Market commentary notes

Monthly call notes
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Wealth Management

Eric A. Stubbs
Senior Vice President – Financial Advisor
Senior Portfolio Manager – Portfolio Focus

1211 Avenue of the Americas
Suite 3300
New York, NY 10036

(212) 703-6165
eric.stubbs@rbc.com

Summary: Key issues last month and this month

The Federal Reserve

Chairman Jerome Powell recently said both that inflation is too high and that the Fed is likely to proceed carefully going forward. Many people take the latter to mean that the Fed isn't in a hurry to raise rates any further.

We can look at the yield curve to try to divine what investors think are the chances of a raise. The current overnight rate is 5.36% while the 1 month rate is 5.52%. That implies that investors are estimating a roughly 60% chance that the Fed will raise at its next meeting. The 4-month rate is 5.6%, suggesting a 100% chance of a raise by the end of January. By the way, the 2-year rate is 4.98%, which implies that investors are anticipating that the Fed will start dropping rates by 2025. [https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value_month=202309, Sept. 9, 2023]

Inflation

Last month's 3% inflation rate has increased in August to 3.2%. That's well within the range of "noise" so it shouldn't trouble you. But some people are using it to raise concerns that the Fed will raise rates again on September 19 and 20. I think there's a chance that they will raise 25 bp, but more likely they will hold where we are. [https://www.bea.gov/news/2023/personal-income-and-outlays-june-2023, Sept. 9, 2023]

August — A pause?

In July, the major domestic and international stock indexes were up while bonds were down a little. That was probably because investors believed that the Fed was at or near the end of its interest rate cycle. In August, we saw a dip. To a limited degree it may have been due to sentiment turning toward the possibility of another Fed raise, but the global economic statistics were weaker too, especially in Europe. The S&P 500 was down 1.6% with mid- and small-caps down a little more. International equities and especially emerging markets were also down. On top of that, domestic bonds were down another quarter-of-a-point. Meantime on a YTD basis, gold is up 6.4%—which is down 2.6% from the end of July.

Global stock indexes

Total Index	August %	YTD %	1 yr. %	2022 Est PE Trailing/ Projected
S&P 500	-1.59	18.73	15.94	19.17/17.57
S&P Mid Cap	-2.89	10.06	10.71	14.17/13.17
S&P Small Cap	-4.14	7.24	5.53	14.94/12.45
FTSE All REIT	-3.33	1.54	-7.71	
MSCI All Country xUS	-4.52	8.78	11.89	
MSCI Emerg Mkt	-6.16	4.55	1.25	

Source: Morningstar as of August 31, 2023. Estimated PEs are 12 month values from S&P Dow Jones Indices. Trailing PEs are as of September 30, 2022. Projected PEs are as of December 30, 2022. Figures are provided for comparisons over time.

Fixed income and alternatives

Total Return Index	August %	YTD %	1 yr. %
Bloom Agg Intermed	-0.28	1.49	-0.35
ICE BofA US Convertibles	-2.71	9.81	4.03
S&P GSCI	0.60	3.00	-1.77
Bloom US Corp HY	0.28	7.13	7.16

Source: Morningstar as of August 31, 2023.

Sector performance

In August, energy was the only sector with a positive return. That we had three months where just about all sectors moved directionally in unison tells us a little about the likely drivers: They are more likely macro influences than individual stock earnings or performance. That's been a through-line for most of the year, with the Fed, inflation and Ukraine dominating the news. The best performing sectors within the S&P 500 on a YTD basis were IT (+44.7%), communications services (+45.2%), consumer discretionary (+34.7%). The worst three performers so far were health care (-1.2%) consumer staples (-0.25%) and utilities (-9.3%). [https://www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us.pdf, Sept. 9, 2023]

Commodities

Commodity and food price changes, current month and YoY

Copper	-2.6%	-5.1%
Lumber	2.1%	-16.9%
Cotton	-1.2%	-19.5%
Sugar	11.0%	44.4%
Coffee	-9.0%	-36.3%
Wheat	-10.7%	-34.8%
Corn	-2.8%	-31.7%
Oil	4.3%	1.8%
Natgas	-14.3%	-67.5%

Source: https://tradingeconomics.com/commodities, Sept. 9, 2023

Six of these nine major commodities saw prices decline in August. Compared to a year ago, seven experienced price declines. Looking more broadly at commodities, when we look at 22 categories of agricultural commodities and 26 categories of industrial commodities, 19 of the 48 saw price declines in August, compared to 14 in July, 22 in June and 32 in May. So that's a significant change. 30 saw lower prices than a year ago compared to 34 in July and 37 in June. So I think that's evidence that commodity prices are stabilizing rather than declining—meaning that the easy wins where inflation is concerned are probably mostly accounted for. It looks to me like we'll have a harder time getting inflation below the high 2s in the next couple of years.

The U.S. economy keeps growing

GDP estimates

[https://www.bea.gov/data/gdp/gross-domestic-product, Sept. 9, 2023] [https://www.atlantafed.org/cqer/research/gdpnow, Sept. 9, 2023] The latest GDP estimates are up 2% in the first quarter of 2023, and up 2.1% for the second quarter, annualized. These are down a little from the last two quarters of 2022—3% and 2.6%, but are still moderately strong readings. The recent growth was mainly due to consumer spending and government spending while exports were down a little. Corporate profits were down, but only a little—which supports my sense that profits lag when you have inflation because input prices and costs rise before producers can increase their selling prices—squeezing margins temporarily.

The Atlanta Fed's GDPNow model to estimate 3Q GDP growth is now estimating a heroic 5.6% growth rate for the quarter we're currently in. I'd like to believe it, but I bet it will come down by the end of the month. I think anything north of 3.5% would be a big win.

Jobs

The August non-farm payroll was up 187,000 and unemployment ticked up to 3.8%. 187K is a good figure but it came with a downward revision for July and June totaling -110,000 jobs. That puts the 12-month average at +271,000 new jobs per month. Since we typically see 80-90,000 new job market entrants per month, this is still a substantial expansion. The main growth areas were health care, leisure and hospitality and construction. Wages were also up 4.3% over 12 months. The total number employed in the U.S. has risen from 158.7 million a year ago to 161.5 million at the end of August—a 2.8 million person increase. [https://www.bls.gov/news.release/pdf/empsit.pdf, Sept. 9, 2023]

U.S. PMI statistics

The U.S. manufacturing PMI for August dropped slightly to 47.9. So it has been hovering around the 46 to 49 range for a few months now. The services PMI dropped to 50.5—still expansionary territory but down 4 points in the last 2 months. That correlates with the weaker recent new payrolls figure but it's too early to tell if it's a downward trend. [Trading Economics, PMI statistics Sept. 9. 2023.] [Trading Economics, https://tradingeconomics.com/country-list/services-pmi Sept. 9, 2023]

International

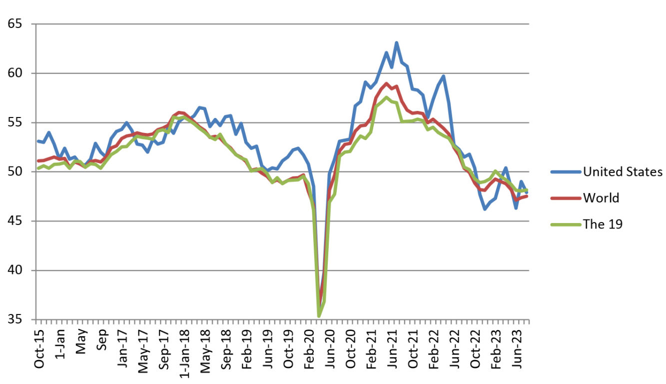
Manufacturing PMI

Every month I look at global purchasing managers index (PMI) statistics. We've got August results and out of our 38 that we track, we're up to 12 registering above 50, up from eight last month. Another six were between 49 and 49.9. The Euro area bumped up a little to 43.5. Germany was still in the doldrums at 39.1—still due to disappointing car production and exporting. Arguably the German car manufacturers have lagged in rolling out efficient EVs. [https://recruitonomics.com/the-decline-of-car-manufacturing-is-hurting-the-german-economy/, Aug. 5, 2023]

Some other issues leading to stagnant growth in the German economy are reported here: [https://www.spiegel.de/international/business/wirtschaftsblunder-why-germany-s-economy-is-flailing-and-what-could-help-a-c5047bf2-0c66-4a8a-bf62-e52baaef0acd]

China rose to 51 and there are signs in production as well as their price levels that the beginnings of a recovery are taking root. In terms of our GDP-weighted average, the world is at 47.5 while the 19 biggest economies are at 48.1—both about the same as last month. [https://tradingeconomics.com/country-list/manufacturing-production, Sept. 9, 2023] On the services side, the Euro area is at 47.9, which is leading to concerns about an EU recession. U.K. in particular registered a 43 in manufacturing and 49 in services so the worry that a recession might be on the horizon is taken seriously there. [https://tradingeconomics.com/country-list/services-pmi, Sept. 9, 2023]

Here's our updated graph of Manufacturing PMIs:



Source: Author's calculations based on published PMI statistics, as of Sept. 9, 2023.

Table summary

Region	Manu PMI	Last Month	12 Mo. Ago
U.S.	47.9	49	51.5
19 majors	48.1	48.1	50.5
38 world	47.5	47.4	50.3
EU	43.5	42.7	49.6
China	51	49.2	49.5

Source: Author's calculations based on published PMI statistics, Sept. 9, 2023

Investment strategy

What does all of this mean for investors?

Recession?

Possible, especially since on average we've seen one every six years for the last 60 years. However, the domestic signs don't currently point to any elevated risk. International indications are more variable, so one could imagine a recession in Europe spilling over to the U.S. via depressed export trade. Watch Europe and watch to see if the U.S. doller starts declining in value.

Interest rates?

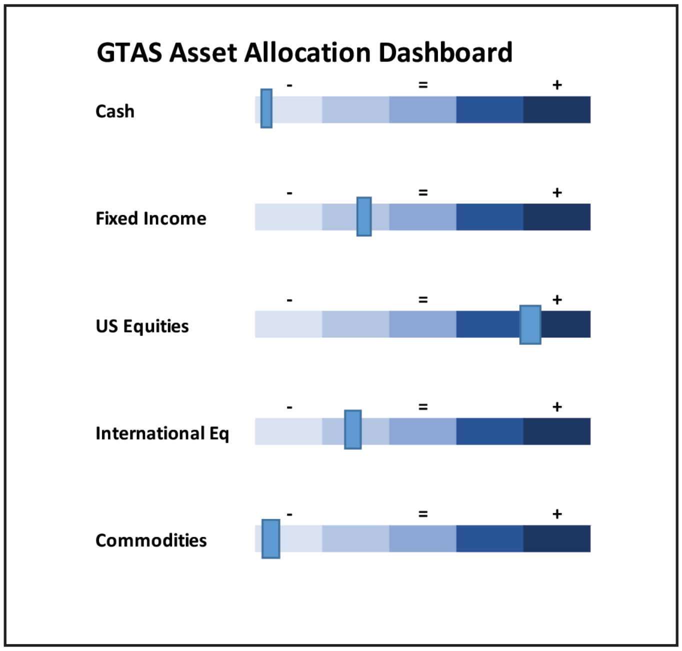
Possibly one more Fed raise (Sept. 19/20), or maybe not. Either way, we're probably near or at the end of the Fed cycle. Overall, it is a healthier investment environment when you can make 5% on bonds as an alternative to owning stocks. Bear in mind that if you are a taxable investor, 5% yields, after tax and after inflation is a yield of 0-0.5%. However, for the first time in a decade, we can broaden investments.

Inflation?

We went from 8% a year ago to 3–3.2% now. My guess is that we'll get to the high 2's but it will take the rest of the year to do it. So far in the first seven months of this year the PCE price index is up 1.8%. That means for the last five month, the total would have to be less than 1.2% to come in at 3% or less. That would be 0.2% per month—which is possible but not obviously achievable. [https://apps.bea.gov/iTable/?reqid=19&step=3&isuri=1&1921=survey&1903=84, Sept. 10, 2023]

Europe?

Germany in particular has to pull itself out of a ditch in terms of its auto industry but also bureaucratic impediments, lack of uniform green energy policy and related confusion. The U.S. dollar Eurozone stock index (EZU) remains below where it was at the end of 2021 and the German stock index (USD) is almost 20% below where it was at the end of 2021, so it may be the case that slowdown risk is already priced in.



GTAS allocation chart

(+/=/-) represents our group's views over a 6- to 18-month time horizon concerning tilts relative to our strategic positions.
+ implies an overweight in that asset class.
= implies a weighting similar to our strategic weight.
- implies an underweight.

Index definitions

Past performance is no guarantee of future results. You cannot invest directly in an index.

Bar Agg Intermed — Bloomberg Barclays US Aggregate Intermediate Total Return index is composed of the BarCap Government/Credit Index, the Mortgage-Backed Securities Index, and the Asset-Backed Securities Index. The returns for the index are total returns, which includes the daily reinvestment of dividends.

Bar US Corp HY — Bloomberg Barclays US Corporate High Yield Total Return index includes all fixed income securities having a maximum quality rating from Moody's Investor Service of Ba1, a minimum amount outstanding of $100 million, and at least one year to maturity.

FTSE All REIT — FTSE Nareit All Equity REITs Total Return index is an index of publicly traded Real Estate Investment Trusts (REITs) that own commercial property. All tax-qualified REITs with common shares traded on the NYSE, AMSE or NASDAQ National Market List are eligible. Additionally, each company must be valued at more than $100MM USD at the date of the annual review.

ICE BofA US Convertibles — ICE BofA US Convertible Bonds Total Return index tracks the returns of U.S.-traded convertible debt issued by companies with a significant presence in the United States. The index is composed of various combinations of convertible structure and credit quality, e.g. it includes investment-grade, speculative-grade, and non-rated issues. The returns for the index are total returns, which include reinvestment of dividends.

MSCI All Country xUS — MSCI All Country World Index Ex USA NR is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets. The index consists of 48 developed and emerging market country indices. The returns for the index are total returns, which include reinvestment of dividends.

MSCI Emerg Mkt — MSCI Emerging Markets NR index consists of 26 developing economies including Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates.

S&P 500 — S&P 500 Total Return index is a market capitalization-weighted index composed of the 500 most widely held stocks whose assets and/or revenues are based in the US; it's often used as a proxy for the U.S. stock market. Total Return (TR) indexes include daily reinvestment of dividends.

S&P GSCI — S&P GSCI Total Return index is a composite index of the commodity futures. It represents unleveraged, long only investments in commodity futures that are broadly diversified.

S&P Mid Cap — S&P MidCap 400 Total Return index is comprised of stocks in the middle-capitalization range, and includes approximately 10% of the capitalization of U.S. equity securities. Total Return (TR) indexes include daily reinvestment of dividends.

S&P Small Cap — S&P SmallCap 600 Total Return index consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation. Total Return (TR) indexes include daily reinvestment of dividends.

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