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MARKET COMMENTARY

MARKETS DECLARE PREMATURE VICTORY

The Fed began its war on inflation in March of 2022, and 11 rate hikes later, progress has been nothing short of remarkable. While history would suggest that a soft landing was a long shot, we've seen meaningful improvement in inflation, minimal job loss and instead of a slowing economy, GDP growth has accelerated. Last October, a *Wall Street Journal* survey of economists pegged the odds of a recession in the next twelve months at 63%. Flash forward to today and the economy may have grown as much as 3% in the third quarter, which is markedly above trend. Tight monetary policy is supposed to slow the economy as higher borrowing costs discourage consumption and incentivize saving. Apparently, the US consumer didn't get the memo.

Core inflation peaked last September which happened to coincide with an S&P 500 trough of 3600. In the year since, progress has been persistent and long-term inflation expectations remain a well-anchored 2.2%. A series of bank failures in March initially looked as if the Fed had 'broken something,' and while the banking system is still quite challenged, a financial crisis has failed to materialize. Despite the Fed's poor track record of engineering soft landings, data increasingly suggests it's a distinct possibility.

Markets tend to get ahead of themselves, and it recently erred by assuming the Fed would immediately pivot from rate hikes to rate cuts. Students of history know that hiking cycles are rarely surprise-free, and if the 1970s taught us anything, it's that the risks of premature easing outweigh the risk of over pumping the brakes. Being sure isn't enough, central bankers have to be *certain*. So, when markets began anticipating the Fed would begin cutting as early as this Fall, we remained skeptical. Asking an economy to grow, inflation to fall and interest rates to come down struck us as a really big ask.

It's this expectation of 'higher for longer' that has recently taken steam out of markets. Starting in early May, the S&P 500 was up nine weeks out of eleven. Since the Fed Meeting in late July, the market has been down seven weeks out of nine. Yields on the benchmark 10-year Treasury troughed at 3.3% in April and have since risen to 4.55%, the highest since 2007, and expectations for rate cuts in 2024 have declined by two-thirds. We're not sure why investors would expect the return of cheap money when core inflation is still north of 4%, but expect it they did.

When it comes to the outlook for the next twelve months, we remain circumspect if not outright cautious. While economic data currently paints a rosy picture, we look under the hood and see more than enough to give us pause. Estimates for 4Q GDP are an uninspiring 0%. Thanks to production cuts from the Saudis and the Russians, oil prices are up 34% in the past three months complicating further inflation progress. Thanks to rising deposit costs and the prospect of higher charge-offs, bank lending has nearly ground to a halt, which acts as a significant damper on economic growth. The potential for a government shut down, an ongoing auto strike and the resumption of student loan payments could further derail the Fed's hard-fought progress. While the yield curve isn't as inverted as it was, in our opinion, it remains the best recession predictor available and investors shouldn't ignore it lightly. In other words, we may not be out of the woods quite yet.

As for equities, they've been largely range bound for much of the past two years. Earnings growth is currently negative and estimates are for a herculean 12% growth in 2024. Outside of the pandemic recovery and a one-time benefit from lowering the corporate tax rate in 2018, the S&P 500 hasn't grown earnings 12% since 2011 (also a recovery year). Higher interest rates suggest a lower justified multiple on earnings as investors have competing alternatives for their capital. Higher inflation suggests a lower multiple as inflation erodes the purchasing power of said earnings. 19 times this year's earnings (which aren't growing) and 17 times next year's (which seem likely to disappoint) strikes us as optimistic given our expectation for the economy to slow. The equity risk premium (the earnings yield equities offer over prevailing interest rates) is flashing orange if not red.

We have become increasingly constructive on fixed income this year given some of the most attractive (or at least most positive) real returns in decades. Measured over longer periods, we typically expect equities to outperform fixed income. That is still very much the case, but our estimates of excess return are more narrow than they've been in some time. We suspect the equity market may be forced to lower its expectations should it confront a slowing economy, increasingly stubborn inflation or a resolute Fed, which could lead to more attractive prices. Consequently, we've reduced equity exposure for many of our clients on the margin.

Given the strong performance of the equity market this year, we're aware that this derisking has come at a cost, but we suspect we'll see more attractive entry points in 2024 and beyond. While it seems counterintuitive to hope for volatility, we view it as an opportunity to allocate capital to great businesses at potentially more reasonable valuations.

We thank you for your support and if you have any questions, please don't hesitate to reach out to your Relationship Manager.

Sincerely,

Bridges Trust Investment Committee

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