BFS Advisory Group

Risks & Opportunities

BFS Advisory Group Market Report

Third Quarter 2023

Based on the increased amount of feedback we received on our last edition of *Risks and Opportunities*, we know that people are very confused about where we really are in the economy and the financial markets. Rest assured, you are not alone. We find financial markets to be fascinating, especially because outcomes can change even in the most predictable times. This environment, however, is very unpredictable.

The most intense parts of the inflation and interest rate cycles are in our rearview mirror, but we still lack clarity about when we will be back to normal, and what "normal" will look like. We took your feedback seriously and we hope that this edition of *Risks and Opportunities* – while still acknowledging the uncertainties in the current environment – clarifies the possible paths ahead of us.

We maintain our opinion that the US will avoid a meaningful recession. Ironically, a recession may very well be the best thing for the financial markets at this point, as it would motivate the Fed to decrease rates, which would allow the stock and bond markets to begin a longer term recovery. Yet, economic data is not yet pointing towards a recession. The real question is when, in the absence of a recession, the Fed will see a reason to decrease rates.

Our theme for this edition of *Risks and Opportunities* is "center of gravity," which is the average location of the weight of an object. Knowing this location informs the understanding of the expected motion and activity around that object. Translated to the domestic economy, the US consumer is a clear center of gravity. The concept also applies globally, with the United States being the center of gravity for the world economy, and a possible change underway in the Asian center of gravity, as China's economic woes deepen. You will see more on these points below.

The Global Landscape

Risks	Opportunities
Global recession concern. Even as the US is showing healthy positive economic growth, other parts of the world, including Europe and China, have enough economic headwinds to potentially slow global growth to the point of a recession.	**Peaked inflation.** Around the world, inflation seems to have peaked, with central banks now focusing on maintaining that progress and pushing inflation back to target level.
Increasing geopolitical tensions. In addition to the Russia-Ukraine war and challenging US-Chinese relations, the Israel-Hamas conflict adds significant risk to oil prices and the global economy.	**Slowing interest rate campaigns.** Cooling inflation provides the opportunity for central banks to slow their interest rate increases and start to forecast when they can decrease rates.
Unknown direction and timing for interest rates. Without a major economic slowdown, the "higher for longer" scenario may create stagnant financial markets in multiple countries.	**The outlook for Japan.** With so many countries struggling through inflation, Japan reminds us that what creates a negative outlook for some can be good for others.

As we began writing this report, Hamas attacked Israel. Since then, Israel has conveyed that a "scorched earth" offensive is on the horizon to obliterate Hamas in Gaza. This caused oil prices to rise as investors weighed the possible results of a larger **Middle Eastern conflict** involving other nations. Tensions in the area are at an extreme level, and while this war is unbelievably difficult to watch from a humanitarian perspective, financial markets have not responded significantly. A few weeks into the war, oil prices have started to ease back down. Due to the lengthy and deep ideological differences between the participants in this war, and between the allies of Israel and Hamas, we are mindful that this war could intensify quickly. As of the release of this report, Israel launched its ground offensive on northern Gaza.

Without question, **international tensions** are very high in multiple places for multiple reasons. The Russia - Ukraine war is showing no signs of ending, the Russia-China alliance seems to be growing stronger, and the Western world is now re-evaluating its relationship with Iran. Our news feeds are peppered daily with updates about wars. Coupled with the unsettled nature of the US economy, this explains why so many feel uncertainty about the global outlook. However, it is not as unusual as it may feel, given that the world has plenty of experience with both inflation and war.

Interest rates and the fear of ongoing inflation are truly the center of gravity in the global markets. Some very welcome news is that **global interest rates** for most developed countries appear to have peaked, which means that a coordinated recovery from inflation may be on the horizon. The European Central Bank (ECB) halted its rate increases when it announced that it would leave rates at 4%, a record high, and monitor the economy going forward. Inflation has a pesky habit of coming back if not stamped out forcefully at the outset, and there is no major economy that is currently considering decreasing interest rates in 2023, so our timeline for robust global recovery continues to begin in mid-2024. As with most global trends, interest rate changes will happen at different paces and at different times country by country, so a cohesive economic growth spurt is unlikely.

The outlook for **China** continues to get more grim due to downturns in its real estate sector and its painful economic recovery from COVID. Q3 GDP came in at 4.9%, still very positive but well below the forecasted 2023 Gross Domestic Product (GDP) of 6%. Mega companies Country Garden and Evergrande are both predicting very negative outlooks, with Evergrande warning of a possible "uncontrollable collapse," and Country Garden warning that it expects to default on its debt. US investment in these companies is not significant, but China's standing as the second largest economy in the world is meaningful.

Japan is once again a shining star in the global economy. As the second largest economy behind America until 2010 (when it was surpassed by China), Japan is eager to be back on the world stage. After years of languishing in deflation, an aging economy, and negative interest rates, Japan's diverse economy is really benefiting from global inflation. The country's Q2 economic output surged to 6%, surprising economists and spurring a deeper dive into how sustainable these numbers are. Exports and tourism are the main components of current Japanese growth, as the weak yen is making it difficult for consumers to buy imports at a high level.

The International Monetary Fund (IMF)'s World Economic Outlook indicates a better economic outlook for the US this year, and a lower outlook for China and Europe, resulting in a global growth outlook of 3% for 2023 and 2.9% in 2024. These numbers are substantially flat quarter over quarter, and are lower than the historical average of 3.8%, but are still quite strong. Global inflation is expected to land at 6.8% in 2023 and 5.2% in 2024.

Given the struggles in the global markets this year, **international stocks** have not performed as well as US stocks. However, the outlook for international stocks is at least as strong as it is for US holdings, and possibly even stronger given the high dividends available internationally and the lower P/E ratios. (P/E ratios, or price to earnings ratios, are a measure of a stock's share price to its level of annual earnings and are an indicator of whether the stock is fairly valued. A low P/E can be seen as a good time to buy.) Additionally, given the expectation that countries will recover from high inflation and adjust interest rates at various times and to various degrees over the coming months and even years, investors have solid diversification reasons to maintain an allocation to international holdings in their portfolios.

Interesting Note: Deglobalization continues to be a trend as countries look for ways to move their supply chains back within their own borders. This reshoring effort has major capital spending implications which could be very significant.

The US Landscape

Risks

- **Consumer spending headwinds.** Quarter after quarter, consumer spending has been high. With savings dwindling and student loans coming due, both spending and the economy may finally slow.
- **All I want for Christmas is 2% inflation.** The Fed continues to affirm its goal to battle inflation until it drops to its long-term target of 2%. With inflation hovering at 3-4%, this will be the hard part.
- **The Fed keeps saying "higher for longer." How much higher? How much longer?** The Fed's commitment to 2% creates a lot of uncertainty about when rates will be lowered. We may be at the beginning of a paradigm shift, where rates stay high for an extended period.

Opportunities

- **Spending supports current positive economic growth.** Unbelievably, the US consumer, businesses and government entities keep spending despite higher prices, supporting steady economic growth. US GDP is expected to grow by 2% annualized in Q4 - much lower than Q3 but still a very healthy economy, which would be an opportunity for consumers.
- **However, less robust economic data would put the Fed at ease longer term.** It sounds counterintuitive, but the Fed needs the economy to slow down so they have reason to decrease rates next year. Once rates are dropped, the stage is set for a longer term growth, which would be a good opportunity for the financial markets.
- **Deals are being made.** M&A (mergers and acquisitions) activity ticked up in the US, despite low global M&A volumes.

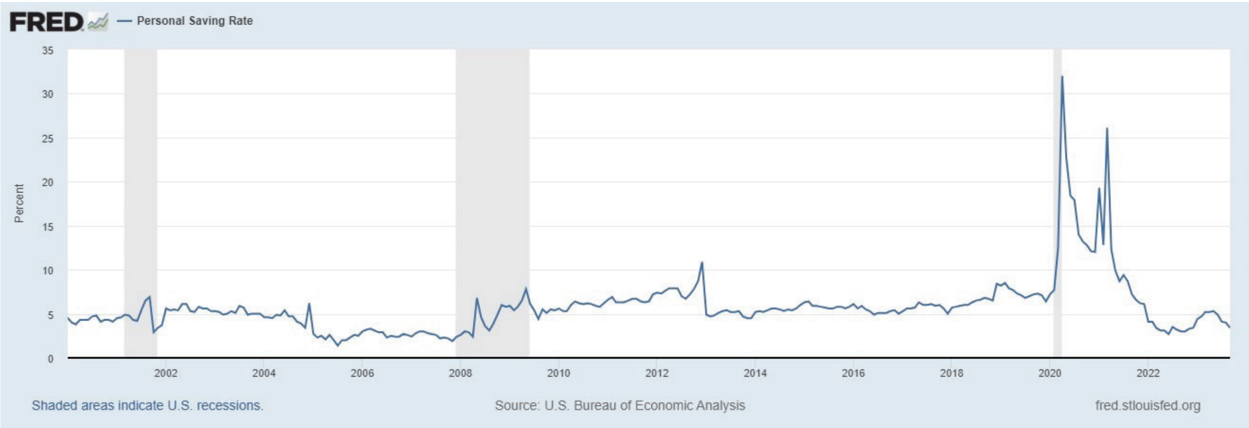
According to predictions since early 2022, the US economy should be a few months into a full-scale recession by now. Instead, the opposite is true, with **economic activity** accelerating, even in the face of significantly rising costs. We noted in our last edition that "The US is currently in the fairytale moment of waning inflation and still positive economic growth," which remains true. According to the *Wall Street Journal*, "The IMF thinks the U.S. economy, the world's largest, will expand by 2.1% this year, 0.3 percentage-point higher than its forecast from the summer."

The US economy has plenty of **complications:** soaring Treasury yields (see the US Fixed Income section below), tighter lending standards, student-loan repayments being reactivated, the ongoing depletion of excess "pandemic" savings, two foreign wars, trillions in federal debt, a frozen housing market, and record-low oil inventory, and potentially unstable oil prices due to the Middle East conflict.

Some companies are focused on the bright side. When companies fundamentally lack confidence in the economic outlook or determine that there is too much uncertainty to make significant financial decisions, they tend to hunker down. However, Q3 provided some very encouraging **M&A activity** which could be an indication that large US corporations see a positive outlook ahead. The energy sector had two noteworthy M&A deals, with Chevron buying Hess Corporation in an all stock $53B deal, and Exxon acquiring Pioneer Natural Resources for $59.5B, also an all stock deal. The tech sector was also part of the M&A story this quarter as Cisco acquired cybersecurity firm Splunk for $28B in cash.

Employees are ultimately consumers, and when employment opportunities are strong, people feel confident to spend. We have seen this in abundance in our economy. The strength of the **American consumer**, who accounts for 70% of our country's GDP, has served as the center of gravity for our economy in staving off a recession – from remodeling in 2020 to refinancing in 2021 to "revenge travel" and other experiences in 2022-23. Consumers have been a seemingly unstoppable force. Indeed, consumer spending increased in September, and Q3 GDP landed at a staggering 4.9% - all in the face of high interest rates. The same way we don't fight the Fed, we shouldn't fight the US consumer. But we should try to figure out if they will slow down at some point.

Consumers do have new headwinds, now evidenced in data that they are having **challenges with their debt.** In addition to student loans being due again, banks are no longer lending to consumers at the same rate that they were prior to the March banking crisis. For now, as T. Rowe Price points out, we are in a steady state: "…debt servicing costs remain low relative to history, even with rising interest rates, and U.S. consumers' financial obligations remain manageable relative to disposable income." The 2000-2023 Personal Savings Rate chart below shows that Americans have spent their pandemic savings, so future spending will have to come out of normal monthly cash flow - which may mean decreased spending.

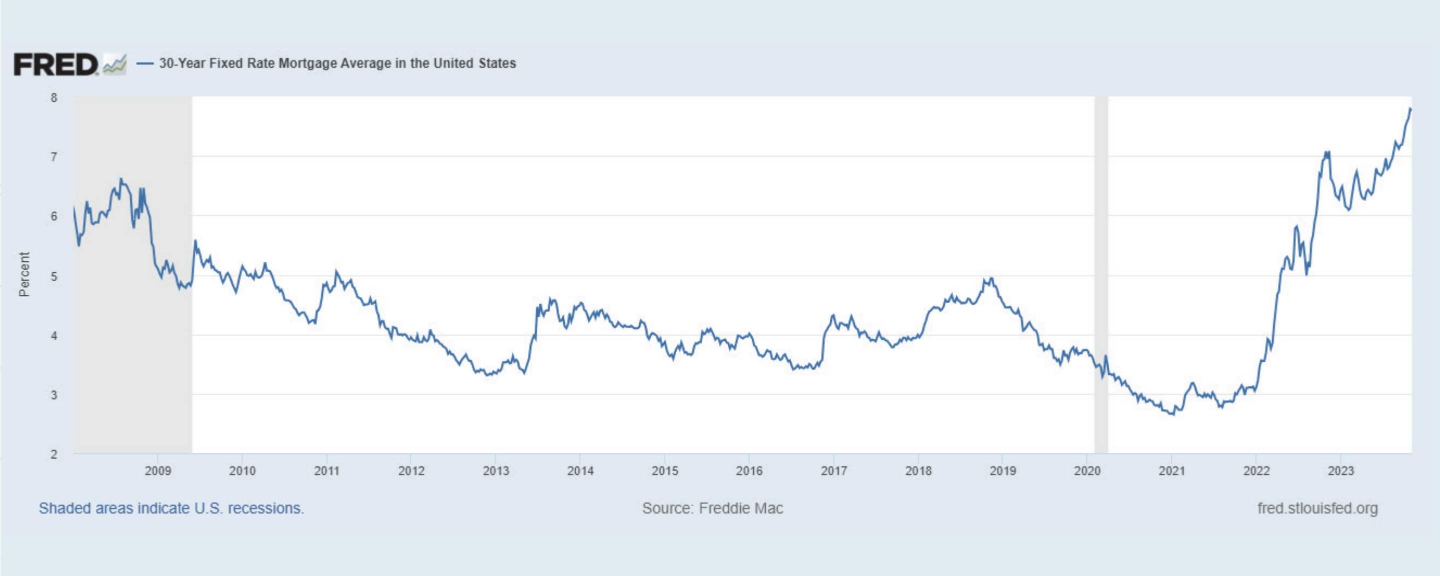


As long as the **employment numbers** are strong, which they are, we are not sliding towards a recession. Many economists believe that employment trends are easing, but we don't see substantial evidence of that yet. In the meantime, wages are growing due to demands by employees and unions. This is causing real pressure on companies. As an example, the UAW strike is affecting the bottom line for car manufacturers: GM beat its Q3 expectations but eliminated forward-looking guidance due to the unpredictable nature of the strike and negotiations.

We have focused on **the Federal Reserve** extensively in the last few market reports because its decisions about interest rates are currently the center of gravity for the US. The Fed has a "dual mandate": to support full employment and to keep inflation steady at a long-term rate of 2%. This duality is particularly challenging in an environment where full employment is causing inflation above 2%. Jerome Powell's clarity about the Fed's commitment to push inflation down to its target 2% was one of the primary reasons that we saw such a volatile quarter as financial markets wrestled with what it will take to get there. JP Morgan's Chief Global Strategist, David Kelly, is predicting that inflation could return to a 2% rate by Q4 2024, which would be welcome news if true.

But what if that doesn't happen? To combat the 2008 financial crisis, the Fed lowered rates to 0%. At the time, the expectation was that rates would be eased back up as soon as the economy was stable enough to tolerate it – which didn't happen until the end of 2015. Today, the Fed indicates that it will keep rates "higher for longer" to combat inflation. If "longer" is twelve months, we will get back to more predictable financial markets fairly quickly. If "longer" is multiple years, a **paradigm shift** may be settling into the financial markets. Historically, interest rates were closer to the 4% level, not 0% as we have had since 2008. A return to 4% rates will have many effects on business, government, and personal spending.

Interesting Note: According to Redfin, a homebuyer must earn $114,627 in annual income to afford the median-priced U.S. home. This is the highest necessary annual income recorded, up 15% over the past year and up more than 50% since the pandemic started. The monthly mortgage payment for the typical U.S. homebuyer is $2,866, which is also an all-time high..



US Bond Market

Risks	Opportunities
Rising yields. The Fed has been raising rates to cool the economy. The bond market recently decided that it wasn't enough, and yields rose in the market, causing bond values to drop.	**Long-term outlook.** For long-term investors, the recent surge in yields presents a buying opportunity and a chance to lock in those higher rates.
Creeping inflation. If inflation starts to climb again, the Fed will be motivated to raise rates again, which should cause bond prices to fall and strain resources for lower quality companies.	**Municipal bonds.** While the municipal bond market has not had its moment to shine in 2023 as predicted, these bonds offer high current tax-free income and a compelling price value.
An uncertain or incorrect Federal Reserve. The bond market has a keen focus on the Fed's every announcement, and any missteps or uncertainty is likely to create volatility in the markets.	**Income, income, and more income.** Fixed income investors – for example, in bonds, money markets, CDs, fixed annuities – are benefiting from high current rates.

We were right and also not yet right in our Q2 Market Report analysis about the **US bond market.** We talked about the "higher for longer" scenario outlined above, meaning that we didn't expect the Fed to lower rates this year. Jerome Powell confirmed this in his September 20th press conference, when he indicated that rates would not be dropped until 2024 – and even then it wouldn't be a dramatic reduction. On that note, we were right.

However, we also expected the bond market to start to stage a recovery once peak inflation was clearly behind us and the Fed meaningfully slowed its interest rate campaign. On that note, we haven't been right yet. Bond managers (the people who buy and sell bonds on behalf of investors) and wealth managers (people like us who choose which types of bonds and which managers should be in our clients' portfolios) still see **mid-term upside in the bond market.** The question remains about when that will happen.

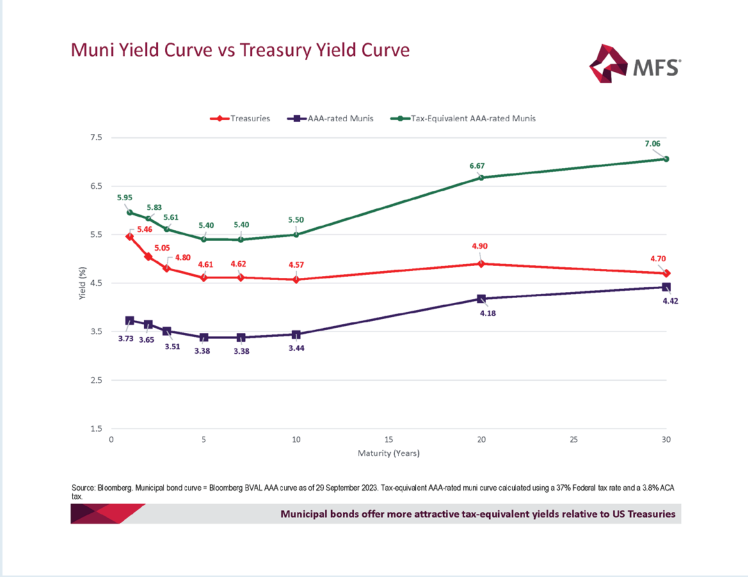
Many expect the Fed to decrease interest rates in 2024. However, the timing and size of the decrease is very much unknown. It is also possible that if we are in a true paradigm shift on interest rates as noted above, the Fed may keep the rates at the current level for an extended period. This is why each and every economic data point is consumed by Wall Street and why the **bond market is reacting** so significantly to those data points, as evidenced by the recent surge in bond yields.

In the short term, bond investors will need to have a great deal of **patience** as we muddle through the next six to nine months until the Fed can consider decreasing rates. And certainly, if inflation starts to tick back up meaningfully, either due to consumer spending or oil prices or another unexpected event, bond investors should consider that interest rates may stay high for quite some time. The very good news is that while investors need price patience, they no longer need yield patience. Today's yields are meaningful, especially to retirees who no longer need to turn to the higher risk of stocks just to meet portfolio return needs. Yields can now behave like the center of gravity that they historically did for bond investors. PIMCO highlights the opportunity: "…investors can now seek to construct resilient portfolios, pursuing robust yields and predictable flows, with a moderate amount of risk."

Municipal bonds have had a particularly confounding year, as performance has not at all matched expectations. They continue to provide a great buying opportunity, specifically for investors in high tax brackets. Muni bond managers still see the opportunity to buy, but concede that the timing - as always - is unknown. AllianceBernstein recently noted, "We can point out the generational opportunity that exists in muni bonds today, but investors are still searching for the most opportune entry point. Unfortunately, no one can perfectly time the market. Nor can you always predict what the catalyst of a rally will be."

Fixed income investors continue to benefit from **increasing rates** in the Money Market, CD and fixed annuity markets. We now believe high rates will be available through Q1, 2024, allowing savers and investors plenty of opportunity to lock in high rates on their conservative portfolio holdings.

★ **Interesting Note:** The **bond yield curve inversion** is a much-discussed topic among economists and money managers. As a reminder, modern day recessions have all been preceded by yield curve inversions. Importantly, however, not all yield curve inversions have been followed by a recession. The persistence of the current yield curve inversion – which started in July, 2022 - has been one of the main indicators that journalists cite when they say a recession may be on the near-term horizon. Sixteen months after the inversion, we are instead in a growing economy.



US Equity Market

Risks	Opportunities
The possibility of… so many things. The stock market likes certainty, which is in short supply right now. With so much focus on short-term economic data, the market may be stuck in a trading range until a longer term growth trend can be launched.	**Earnings are showing signs of hope.** Corporate earnings have been declining all year, but forward-looking guidance from Q3 announcements indicate that we may see earnings growth in upcoming quarters.
The ghosts of the spring banking crisis. Banks continue to be cautious about their lending policies, which can cause rates to go up and economic activity to stall.	**Dividends.** Growth has had a nice run in 2023, but value stocks and dividend-producing stocks are likely to be in favor in a "higher for longer" interest rate environment.
Concentration. The phenomenon of the "Magnificent Seven" stocks fueling the vast majority of the S&P 500 returns in 2023 is not healthy. We need to see price appreciation from a wider group of companies.	**Resilience.** Companies have been very resilient and know that historically, opportunities abound after the last rate hike in a cycle. While still keeping costs down and protecting cash reserves, corporate America had an uptick in M&A activity – unlike the rest of the world.

We continue to see a r**eal divergence between companies** and across sectors in the US stock market, though all stocks lost value in Q3. Indeed, cash and commodities were the only positive asset classes in Q3, with the S&P 500 trimming 3.3%. One of the "Magnificent Seven" stocks that drove the majority of the stock market returns in the first half of the year have cooled (most notably Tesla which recently lost 13% after announcing Q3 results). While the other six companies – the ones currently noted for fueling AI (Google, Apple, Nvidia, Microsoft, Amazon, and Meta) are the ones that continue to be the driving force behind 2023 US stock market returns, they did not perform well in Q3. Instead, nine of the top 30 performers in the S&P 500 in Q3 were energy companies.

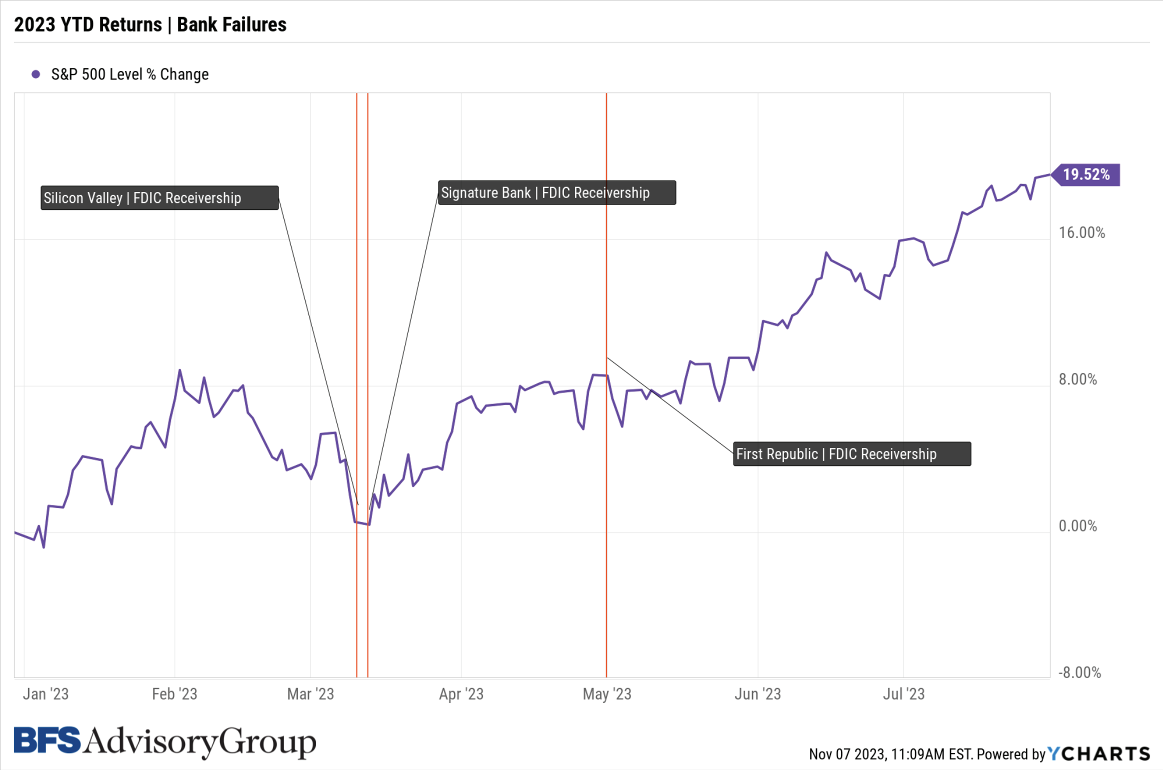
The performance of the **AI craze stocks** is an important reminder for investors: even when the economic environment can seem challenging, companies can have enormous success and therefore perform well. We have noted previously that high interest rate environments are classically challenging for growth stocks, partly due to higher borrowing costs, and yet these stocks have excelled this year. Interestingly, the sectors that really stand to benefit from AI over the long-run – think healthcare and financials – are currently lagging due to economic dynamics noted above. We expect to see opportunities for these sectors to perform well in 2024 as AI becomes a more useful tool. We also expect to see new substantial capital expenditures from companies in many sectors as AI gains traction.

With all of the talk about recession on the horizon, one might think that consumer staples (think Dollar General, Target, Kraft Heinz) would be a leader. Not so, or at least not yet. In fact, more than twenty S&P 500 stocks in the consumer staples and discretionary sectors set new 52-week lows in October. This tells us that there is still a very broad opportunity for a rebound once rates can be decreased. In fact, the **Q3 earnings season** – while still expected to be down 1% - is showing the beginning signs of a turn to the positive, as companies are broadly beating expectations. This alone is not that exciting, since so many companies lowered expectations throughout 2023. However, the change is that companies are starting to provide a positive forward-looking outlook.

The really great news about Corporate America is that it is chock full of **people who like to win.** While the transition to a somewhat permanent higher interest rate environment will take some time, it does not need to be seen as a negative long-term outlook. In fact, quite the opposite may be true. Companies have been very resilient and know that historically, opportunities abound after the last rate hike in a cycle.

Healthy, well-run companies are winners in an environment like this, as are their investors who commonly benefit from the **dividends** these companies can provide.

Interesting Note: The S&P 500 was only up 0.6% until the March banking crisis, at which time the government pumped hundreds of millions of dollars into the economy. The S&P then surged 19.5% YTD by July 31.



Our Final Thoughts

In our last market report, we noted how many people had changed their opinions about the outlook for the economy and the financial markets to a more positive one. We also noted that we had "enough clear and present dangers in the economy to know that the worst may be behind us, but we are not in the clear yet." Now with the Israel and Hamas conflict, there is a new layer of "what if?" scenarios to build into the possible outcomes. Without question, one version of the outcome of the conflict is a long war that could spike oil prices and allow inflation to return with a vengeance.

Even if the last interest rate increase is behind us, we may not be in an environment that can immediately move to recovery in the financial markets. The increase in yield in the bond market is a big current-day reward for bond investors, with stock market dividends only slightly higher. We expect a sideways market for the next two quarters, with an understanding that we have had enough negative surprises over the past 18 months to believe in remaining invested for when the markets surprise us in a positive way.

A special note about increasing US political dysfunction: We believe strongly in taking an apolitical point of view when it comes to investment decisions, knowing that Republican and Democratic power will ebb and flow, and each side presents its own risks and opportunities. However, both parties are contributing to the current dysfunction in Washington instead of acting like the leaders we need to address substantive decisions about our budget, our nation's debt, and our relationships with other countries. As an example, the temporary vacancy of the critical Speaker of the House position after Kevin McCarthy's ouster occurred at a high-stakes time. This is yet another example of last-minute leadership that politicians on both sides of the aisle currently use to govern, which has become increasingly chaotic. Leadership faults by either party can have an effect on the financial markets, which we will continue to weigh in our decisions.

We appreciate the confidence and trust that you place in us, and we are dedicated to helping you pursue your long-term goals. If you have any questions about our views on the markets, or about your portfolio, please contact us. We're here for you.

Debra Brennan Tagg, CFP®
President

BFS Advisory Group

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