Schroeder | Capital Management, LLC

Global Investment

# Investment Review and Outlook – Fall 2023

## The U.S Economy – Third Quarter Growth Surged:

On October 26, the Commerce Department reported that U.S. Gross Domestic Product (GDP) surged 4.9% for the recently concluded third quarter, the fastest pace since 2021. This compared with a 2.4% rise in GDP for the previous quarter and 2.0% for the first quarter of 2023. Stronger than expected consumer spending (two-thirds of overall GDP) fueled the rapid rate of expansion, despite the higher cost of borrowing and high inflation. Spending on travel and entertainment was a standout, supported by the strong labor market and savings accumulated during the pandemic. Consumer credit card debt also rose to an all-time high of over a trillion dollars and helped source expenditures. Government outlays and a buildup in inventory levels, especially in the automotive industry, also contributed to the third quarter's strong economic expansion.

For the fourth quarter of 2023, and into 2024, recent economic strength isn't expected to continue at the same pace as the third quarter. Consumers are increasingly mindful of inflationary pressures and this is having a significant impact on their spending. According to the U.S. Index of Consumer Sentiment report released on October 27, consumer sentiment fell for the third consecutive month in September, down to 64 from 68 in August and well below the historical average of 86.

The current consensus is that consumers will be more cautious this holiday shopping season with elevated prices for essential items, including gasoline, causing a reduction in discretionary spending. This also comes at a time when consumer savings accounts are shrinking, the savings rate is declining and nationwide credit card balances are ballooning. Goldman Sachs recently noted that credit card companies are seeing delinquencies rise at the fastest rate since the Great Recession of 2007-2009. In addition, many individuals will soon have to resume paying off student debt obligations that is likely to place extra stress on consumer spending heading into 2024.

Higher interest rates and borrowing costs have taken their toll on the housing market. Both new and existing home sales have weakened as the rate on the 30-year fixed mortgage recently reached 8%. Also, new housing starts are well below forecasts, reflecting pessimism among homebuilders.

Finally, escalating global geopolitical tensions, especially the wars in the Middle East and Ukraine, are likely to result in global supply chain interruptions, including key energy markets. This could potentially push commodity prices higher and make the Federal Reserve's task of bringing down overall inflation even more challenging.

## Corporate Earnings Developments – Relatively Flat Comparisons:

Third quarter corporate earnings season got off to a good start with a number of the big money center banks, including JPMorgan Chase and Bank of America, surpassing revenue and earnings forecasts. To date, overall reported results have not produced many surprises. While profits have declined in the past three consecutive quarters of 2023 for S&P 500 companies, results are forecast to be relatively flat, on average, with year-earlier values for the recent third quarter ending September 30. Of note is that most of the earnings reports have been accompanied by guarded statements from management regarding current fourth quarter prospects and estimates for 2024.

## Inflation – Remains Sticky:

After trending lower over the late spring and early summer months, both the Consumer and Producer Price Indices rose more than expected in August and September. In large part, the increase was due to higher energy costs. However, the core CPI and PPI, which exclude the more volatile food and energy components, moderated a bit.

On a positive note, the Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures Index (PCE) is showing improvement. The Commerce Department reported on October 27 that PCE advanced by 3.7% for the twelve months ending September, down from 3.8% in August and the smallest year-over-year increase since 3.2% in May 2021. That was an encouraging sign for Federal Reserve officials. However, the pace of price increases in the overall economy is still running well above the central bank's target rate objective of 2%.

## Federal Reserve – Their Next Move:

The monetary policy stance of the Federal Reserve has not changed. While Fed Chairman Jerome Powell has not ruled out the possibility of another interest rate hike before the end of 2023, that does not seem likely at this point. The central bank would like to see what the full effect of raising the benchmark short-term interest rate eleven times, from near-zero to 5.25%-5.50%, over the last twenty months, has had on both inflation and economic expansion.

Wall Street expects the central bank to keep the federal funds rate higher for a longer period of time while inflation remains above the Fed's target level of 2%. Also, with the fixed-income market "doing the work for the Federal Reserve" as Treasury market yields remain elevated, it is not likely there will be a further rate increase any time soon.

# Investment Strategy – Exercising Caution:

Given the current high interest rate backdrop, corporate earnings will need to be solid going forward for current market valuations to be maintained, especially the high growth securities that are valued on their future cash flows. Fed Chairman Powell has suggested that interest rates are likely to remain high for a longer period of time. The securities markets will continue to be challenged by this restrictive monetary policy, inflation, another looming debt ceiling battle on Capitol Hill and the impact of escalating geopolitical unrest. This latter concern includes the horrific events and ongoing wars in the Middle East and Ukraine, as well as the mounting tension between China and Taiwan. Recently, the Chairman of JPMorgan Chase, Jamie Dimon said that the geopolitical turmoil and rising interest rate environment will have a far-ranging economic impact on supply chains in energy and food markets, global trade and geopolitical relationships.

In the current high interest rate environment, we continue to emphasize high-quality securities with solid long-term fundamentals, steady earnings and dividend growth and low debt balance sheets. Key is also pricing power to manage higher operating costs in an inflationary environment.

In the fixed-income arena, we are currently taking advantage of the attractive yields in U.S. Treasury securities, especially short maturity T-Bills that are currently yielding over 5%.

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