

ECONOMIC OUTLOOK

Summary

As of early September, the Atlanta Fed's estimate for third-quarter GDP stands at an astounding 5.6%. To put that into context, outside of the economic rebound following COVID lockdowns, we have not seen estimated quarterly growth that strong since 2011. While we do not expect the GDP print to remain that elevated upon its official release in October, it's still likely the Fed will need to double their full-year GDP expectations during their September meeting. That would mark the second significant revision higher this year, following June's increase from 0.4% to 1.0%.

However, strong growth projections do not necessarily mean smooth sailing for the economy. There have been plenty of mixed and negative data releases as well. For example, nonfarm payrolls beat expectations by 17k in August, but downward revisions from the prior two months decreased net job growth to a paltry 77k. At the same time, the unemployment rate surprised many as it increased by 0.3% to 3.8%. Headline Consumer Price Index (CPI) ticked higher for the first time in a year, while durable goods and factory orders were negative month over month. ISM manufacturing remains in contractionary territory, but ISM services is starting to show signs of expansion.

But no matter how you look at it, as we approach the nineteenth month in one of the most aggressive rate-hiking cycles in history, the economy has been much more resilient than anyone would have anticipated. The overnight rate is at its highest level in more than 20 years, yet GDP has remained above 2% during each of the previous four quarters. Headline inflation has dropped by roughly six percentage points, but

with overall inflation still above the Fed's target we remain in dangerous waters. The reality of solid economic growth against a backdrop of sticky core inflation will make it difficult for the Fed to reverse course unless the economic data starts showing significant cracks. While that doesn't appear imminent, the odds of a recession increase as the Fed leaves rates higher for longer. If core inflation, specifically Core PCE, drops materially toward 2% while overall growth remains strong, it is possible this Fed can navigate us through their first true "no landing" or "soft landing" outcome.

Positives

The labor force participation rate increased by 0.2% to 62.8%

Personal spending increased by the largest amount in six months (0.8%)

Retail sales in July exceeded expectations (0.7% vs. 0.4% est.)

Negatives

Second-quarter GDP was revised lower by 0.3% to 2.1%

Average Hourly Earnings increased by the smallest amount in 18 months (0.2%)

Core PCE (the Fed's preferred measure of inflation) moved higher by 0.1% year over year

EQUITY OUTLOOK

Summary

Equity markets retreated in August with the S&P 500 Index falling 1.6%. Still, that index sits 18.7% higher for the year. After such an impressive start the stock market seems to be content to take a late summer breather while digesting recent gains.

Losses in August were widespread across style, size and geography. The Russell 1000 Value Index declined 2.7% while the Russell 1000 Growth Index held up slightly better losing just 0.9%. In terms of sectors, value oriented utilities and consumer staples were the worst performers falling 6.2% and 3.6% respectively. Energy was the only positive sector for the month rising 1.8%. The Russell Midcap Index dropped 3.5% and the small cap, Russell 2000 Index lost 5.0%. Looking abroad, the developed international MSCI EAFE index dipped 3.8% while the MSCI Emerging Markets Index fell 6.2%.

As we moved through the summer months stocks were overbought and heading into August the rally lost some steam. We should remember there is also some seasonality in play given August and in particular September are historically weaker months. It would also not come as a huge surprise if stocks failed to resume the uptrend in the weeks ahead. Additionally, with earnings season now behind us the equity markets will likely struggle to find much of a catalyst. Much attention will be focused on the next Federal Reserve meeting scheduled for later this month.

The soft landing scenario that we wrote about a few months ago is becoming the consensus view on the street. Some weaker economic data in recent weeks is leading to the belief that

the fed may have completed or will soon complete the current hiking cycle. If this holds true, the equity markets will likely celebrate that development. To be sure, much of the positive news is likely reflected in the market today but there should still be some positive reaction when we learn the Fed has become comfortable with the path of inflation.

We expect the market to remain volatile with downside pressure in the coming weeks. However, we remain constructive on the stock market as we head into the closing quarter of the year. If the current economic trends remain intact and earnings continue to be resilient, the backdrop sets up well for a nice fall.

Positives

Cooling labor market should pacify Fed

Resilient corporate earnings

Market breadth has improved in recent months

Negatives

Higher crude oil prices

China recovery has fallen flat

Potential auto worker strike

FIXED INCOME OUTLOOK

Summary

Bond investors started August with the downgrade of U.S. debt by Fitch Ratings. With Treasury note yields already trending upward in the previous three months, the surprise action sent 10-year yields slightly through this year's double-top high of 4.06%. Fortunately, with the economy and markets in much better shape than when the U.S. was downgraded by S&P in 2011, the impact of the Fitch downgrade was modest. While they cited fiscal deterioration, increasing debt burden and government dysfunction, many investors reported there was nothing really new in their analysis. Much of their rationale was based on the government's willingness to service the debt as opposed to its ability to do so.

But then the very next day, one of their central themes came to the fore when the Treasury Department announced larger-than-expected Treasury bond issuance to finance a higher-than-expected Treasury cash balance, elevated deficits and to term out the heavy T-bill issuance from the past few months. With renewed concerns about supply, the 10-year rose to 4.20% for a couple of days before consolidating back lower. This move was important from a technical basis. It made a retest of the 4.25% October-cycle high seem much more likely as that remained the last important target level.

With a bearish tone in place, a number of additional factors began to weigh on bond investors and push yields back up again. First, the economy remains resilient and continues to defy predictions of a recession. Along with slowing improvements in inflation, this strength increases the odds of an additional Fed rate hike by November. And from an international perspective, there is concern Japan's easing of their control on longer-dated bond yields and increasing tensions with China could lessen demand for U.S. debt from the two largest foreign holders. Just after mid-month, yields pushed through to 4.34%, a level last seen in the fall of 2007. The 10-year yield faded into the month's end closing at 4.11%, still 15 basis points (bps) higher than July's

close. The 2-year was little changed at 4.86% and credit spreads increased by about 6 bps from the tightest levels in more than a year. Overall for the month, the intermediate-maturity, investment-grade bonds delivered a -1 bps return with Treasury notes slightly positive and corporate bonds slightly negative.

Whether the Fed feels obligated to increase the overnight rate one more time or not, we believe longer-maturity yields represent good value at current levels. No, we are not certain of an absolute top and yes, yields could rise from here, but we believe moves above these levels will be modest and temporary in duration. Intermediate-maturity Treasury note yields are now more than 4.50% and intermediate investment-grade corporates are more than 5.50%. A few years from now, we believe we may look back on this as the beginning of the next secular bond bull market.

Positives

The Fed rate-hiking cycle is likely complete with one more at most

U.S. investment-grade corporate bonds yield more than 5.50%

Negatives

Significant government issuance with no budget discipline in sight

Disinflation is slowing as path to 2% becomes more difficult

Unknowns

International demand for U.S. debt particularly China and Japan

Russia/Ukraine war impact of commodity prices and inflation
