WEALTH

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A cooler August

Market Digest, September 2023

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Executive Summary

There is cautious optimism about the U.S. economy's short-term prospects, but we remain watchful of potential challenges, especially in the manufacturing sector and the impact of tightening monetary policy. The odds of a recession are considered low in the near term, but there is some very real concern about the possibility of a recession in 2024.

However, the risk of a sustained moderate global slowdown is a real possibility amid diverging trends among the world's economies. Europe, which was a major source of rising momentum in the first half of the year, has seen activity ease markedly in recent months, and is even flirting with the prospect of recession. Trends in China remain positive, but not as much as the first half of the year.

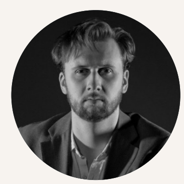
Concerns about inflation, potential increases in Treasury yields, and the expectation of a weaker U.S. dollar over the medium to long term, are acute to our fixed income outlook. While inflation has receded temporarily, commodity prices and shelter costs could prevent inflation from falling significantly further.

Through the first seven months of this year, the S&P 500 soared 19.5%, notching its strongest start since 1997 and 10th best since 1926. The only drawdown of more than 5% was a 7.8% decline from February 2 to March 13, a period that included the second- and third-largest bank failures in U.S. history. However last month the S&P 500 slipped 1.8%. Was August the start of a prolonged downtrend, or was it a healthy correction? Our historical analysis sides with the latter.

The monthly August pullback cooled off the run across sectors. Energy was the only sector to finish the month not in negative territory. We lifted Energy to overweight as it was supported by a rising 10-year Treasury yield, and bullish readings from our Crude Futures and Commodity models.

The current phase of the earnings cycle is a bullish influence on global stocks. If the next earnings season brings more of what we've seen during the current one, then there's a good chance that fourth quarter equity performance will have the degree of strength consistent with historical tendencies.

Last month, the S&P 500 slipped 1.8%. Was August the start of a prolonged downtrend, or was it a healthy correction? Our historical analysis sides with the latter.



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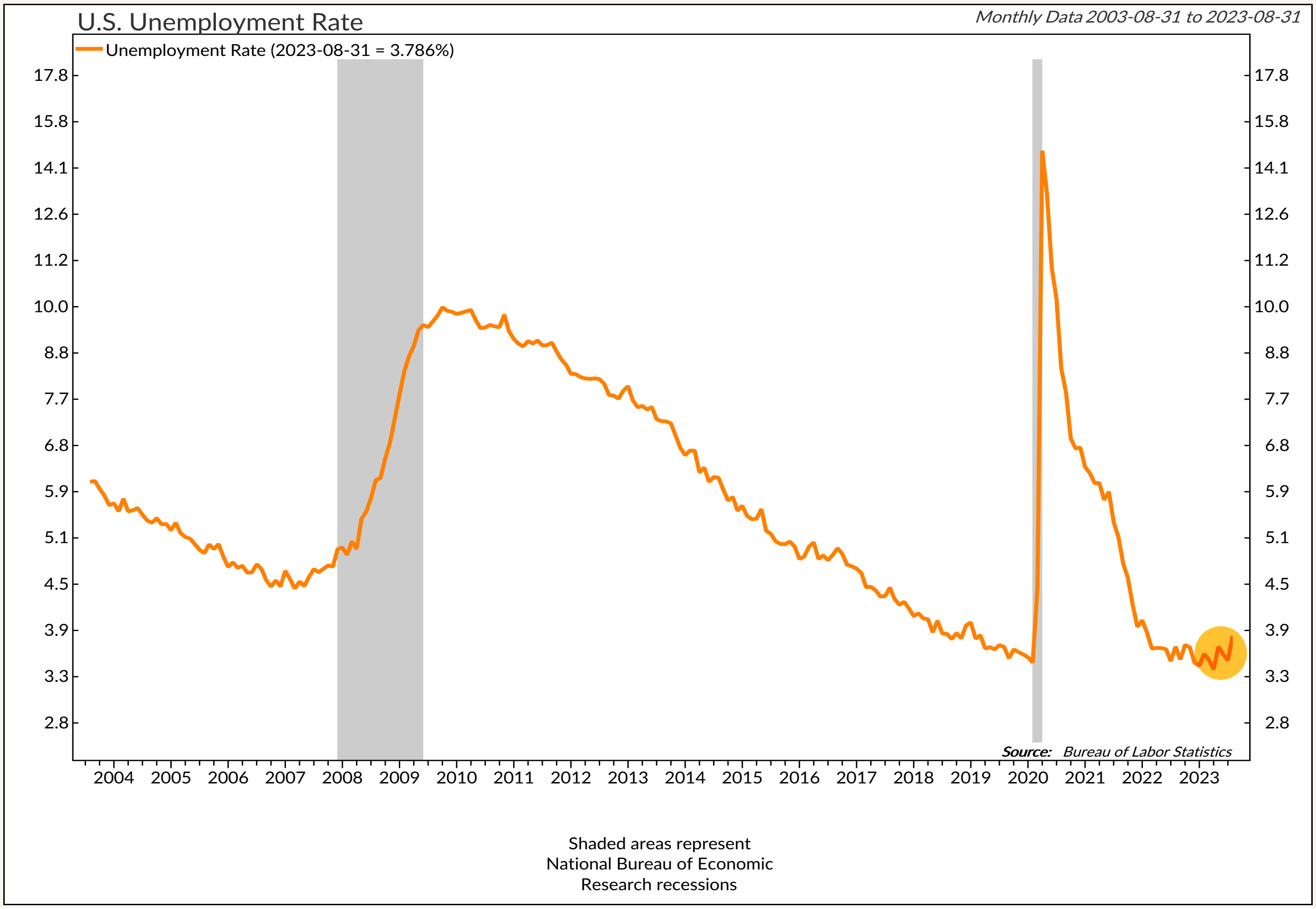
U.S. economy: Continued signs of soft landing

The U.S. economy has been surprisingly resilient this year despite higher interest rates, 525 basis points of Fed rate hikes since March of last year, and still-elevated inflation. Real gross domestic product (GDP) expanded at an annualized rate of 2.4% in Q2, following a 2.0% gain in Q1. The Atlanta Fed's GDP-Now model is tracking at over a 5% annualized rate for Q3.

Moreover, just two of the 10 indicators in our U.S. Recession Watch Report are flashing negative signals, indicating the risk of near-term recession is low. The consistent growth driver has been the consumer. Excess pandemic savings remain positive, according to our calculations, which has helped keep consumer spending strong. Real wages are now rising, indicating increased purchasing power. Not surprisingly, consumer confidence and small business confidence have been increasing in recent months.

Additionally, reducing labor demand without causing a rise in unemployment will be an important feat for the Fed and a hallmark of a soft landing, post-Jackson Hole meetings (chart below). The amount of policy tightening already in the pipeline is expected to be a headwind to real GDP growth over the next 12 months, but likely not enough to cause a recession in the short term. However, we still think there's a decent probability for a U.S. recession in 2024.

Fewer job openings but no rise in unemployment



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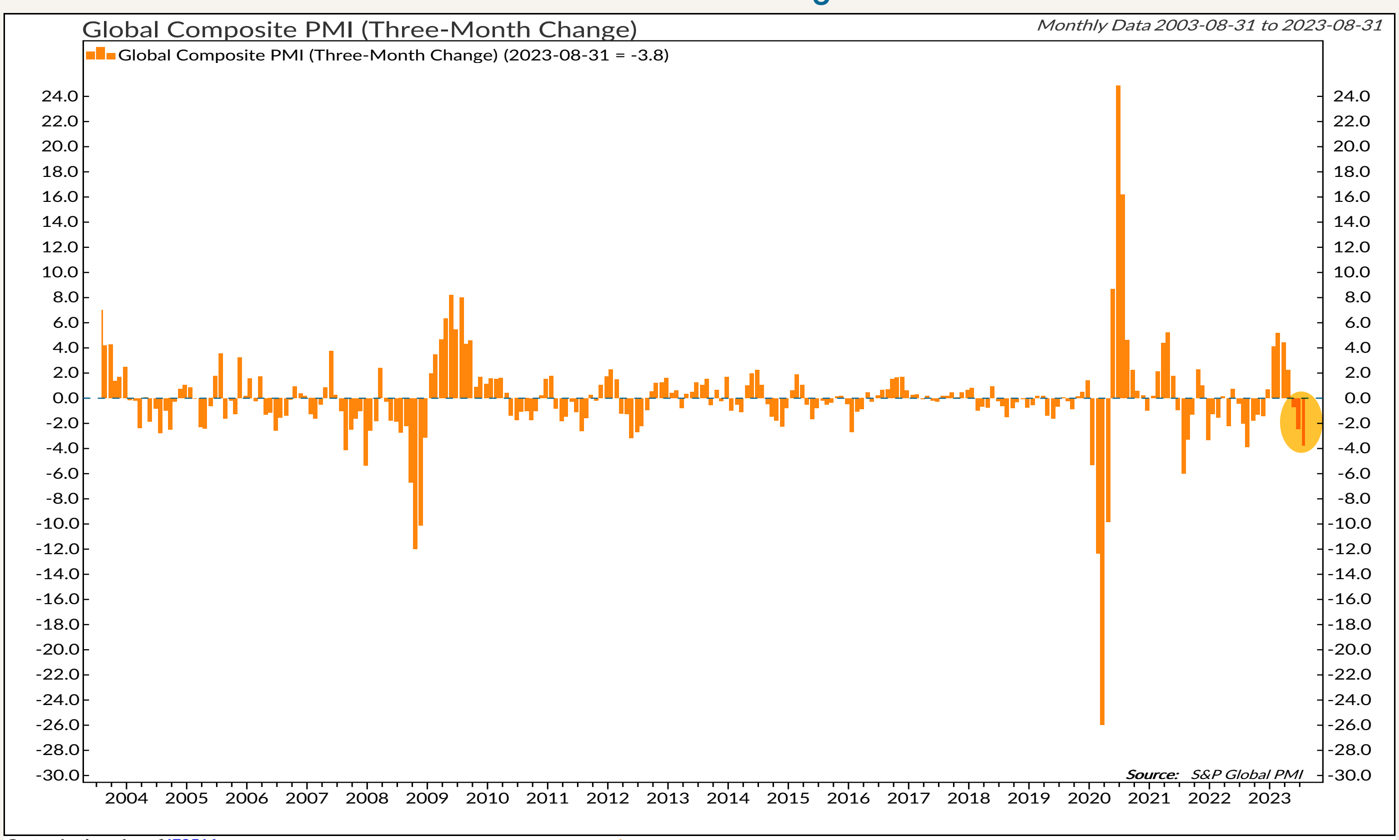
International economy: Global growth slows

After a strong first half of the year, the global economy saw economic momentum ease for a third straight month in August, according to the latest global PMIs. This supports our narrative of a tougher second half for the world economy, as presented in our 2H outlook in June. The global composite PMI (comprised of services and manufacturing, chart below) fell 1.1 points in August, its third straight decrease, to 50.6, indicating its slowest growth since January. The easing momentum is historically associated with less upside in global stocks, supporting our view of choppier stock market performance in 2H.

Despite the moderating expansion, there isn't sufficient evidence to suggest that the global economy is entering a severe recession, which has historically been associated with the worst bear markets for stocks. Many of the indicators in our Severe Global Recession Watch Report are far from their recessionary thresholds. This includes the composite PMI, which would need to fall below 47.8 to trigger a signal. Moreover, some forward-looking indicators in the PMI report, such as the future output index, improved in August.

However, the risk of a sustained moderate global slowdown is a real possibility amid diverging trends among the world's economies. Europe, which was a major source of rising momentum in the first half of the year, has seen activity ease markedly in recent months, and is even flirting with the prospect of recession. Trends in China and the U.S. remain positive, but not as much as the first half of the year, while Japan and several large emerging markets, such as India, continue to report robust activity.

Global economic momentum continued to ease in August



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Fixed income: Where we are and what's ahead

We have previously argued that the biggest risks for the bond market were an un-anchoring of inflation expectations and a higher term premium, which could push 10-year Treasury yields back toward 5.25%, where they were in 2006-07.

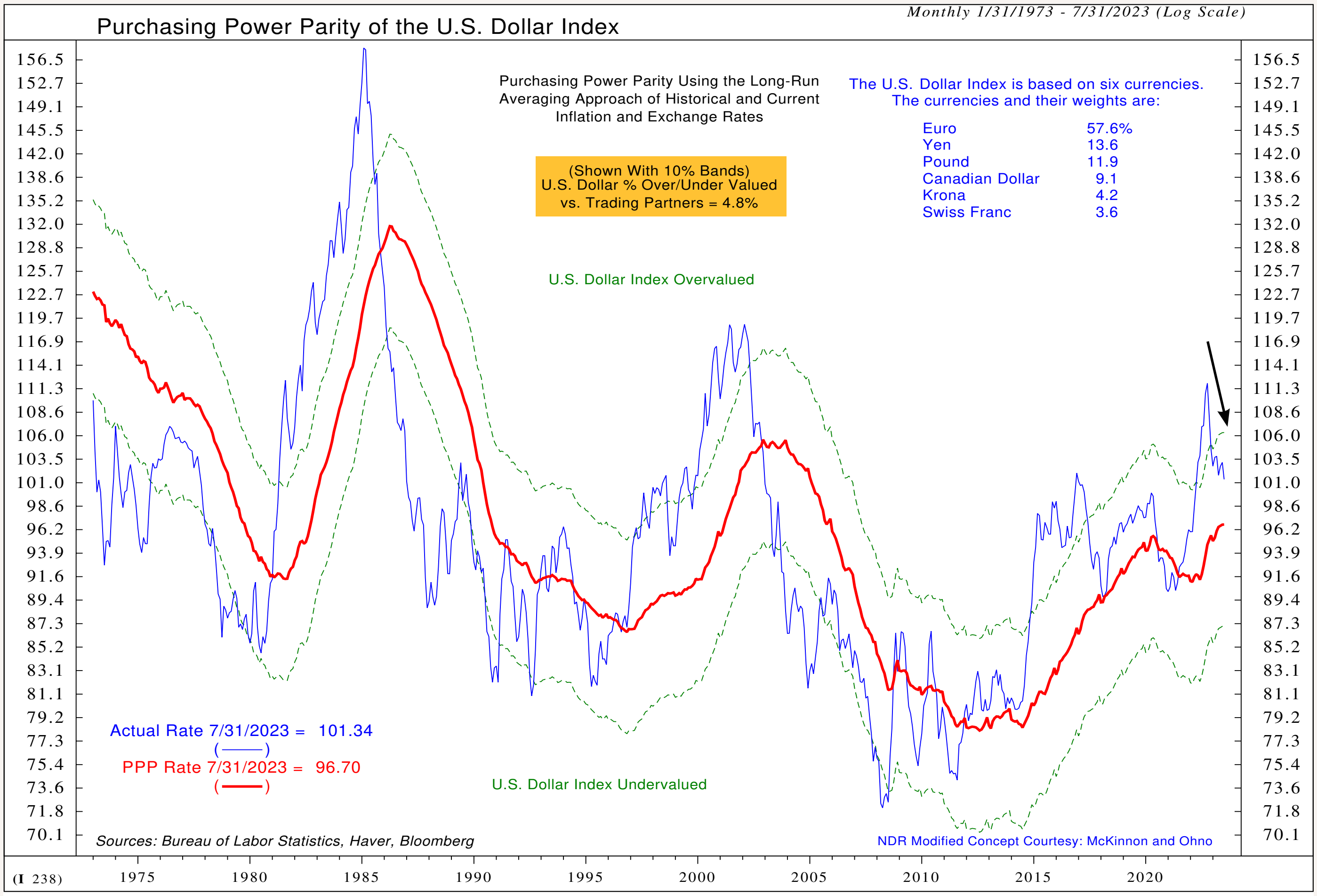
We've been totally on board with a higher yield structure over the intermediate to longer-term. The debate is over the timing. We expected inflation to fall hard into the spring and summer months, which it has. Further progress over the balance of the year may prove more difficult.

Led by mostly by energy, commodity prices have bounced, and base effects are reversing. House prices have rebounded, and rents have stabilized, which could cause shelter costs to remain sticky.

We also see a weaker U.S. dollar (USD) to be our biggest macro trade over the next 3-5 years. This has been on our radar ever since the USD became 18% overvalued last September (chart below).

The overvaluation has since been reduced, falling out of extreme territory to 4.8% in July. The U.S. Dollar Index, which is heavily weighted toward the euro, has declined 9.4% from its September peak. Additionally, a more balanced labor market from downward revisions could put pressure on the Fed's expected policy path, reducing rate differentials, and weighing on the U.S. dollar.

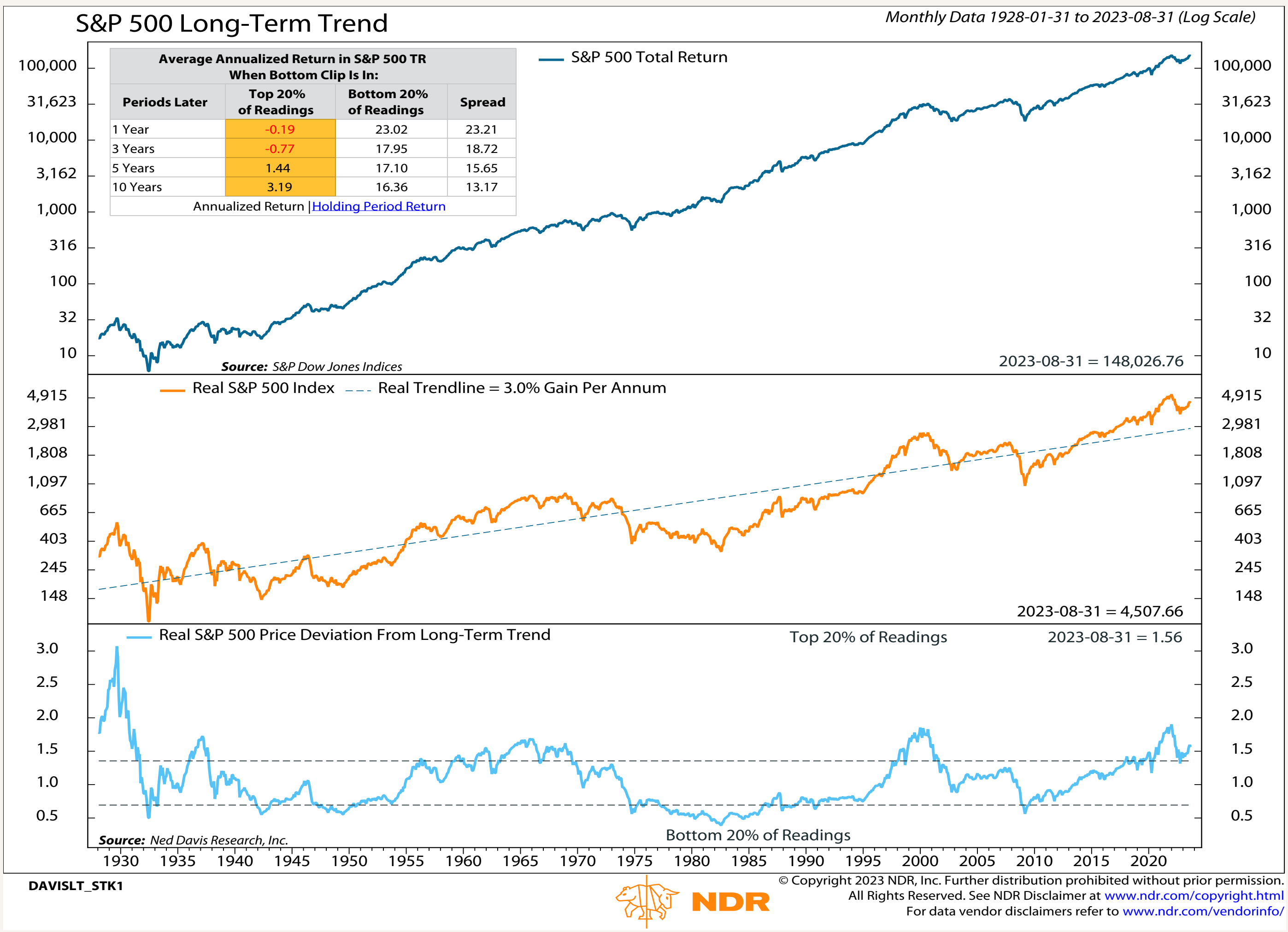
U.S. Dollar Index retreating from overvalued territory



Investment implications: Trend leans bullish

- General stock market trend evidence remains bullish short-term to long-term. The long-term evidence is shown by the rising linear regression trendline of the real (inflation-adjusted) S&P 500 price (chart below, middle clip).
- There have been no 20-year periods since 1925 where the S&P 500 total return was not bullish, and this includes 1929.
- Nevertheless, we are currently well above the longer-term trendline (bottom clip), suggesting the market is extended on the upside. Looking out over the next 1-to-10 years, average annualized returns could range from slightly negative to moderately positive (table below, top clip).

Long-term trend is up, but S&P 500 extended



Average Annualized Return in S&P 500 TR When Bottom Clip Is In:

Periods Later	Top 20% of Readings	Bottom 20% of Readings	Spread
1 Year	-0.19	23.02	23.21
3 Years	-0.77	17.95	18.72
5 Years	1.44	17.10	15.65
10 Years	3.19	16.36	13.17

Annualized Return | Holding Period Return

U.S. equities: A compelling historical study

The U.S. stock market started 2023 strong and has barely looked back. The S&P 500 Index jumped 7.0% in Q1, added another 8.3% in Q2, and still another 3.1% in July. Through seven months, the S&P 500 soared 19.5%, its strongest start since 1997 and 10th best since 1926. The only drawdown of more than 5% was a 7.8% decline from February 2 to March 13, a period that included the second- and third-largest bank failures in U.S. history.

We took a look at all cases since 1926 when the S&P 500 Index rose at least 10% year-to-date through July and declined in August (table below). From August 31 through year-end, the S&P 500 has risen 14 out of 14 times by an average of 9.9% versus an average of 1.9% for all September-to-December periods.

The NDR Cycle Composite (a combination of the 1-, 4-, and 10-year cycles) for 2023 suggested another seasonally weak period heading into August, and on cue, the S&P 500 slipped 1.8%. Was August the start of a prolonged downtrend, or was it a healthy correction? History sides with the latter. Recent weakness could have further to go, but strong starts to the year followed by a pullback are often followed by further gains through year-end.

After >10% through July & ↓ August, big gains through year-end, on average

S&P 500 Index Performance September - December When January - July >10% & August <0%

Year	12/31 - 7/31 (%)	7/31/- 8/31 (%)	8/31 - 12/31 (%)
1938	17.5	-2.7	9.5
1954	24.5	-3.4	20.6
1955	21.0	-0.8	5.3
1964	10.9	-1.6	3.6
1967	18.0	-1.2	3.0
1975	29.5	-2.1	3.8
1976	14.7	-0.5	4.4
1985	14.2	-1.2	12.0
1988	10.1	-3.9	6.2
1995	22.4	0.0	9.6
1997	28.8	-5.7	7.9
1998	15.5	-14.6	28.4
2013	18.2	-3.1	13.2
2019	18.9	-1.8	10.4
2023	19.5	-1.8	??
Mean	**18.9**	**-3.0**	**9.9**
Median	**18.1**	**-2.0**	**8.7**
% Positive	**100.0**	**0.0**	**100.0**
All Periods Mean	**5.2**	**0.7**	**1.9**

2023 case not included in summary statistics.
Source: S&P Dow Jones Indices

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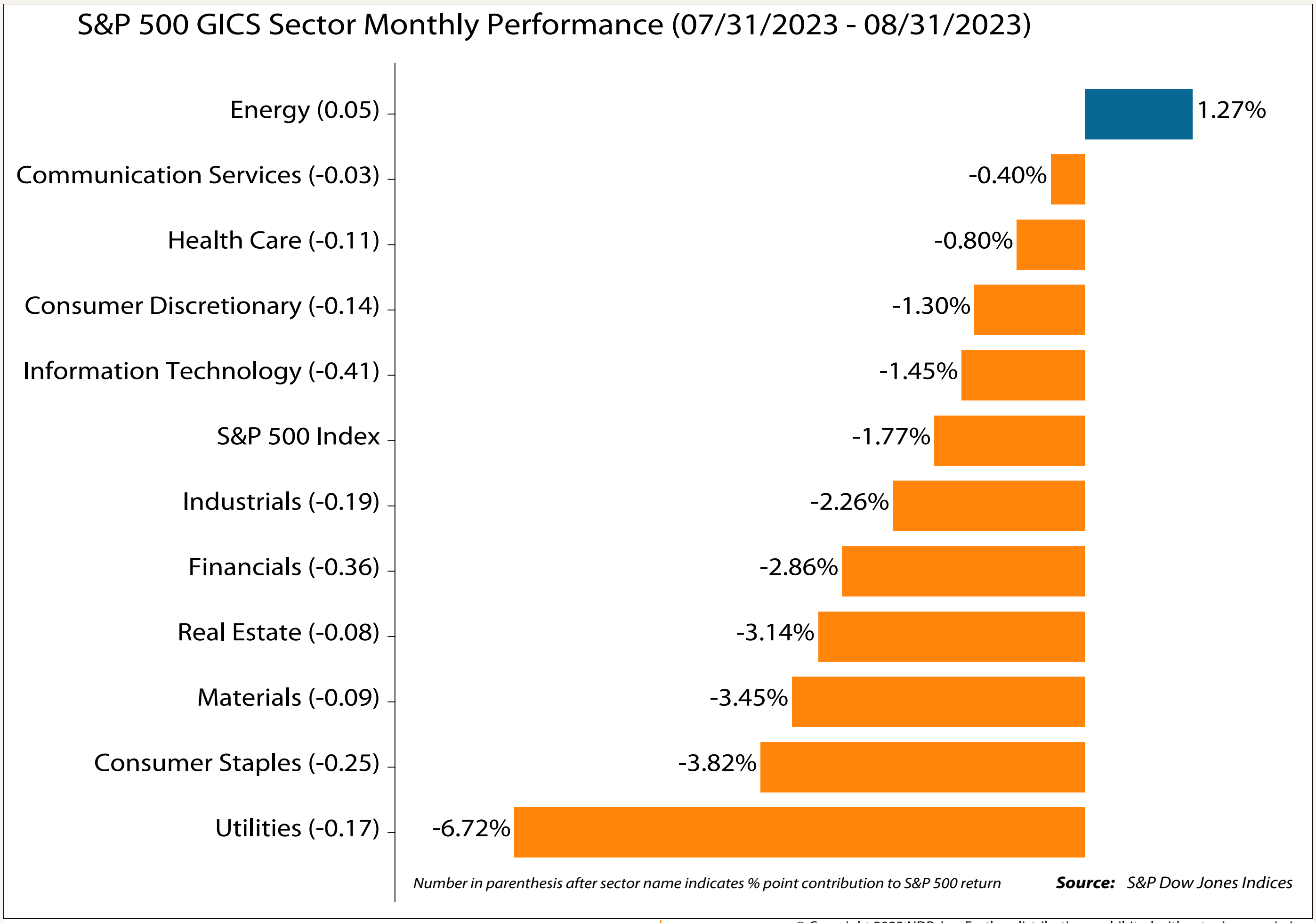
U.S. sectors: Rates impacted sector leadership

The S&P 500 fell 1.8% in August, registering its first monthly decline since February. All sectors other than Energy finished the month in negative territory (chart below). Despite the broad weakness, leadership was more cyclical than defensive, with low-beta sectors of Utilities and Consumer Staples finishing as the worst performers for the month.

The combination of a resilient economy and a moderation of inflation improvement has led to growing expectations that the Fed will have to keep rates higher for longer to bring inflation closer to its 2% target. The recalibrated outlook has now led to a surge in long-term bond yields. In general, rising yields have been associated with a strong economy and outperformance from the most economically-sensitive, cyclical Value sectors. We lifted Energy to overweight, supported by a rising 10-year Treasury yield and bullish readings from our Crude Futures and Commodity models.

Entering September, the sector model is overweight Information Technology, Communication Services, and Utilities. While Consumer Discretionary, Consumer Staples, Materials, and Real Estate are underweight.

All sectors but Energy were down in August



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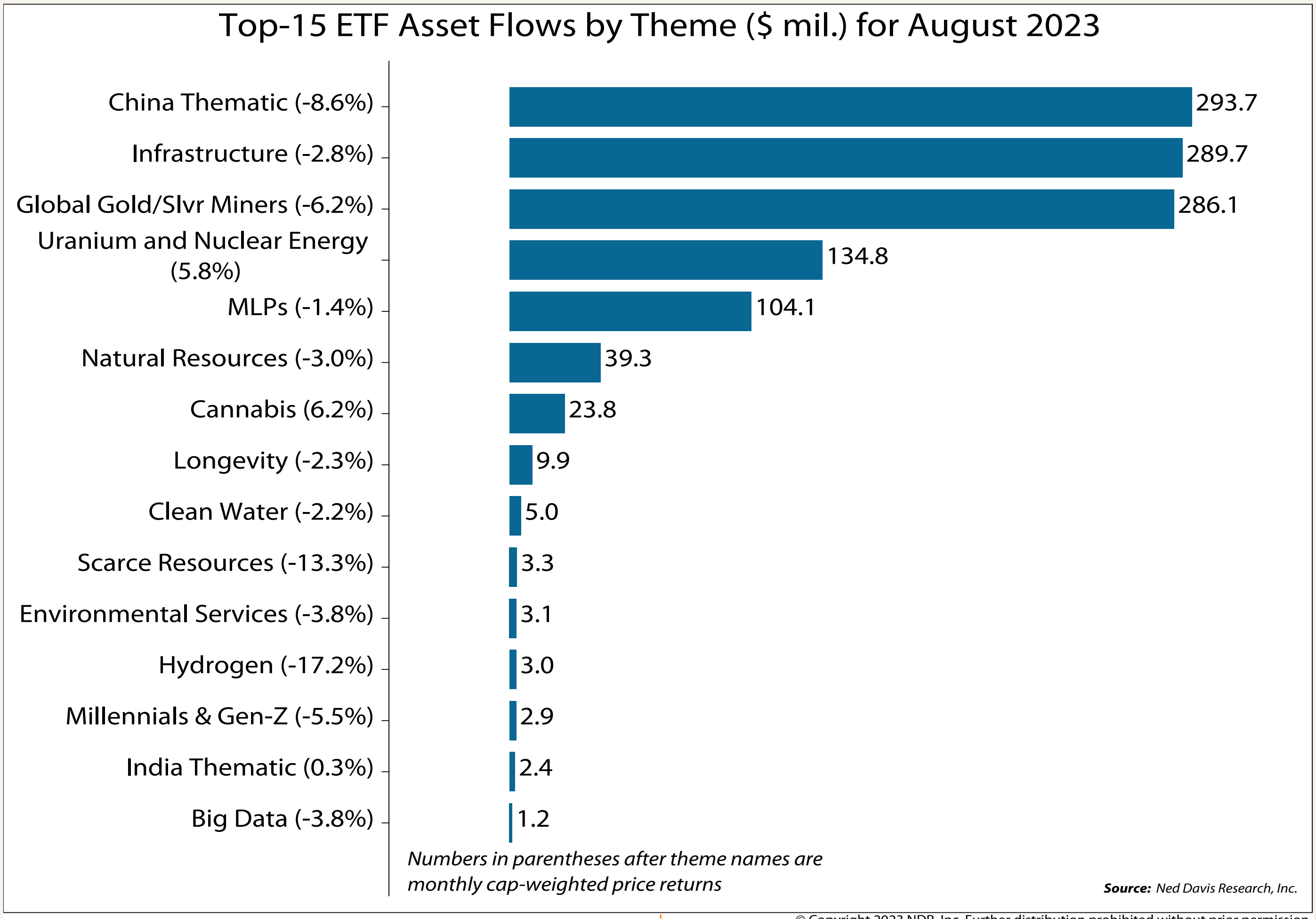
Themes: Taking a breather

After three strong months, the thematic space was due to cool. Only 7 of 51 themes (13%) outperformed the S&P 500 (-1.8%) in August, the worst showing since January 2022. Highlights from our three groups:

- Technology (-6.6%) saw only 2 of 17 themes outperform — Cybersecurity and Cloud. Even though the Tech group was among the worst performers, our cap-weighted Tech Titans theme outperformed the S&P 500 (-1.8%) by 100 basis points.
- Demographics (-5.2%) saw only 2 of 19 themes outperform — Cannabis and India Thematic.
- Global Shock (-6.9%) saw only 2 of 15 themes outperform — Uranium and Master Limited Partnerships (MLPs). This is a commodity-heavy group and was the worst-performing group of the three groups we follow.

Last month's performance was to be expected given the broad risk-off sentiment and strong rallies over the last three months. Despite expected increased volatility over the next few weeks, we maintain our overweights on AI and China Tech. We upgraded Uranium/Uranium Producers on August 30, based on expected supply constraints and an increased focus as an alternative energy in the U.S.

Commodity-related themes saw positive flows



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International equities: Earnings influence

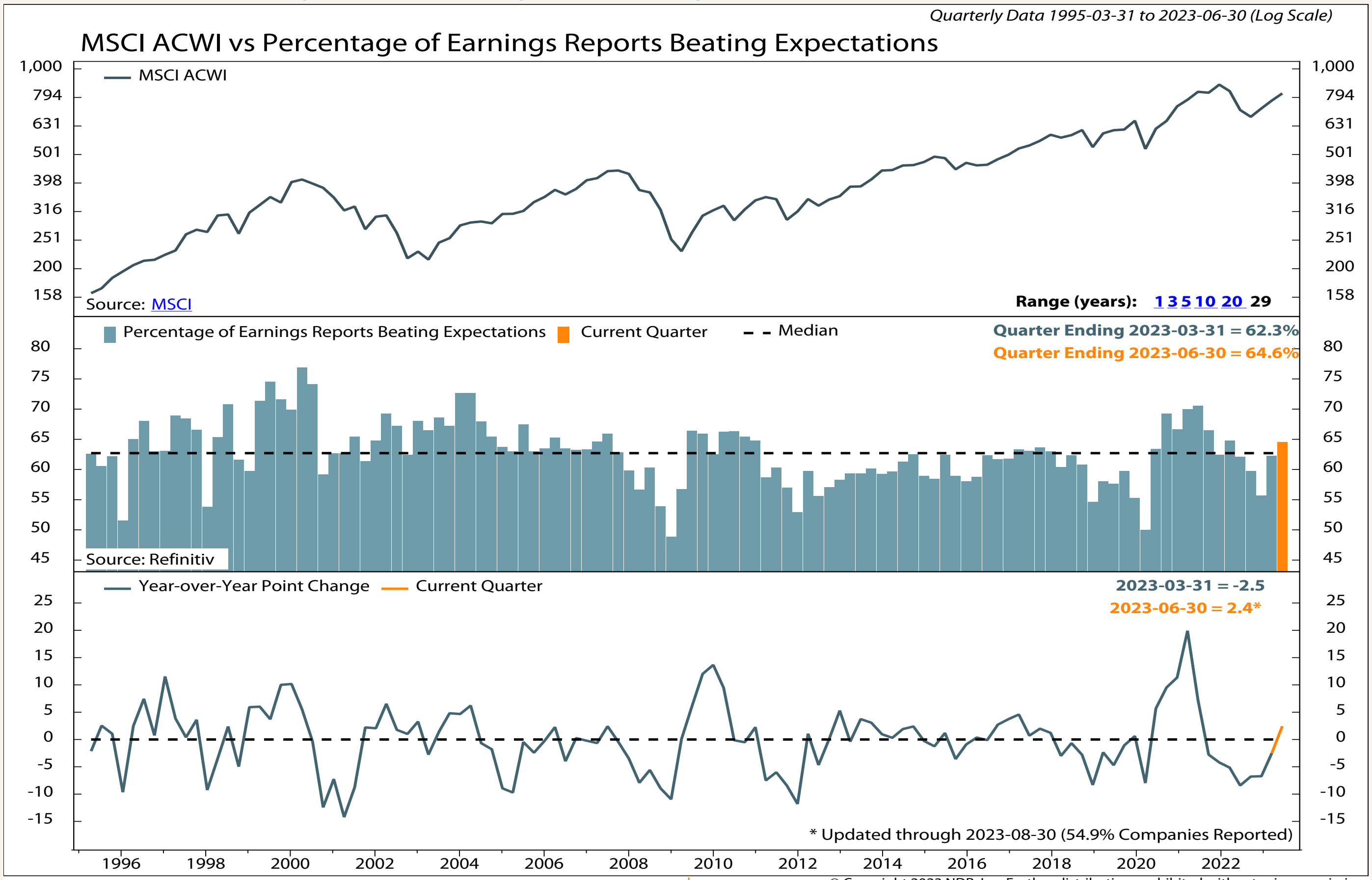
The current phase of the earnings cycle is a bullish influence on global equities. And if the next earnings season brings more of what we've seen during the current one, then there's a good chance that fourth quarter equity performance will have the degree of strength consistent with historical tendencies.

Over the three months starting at the end of September and ending at year-end, global stocks have had a mean gain of 4.4% and have risen in 83% of the cases since 1987, both higher than any other three-month period.

Earnings have become a positive driver in several ways. First, beat rates have been positive and gaining momentum. Second, the earnings advance has been led by rising percentages of companies with earnings upgrades. Third, forward earnings growth has been leading trailing earnings growth that has been bottoming out in most cases, currently indicating that an ongoing earnings uptrend can be expected.

65% of second quarter earnings reports have beaten expectations after reports from 55% of the component companies. The global earnings beat rate's year-to-year point change has reached its highest level in nearly two years (chart below).

Global stock earnings beat rate high and rising



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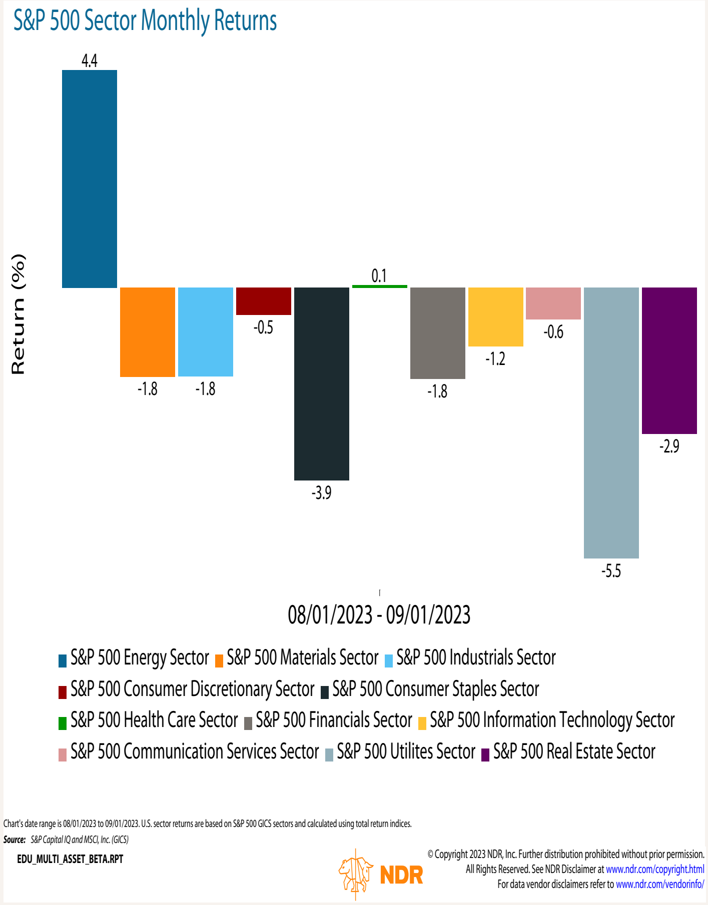
August - Monthly Returns



ASSET CLASS BENCHMARK PERFORMANCE

2023 Q2	2023 June	2023 July	2023 August	Year-to-Date	Rolling 1-Year Through 08/31/2023
NASDAQ 12.81	S&P 500 TR 6.61	S&P GSCI 9.80	Dollar 1.72	NASDAQ 34.09	NASDAQ 18.78
S&P 500 TR 8.74	NASDAQ 6.59	EM 5.30	T-Bills 0.44	S&P 500 TR 18.73	S&P 500 TR 15.94
S&P 500 8.30	S&P 500 6.47	NASDAQ 4.05	S&P GSCI -0.33	S&P 500 17.40	EAFE 14.07
EAFE 4.28	DJIA 4.56	DJIA 3.35	Bond Agg -0.64	EAFE 11.88	S&P 500 13.97
DJIA 3.41	EAFE 3.60	S&P 500 TR 3.21	S&P 500 TR -1.59	Gold 6.73	Gold 13.83
EM 1.71	EM 3.45	S&P 500 3.11	Gold -1.63	EM 5.95	DJIA 10.19
T-Bills 1.28	S&P GSCI 2.32	Gold 2.62	S&P 500 -1.77	DJIA 4.75	T-Bills 4.70
Dollar 0.32	T-Bills 0.43	EAFE 1.67	EAFE -1.84	T-Bills 3.37	EM 2.32
Bond Agg -0.84	T-Bonds -0.02	T-Bills 0.44	NASDAQ -2.17	Bond Agg 1.37	Bond Agg -1.19
T-Bonds -2.30	Bond Agg -0.36	Bond Agg -0.07	DJIA -2.36	Dollar 0.11	Dollar -4.63
Gold -2.37	Dollar -1.25	Dollar -1.01	T-Bonds -2.79	T-Bonds -1.36	T-Bonds -9.69
S&P GSCI -5.85	Gold -2.19	T-Bonds -2.17	EM -4.68	S&P GSCI -3.06	S&P GSCI -11.19

All data in local currency and price only unless specified as total return (TR). Sources: MSCI,Barclays, Commodity Systems, Inc. (CSI) www.csidata.com, IDC, Ned Davis Research, Inc., S&P Dow Jones Indices.

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Citations

Excerpts from the following NDR publications:
"Global growth slows again, should we be worried?" by Alejandra Grindal, September 7, 2023
"G7 and BIC Outlook – Diverging trends" by Alejandra Grindal, August 26, 2023
"Where we are and what's ahead" by Joe Kalish, August 21, 2023
"My biggest macro trade" by Joe Kalish, August 31, 2023
"A compelling historical study and whether it applies to 2023" by Ed Clissold, September 6, 2023
"Monthly sector update – September 2023" by Rob Anderson, September 6, 2023
"Thematic update September 2023" by Pat Tschosik, September 6, 2023
"A bullish earnings influence" by Tim Hayes, August 31, 2023

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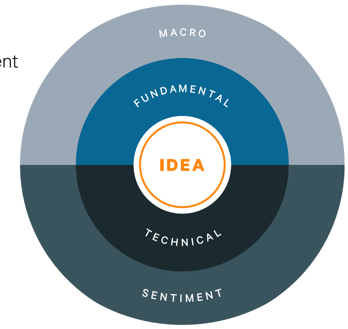

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