

Finale or Encore?

“The suspense is terrible; I hope it will last.”

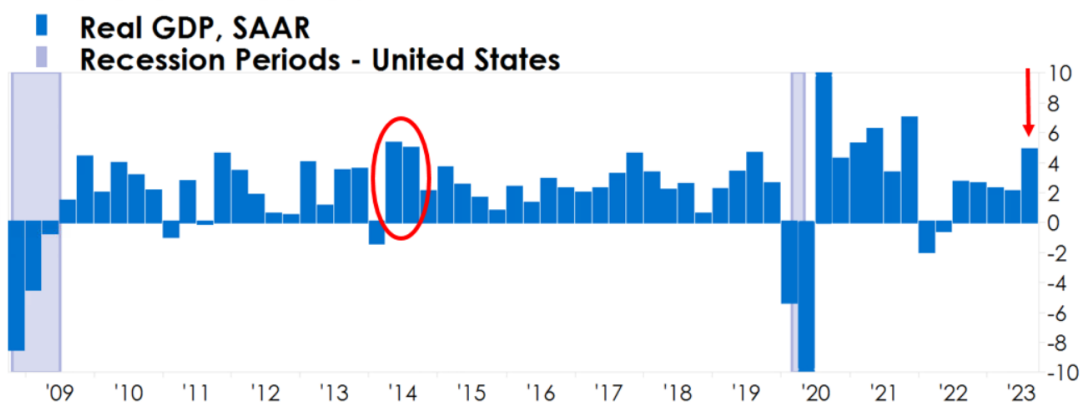
– Willy Wonka and the Chocolate Factory (1971)

Chances are you’ve likely seen the movie, Willy Wonka. The “candy man” was played by Gene Wilder in what was considered one of his most iconic roles. In it, Charlie Bucket – against all odds – pulls a fifth Golden Ticket to get access to the secretive Wonka factory.

In similar fashion, it feels like a Golden Ticket was just pulled following the third quarter GDP report – which saw the economy grow at an almost 5% annualized pace, in real terms, for the quarter! The growth was

driven by a resurgence in personal consumption (“revenge spend”) along with an inventory rebuild (in anticipation of the auto strikes) and government spending

Finale or Encore?



Source: Factset; Real GDP, SAAR; 2Q-3Q20 truncated.

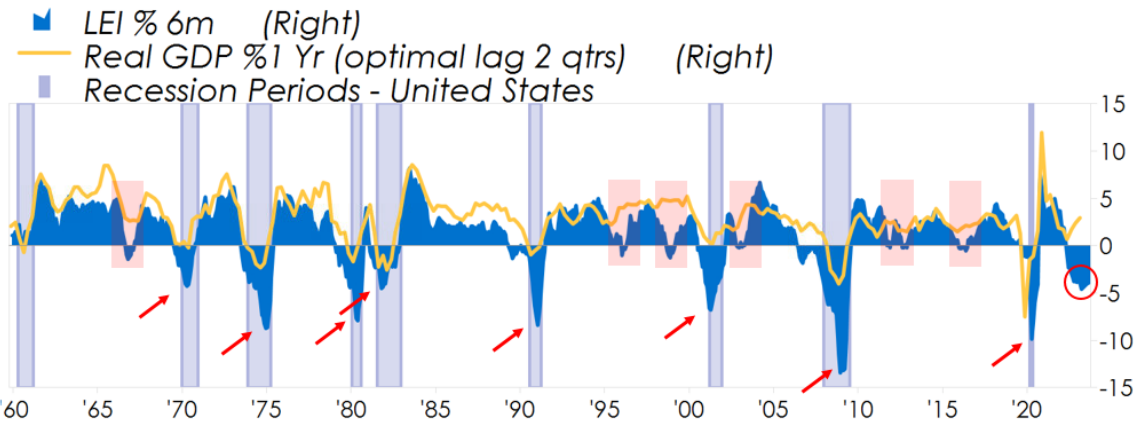
(boosted by national defense). Housing was even a (albeit modest) contributor for the first time in ten quarters! As can be seen in the chart above, excluding the COVID rebound, this kind of real growth was last seen in 2014. Back then, it would be another five years before the economic cycle ended in recession.

As a result, investors are now asking the question, “Is this the Finale or the Encore?”. There are good arguments for both. Those suggesting the “Encore” might point to being just three years removed from the last economic recession as well as what appears to be a bottoming in many of the economic fundamentals and in earnings growth. On the flip side, arguments for the “Finale” include indications of a “late cycle” set up. The conference board’s leading economic indicator composite (LEI) is a great example of such. It includes ten components – both financial and economic inputs – that have traditionally been helpful in identifying the



evolution of the business cycle. As can be seen in the chart below, meaningfully negative readings in the LEI (six month change) have often been a precursor to recessions dating back to 1965 (red arrows). Generally speaking, the direction of the change in the LEI has been consistent with the year over year change in real GDP (lagged by about two quarters). Of course, no reading is perfect and the LEI is no exception as this measure has come with six false positives over the last sixty years (red shaded regions – slight negative readings that ultimately proved to be head fakes).

LEI vs GDP



Source: Factset; Conference Board LEI and Real GDP.

Per the table below, absent those (“Encore”) head fakes, a negative LEI reading has signaled a recession, on average, ten months in advance with a minimum lead time of five months (’74-75) and a maximum lead time of nineteen months (’08-09). Today’s reading is sixteen months removed (May of ’22) and the LEI has never been this negative without a recession in the past. Still, you wouldn’t know it by looking at real GDP growth

LEI % 6 mo change	Duration to Recession (months)	LEI 6 mo % less GDP % 1 Yr (difference)
Average	10	-2%
Median	8	-2%
Current	16	-7%

Source: Factset; 1965-Current. Conference Board LEI includes 3 financial components - leading credit index, S&P 500, yield curve spread - and 7 nonfinancial components - consumer expectations, ISM new orders, building permits, average weekly hours, weekly jobless claims, manufacturer new orders - core durables and consumer goods.

(yellow line) which has been accelerating since 4Q22. The current difference between the change in the LEI and in GDP is outsized relative to the average historical experience – highlighting a big disconnect. In fact, when the LEI has been in negative territory, today’s gap is among the widest in history outside of an imminent recession. The closest comparable “Encore” was in ’98-99 which saw elevated growth of around 5% for another six quarters.

So, “Is this the Finale or the Encore”? The sustainability of growth remains a critical question, in our minds, with the labor market being a key linchpin in that calculus. Inflation and the Fed are likely to factor in as well in determining whether the economy can continue to pull a Golden Ticket.



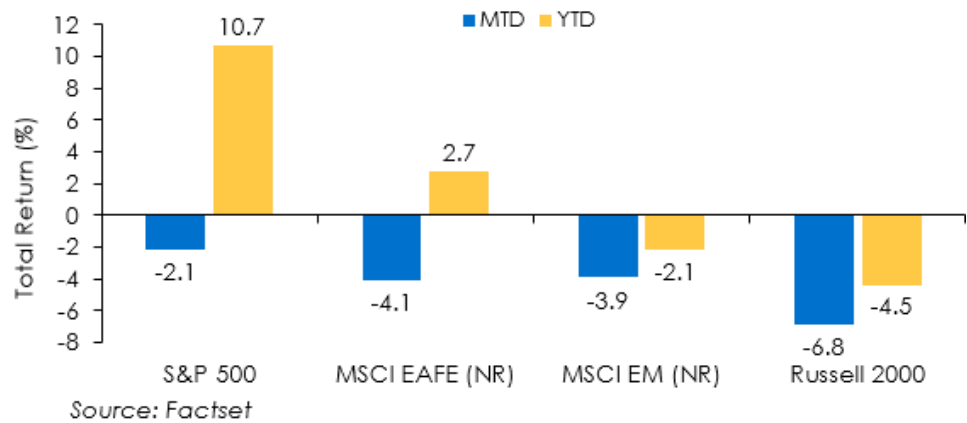
Market returns were weak in October with Stocks, Bonds and REITs posting negative, low-single digit returns, with Commodities slightly positive. Profit taking amid higher rates and general uncertainty likely contributed to the weakness. Meanwhile, year to date equity returns were mixed with Domestic and International Large Caps positive while Small Caps and Emerging Markets recently turned negative. Commodities, REITs, and most Bond indices were negative for the year as well.

Stocks

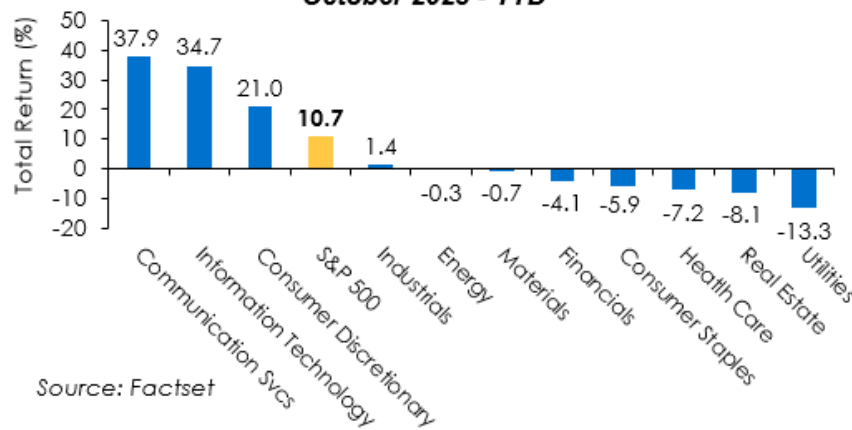
Year-to-date equity performance has become more bifurcated with a narrow subset of U.S. Large Caps (S&P 500) leading to the upside. Conversely, US Small Caps (Russell 2000) have lagged given their

interest rate sensitivity and are now negative for the year. Overseas, equity performance in International Developed Markets (MSCI EAFE) remains positive – 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 negative returns in October and are now down slightly for the year. Meanwhile, sector outperformance has favored the higher priced “Magnificent 7” within the cyclical growth sectors (Technology, Discretionary and Communication Services). Conversely, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) have starkly underperformed despite the latter group exhibiting relative strength in October.

Global Equity Returns October 2023



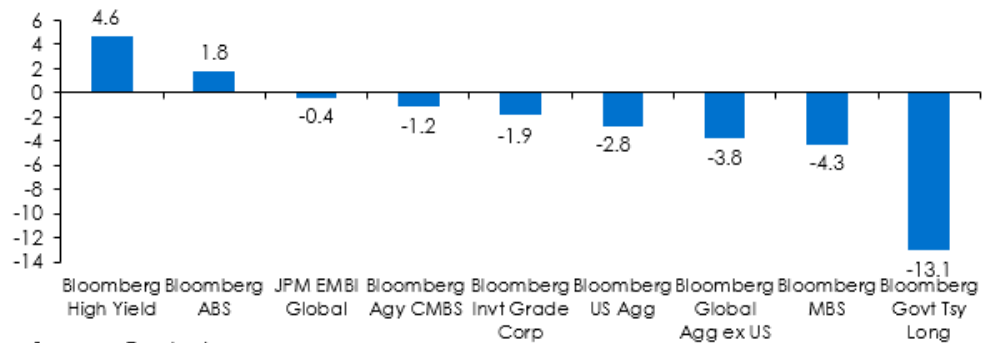
S&P 500 Sector Returns October 2023 - YTD



Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer-term rates broke out to the upside with 10 Year U.S. Treasury yields increasing roughly 80 bps from August through October. The Fed has indicated they are likely to leave rates higher for longer in their fight with (still sticky) inflation though policymakers have now left rates unchanged in their last two FOMC meetings. Meanwhile, the yield curve remains inverted but has steepened notably. The year-to-date upward move in rates, has now offset solid carry resulting in negative returns in aggregate (US Agg). Shorter duration and tightening credit spreads have led to outperformance in High Yield corporate bonds. Conversely, longer duration securities represented by Long-Term Treasuries (Govt Tsy Long) fell deeper into negative territory year-to-date as long rates increased again in October.

Global Fixed Income Returns
October 2023 - YTD

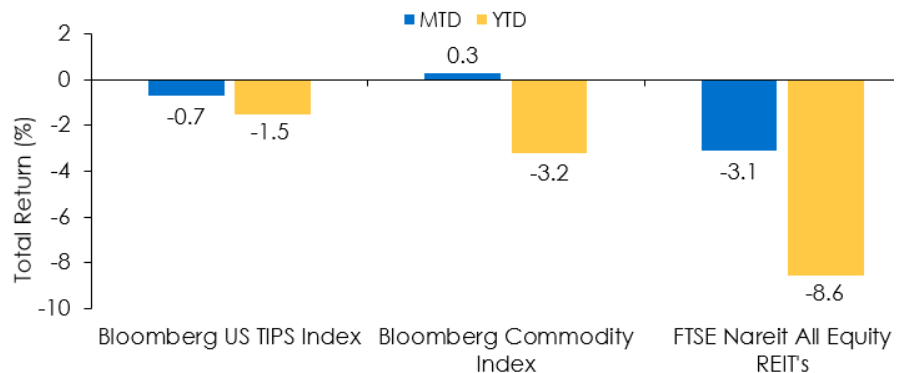


Source: Factset

Alternatives

Commodities traded lower year-to-date with negative returns in Agriculture, Energy and Industrial Metals while Precious Metals rebounded strongly in the month leading to positive returns for the year. Meanwhile, publicly traded Real Estate (REIT's) remained weak resulting in year-to-date returns that have materially lagged relative to equities. Finally, Treasury inflation protected securities (TIPs) – in comparison to nominal Treasuries – benefited from the positive carry in bonds year-to-date along with a bottoming in inflation expectations.

Alternative Market Returns
October 2023



Source: Factset



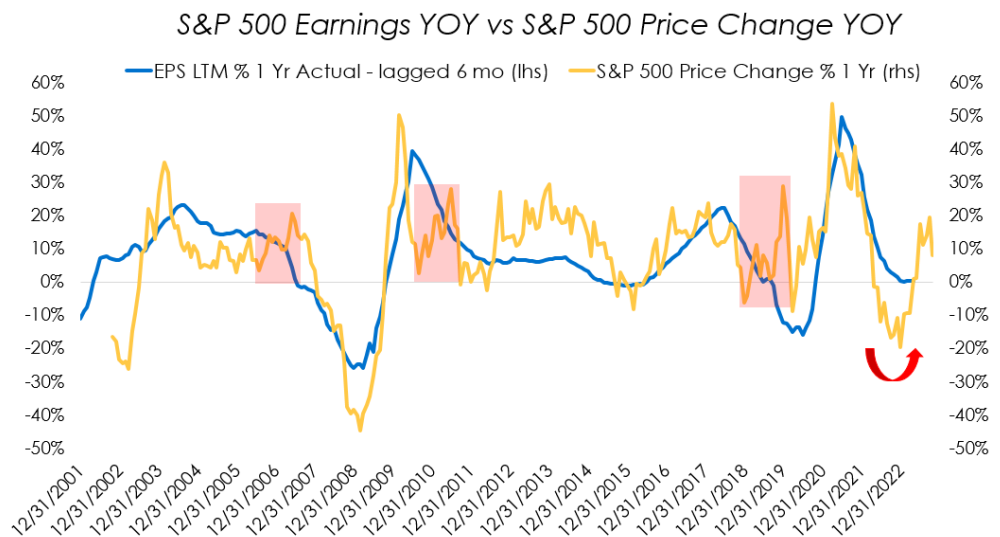
Market Outlook

“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 and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations. 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).



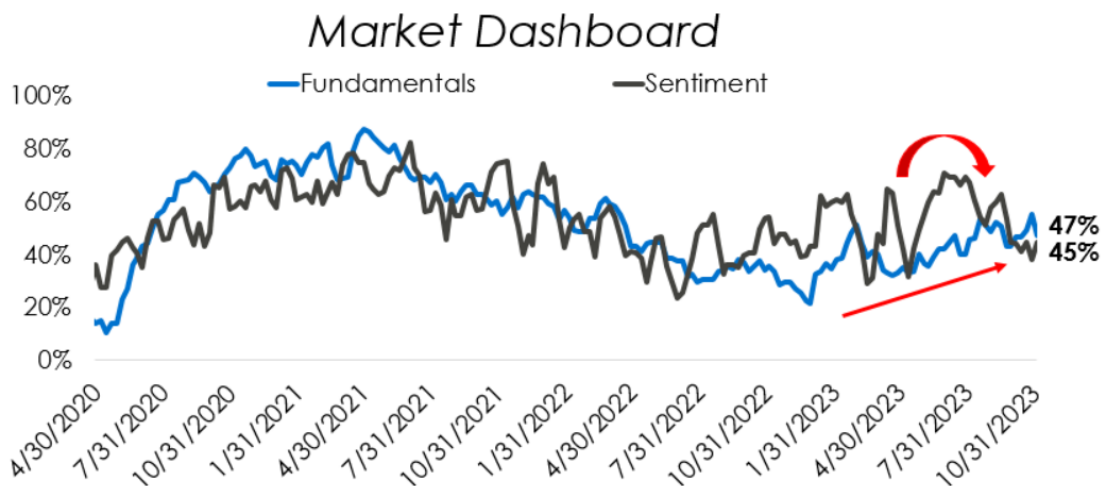
Source: Factset; EPS Growth LTM actual earnings based on iShares S&P 500 (IVV) from Factset.

At the other end of the spectrum is the cyclical perspective, which has recently shown some improvement in the Fundamental data. The chart above suggests the S&P 500 has been anticipating an acceleration in corporate profit growth – which now looks to be bottoming. The two lines above (EPS growth and the S&P 500) tend to



be correlated through time – not without some notable disconnects along the way including 2006-07, 2010-11 and 2018-19 (red shaded regions – so this is not necessarily a given). Note that the recent choppiness in the S&P 500 might be the market beginning to realize it was, perhaps, getting overly optimistic in anticipating high double digit earnings growth six months out.

Still, we're sympathetic to the improving Fundamental data, which we track on a weekly basis as can be seen in the chart at right. The blue line is a proprietary composite of fundamentally based inputs



Source: Factset; FFWM Research. Each score incorporates the percentage of metrics in each category that score favorably with regards to both trend and momentum measures while also including their respective percentile ranks. Scores are based on an equally weighted composite.

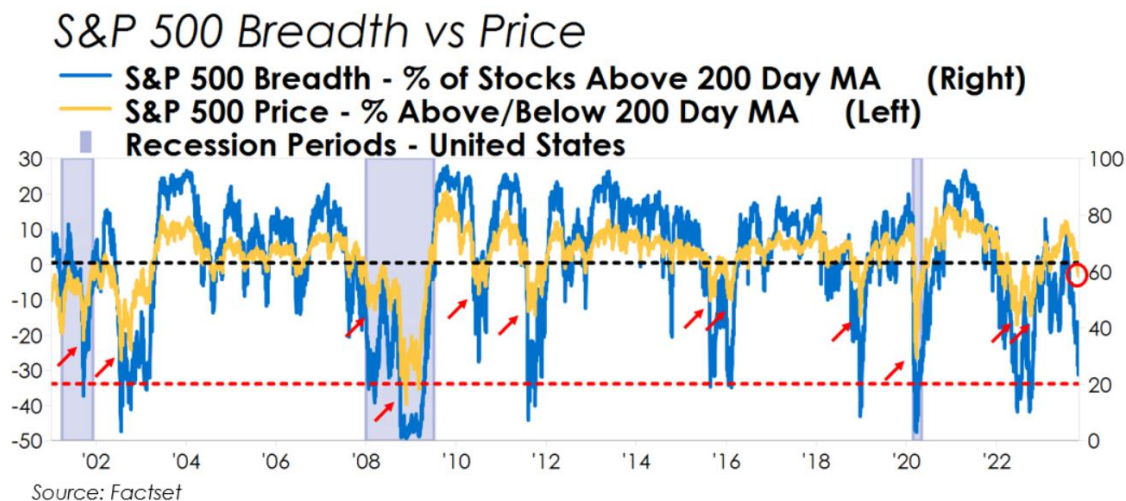
related to the economy, earnings and markets. It's noteworthy that this measure has recently broken out to new year-to-date highs nearing the end of October. The gray line is a proprietary composite of sentiment based inputs related to the economy, equity and credit markets. Sentiment measures have generally been tracking above the Fundamentals for much of this year until recently. It's a subtle change, but our take is that the market might be starting to question the sustainability of the improving growth backdrop and needs an outside catalyst to help. That's why risk assets reacted better following the recent Fed meeting – the second of which that saw no rate hikes. The market is suggesting the Fed is done.

Another indication that the market might be battling with the setup includes a look at the internals. It's often been said that "it's not a stock market but a market of stocks". Therefore, determining how the majority of stocks are acting within the index can tell you more than just looking at the aggregate index itself. Technicians often refer to this as evaluating the "internals".

Often times, market breadth can lead market price. One way to measure that is by looking at the percentage of stocks within the S&P 500 that are trading above their respective 200 day moving average (long-term trend) against the percentage that the S&P 500 index is trading above or below its own 200 day moving average. The spread between these two measures can tell investors how strong or weak the foundation of the index might be. As can be seen in the chart below, the S&P 500 Breadth measure (blue line) has been



historically weak relative to the S&P 500 Price measure (yellow line). This disconnect can get resolved by either a broadening participation in the market or by the S&P 500 index catching down to reflect the lack of breadth.



The bottom line is that investors are grappling

with how to interpret the shift in the market's Sentiment relative to the Fundamentals, which has also been reflected in a disconnet in the internals.

We think this begs the question, "How sustainable is the improvement in the Fundamentals?" AND "What influence might Inflation and the Fed have on the answer?"

We still find it helpful 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 3.4% unemployment rate – a record low level reached earlier this year only seen in one other period over the last sixty years (in the late '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 (more than \$900b off the peak), the Fed tightening policy (recent pause after 525 bps of rate hikes), a deeply inverted yield curve (albeit less so) and credit standards that are the tightest since 1Q09 (ex Covid) – which have continued to worsen.
- Growth sustainability is unclear. While improving Fundamental data are consistent with the bottoming 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. This might set up the "Good News is Bad News" dynamic until a significant enough reset of the business cycle can take place.



- Valuations are elevated. With flat earnings growth so far this year, solid stock market returns have resulted in a partial reversal of the valuation compression seen last year (1.5X P/E NTM). The S&P 500 is now back to trading near long-term forward valuation levels (18X P/E NTM) – 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. From our lens, stock valuations at the (market cap weighted) index level continue to carry greater risk because of the top-heavy concentration in the most cyclical and growth oriented names. These (expensive) stocks might be doubly at risk if the secular view results in perennially higher rates and a more volatile inflation backdrop, which might pressure stock valuations like it has in the past.

Ultimately, 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 keeping one's "head on a swivel" is critical.

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 as Fundamentals appear to be bottoming. For now, our composition within US Equities, US Core Fixed Income and Diversified Alternative managers remains more conservative in nature for the reasons cited above. Our overall portfolio bias has generally been to have more exposure to less expensive areas while maintaining conservative leanings – though we're continuing to asses the sustainability of the growth improvement.

Within equities, our positioning continues to favor a tilt toward the more traditionally defensive sectors (Staples, Health Care, Utilities) with a lesser lean toward cyclical value (Energy, Industrials, Materials) 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 (along with the more recent adjustment from a barbell to belly approach).



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 slightly OW 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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