

Quarterly Market Outlook

October 2023

Economic and Market Backdrop

Despite the most aggressive tightening in four decades, the U.S. economy and equity markets have been resilient. A rebound in housing, strong consumption, and substantial government spending are leading many to predict a soft landing, and earnings estimates have been rising. Meanwhile, inflation has come down: supply chain bottlenecks have resolved and rent growth has flattened, which may give the Fed room to pause.¹

A Less Rate-Sensitive Economy?

Tightening normally slows the economy, but its impact thus far has been muted. The corporate and housing sectors are far less levered than in 2008, and both locked in record-low rates and termed out their debt during Covid, leaving them relatively insulated from rate hikes while now earning 5%+ on their cash. Moreover, the primary drivers of growth today have been stimulus, rising incomes and increased deficit spending rather than credit, while post-pandemic consumption has been dominated by services (which are less rate-sensitive) rather than goods.²

Credit Still Matters

Tightening flows through to the economy with a lag, and we are now 18 months in. Notwithstanding differences this cycle, credit remains the lifeblood of the economy and continues to tighten, as banks face capital constraints and deteriorating profitability, and securitization markets (another source of financing) remain largely shut. New borrowing at current rates is increasingly unaffordable – whether for businesses or real estate owners that need to roll debt or borrow to invest, or for households looking to buy a house or car.³

Calm Before the Storm?

Much of what supported the economy is now reversing. Student loan payments have resumed, excess Covid savings are finally running out, wage growth may be softening, and corporate profits are falling. At the same time, credit-card and auto delinquencies and corporate default rates are on the rise. In addition, more workers are on strike, and with oil quietly surging 29% in Q3 and inflation still above target, the Fed may have to keep rates elevated or raise them further to bring inflation back to 2%, even as recession risks continue to mount.⁴

Commercial Real Estate Headwinds

Since the 1980s, commercial real estate has ridden a wave of declining interest rates, favorable tax reform, bank lending and financialization, often with government support, that spurred a building boom and sent property values to record levels. The sector is now being challenged as over \$1 trillion in debt matures over the next couple of years. With construction, operating and financing costs up and rents starting to dip, transaction activity is likely to remain depressed until prices adjust – both for troubled sectors like office and even investor favorites like multifamily, where many markets face an influx of supply. We continue to seek responsible partners that can not only navigate through this environment but take advantage of the opportunities it will likely present.⁵

Equities Cool; Bonds Sell Off

The S&P 500 cooled this quarter but is still up ~13% on the year, led by megacap tech, despite another 100 bps in Fed rate hikes and rising long-term bond yields, which are up over 70 bps YTD. Nominal and real yields are now above 4.5% and 2.2%, respectively – levels not seen since before the Global Financial Crisis. And with the P/E ratio for the S&P 500 at 20, the gap between U.S. earnings yields and Treasury yields has narrowed considerably. At the same time, Treasuries still face ongoing pressure from quantitative tightening (QT) and substantial issuance expected through year-end, while demand from China and Japan continues to weaken – all of which may continue to pressure yields higher and weigh on asset prices (as higher rates reduce the present value of future cash flows).⁶

Building a Robust Portfolio

Economic and market cycles unfold gradually, then suddenly. And with so many firsts and extremes – Covid, QE, fiscal stimulus, inflation, war, tightening, deglobalization – forecasting how this one will unfold seems particularly perilous. We believe it is critical for investors to build diversified portfolios that are robust to different outcomes, including the risks of recession and stagflation. In that context, we think diversification remains essential and skilled managers in both the public and private markets can play a valuable role, as they can act opportunistically and potentially add value regardless of how markets perform.

Notes

All data as of 9/30/23.

¹ Bloomberg (DOTS, FEDL01 Index, CPI YOY Index); [Resilient U.S. Economy Defies Expectations – WSJ](#); [Housing-Market Rebound Poses Challenge for Fed's Inflation Fight – Bloomberg](#); [US retail sales beat expectations as Americans pay more for gasoline | Reuters](#); [The federal deficit surges, nearly tripling in the last nine months : NPR](#); [Earnings Estimates Are Rising, a Welcome Sign for 2023 Market Rally – WSJ](#); [Calculated Risk: Asking Rent Growth Flat Year-over-year \(calculatedriskblog.com\)](#); [Why Higher Unemployment Is Good News Now – WSJ](#); [Global Supply Chain Pressure Index \(GSCPI\) - FEDERAL RESERVE BANK OF NEW YORK \(newyorkfed.org\)](#).

² [Why the U.S. economy is so immune to the Fed's rate hikes \(axios.com\)](#); [The Economy's Surprising Resilience Has Big Implications for Fed Interest Rates | Barron's \(barrons.com\)](#); [Why Has Monetary Policy Tightening Not Cooled the Labor Market Enough to Quell Inflation? - Federal Reserve Bank of Kansas City \(kansascityfed.org\)](#).

³ [Long and Variable Lags in Monetary Policy | St. Louis Fed \(stlouisfed.org\)](#); [CRE Lending Down 52 Percent Annually: Newmark – Commercial Observer](#); [‘Almost All Loans Are Bad’—Why Banks Aren’t Lending – WSJ](#); [The Fall in Home Prices May Already Be Over – WSJ](#); [Rates Are Up. We’re Just Starting to Feel the Heat. – WSJ](#).

⁴ [The \\$1 trillion ‘wall of worry’ for commercial real estate that spirals through 2027 – MarketWatch](#); [Landlords with \\$1.2 trillion of debt face rising default risk - Los Angeles Times \(latimes.com\)](#); [‘We’re in the first inning of the commercial real estate correction,’ billionaire real estate investor Jeff Greene says | Fortune](#); [Apartment rents on verge of declining due to massive supply \(cnbc.com\)](#).

⁵ [Student-Loan Restart Threatens to Pull \\$100 Billion Out of Consumers’ Pockets – WSJ](#); [The Rise and Fall of Pandemic Excess Savings | San Francisco Fed \(frbsf.org\)](#); [A Soft Corporate-Earnings Season Poses Next Test for Stock Market Rally – WSJ](#); [Corporate Profits: A Rapid Rebound by 2024? | Morgan Stanley](#); [US labor market softens as job openings drop, layoffs at highest level in over two years | Reuters](#); [Credit card, car loan delinquencies rise above pre-pandemic levels \(axios.com\)](#); [Corporate defaults jump, highest August monthly tally since 2009, S&P says | Reuters](#); [Why America is on strike: writers, auto workers, and actors | CNN Business](#); [U.S. Stock Futures Slip as Higher Oil Prices Renew Inflation Fears \(barrons.com\)](#).

⁶ Bloomberg (SPX Index, USGG10YR Index, GTII10 Govt); [S&P 500 Dividend & Earnings Yield \(yardeni.com\)](#); [US Ramps Up Debt Issuance, Adding Fuel to Selloff in Treasuries – Bloomberg](#); [China, Japan share of US bond market shrinks to record low | Reuters](#).

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