

Good News, Bad News

“Give me a one-handed economist! All my economists say ‘on the one hand...[and then] on the other’.”

– Harry Truman (US President 1945-1953)

A man with an incredible passion for baseball recently fell ill and asked God for strength and encouragement. God answered his prayers by saying, “I have good news and bad news. The good news is that we have baseball in Heaven. The bad news is that you’re pitching on Friday.”

Please forgive us Mr. Truman. Market observations for this month have become, candidly, more balanced. On the one hand, there’s been an increasingly large package of Fundamental data evidencing a bottom. On the other hand, early signals of Inflation data might be basing as well. This begs a couple of questions – what implication might this have for markets and what reaction might it imply for the Fed? Let’s explain.

As can be seen in the table below, we highlight two sections – the Fundamental data and the Inflation data. The Fundamental data includes a broad swath of metrics including consumer and business owner confidence (UofM Consumer Sentiment, NFIB Small Business Owner Confidence), personal consumption (Core Retail Sales) and housing (Building Permits), capital investment (CAPEX Book to Bill Ratio), manufacturing (ISM Manufacturing New Orders), corporate credit (High Yield less Investment Grade Credit Spreads) and profit growth (S&P 500 Next Twelve Month Earnings). In all cases, we’re seeing current readings today that are improving from trough levels hit over the past two years. From this lens, the Fundamentals are getting better.

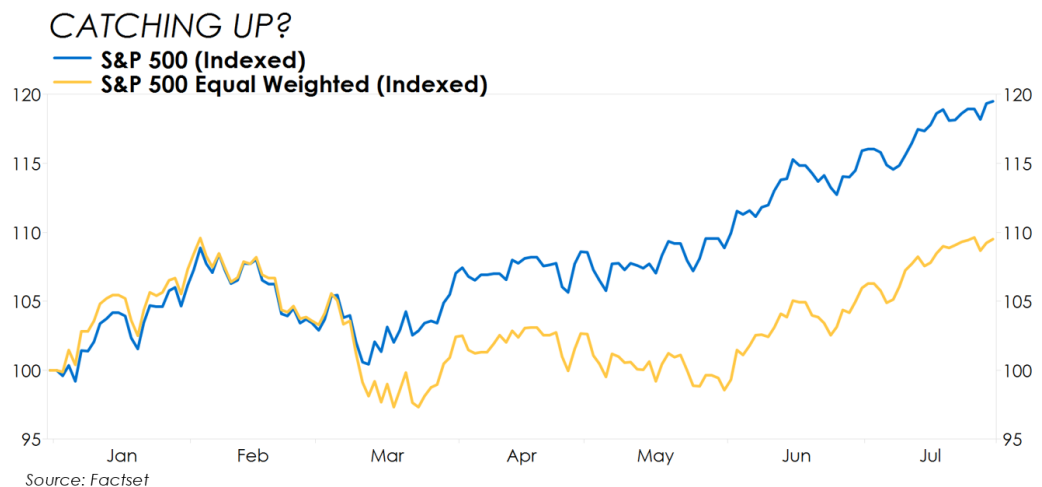
GOOD NEWS				BAD NEWS			
Fundamental Data	Current as of 7/31/23	Trough since 7/31/21	Change	Inflation Data	Current as of 7/31/23	Trough since 7/31/21	Change
UofM Consumer Sentiment	72.6	50.0	22.6	Bloomberg Commodity Index % 1 Yr	-9%	-25%	17%
NFIB Small Business Owner Confidence	91.0	89.0	2.0	Copper Price % 1 Yr	12%	-28%	40%
Core Retail Sales % 1 Yr	3.7%	3.6%	0.1%	CPI Core Goods % 1 Yr	1.4%	1.0%	0.4%
Building Permits % 1 Yr	-15%	-29%	13%	NFIB Selling Price Plans	31	21	10
CAPEX Book to Bill Ratio	1.00	0.95	0.06	ISM Manufacturing Prices	42.6	39.4	3.2
ISM Manufacturing New Orders	47.3	42.5	4.8	Capacity Utilization Rate %	78.9	77.8	1.1
HY less IG Credit Spreads (bps)*	255	420	165	TIPS 5 Year Inflation Expectations %	2.28	2.11	0.16
S&P 500 EPS NTM % 1 Yr	-0.8%	-3.7%	2.8%	5 Year 5 Year Forward Breakevens %	2.47	2.02	0.45

Source: Factset; Credit Spreads (*change in absolute terms), S&P 500 EPS NTM Estimates, Bloomberg Commodity Index, Copper Price, TIPS implied 5 Year Inflation Expectations, 5 Year 5 Year Forward Breakevens calculated using weekly data. All other metrics calculated using monthly data. CAPEX Book to Bill Ratio defined as Core Orders over Core Shipments.



On the other hand, we find hints of inflation data percolating under the surface. This isn't apparent when looking at the traditional inflation indices, where the data has continued to moderate well off the highs. Such is the case when one looks at consumer price inflation (CPI), wholesale price inflation (PPI) or the Fed's preferred personal consumption expenditure inflation (PCE). However, we find it premature to claim mission accomplished – a sentiment that the Fed is reluctant to claim as well. Core inflation readings remain above headline readings in all three cases implying some stickiness remains. Additionally, all of these measures are realized inflation data, thus, are backward looking. When examining some of the more leading edge inflationary metrics, we find evidence that this data is also bottoming. Commodity prices (Bloomberg Commodity Index, Copper Prices), core goods inflation (CPI Core Goods), regional pricing surveys (NFIB Selling Price Plans, ISM Manufacturing Prices), industrial production capacity (Capacity Utilization Rate) and inflation expectations (TIPS 5 Year Inflation Expectations, 5 Year 5 Year Forward Breakevens) all have readings today that are above trough levels hit over the past two years. If this leading edge data begins to bleed into (still elevated) realized inflation measures at a time when the Fundamental data is also bottoming – then the Fed might have to do more than most are expecting should they stick to their 2% inflation target.

If the Fundamental improvement is sustainable (a big IF), there could be a period where the Good News leads to a catch up trade in the equity markets. The chart below suggests how this dynamic could play out. So far this year, the market cap weighted S&P 500 (influenced by megacap company concentrations) has significantly outperformed the equal weighted S&P 500 ("average" stock). While the bulk of that performance gap occurred from March to May – since then – it's yet to have materially closed. Should Fundamental data continue to evidence improvement, the gap could close as investment opportunities are more broadly recognized.



The caveat here is that Good News might become Bad News if the inflation data evidences some resurgence triggering a more hawkish response out of the Fed. While the consensus suggests the Fed is done raising rates, the potential for renewed inflation means a "head on a swivel" mantra is critical – recent news on Fitch's downgrade of US Treasuries and the Bank of Japan's policy "tweak" are two prime examples beyond the discussion above. Perhaps that's why late cycle environments are especially tricky as things are often good until they're not. Staying clear headed remains important.



Market returns continued to broaden out in July with Stocks, REITs and Bonds all posting positive, low-single digit returns. Commodities were the best performing asset class for the month, up over 6%. Year to date, major equity indices were up double digits, led by the S&P 500 – best since 1997. Fixed Income and Real Estate were up low to mid-single digits, respectively, as inflation continued to moderate. Commodity returns were still slightly negative despite the bounce in July.

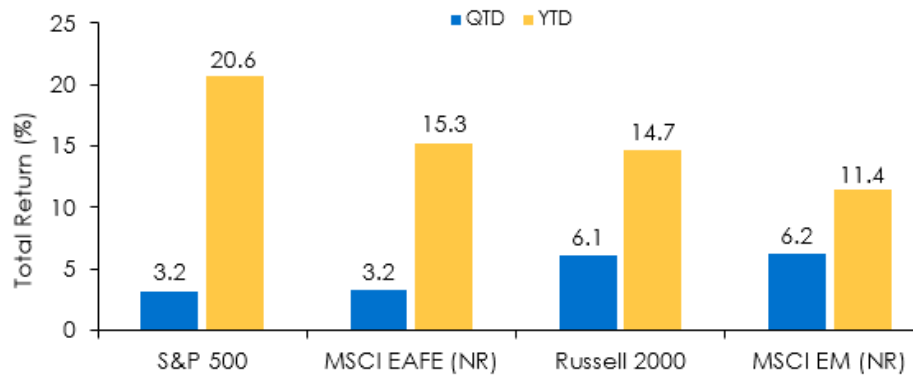
Stocks

Year to date equity performance continued to broaden out with the gap between U.S. Large Caps (S&P 500) and everything else narrowing. US Small Caps (Russell 2000) – in particular – have outperformed over the last two months. Sector outperformance has favored the higher priced “Magnificent 7” within the cyclical growth sectors (Technology, Discretionary and Communication Services).

Meanwhile, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed despite the former group continuing to exhibit relative strength in July. Elsewhere, equity performance in International Developed Markets (MSCI EAFE) has been solid – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis in Europe along with better economic data out of Japan. Finally, Emerging Markets (MSCI EM) posted strong returns in July, closing the gap somewhat with Developed Markets and benefiting from a favorable commodity backdrop in the month.

Global Equity Returns

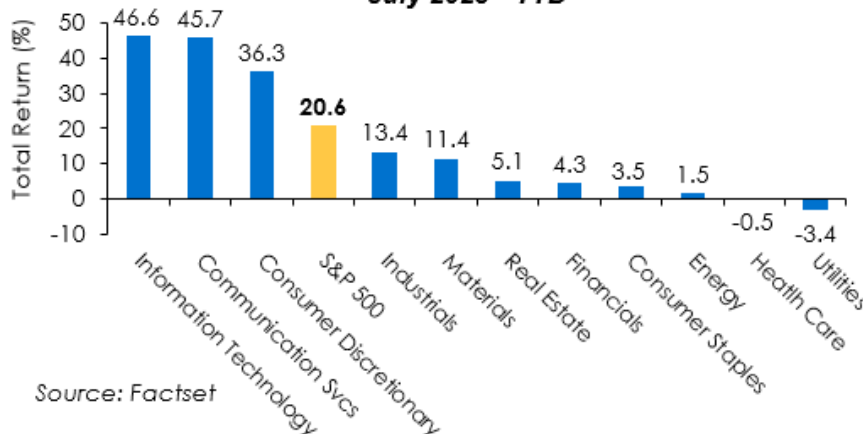
July 2023



Source: Factset

S&P 500 Sector Returns

July 2023 - YTD



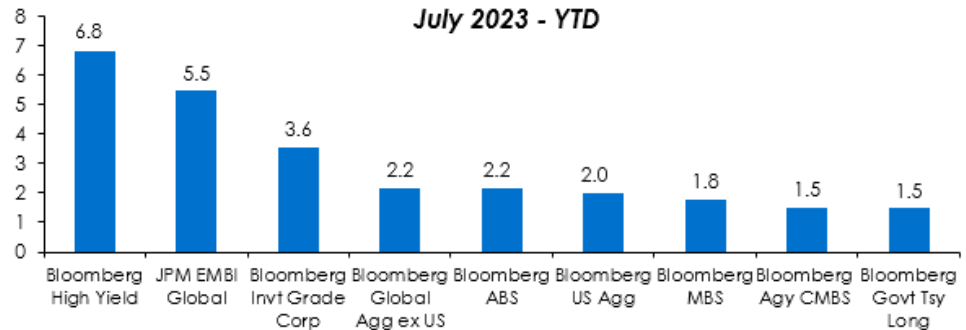
Source: Factset



Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 525 basis points (to 5.25-5.50%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy (with a 25 bps hike in July). Year-to-date, longer-term rates have been volatile within a range and are now trading toward the upper band despite a moderating (though still sticky) inflation backdrop. Meanwhile, the yield curve remained deeply inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the entire Treasury curve having moved below the Fed Funds rate. The sideways movement in rates combined with solid carry and tightening credit spreads have combined to produce positive broad-based returns year-to-date. As such, Corporate bonds (High Yield, Investment Grade) and Emerging Market debt (JPM EMBI) outperformed.

Global Fixed Income Returns
July 2023 - YTD



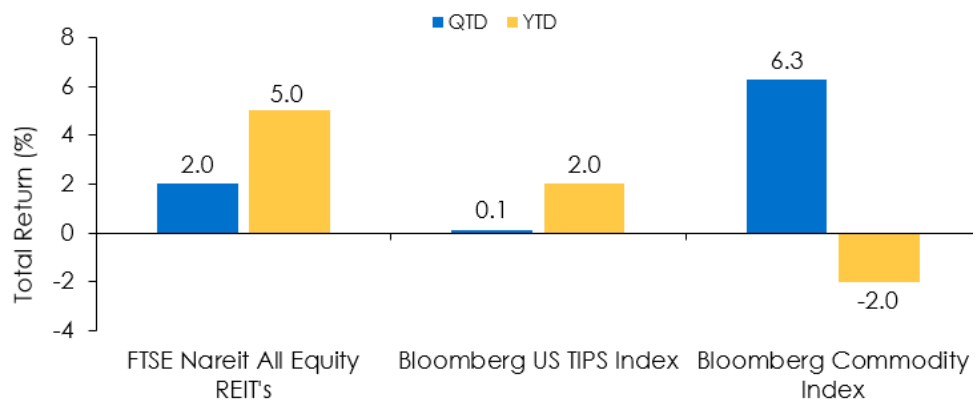
Source: Factset

Duration represented by Long-Term Treasuries (Govt Tsy Long), Securitized credit (MBS, CMBS) and International debt (Global Agg ex US) were positive but lagged.

Alternatives

Commodities traded lower year-to-date despite strong returns in July with Energy and Industrial Metals pricing soft (notwithstanding a rebound in the month). Meanwhile, publicly traded Real Estate (REIT's) saw a continued bounce in July though year-to-date returns

Alternative Market Returns
July 2023



Source: Factset

have materially lagged comparable stock returns. Finally, Treasury inflation protected securities (TIPs) benefited from the positive carry in bonds year-to-date along with a bottoming in inflation expectations.



Market Outlook

“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”

– Bill Bryson, *A Walk in the Woods* (1998)

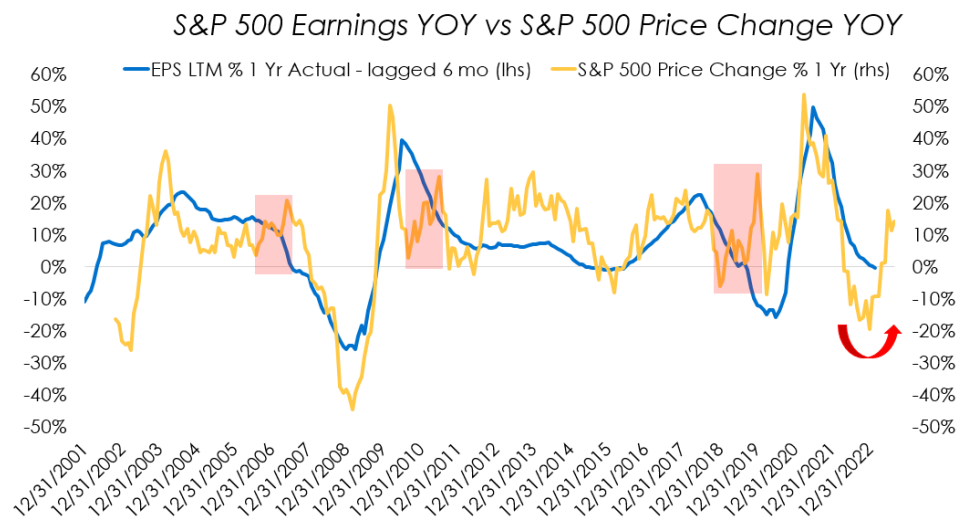
We’ve dubbed our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon.

Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

At the other end of the spectrum is the cyclical

perspective, which we think currently carries greater weight given its more immediacy – at least for a time. As noted in the opening, one area of Good News has been the improvement in bottom-up earnings estimate revisions feeding into improved earnings growth expectations. The chart above suggests the S&P 500 is anticipating an acceleration in corporate profit growth. The two lines above (EPS growth and the S&P 500) tend to be correlated through time, though there have been some notable disconnects along the way including



Source: Factset; EPS Growth LTM actual earnings is based on iShares S&P 500 ETF (IVV) from Factset.



2006-07, 2010-11 and 2018-19 (red shaded regions – so this is not necessarily a given). A broadening improvement in the Fundamental data has been additionally supportive of the market’s positive view on earnings. However, the sustainability of that view remains an open question as investors tend to fall into two camps.

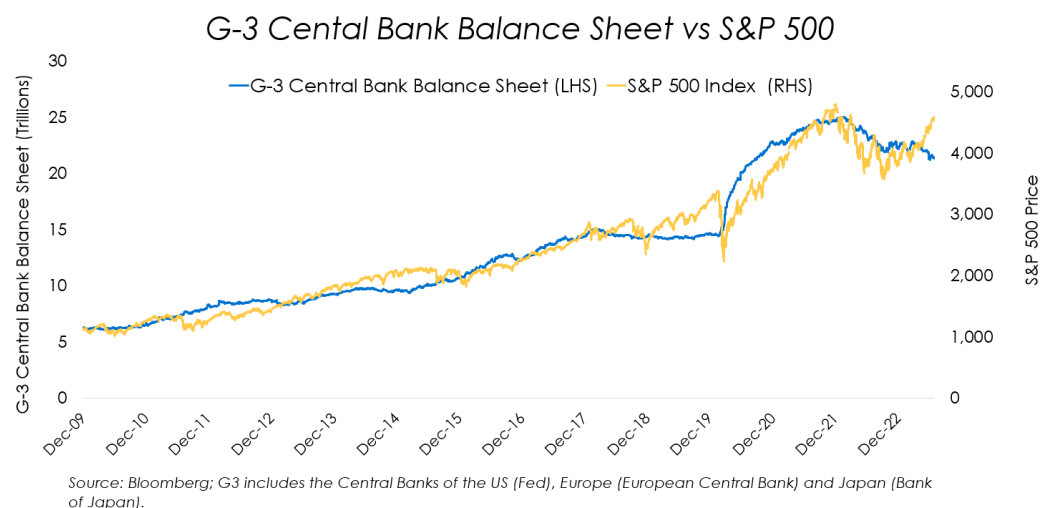
The first camp assumes this time is different in the sense that a reset to an early cycle can occur by threading the needle between growth and inflation. Structurally tight labor markets suggesting an even lower unemployment rate and an “AI” driven productivity boom are a part of that narrative.

The second camp is one that places greater evidence on the historical lesson that there’s no free lunch for curing the ills of inflation and that the bill will eventually come due via monetary policy that’s either already been or yet to be enacted.

Our view tends to fall in the latter camp. Things can be good for a time and might even broaden and reaccelerate but the question remains around such sustainability. As such, we continue to focus on the following set of conditions:

- We remain in the latter stages of the business cycle. What inning we’re in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle. Perhaps the simplest measure is a 3.5% unemployment rate – which puts this reading in the 99th percentile relative to history dating back to the early ‘60’s.

- Liquidity is being drained from the economy. Lots of data support this notion including a dramatic decline in the savings rate, negative year on year money supply growth (approximately \$800b off the



peak), the continued Fed tightening policy (including another rate hike this month), a deeply inverted yield curve and credit standards that are the tightest since 1Q09 (ex Covid) – worsening again this month. Yet another example is the chart above which aggregates the central bank balance sheets of the US (Fed), Europe (ECB) and Japan (BOJ). Ever expanding central bank balance sheets since the Great Financial



Crisis have been correlated with the general uptrend in equities. Hiccups have occurred when the stimulus waned in 2018, 2020 and most recently in 2022. This past month the Bank of Japan announced a “tweak” to its monetary policy by allowing its 10 year bond to float in a wider band than previous tolerance limits (loosening so called yield curve control). While not couched as such, this might represent the beginning of (uber accommodative) policy normalization. The unwind might have consequences for (higher) yields globally and, at a minimum, lead to a further liquidity drain. It’s even been speculated that the Fed is coordinating actions with the BOJ as the tightening baton is handed from one central banker to another. That assumes, of course, that the Fed is done tightening which remains up for debate.

- Growth sustainability is unclear. While improving Fundamental data and market price action suggest the potential for improvement in underlying profit growth, the combination of the above can act as a governor on growth. If growth does lift off with an inflation follow through, central banks might have to respond with additional actions or their credibility might be called into question.
- Valuations are elevated. With flat to down earnings growth so far this year, the valuation compression seen last year has partly reversed. The S&P 500 is now trading back above long-term levels (19X versus 18X) and well above where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X). Of course, this has been most acute at the top of the market where the mega-cap growth stocks have seen more dramatic multiple expansion. This begs the question, will multiples begin to compress under the weight of a potential back up in rates especially at a time where there’s now a real alternative to stocks (i.e. skinny equity risk premium)?

Perhaps most critical to recognize is the notion that late cycle backdrops are especially tricky as things are often good until they’re not when at these inflection points. This doesn’t mean that risk taking has to be completely absent though we find that it does mean that clear heads tend to prevail. As a result, to us, it still doesn’t appear to be a great setup for significant risk taking – particularly in areas where there’s a limited margin of safety.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to believe that it’s important to “See both the Forest AND the Trees”. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). While we entered this year with an UW to risk assets, we’ve let that UW lessen amid the year-to-date market rally. Still, our composition within US Equities, US Core Fixed Income and Diversified Alternative managers remains more conservative in nature for all of the above reasons. Our overall portfolio bias has generally been to have more exposure to less expensive areas while maintaining conservative leanings.



Within equities, our positioning continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a “Heads I Win, Tails You Lose” mentality with speculative fervor.

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we’ve previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we’re slightly OW in aggregate with a bit more defensive skew. We remain OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there’s lower correlations between stocks and bonds). We’re generally EW to Commodities as a way to bolster inflationary hedges. Meanwhile, we’re slightly UW Real Estate as a way to further reduce overall portfolio risk.

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