Market commentary notes

Monthly call notes
Monday, October 2, 2023

RBC Wealth Management

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"A little experience is worth much argument; a few facts are better than any theory."

— **William Stanley Jevons**

Summary: Key issues last month and this month

The federal shutdown—saved by the bell

A continuing resolution to cover the next 45 days passed and was signed. Meaning the government stays open and there are 45 days to negotiate the current budget. If this hadn't passed, several services would have been stopped—although Social Security checks would have still gone out—and active military and TSA would not have been paid.

In terms of the impact on markets, I expect the U.S. stock market to have a better October and November than what we saw over the last two months.

The Fed

Very little new news on this front. Chairman Jerome Powell implied that we should expect overnight rates to stay above 5% for most of 2024, or longer. Other governors have variously said that rates look about right to them or that rates need to go up a little more. The yield curve is estimating one more raise this year. We'll see if it happens. I think the chances are low but not zero—maybe 25%.

Inflation

Core PCE was up 3.9% while overall PCE was up 3.5% year over year in August. The core figure, excluding food and energy, was a little better than a month ago while the overall figure was slightly raised from a month ago. That may imply a little less pressure on the Fed to continue raising rates, at least for now. [https://www.bea.gov/news/2023/personal-income-and-outlays-august-2023, Oct. 1, 2023]

Volatility isn't a measure of risk

2023 gave us a good natural experiment to compare volatility measures to actual risk to see how they are related. This is worthwhile because we are constantly told that higher risk is correlated with greater returns and that volatility is how we measure risk. So here's the natural experiment: Since the beginning of August, we've been conscious of the risk of a government shutdown and the potential negative impacts that it would have on the economy and the markets. Indeed, looking at weekly S&P 500 data, from January to July, the S&P rose an average of 19 points per week (about 2% per month). In August and September, the S&P fell 16 points per week. I'd argue this was mostly due to shutdown risk.

However, if you look at volatilities, there isn't much difference. In the January to July period the annualized volatility of the S&P was 12.9% (standard deviation). In August and September, it was 12.2%—essentially the same. So, the period that I'd argue had more risk that investors understood, had the same volatility as the previous period.

That leads to one of two conclusions: Either the total risks as understood by investors were the same, or volatility doesn't measure risk. My money would be on the second of these. There's a lesson there for us as investors: Don't assume that comparing volatilities across investments or across time tells you anything about relative risks. You need to dig deeper to understand investments.

September—why the dip?

Major stock and bond indexes were down again in September. Between August and September, the S&P was down about 6.5% and the small cap index was down about 10%. Why? Some analysts attribute it to weaker global economic performance and/or the threat of the Fed raising rates again. My sense is that it has more to do with the threat of a federal government shutdown and the negative economic impact that that would have. We'll see if the stock market recovers in the next few weeks, which would be something of a test of my hypothesis. International stock indexes were down less than domestic ones, which supports my view. However, bonds were also significantly down, which works the other way. Meantime on a YTD basis, gold dropped a little so that it is now up 2.1% YTD.

Global stock indexes

Total Index	September %	YTD %	1 yr %	2022 Est PE Trailing/ Projected
S&P 500	-4.77	13.07	21.62	19.17/17.57
S&P Mid Cap	-5.26	4.27	15.51	14.17/13.17
S&P Small Cap	-6.00	0.81	10.08	14.94/12.45
FTSE All REIT	-7.04	-5.61	-1.71	
MSCI All Country xUS	-3.16	5.34	20.39	
MSCI Emerg Mkt	-2.62	1.82	11.70	

Source: Morningstar as of September 30, 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	September %	YTD %	1 yr %
Bloom Agg Intermed	-1.76	-0.30	1.42
ICE BofA US Convertibles	-2.53	7.03	7.77
S&P GSCI	4.12	7.24	10.93
Bloom US Corp HY	-1.18	5.86	10.28

Source: Morningstar as of September 30, 2023.

Sector performance

In September there was a very significant bifurcation in sector performances on a YTD basis. The best three sectors were still communications (+39.4%), IT (+33.8%) and consumer discretionary (+25.7%). The bottom three were utilities (-16.5%), real estate (-8.0%) and consumer staples (-6.6%). Apart from the top three, the next best was energy at +3.2%, so none of the other eight sectors broke into double digits. What's interesting about the worst three as well as the next two worst, health care and financials, is that they tend to be the dividend stocks. That argues that we had two things going on in 2023 so far: sectors that were hurt by rising interest rates (utilities, real estate and financials) did poorly and high dividend sectors that compete with bonds, did poorly. [https://www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us.pdf, Oct. 2, 2023] [https://digital.fidelity.com/prgw/digital/research/sector, Oct. 2, 2023]

Commodities

Commodity and food price changes, current month and YoY.

Total Index	September %	YTD %
Copper	-2.3%	8.7%
Lumber	-1.0%	-4.4%
Cotton	-1.6%	1.8%
Sugar	3.7%	42.6%
Coffee	-4.7%	-34.0%
Wheat	-10.8%	-41.2%
Corn	-1.0%	-29.8%
Oil	11.9%	15.3%
NatGas	-8.0%	-58.6%

Source: https://tradingeconomics.com/commodities, Oct. 1, 2023

Seven of these nine major commodities saw prices decline in September. Compared to a year ago, five experienced price declines. Looking more broadly at commodities, when we look at 22 categories of agricultural commodities and 26 categories of industrial commodities, 25 of the 48 saw price declines in September, compared to 19 in August and 14 in July. So that indicates that some price declines are still occurring. 30 saw lower prices than a year ago. That's the same number as in August but down from 34 in July and 37 in June. That suggests to me that price declines are still happening, but that the rate is slowing. Remaining inflation may be a little more stubborn going forward.

Also, where commodities are concerned, the price level is generally higher now than it was pre-COVID0-19. If we compare current price indexes to their levels in 4Q 2019, we see that the overall commodity index is up just under 50%. The food price index is up about 40%. Interestingly, agricultural raw prices are flat over the four years. Energy is up about 20%. Commodity metals are up 45%. [https://www.indexmundi.com/commodities/, Oct. 1, 2023]

The Baltic index for Asia-North American West Coast rates for a 40-foot container are now down to $1,712. That's down 16% in the last month. They were last this low in 2018. You may recall that during the Pandemic they were 10 times that. [https://www.freightwaves.com/news/trouble-ahead-container-shipping-rates-sinking-further-into-the-red, Oct. 1, 2023]

The U.S. economy keeps growing

GDP estimates

[https://www.bea.gov/data/gdp/gross-domestic-product, Oct. 1, 2023] [https://www.atlantafed.org/cqer/research/gdpnow, Oct. 1, 2023] The latest GDP estimates for 2Q are up 2.1%. Q1 estimates were revised up to 2.2%. These are decent growth numbers so far this year, especially considering the interest rate increases. Consumer spending remains a driver. Other data suggests that corporate profits are trending upward.

The Atlanta Fed's GDPNow model to estimate 3Q GDP growth is now estimating a 4.9% growth rate for the quarter we're currently in. That seems high to me, especially given the government shutdown and slow European economies. We'll see if it comes down in the next couple of weeks. I'd optimistically guess +3.5%, which would still be a very healthy growth rate.

Jobs

Seasonal hiring plans: The major ones that we know about include Amazon +250,000, Target +100,000, UPS +100,000, Macy's +38,000. [https://www.reuters.com/business/retail-consumer/us-retailers-unveil-hiring-plans-ahead-holiday-shopping-season-2023-09-19/, Oct. 1, 2023] These are similar to 2022 numbers, except Amazon is increased by 100,000. However, Walmart so far seems to be scaling back to 40,000 hires versus 100,000 last year. Overall, it looks like this year will come in similar to last year's 800,000 seasonal worker spots.

September non-farm payroll isn't out yet so no updates available. [https://www.bls.gov/news.release/pdf/empsit.pdf, Oct. 1, 2023]

U.S. PMI statistics

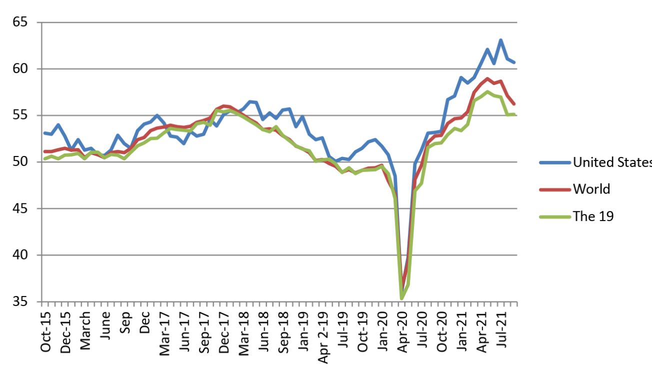
The U.S. manufacturing PMI for August rose a point to 48.9. It has been in the 46 to 49 range for six months now, despite a growing economy. The services PMI—80% of our economy—is still in positive territory and about where it has been, at 50.2. [Trading Economics, PMI statistics Oct. 1. 2023.] [Trading Economics, https://tradingeconomics.com/country-list/services-pmi Oct. 1, 2023]

International

Manufacturing PMI

Every month I look at global purchasing managers index (PMI) statistics. This is early in the month so most countries haven't yet updated their surveys. Consequently, we still show 12 out of 38 above 50. Another six were between 49 and 49.9. The Euro area bumped up a little to 43.5. Germany has reported a slight move upward to 39.8 from the previous 39.1. Last month I noted that German domestic car production fell from 6 million in 2012 to 3.8 million in 2022. [https://recruitonomics.com/the-decline-of-car-manufacturing-is-hurting-the-german-economy/, Aug. 5, 2023] However, that shouldn't be confused with total global production of cars from German manufacturers. Adding up figures for BMW, Mercedes, Audi and Volkswagen, total global production last year was about 15.2 million cars. Their total production is intact but German production is down. [https://tradingeconomics.com/country-list/services-pmi, Oct. 1, 2023]

Here's our updated graph of manufacturing PMI's:



Source: Author's calculations based on published PMI statistics, as of Oct. 1, 2023.

Table summary

Region	Manu PM	Last Month	12 mo. Ago
US	48.9	47.9	51.8
19 majors	48.0	48.1	50.2
38 world	47.6	47.5	49.9
EU	43.4	43.5	48.5
China	51	51	48.1

Source: Author's calculations based on published PMI statistics, Oct. 1, 2023

Investment strategy

So what do we do in terms of investing?

Recession?

Probably not this year. If the Fed raises again, it is possible that the economy and markets will be weaker in first quarter 2024. Europe might be in a recession, but at least where Germany is concerned, it is arguably priced in already.

Interest rates?

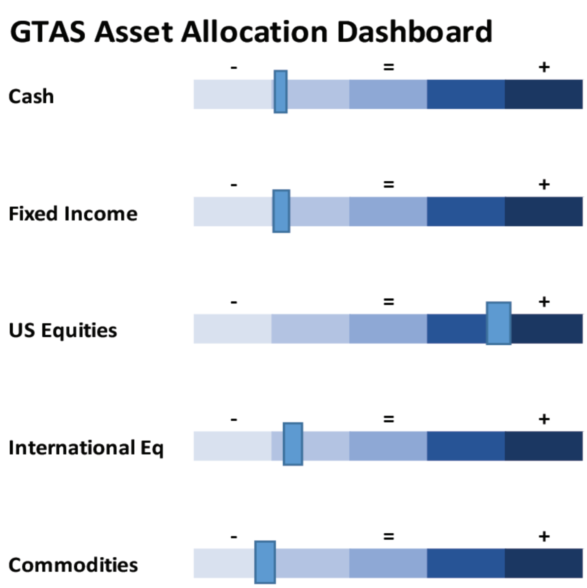
The yield curve seems to be reflecting more or less sensible interest rates going forward. That means that unless something very unexpected happens, you can expect to earn the coupon and not much more or less on bonds. In this environment, there isn't much difference between investing in individual bonds of mutual funds/ETFs. However, I still prefer individual bonds in case the environment changes in unexpected ways.

Inflation?

We went from 8% a year ago to 3–3.2% now. My guess is that we'll drop to the high 2's but it will take the rest of the year to do it. We may see inflation rates come down a little more over the remainder of 2023—possibly ending just under 3%. That should make a better environment for stocks and bonds and help corporate earnings.

U.S. stock market?

Small caps and mid caps are down around 10% in the last couple of months. Mean reversion suggests to me that they may have even more upside than large caps for the remainder of this year. NASDAQ and techs may well recover as well.



(+/=/-) 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.