Q4 2023 MARKET COMMENTARY

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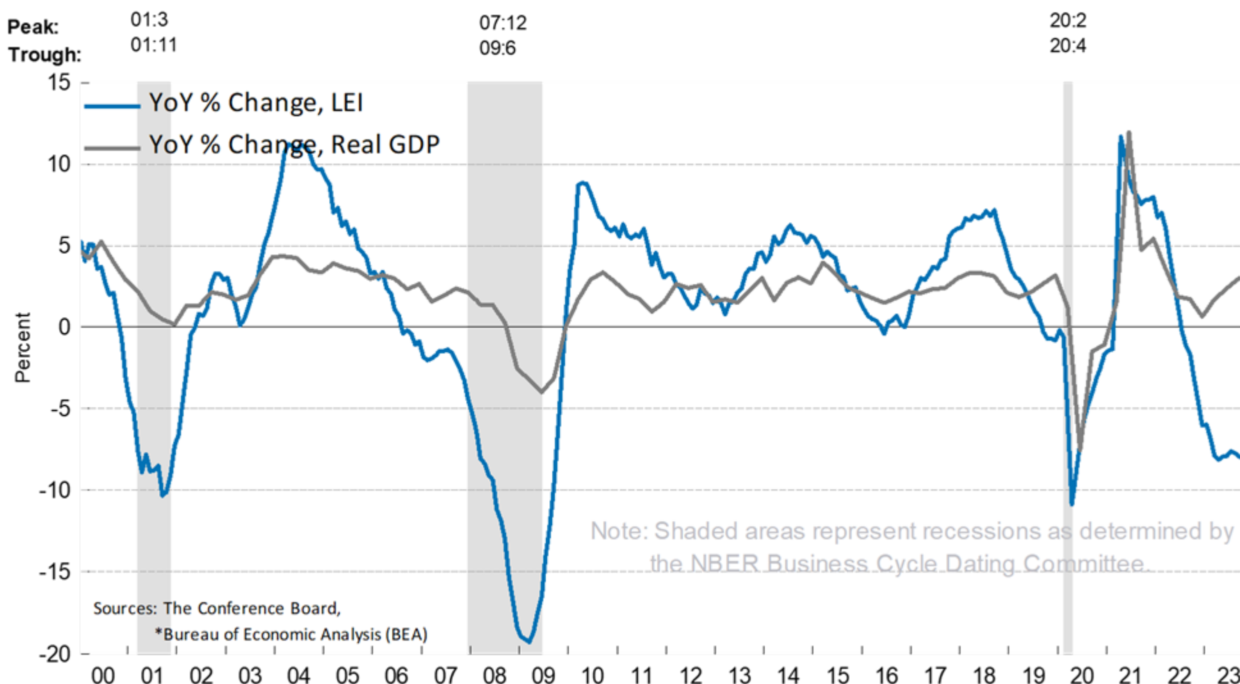
The economy in 2023 defied almost all expectations by remaining resilient despite expectations that higher rates and inflation would slow consumer spending and dim business prospects. On the contrary, easing of global supply chains, declining oil prices, robust consumer spending, a resilient labor market, and stimulative fiscal policies more than offset restrictive monetary policies that led to a moderation in inflation without jeopardizing growth. However, we are refraining from taking a victory lap on last year's economic performance in calling this a new bull market, especially with leading indicators pointing towards a slowing economy that has yet to fully absorb the impact of a tighter monetary policy, larger credit card debt balances, resumption of student loan payments, depleted consumer savings, and softening of the labor market. Yet, we are fully confident that the American economy would be able to withstand a cyclical recession, absent of an external shock (which are often difficult to predict but should not discourage one from investing in financial markets). Therefore, longer-term investors should see any potential volatility in 2024 as an opportunity to better accumulate wealth for the future.

Indicators are Pointing to a Slowing Economy

The Conference Board Leading Indicator Index which is a series of 10 consumer, economic, and market metrics have declined for 18 consecutive months by a cumulative -12% since March 2022. Historically, a decline in the indicator preceded broad-based economic weakness. However, when the indicator turns negative in the magnitude that we have experienced thus far, a recession in the year ahead typically ensued (as highlighted in the shaded area in the figure below).

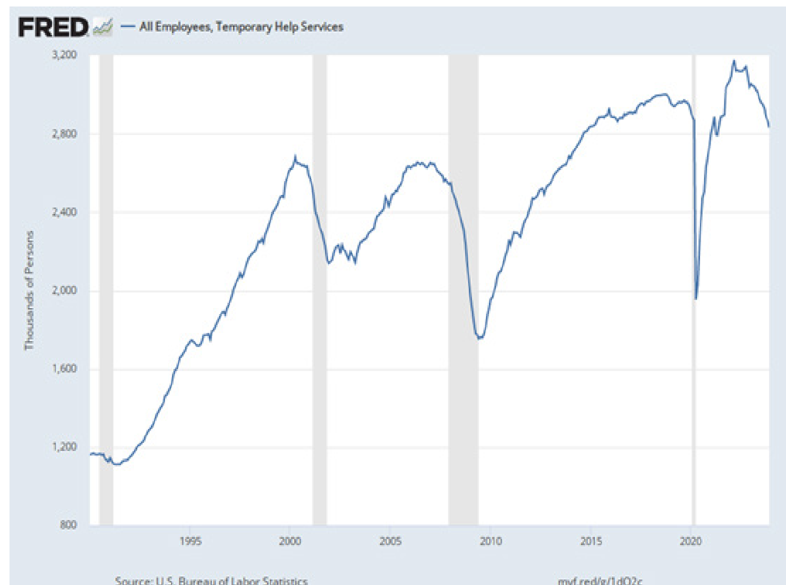


Source: The Conference Board, November 2023. Past performance is no guarantee of future results.

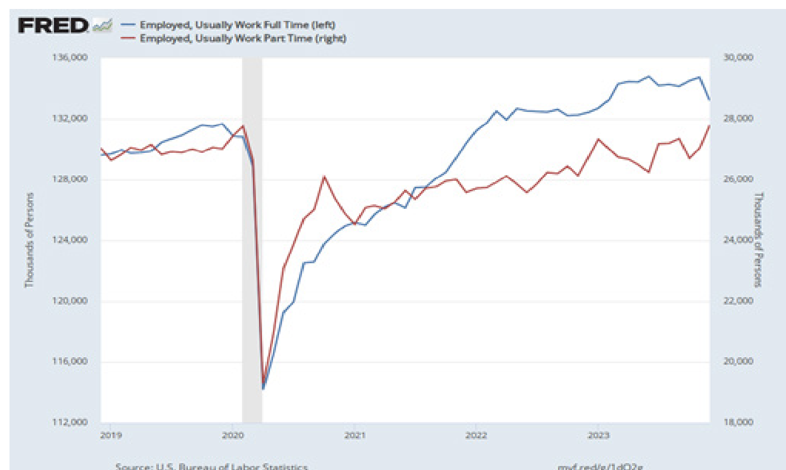
Housing and labor market conditions within the Leading Indicator Index weakened in November, reflecting warning areas for the economy. Given the significant influence the consumer holds in the US economy (70%+), understanding the drivers of the consumer, which is understanding the drivers of the labor market becomes a greater focus in today's commentary.

A Look Into the Labor Market

Despite the recent release of a better-than-expected job growth report, the current labor market conditions in short can be described as fragile. A broad range of indicators point to a notable slowdown in hiring activity, which seems to show that the labor market may be near a turning point. To elaborate, the US economy added an average 193,000 jobs per month in the last 6 months, where 80% of the hiring came from the government, health services, and education industries. These industries have historically been less sensitive to economic fluctuations and labor shortages are already well-known (lack of teachers and nurses), making job growth in these industries less informative to the health of the overall US economy. More importantly, the better-than-expected headline job growth report may appear to be much weaker when looking at the finer details of the report.

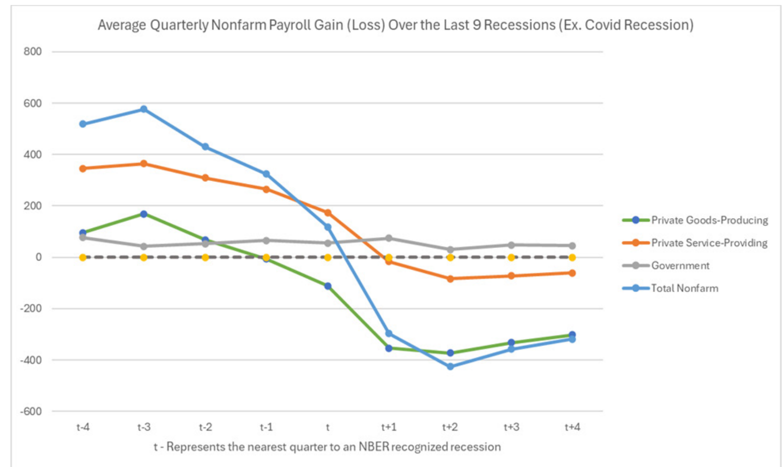


In the past year, businesses have been reducing the use of temporary help service workers, an action which historically coincides with an early stage of weakening business conditions. The labor market cycle typically follows a three-stage pattern. In the first stage, businesses freeze the hiring of temporary help workers as demand begins to soften. Should conditions deteriorate further, the labor market enters stage two- where businesses would try to manage capacity by cutting hours and moving full-time employees to part-time. This is to better align production capacity with existing and projected demand. Should demand continue to weaken from there, the labor market enters into the final stage where businesses begin their layoff measures to better preserve their profit margins.



June 2023 registered the peak level in employment classified as full time (134.78M million workers). Since then, the level of full-time employment has dropped to 133.19 million, a decline of approximately 1.59 million workers. The decline can be interpreted as a reclassification of workers from full time to part time. During the same period, part-time employment increased by 1.546 million, basically offsetting all of the losses in full time employment.

All of the above are signs of a weakening labor market condition. Businesses resort to the preceding two measures (cutting temporary help employment and reducing working source) to better manage their capacity in relation to what is currently demanded. Businesses usually try to avoid layoffs for as long as possible, but at a certain threshold, capacity can't be managed further, and layoffs begin. As we write this commentary, we believe that businesses are still managing their capacity, but a turning point could be near.



Source: U.S. Bureau of Labor Statistics

Methodology: The last 9 NBER recognized recessions (Ex. Covid Recession) near the point (t) occurred in the following periods (in ascending order): 1953:Q3, 1960:Q2, 1970:Q1, 1973:Q3, 1980:Q1, 1981:Q3, 1990:Q3, 2001:Q2, 2008:Q1

The three-month average of monthly payroll gain (loss) at point (t) was averaged across all recessionary periods at point (t) to derive a single number representing all recessions at point (t). The same process was completed for all other periods (t-1; t+1 etc.)

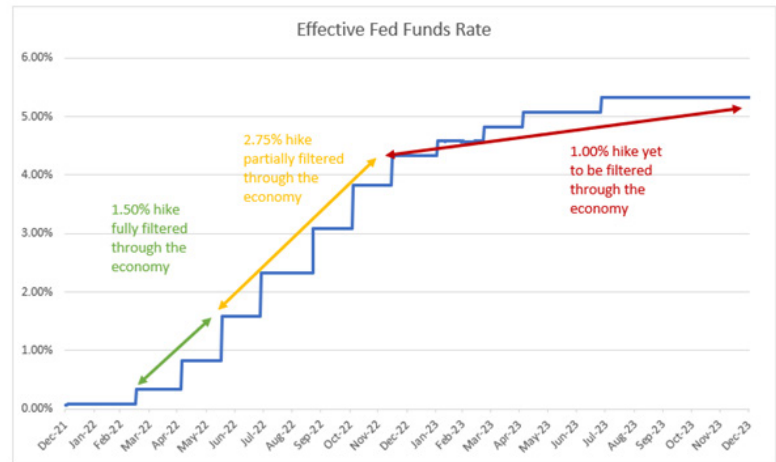
To better understand how the next stage of the business cycle could play out (mainly from the labor market's perspective), we have examined the last 9 recessions (excluding Covid Recession) and made the following key observations. Firstly, the labor market does not collapse all at once, instead, concentrated weakness appears in certain segments of the labor market which then spreads to the rest of the industries. Historically, the segment that usually cracks first is the good producing sector, which is mainly composed of manufacturing and construction industries. Job layoffs in the two respective industries had preceded the rest of the labor market by one quarter 50-60% of the time, which makes these industries a good leading indicator to the future path of the broader labor market.

This pattern can intuitively be understood with the following reasoning. The final product of both industries consists mainly of large ticket items (durable goods and structures), which are interest rate sensitive since the financing cost is generally a part of the price that households and businesses pay. Because a tight monetary policy historically preceded recession, higher interest rates make these goods less affordable, and demand falls. In response, businesses cut capacity and employment to preserve profit margins.

Currently, hiring weakness is observed in manufacturing which for the last 9 months has stayed roughly flat (no hiring). Construction on the other hand, has been rather resilient; this is mainly due to a strong demand for construction workers from the government and homebuilders. Supportive fiscal industrial policies and a tight existing home supply have contributed positively to the construction industry. However, signals from the respective industries are mixed and not clear. Nonetheless, because layoffs here usually lead the rest of the labor market by approximately 3 months, paying a closer attention to the developing trends within the goods-producing labor market may be beneficial.

Investors Should Focus on What Is "Real"

Today, financial media and mainstream investors seem to be more concerned about nominal interest rates with their discussions based predominantly on how much the Fed is going to cut and when. However, we are more interested in the path of "real" interest rates which historically has a greater impact on the economy (GDP is measured in real terms). It is in our view that the Fed has projected interest rate cuts in 2024 not because they expect the economy to enter a recession, but because inflation is showing a moderating path towards their long-term target of 2%. If the Fed does not cut interest rates while inflation continues to moderate, "real" interest rates would essentially become more restrictive, posing a greater threat of rendering the economy into a recession. It is therefore our belief that the Fed must lower nominal interest rates in 2024 if disinflationary trends continue, but rate cuts may not be as stimulative to the economy as is expected.



Source: Federal Reserve Board of Governors, December 2023. Past performance is no guarantee of future results.

The three interest rate cuts projected by the Fed in 2024 are meant to mirror their expectations of disinflation, to keep "real" interest rates on a path to normalcy. The last time the Fed raised nominal interest rates was during their July 2023 meeting and have kept it at the 5.25% to 5.50% range since. In July 2023, the "real" short-term interest rate was 0.63% (taking the effective Fed Funds rate in July minus year-over-year core CPI inflation). Over the next 5 months, the Fed held interest rates steady at 5.25%-5.50% but because inflation continued to decline over that period, "real" short-term interest rates doubled from 0.63% to 1.33%, surpassing its long-term average of 1.12%. In short, "real" interest rates could start to become more restrictive as inflation moderates, posing a threat of a hard landing.

The reason we stopped short of saying interest rates are restrictive is because we do not believe that the full impact of higher rates has been fully filtered through the economy. Historically, the impact of higher interest rates takes on average 12-18 months to filter through the economy. The Fed began its 525-basis point or 5.25% rate hiking campaign on March 16, 2022, which means that their first round of rate hikes of +1.50% (March-June) have likely been filtered into the economy by the end of 2023. What this suggests is that there is another 375- basis point or 3.75% of higher interest rates that have yet to be or is partially filtered through to the economy. From a monetary policy perspective, one could argue that current short-term interest rates of 5.25%-5.50% are certainly restrictive, given the progress we've made on inflation despite the lagging effect of monetary policy.

Considering the potential restrictiveness of monetary policy at today's levels, financial markets are looking ahead and pricing in six rate cuts or 1.50% in 2024, far exceeding the Fed's dot plot projections of 3 rate cuts or 0.75% through next year. More importantly, markets are predicting such cuts without revisions to the expected economic and earnings growth. We believe that the market's projections of six rate cuts are more synonymous with a weak economic environment which is not reflected in earnings or GDP growth projections. There appears to be a disconnect between the rate cut expectations and the soft landing/ earnings growth narrative that has encapsulated markets in the final months of 2023, almost pricing in a "Goldilocks" scenario. We believe that investors should remain vigilant and not celebrate rate cuts with an un-founded optimism, primarily because recessions usually begin when the Fed begins to cut rates, not when they are raising them.

Portfolio Positioning

With softening economic trends and optimistic valuation levels, the near-term set up for equities seems less favorable today than a year ago. Nonetheless, this does not mean that investors should abandon equities altogether. Equities have been one of the strongest long-term asset classes for substantial wealth creation. As businesses innovate and economies grow, equity investors stand to benefit from any surplus earnings earned and reinvested back into the company to create additional future surplus earnings. The compounding of these surplus earnings has yielded favorable outcomes for investors, and we do not see this changing. A portfolio of carefully selected diversified stocks that hold characteristics of a high-quality enterprise would likely be able to better help investors navigate any potential volatility given their healthy balance sheet and embedded self-sufficiencies.

We do see bonds as an attractive asset class to diversify against a potential recession, particularly high-quality bonds with intermediate duration. Long-term duration bonds could be strong equity diversifiers as well, but duration-based price risks make their risk/reward profile less attractive to us. Absent of any inflationary or growth shock to the economy, we'd expect the inverted yield curve to un-invert partially in 2024 stemming from declining short-term interest rates vs rising long-term rates as the Fed moves to cut short-term rates. This provides investors with the opportunity to lock in higher yields within their intermediate to long-term bond holdings.

As the Fed has signaled their intention to lower rates in 2024, we think that the opportunity costs for holding cash becomes more expensive. With a record +$6 trillion of assets in money market funds, we think that a lot of investors would be faced with re-allocation decisions, potentially setting a strong near-term technical set up for other asset classes. In short, we believe there are better opportunities elsewhere within the investment landscape than cash in 2024.

Looking Ahead

2024 is shaping up to be a very interesting year for the markets where pressure is on for corporate and economic conditions to meet or exceed expectations. Additionally, two-thirds of global elections are expected to be held in 2024 (including one here in the United States), which could drive heightened volatility. However, it has been our experience that volatility leading up to most elections has mostly been noise. Signals typically come in after the election cycle, where clarity on policy initiatives becomes more apparent. It is therefore paramount to keep a level head from now until November 5, 2024, and not allow any emotional force to drive your investment decision making. Because it is incredibly difficult to predict how the data will come in and what the market reaction will be, it becomes ever more prudent to focus on basic investment principles.

Basic investment principles such as carefully selected diversification and simplicity have been key to our success and should remain top of mind for investors this year. Investing does not need to be complex. By keeping the game simple and sticking to the basic investing principles, investors can better orient themselves against uncertainty or refrain from chasing the next big thing, focusing instead on practical investment decisions based on sound research, which has often yielded very favorable outcomes for investors over the long-term.

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