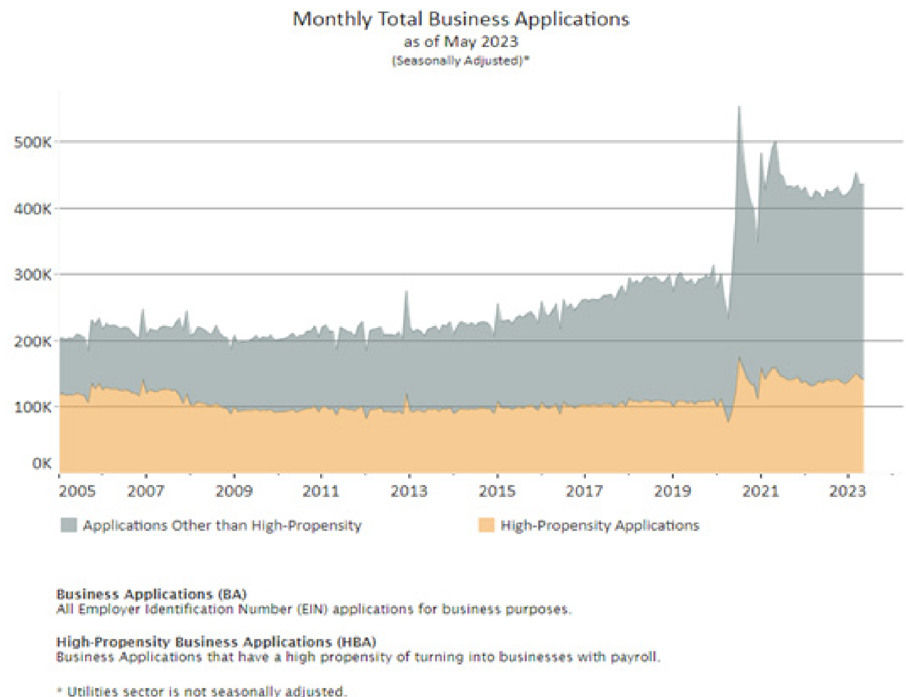
Additionally, we continue to believe that Mr. Market may be underestimating the impact on consumption once the resumption of student loan payments begins later this year. Despite the pause in student loan payments, outstanding student loan balances continued to increase throughout the COVID era. An additional $137 billion in student loans were issued since the moratorium began while very little was paid down. The average student loan payment was $400 per month prior to the moratorium which equates to $4,800 per year. With over 40 million Americans having outstanding student loans, back of the napkin math indicates that consumers could be looking at a $192 billion headwind in discretionary income in the near future.

Bottom line is that many underestimated the consumer's willingness and ability to spend despite higher rates. That begs the question of whether a recession has indeed been avoided, or whether it's simply been delayed. The wild card to this scenario is that if the economy continues to be as resilient as it has been, it may prompt the Fed to act more hawkish at a time where spending growth is beginning to decline, savings buffer has mostly been diminished, resumption of student loan payments creates lower discretionary income, and the effect of higher rates begins to spread throughout the economy (there is a natural lag between when rates are raised by the Fed and when it impacts the economy).

Where Are My Workers At?

The labor market remains extremely tight, which has helped support consumers and their spending habits. As long as people have jobs, we believe that people will continue to spend. This brings us to evaluate the labor market, which holds a significant importance in the future trajectory of inflation and future of our economy.

Over 50 million workers reportedly quit their jobs in 2022, the largest ever recorded in a single year. However, the labor force participation rate continues to edge up while the unemployment rate continues to fall. This suggests that those who quit did not leave the labor force entirely, but merely found work somewhere else. From a broader perspective, this can be extremely disruptive because businesses may be encouraged to hire more than necessary to insure against a potential worker quitting. This could partly explain why there are still more job openings than unemployed people. Total job openings could simply be inflated because of an unstable labor market, instead of exceptional market demand. However, we think that the likely scenario involves a combination of both (especially with the spending growth we've seen in the last 2 years), but an unstable labor market could be making the labor market look stronger than it really is.



Source: United States Census Bureau. June 2023

Of those 50 million workers that reportedly quit in 2022, most of the attrition was coming from frontline, customer facing roles within retail trade and leisure and hospitality industries. These workers either remained in the industry or switched industries entirely in pursuit of higher paying jobs. As the availability of education, training, and certification becomes more accessible, and greater acceptance of remote work, many workers are finding greater opportunities to grow their careers. In the long-term, this could be beneficial as the labor market becomes more technical and proficient in highly specialized work, increasing the average earnings potential for our labor force. However, this also poses a different problem where we face a structural labor shortage in lower-skilled work (the problem we are facing today). This could put dramatic upward pressure on wages for lower-skilled labor which adds to the inflation problem. Nonetheless, the ingenuity of free markets could replace some of the low-skill labor with technology, lessening the burden of upward inflationary pressures over time. (Eg: automated drive thru, self-check-out kiosks, robotic cleaners, advanced garbage trucks, driverless cars etc).

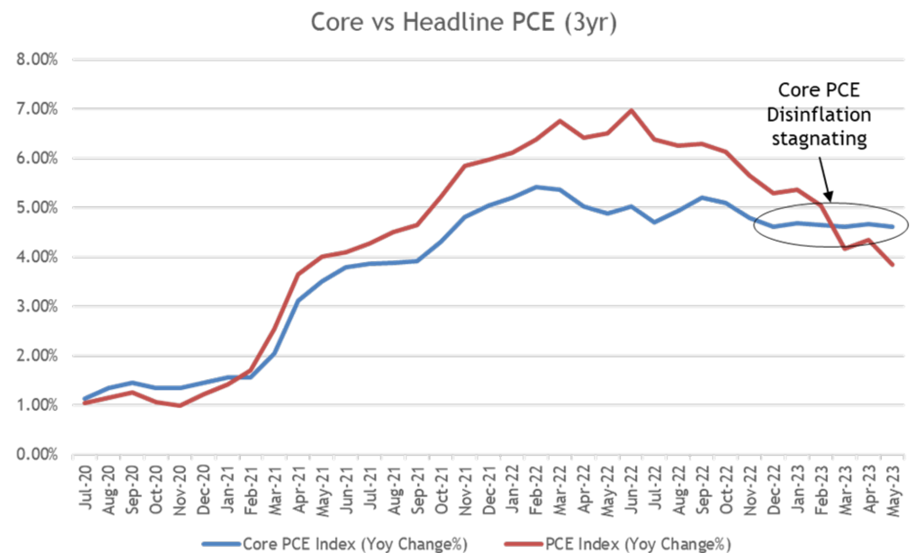
The last insight to the labor shortage puzzle that we are trying to understand revolves around workers leaving to start a business. New business applications have surged since COVID-19 and have remained elevated. Interestingly, 67 percent of new business applications in the last year were for "Other than High-Propensity" businesses. These are businesses that have a low likelihood of becoming a business with employees and payroll capabilities. In other words, 67 percent of new business applications are for businesses that do not plan to hire employees on payroll. This is an interesting dynamic because it affects the composition of our labor force.

Could this be a COVID effect where workers are choosing to leave their employer, only to become an employer of their own to have better control over their working conditions? Afterall, the number one cited reason for workers quitting their job is the unpredictability of their working conditions. Or could this be the effects of the gig economy? Whereby workers are leaving their jobs and opting to become gig workers. To better protect against potential personal liability, these new gig workers set up LLCs and corporations, but with no intention of hiring employees.

The bottom line is that our labor market has the underpinnings of structural challenges. These structural challenges are likely to put continued upward pressure on wages and inflation. Although headline inflation numbers have continued to ease, primarily helped by the decline in food, energy, and general merchandise prices, disinflation in core inflation has stagnated recently. To illustrate this, headline PCE in May 2023 declined to 3.85% year over year, which is a big improvement from 5.36% year over year growth in January 2023. However, core PCE year over year inflation was 4.62% in May 2023, only a slight decrease from January 2023 figure of 4.69%. Coincidentally, the 4.62% year over year core inflation is mightily close to year over year wage growth of 4.37% in May 2023. This makes sense given that the primary cost input in services is labor cost.

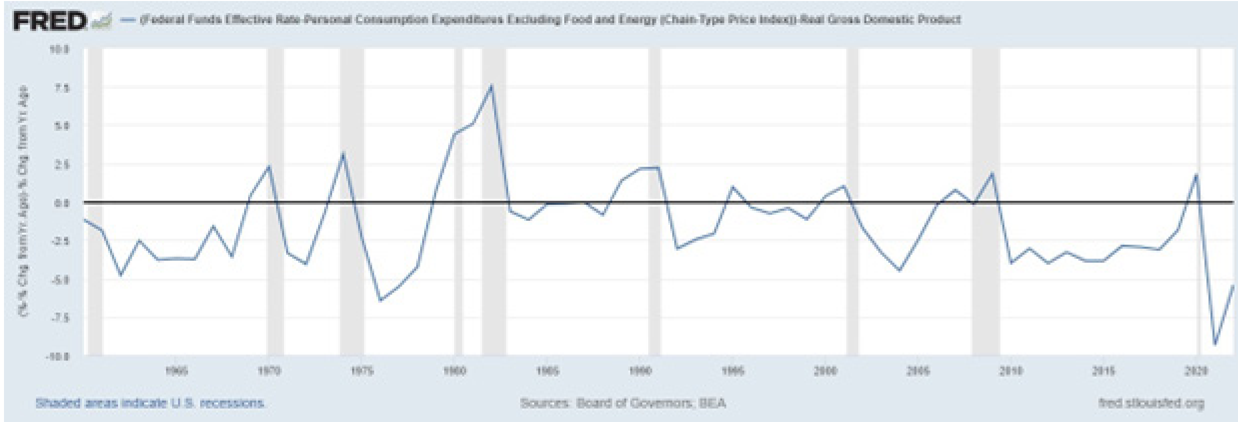
The Fed and Real Rates

Although nominal interest rates received most of the headlines with what the Fed is doing, real interest rates are more insightful in evaluating the true effects on the economy and its impact on American's standard of living. Despite the record ten consecutive rate hikes by the Fed and their restrictive policy stance, real interest rates have been relatively accommodative as they've remained in negative territory up until March 2023. From a policy standpoint, this could help explain why economic growth has remained so resilient. Bottom line is that higher nominal interest rates were simply not high enough to slow the economy and/or discourage borrowing, because inflation rate and wage growth rates were higher and stickier. With inflation being higher than interest rates (as evident in negative real interest rates we've seen), this environment is very favorable for the borrower because they can now pay their debt lenders back with money that is worth less than what they originally borrowed it for. This is especially more beneficial when inflation rates are above interest rates because the inflation benefit on their debt outweighs the cost of interest on their debt. This transfer of wealth from lenders to borrowers encourages more borrowing which could ultimately encourage more spending and investments if inflation expectations are not under control, which then leads to more inflation. Although not a point of discussion in this commentary, this is one of the reasons why the federal government (the biggest borrower in the world) prefers inflation to deflation, as it makes managing their debt load more sustainable through the inflationary benefit on their debt, and higher tax revenues from increased wages through inflation.

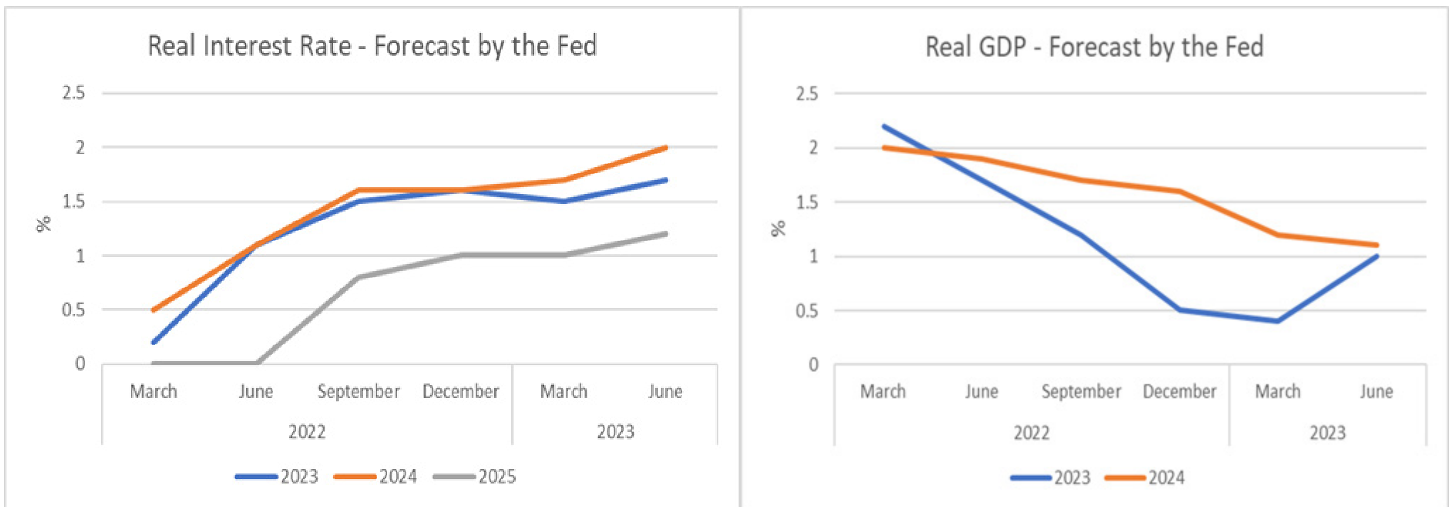


Source: Bureau of Labor Statistics, Liberty One. June 2023

When we compare real interest rates to real GDP growth going back to 1950, every recession had been precluded by real interest rates going above real GDP growth rate.



The graph above depicts the ratio of real interest rates to real GDP growth. If real rates and real GDP growth are equal, the ratio would be exactly 0. A quick observation highlights the strong predictability of recessions (shaded in grey bars) when real rates were above real GDP growth. This is where rates begin to exert their restrictive influence. The post-COIVD recovery has seen very accommodative real rates, although the tide is starting to turn.



Source: Bureau of Labor Statistics, Liberty One. June 2023

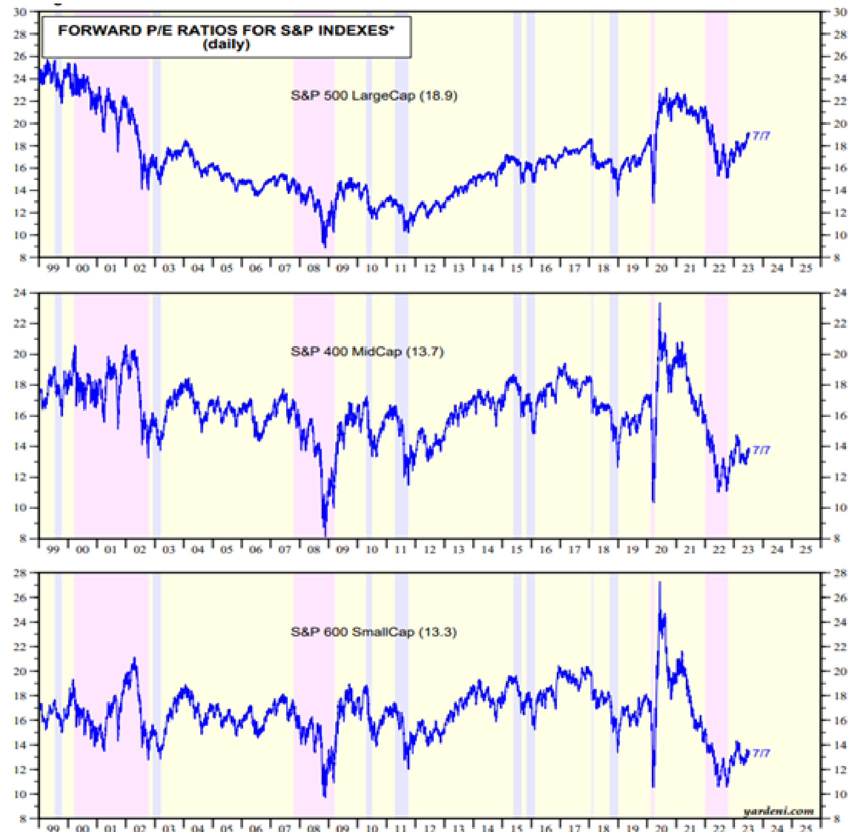
What the above two graphs depict is that the Fed's baseline forecast would imply a challenging 2024. The Fed intends to keep real interest rate levels between 1.5 to 2%, thus, even if the nominal interest rate level begins to come down sometime in 2024, it would occur only to maintain the 1.5 to 2% real interest rate level range. Conversely, they are forecasting real GDP growth to be around 1% as they want the economy to run below its 2% potential to tame inflation. The Fed is data dependent, and these forecasts are subject to change with every new release, but the Fed is indirectly foreshadowing cautionary recessionary signals. It continues to surprise us why real interest rates in relation to real GDP does not get enough attention as it probably should.

Why Markets May Be Overlooking the Fundamentals

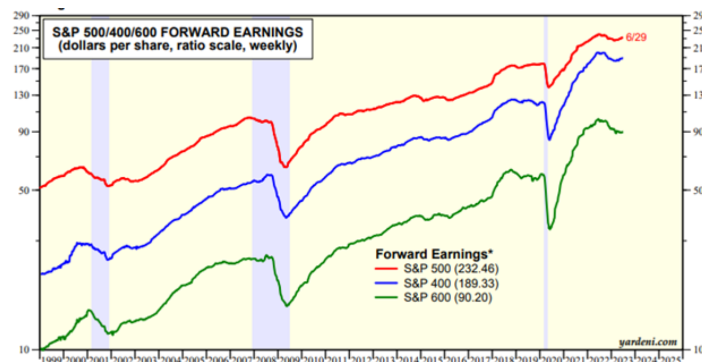
How economic activity will play out over the next 24 months and whether we see a recession and how deep that recession will be remains unknown. But the factors that we just laid out lead us to believe that a recession is simply delayed, not avoided. As a result, we are maintaining our defensive stance because we do not think that equity markets are fully pricing in the impact of a possible recession on revenue and earnings.

The increases in valuation multiples this year were driven mostly by multiple expansion, influenced by improved investor sentiment and the "soft-landing" narrative. Forward earnings did decrease slightly this year, but not at the magnitude of the increase in valuation multiples. The decrease in forward earnings is mainly due to higher cost pressures affecting net margins, rather than a decline in revenue.

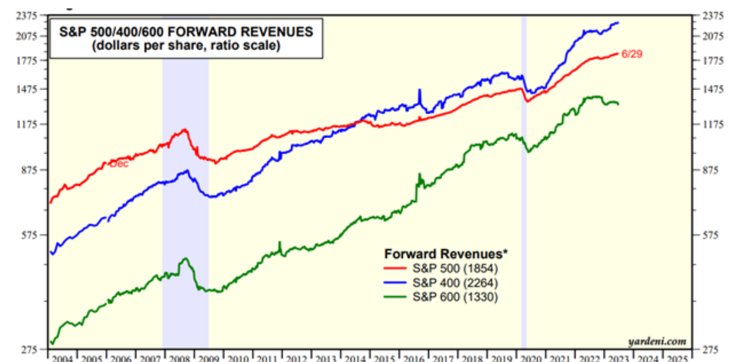
It is our expectation that revenues are most likely to decline in a recessionary environment, which has historically been the case. However, consensus forward revenue estimates forecast increasing revenues in 2024, suggesting that either broader economic activity will hold up or that a recession will have minimal impact on corporate revenues. With our base case of a recession, we do not believe equity markets are fully appreciating the potential risks to corporate fundamentals, which may cause some weakness in equity markets should corporate profits begin to deteriorate.



Source: Yardeni Research, Liberty One 2023

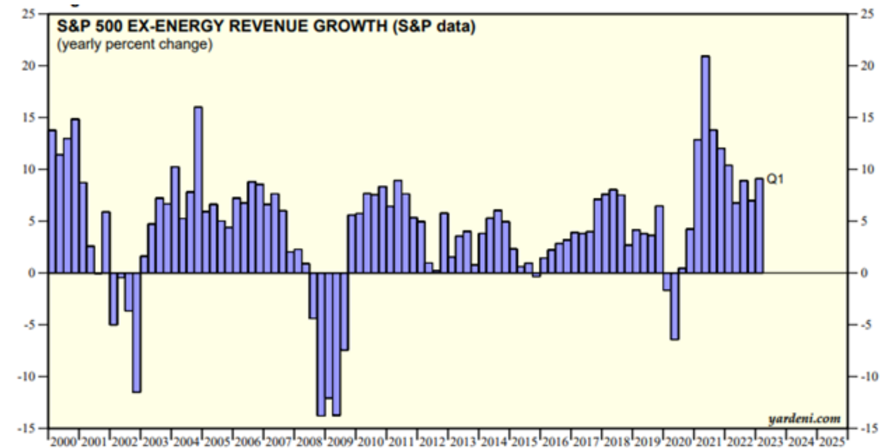


Source: Yardeni Research, Liberty One 2023



Source: Yardeni Research, Liberty One 2023

Looking Forward



Source: Yardeni Research, Liberty One 2023

Investor sentiment has dramatically improved this year and are possibly trying to look past a recessionary scenario. Whether this move is premature remains to be seen, but we believe that absent of an external shock, markets are likely to test October 2022's lows should a recession turn out more harmful than predicted. However, the timing of a recession can be challenging to predict, and the economy could do well for the remainder of 2023. if the economy can avoid a recession, we do think equities are set up favorably going into the next bull cycle. Large inflows into higher yielding money market funds over the last few months suggest record cash on the sidelines. This cash could eventually find its way back into equity markets, potentially boosting returns of equities as sentiment improves further.

Due to our base case expectation of a recession but possibly a favorable technical set up for equities in the long-term, we remain a defensive stance but are actively monitoring the market for attractive entry-points into fundamentally sound businesses. Stocks could slump in a recession as a recession could temporarily punish their valuations, providing us with an attractive entry point. In the meantime, we continue to focus on high quality companies with solid fundamentals that could prove to be more resilient in tough times.

As the next several quarters of earnings roll around, we think that macro factors that have influenced markets would begin to shift towards micro factors (focused on individual company's performance), as dispersion among corporate results are likely to widen. We think this is a landscape that benefits active managers, and where stronger future returns are likely to be generated from active portfolios instead of beta portfolios.

Beta or index-level (passive) portfolios benefitted tremendously from The Fed applying easy monetary policies to help households and businesses recover from the Great Financial Crisis (GFC). Consequently, this helped propped up financial markets where differentiation between individual stocks was slim and valuations remained high. Investors bought the dips, expecting the Fed to come to the rescue in any signs of distress, which caused drawdowns to be short and shallow. Beta exposure rewarded investors well, with the S&P 500 recording average annual returns of +15%, compared to their historical average of 10%.

In the post-COVID era however, inflation, interest rates, and valuations are all higher. The effects of deglobalization, re-shuffling of global supply chains, and higher friction in trade are inflationary pressures unique to this era, which could limit the Fed's ability to be "market-friendly". Higher starting valuations and higher interest rates could limit "beta'" returns generated from equities, leaving more opportunity for active portfolios to generate alpha. We are likely to see greater dispersion between winners and losers, giving skillful managers a greater opportunity to generate alpha.

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