CETERA® INVESTMENT MANAGEMENT

2023 FOURTH QUARTER OUTLOOK

Bears Peek from Dens as Economy Brightens

Overview

As we enter the last quarter of the year, investors are becoming increasingly optimistic about the future of inflation, the economy and fed policy. The optimism, however, is tempered with some healthy skepticism around overhanging risks to both the economy and the markets.

The third quarter saw relatively flat equity returns (as of this writing) and year-to-date the S&P 500 is relatively close to recovering all of last year's decline. As we pointed out in last quarter's Market Outlook, returns were driven in large part by large growth companies that make up an oversized portion of the index. So far, markets have overcome various possible pitfalls from a few regional bank failures to a debt ceiling debate that theoretically could have caused a default on U.S. Treasuries. Looking ahead, the new overhangs in the fourth quarter will likely include the possibility of a government shutdown in early October.

The good news (and bad news) is that government shutdowns are nothing new; this would be the 22nd shutdown since 1976. With markets largely overlooking the debt ceiling debates, we anticipate markets will take any potential shutdown with a grain of salt. Markets tend to trade down on news of a shutdown but recover quickly.

Another possible pitfall facing investors are rising oil prices, which may eventually feed into inflation figures and catch the attention of the Fed, and thus cause another rate hike before year-end. Additionally, there are high valuations in stocks that make up a large portion of major indexes, as mentioned above.

Aside from these potential overhangs, economic data has been surprising to the upside most of this year. Surveys given to business leaders in both the manufacturing and service sectors appear to be improving, while inflation is moderating. Additionally, the labor market is moderating which is good news because labor market imbalances fueled wage inflation. This is something the Fed is looking at closely in creating Fed policy, so with wage inflation and inflation overall dissipating, it could give the Fed room to pause its rate hikes for the remainder of the year, although one more hike could still be on the table.

So, while economic data is relatively weak in some respects, it is showing signs of improvement, which has many economists changing their projections for a possible recession. If we do see a recession, it would likely not be until next year and likely be mild.

Your financial professional can help you stay on track and keep focused on your personalized long-term plans, helping you navigate a changing economy.

For a quicker look into what we are thinking and what is happening in the economy and markets, check out our 2023 Fourth Quarter Outlook Summary.

At-A-Glance

U.S. Gross Domestic Product (GDP) growth for the second quarter was 2.1% and the first quarter was revised higher to 2%. The Atlanta Fed is estimating third quarter GDP growth to be near 5%, ahead of consensus estimates of near 3%.

The Consumer Price Index (CPI) increased to 3.7% year-over-year in August, but more importantly, Core CPI slowed to 4.3%. Gas prices rose, pushing up headline inflation, but core CPI strips out volatile metrics such as gasoline and food prices.

Rates were increased only 0.25% by the Fed in the second and third quarters, putting the current target range at 5.25% to 5.50%.

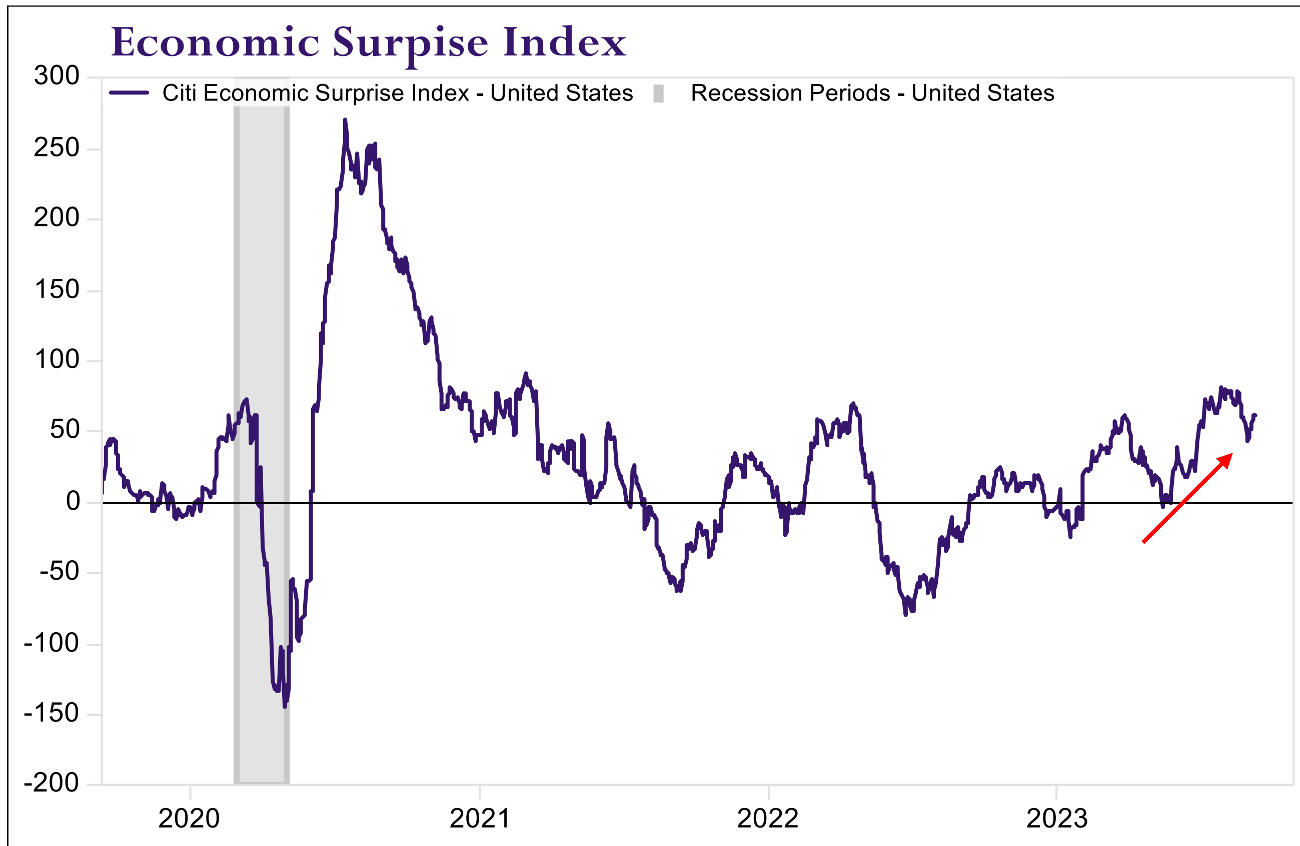
After climbing the wall of worry in the second quarter, stock returns have been muted in the third quarter as investors digest better-than-expected economic data, moderating inflation, and the Fed's response to these changes.

Bond yields have climbed higher on better-than-expected economic growth and a Federal Reserve that has not waivered on its stance to keep rates higher for longer. Higher bond yields have helped mitigate bond losses.

U.S. Economy

Economic resilience has been the theme of the third quarter. Economic data has largely surprised to the upside in the second half of this year **(Figure 1)**, just as we predicted, albeit sooner than we had anticipated. Looking at the Citi U.S. Economic Surprise Index, economic data has beaten expectations since late May and most of this year. This has many economists changing their recessionary outlooks. We have spoken at length about different recession scenarios. Will we experience a deep or shallow recession or no recession at all? While we have been more tempered in our outlook, calling for a shallow recession at some point in the next year, the idea of no recession is gaining traction with economists. As a reminder, a recession is a significant decline in economic activity spread across the economy that lasts longer than a few months. These are feared because when economic activity slows, companies are forced to lay off workers and their profits decline as people cut back on spending.

Figure 1: Citi Economic Surprise Index



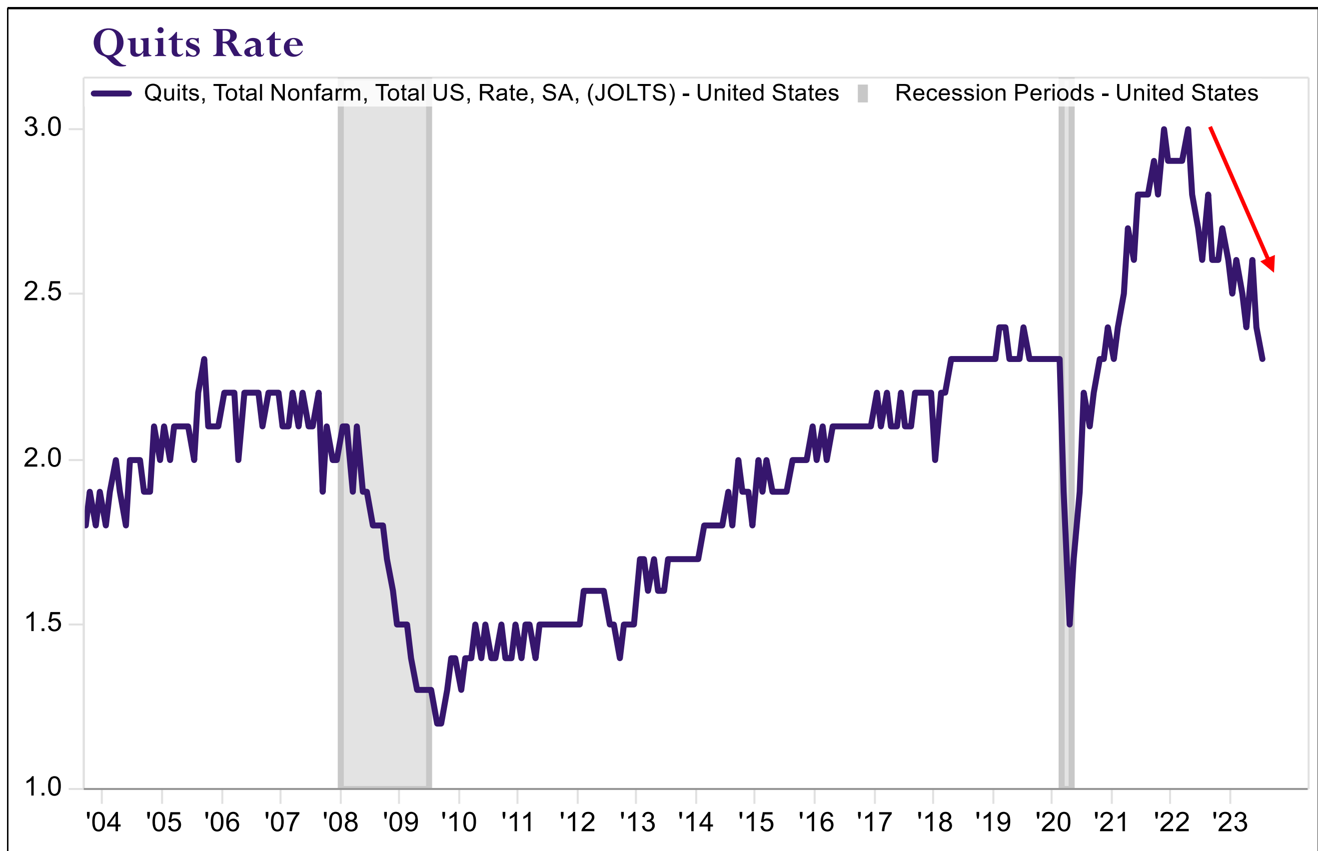
Source: Cetera Investment Management, FactSet. Data as of 9/8/2023.

While some key economic indicators that have forecasted past recessions are flashing red, could this time be different? The Conference Board's Leading Economic Index (LEI) is an index comprised of 10 leading economic indicators. Anytime we have fallen to these current levels, we have experienced a recession. The LEI is still negative year-over-year; however, the index is declining by slightly shallower levels in recent months, and many argue this index is weighted too heavily toward the manufacturing sector, which has already experienced a recession. This observation leads us to the potential goldilocks scenario we have described before—that the U.S. economy could avoid a broad-based recession as different areas of the economy go into a recession at different times (a rolling or sector recession).

The United States is a service-driven economy, and the service sector has kept the country out of a recession. Interest-rate-sensitive parts of the economy are already starting to rebound. Surveys of home builders have painted a better picture for the housing market and vehicle sales have been rising, although still below pre-pandemic levels.

Giving even more credence to a rolling recession (rolling through different economic sectors at different times), is the continued moderation of inflation data and relative health of the labor market. Job openings are falling but are still above pre-pandemic levels. This is good news for wage inflation as companies will have less competition for qualified candidates. This is also evidenced in the quits rate (**Figure 2**), a metric that the Fed has been looking at closely. People generally don't quit their jobs to move to another employer unless they can make more money, so if the quit rate is falling it can tell us that potential workers are not being offered as much money, which is good for softening wage inflationary pressures.

Figure 2: Quits Rate

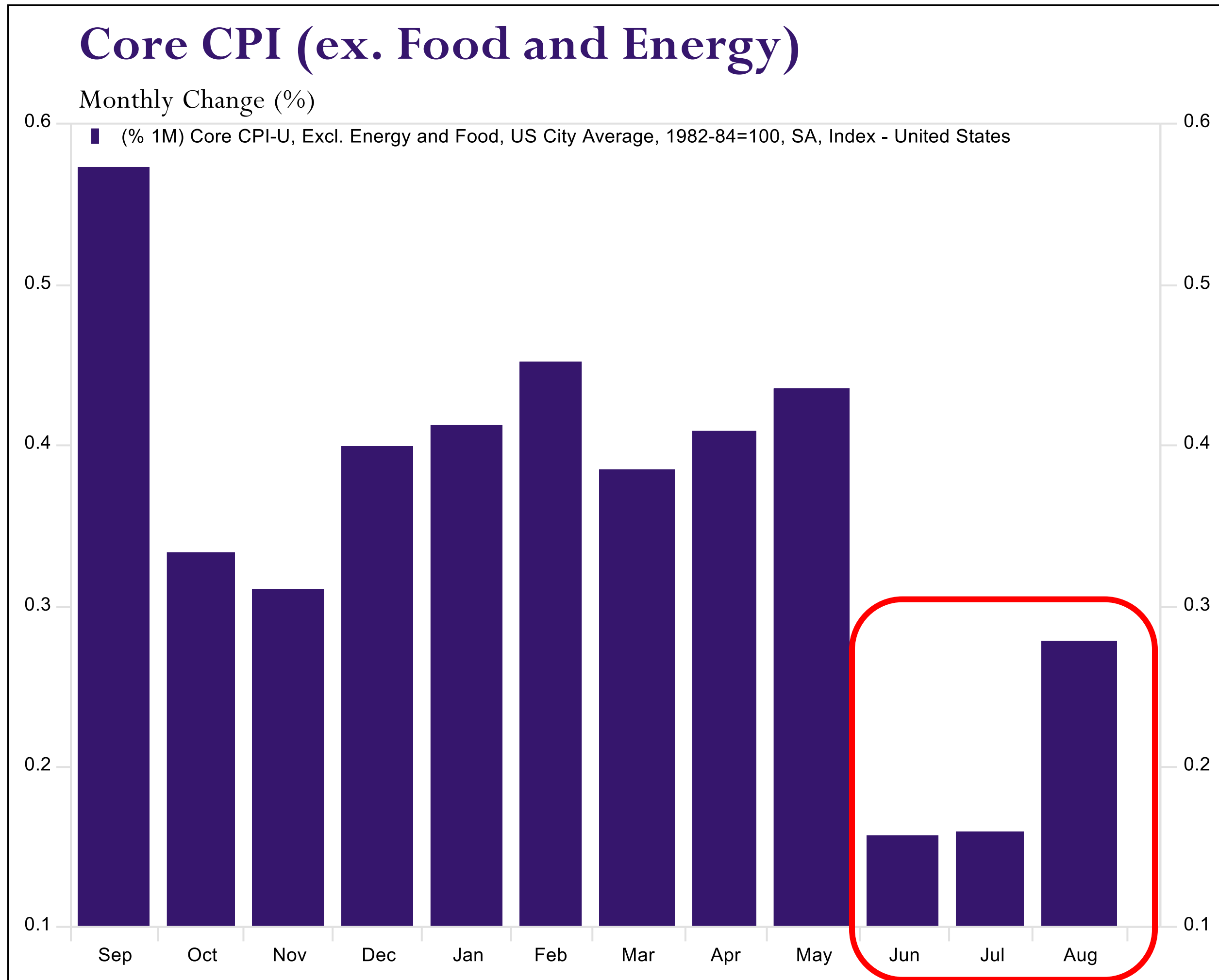


Source: Cetera Investment Management, FactSet, U.S. Department of Labor. Data as of 7/31/2023.

With all the relentless talk about the Federal Reserve, you may have noticed we didn't lead with the Fed discussion this quarter. This brings us to another theme from our 2023 Outlook, that the Fed would eventually pause and possibly pivot in 2023. While a pivot is looking less likely this year, the pause appears to have happened. While there is the possibility of another rate hike before year end (currently estimated at about a 50% chance), it does appear the Fed could be done and that rate cuts won't come until 2024.

Although it may not feel that way, inflation may be under control. Keep in mind inflation is dictated by the pace of price increases. Prices are rising more slowly now, but unfortunately for many consumers, prices are not falling in most categories. If we look at core CPI (**Figure 3**), which the Fed is more interested in because it strips out volatile food and energy metrics, you can see the last few months of inflation have been relatively low. If we annualize the last three months (through August), we get core CPI inflation rising at a 2.4% annual pace. If we look to bond markets, they also expect inflation is under control. Bond investors are very sensitive to inflation because it erodes their fixed returns. Treasury Inflation Bonds are priced so investors will break even with inflation rates around 2.25% for both 5-year and 10-year bonds.

Figure 3: Core CPI



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 8/31/2023.

Looking at the remainder of the year, we expect inflation will continue to moderate. While oil prices have risen, this will impact headline CPI, but not core CPI directly. The economy is going through a transitional period as the Fed appears to be pausing its rate hikes. This transitional period is caused largely by the economy adjusting to high interest rates and a lack of new government support as it comes off a period of low interest rates and outsized stimulus aid. Student loan payments are due again and personal savings rates are below 2019 levels.

Many companies took advantage of low interest rates and don't need to refinance at the current rates for a while. The economy does look to be resilient, but at the same time risks do remain. A Fed policy mistake is possible in 2024, as it may be too late to cut interest rates in the face of falling inflation and softening labor data.

Global Economy

Looking overseas, most key economic regions haven't been as resilient as the United States. While the European Central Bank (ECB) is trying to set expectations about the possibility of future rate cuts, investors are speculating when the ECB will cut rates. The Eurozone unemployment rate was 6.4% in July, compared to a 3.8% August unemployment rate in the United States, and recently European economic growth forecasts were lowered. London-based economic research firm Capital Economics estimates Eurozone GDP growth to be only 0.3% in 2023, much lower than the 2% estimate for the United States. Recently, the European Commission, forecasted that Germany, Europe's largest economy, will fall into a recession in 2023.

It is a similar story in China, the largest emerging markets economy, which recently cut its interest rate. While GDP growth is estimated to be about 5% for this year, China's economy is hindered by a lack of real estate investment and higher unemployment rates. New home sales are plummeting and while the reported unemployment rate is only around 5%, the youth unemployment rate (ages 16 – 24 years old) hit record highs recently at over 20% before the government stopped reporting this figure. While Chinese inflation is under control and near zero, European inflation is running hotter than the U.S., which could present challenges for the ECB as the Eurozone battles potential stagflation or stagnant economic growth coupled with high inflation.

As central banks and governments worldwide address different problems, economic growth and economic policies may diverge. The U.S. does appear to be in a stronger position economically with economic growth that is defying expectations and a relatively low unemployment rate. This has caused the U.S. dollar to strengthen recently relative to other currencies.

Equity Markets

As we approach quarter end, the S&P 500 is up around 15% on a year-to-date basis. The third quarter was relatively flat as much of the gains were realized in the first and second quarters. If we look back to 2022, when the S&P 500 lost around 18%, the index is getting close to recovering that loss. The math isn't always intuitive, but the index needs to climb around 22% to recover an 18% loss. If this math sounds confusing, consider this: if you start with $100 and lose $18, now you have $82, and to get back to $100 it would require a 21.95% return since your asset base is lower.

Market breadth was improving, but as it stands now, the S&P 500 is up around 12% versus the equally weighted S&P 500 index. The differential was 10% at the end of June. This is important because the S&P 500 index is weighted by market capitalization, meaning it is weighted by company size. The bigger the company, the bigger the weight in the index. When a company's stock rises and its shares are relatively stable, the company is worth more money and weighted more within the index. With the largest 10 companies in the S&P 500 doing so well recently, they now comprise over 30% of the index and have been driving the index higher as the other roughly 490 stocks collectively have not done as well. Hence the equally weighted S&P 500 has underperformed its market cap counterpart. The big question last quarter was whether the other 490 stocks would catch up, or if the 10 stocks dragging up the index would come back down. In the third quarter, these dynamics have held relatively stable.

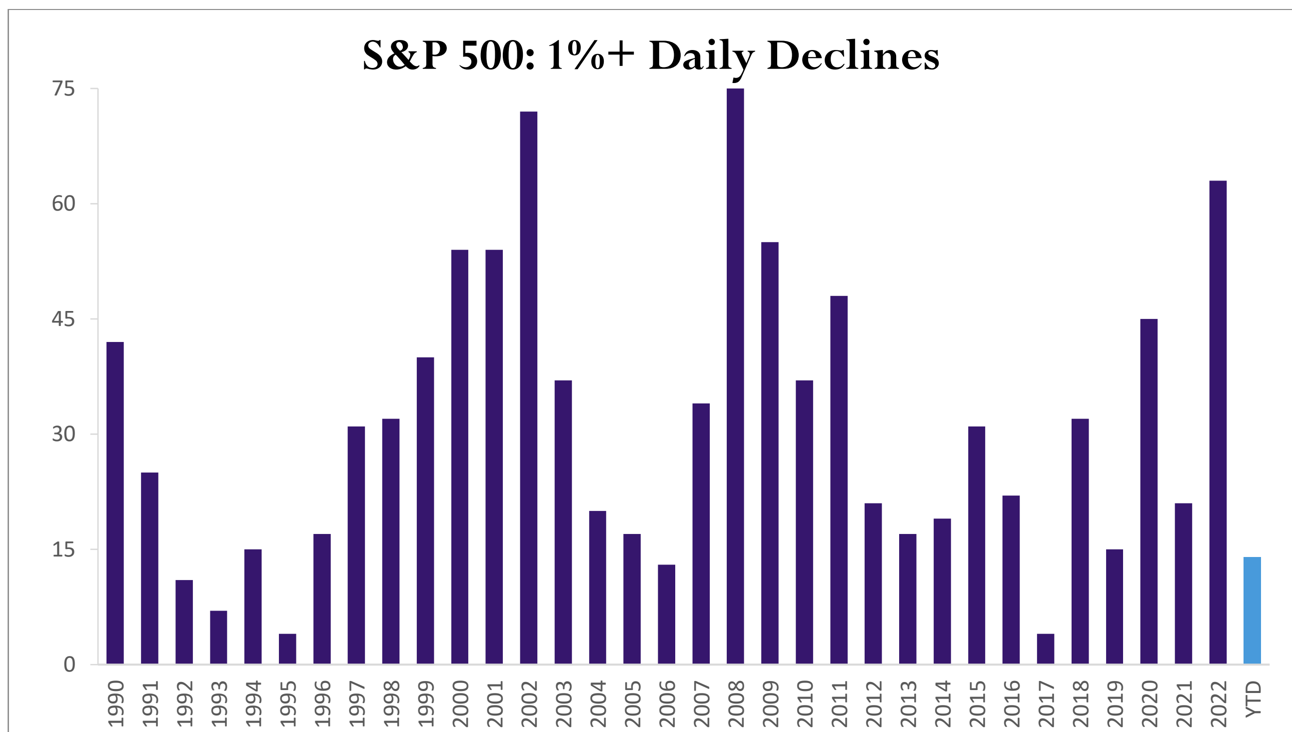
Another point we should mention about those top 10 holdings is that they are largely technology focused companies and have benefited from the optimism around artificial intelligence and the anticipation the Fed would pause interest rate hikes (technology companies can be high-growth companies and higher interest rates are not conducive to fast growth).

Moving away from market breadth and looking at valuations, the major theme here hasn't changed much either. One way to measure whether a stock is overvalued or undervalued is to look at the stock's price relative to its earnings or expected future earnings. While large companies have price-to-earnings ratios that are well above their historical averages, smaller companies are well below their historical averages. Prices can remain above or below their averages for a long period of time, but for longer-term investors this could present an opportunity to invest in smaller companies.

Going into the year we thought low expectations could eventually be easier to beat, which we saw with economic data. We also thought this might be the case for earnings and profit margins. Many companies raised prices factoring in high inflation, but with inflation moderating, this helps profit margins and earnings. Although the S&P 500 collectively had negative earnings growth, the earnings largely surprised to the upside thus far in 2023 and beat expectations. Next year, anticipation will rise as earnings growth is expected to be over 10%.

With uncertainty around when the Fed would pause its rate hikes and what impact those rate hikes would have on the economy, we expected more volatility. **Figure 4** shows the number of daily 1% declines by year in the S&P 500. On average the S&P 500 has declined 1% or more 31 times a year since 1990. While last year we had 63 such declines, we have only had 15 this year as of this writing. Markets can change quickly, but thus far markets have been climbing a wall of worry, as the old Wall Street adage goes.

Figure 4: Lack of Volatility



Source: Cetera Investment Management, Yahoo Finance, Standard & Poor's. Data as of 9/21/2023.

While volatility has been low, we could expect an uptick as uncertainty grows around labor strikes, a potential government shut down, and an impending election year. While high concentrations of growth and technology companies have helped many indexes outperform this past year, we think diversification will be key in reducing potential volatility. Valuations in value stocks and smaller capitalization stocks are lower than valuations in

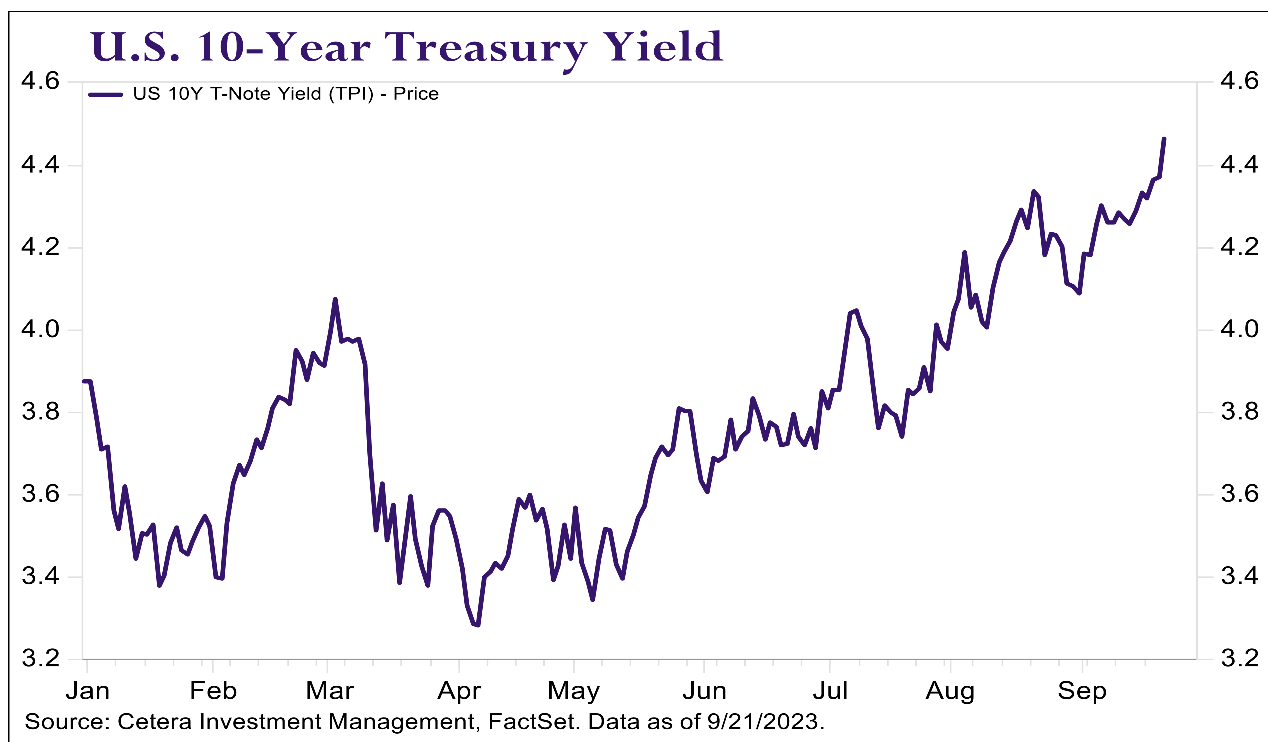
large cap growth stocks. Additionally, international stocks can offer diversification and lower valuations. While the European economy appears weaker, the European Central Bank will likely pivot sooner than the Fed. Additionally, Chinese stimulus is already starting to stabilize the Chinese economy, so while other central banks could potentially still be a headwind, the People's Bank of China (PBOC) could be a tailwind for their economy and stock market.

Fixed Income

Bonds continue to offer improving risk-and-return relationships compared to a year ago. If we look at the bond market, the duration of the overall market has come down, while the return for taking this interest rate risk has gone up. For instance, the 10-year Treasury yield is back up over 4%, high-quality corporate bonds yields are close to 6%, and low-quality corporate bonds have yields over 8%. Bond prices move inversely to bond yields, so if bond yields rise more, bond prices would fall but the yield already being paid can offset losses.

This explains why bond returns in 2023 have been muted even with relatively high yields. The 10-year Treasury yield rose from 3.88% to now around 4.4% (**Figure 5**). A roughly 0.5% rise in yields on these long-dated bonds would cause about a 4% price loss in those bonds. But bond investors have already received about 3% in coupon payments this year, so the loss for 2023 is currently roughly 1%. If yields remain stable one can expect returns to be like the current yields. If yields fall, bond investors could see returns that they have not seen in decades. We will talk more about this in the 2024 outlook, as this is a longer-term theme.

Figure 5: Bond Yields



Source: Cetera Investment Management, FactSet. Data as of 9/14/2023.

To summarize, so far in 2023, bond investors have faced the headwind of rising yields but have largely weathered this through offsetting coupon payments.

Looking at the yield curve, short-term bonds continue to pay more yield than longer-term bonds. This is counter intuitive because shorter-term bonds have less interest rate risk and yet they offer more return for taking less risk. This inverted yield curve happens when future growth is expected to be lower than current growth and may indicate a recession is on the horizon. While this may be true, it should be noted that the Federal Reserve has direct influence over short-term rates and the Fed has pushed short-term rates to elevated levels by raising the Fed Funds rate over 5%. As we indicated last quarter, many look at the 2-year Treasury yield as an indication of where the market thinks the Fed funds rate will be a year in the future, so we will provide an update on this metric too. The 2-year Treasury yield is now around 5%, implying the market thinks the Fed will only cut interest rates by around 0.25% over the next 12 months. While this is bad news for investors that want Fed rate cuts, it could be an indication that the market is beginning to think a recession is less likely, because the Fed would be forced to cut interest rates in a recession.

Another possible future indicator for a recession is high-yield bond spreads. This is the amount of yield that below investment-grade bond (junk bond) investors demand over risk-free treasuries. If investors anticipate a recession, they demand more yields to compensate for potential future losses due to credit downgrades and defaults. Currently, high-yield spreads are relatively low and do not indicate a recession.

Overall, bonds offer better diversification than they did in 2022 with higher yields and lower interest rate sensitivity. If we finally start to see equity volatility, even high-quality bonds are offering decent yields. If we saw a flight to quality, this could drive down bond yields, thus driving up bond prices giving bond investors price appreciation in addition to the coupon payments. Also, if the Fed pauses and eventually pivots in 2024, this would be supportive for bond holders if yields fell for these reasons.

The Bottom Line

To recap, the U.S. economy has been resilient thus far in 2023, largely outpacing some areas of the globe that are facing the potential of stagflation and recession. While the economic data isn't stellar, it is improving off the lows to the point many economists are starting to think a recession could be avoided.

The outlook for stocks and bonds will be driven around the Fed's ability to navigate the changing economic landscape. Can the Fed manage to tame inflation and not cause a recession? And will the Fed lower rates soon enough after inflation is under control? The second half of that question will likely be answered in 2024. Meanwhile, valuations, which can remain elevated or depressed for long periods of time, are elevated in large cap growth stocks. Valuations for value stocks, small company stocks and international stocks are more attractive. These can offer good entry points for long-term investors. Within bonds, rising yields can create better return opportunities offering some protection if yields rise further. Bonds could offer good diversification if inflation moderates, economic growth slows, or when the Fed cuts rates.

Volatility has been somewhat absent in broader equity categories thus far in 2023, but that is hard to predict and can change quickly. Your Cetera financial professional can keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Citigroup Economic Surprise Index** is a measure of how economic data releases compare to market expectations. It is calculated as the weighted historical standard deviation of data surprises.