CIO Strategy Bulletin

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Faster, Broader and Higher

In our Wealth Outlook for 2024, we observed that in 2023 “rolling recessions” across portions of the US economy would “roll off” in 2024. The idea that the US economy was already enduring major recessionary conditions anticipated by the long-inverted yield was novel. Now we are faced with a second novel possibility: perhaps all the rate increases and restrictive monetary policy on the past 18 months won’t slow the economy in 2024 as much as we thought.

When we look at sector performance since late ‘23, we can see that investors have already begun to price in elements of a cyclical recovery. But like most of the post-pandemic period, this is not a typical cyclical rebound. While sectors tied to manufacturing and housing have surged, other traditionally high beta segments remain in the doldrums.

Markets are also beginning to see results from the higher growth/lower inflation combination. Large-cap US industrial sector shares have already risen 21% since October 27 and trade at 21x estimated EPS for 2024. US small and mid-cap industrials having risen just as rapidly over the same period. All this while shares in other regions, foremost China’s, lag.

These better-than-expected circumstances have already created a tension between the Fed and bond traders, where Chairman Powell see economic resilience as a reason to delay rate cuts. The futures markets price 6 rate cuts of 25 basis points over the next year.

Is “Slow Then Grow” Becoming “Grow and Grow”?

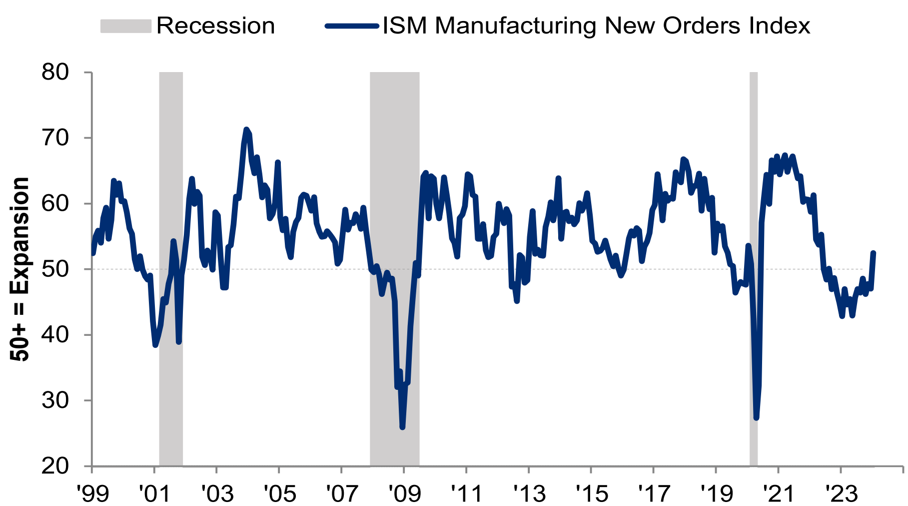
Signs of economic growth and recovery are spreading faster than most economists believed possible.

In our Wealth Outlook for 2024, we observed that in 2023 “rolling recessions” across portions of the US and world economy would “roll out” in 2024. The idea that the US economy was already enduring recessionary conditions “hidden” beneath the veneer of rising employment was novel. Now we are faced with a second novel possibility: perhaps all the rate increases and restrictive monetary policy on the past 18 months won’t slow the economy in 2024 very much.

Mounting Evidence of Recovery in Cyclical Industries

In the US, the Institute for Supply Management New Orders Index showed expansion in January for the first time since August of 2022 (see **FIGURE 1**). While still subdued, US manufacturing production increased as 2023 ended. And there are signs the most impacted sectors are bottoming earlier. This has portfolio implications from interest rates to equity selection across regions.

FIGURE 1: Manufacturing New Orders Purchasing Managers Index

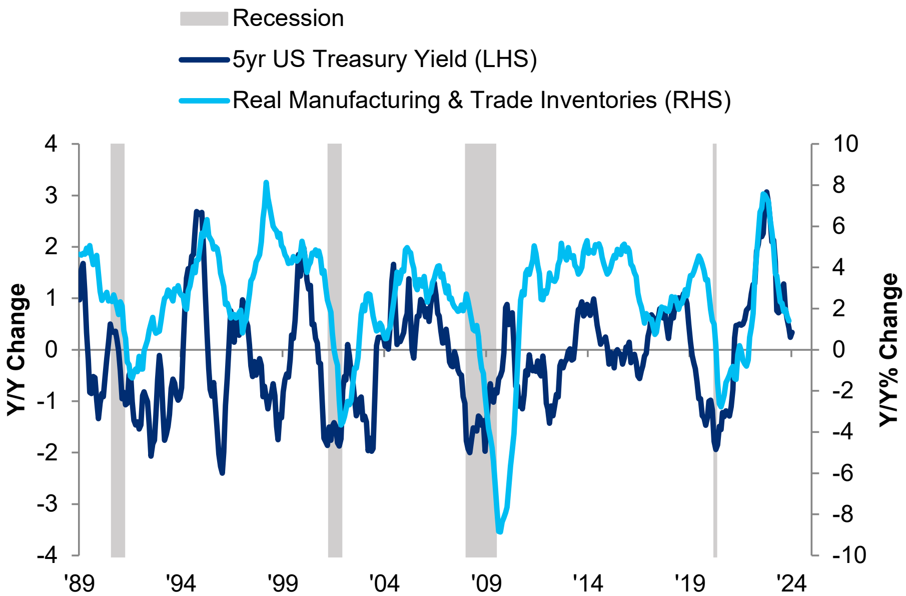


Source: Haver Analytics and Institute for Supply Management (ISM) as of February 8, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

If the lull for cyclical industries is short and shallow, it has direct impact on the trajectory of equity sectors and rates. Consider the strong correlation between changes in US Treasury yields and inventories in **FIGURE 2.** A typical slump that would push rates down is looking mild. Without a plunge in the economy, there are fewer pressures driving rates lower.

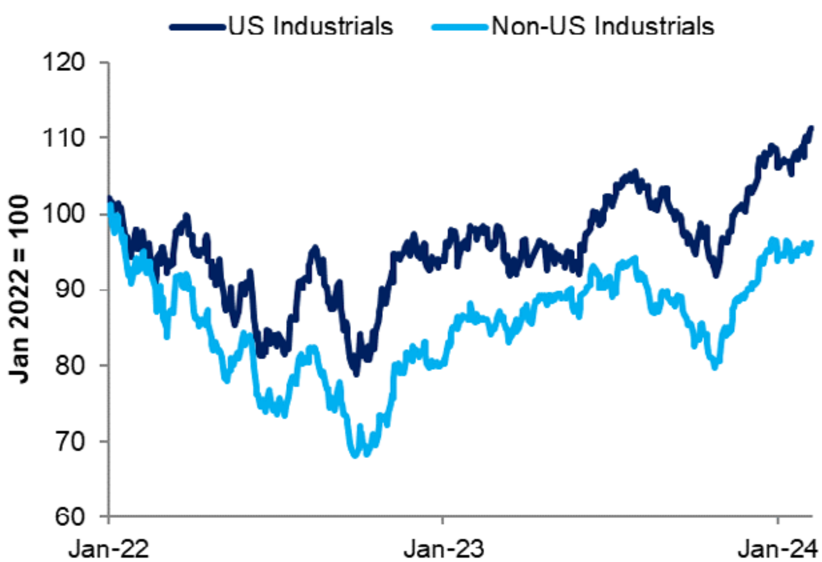
Given that markets are forward-looking predictors of the economy, we see data to suggest that an industrial recovery is becoming discounted. It is not “waiting to be discovered” (**FIGURE 3**)

FIGURE 2: Real US Business Inventories and 5-Year US Treasury Yields



Source: Haver Analytics, Bloomberg as of February 8, 2024.

FIGURE 3: US and Non-US Industrial Sector Shares



Source: Bloomberg as of February 8, 2024. S&P500 Industrials used as proxy for US Industrials. MSCI ACWI ex-USA/Industrials used as proxy for Non-US Industrials. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

The signs of recovery for production and trade are mild but have come earlier than expected. The US, Germany and even China all saw at least a modest export gains near year-end '23 **(FIGURE 4).** However, like January employment data, they are possibly biased by changing seasonal patterns measured at the peak of winter.

FIGURE 4: Global Exports (USD, Y/Y%)

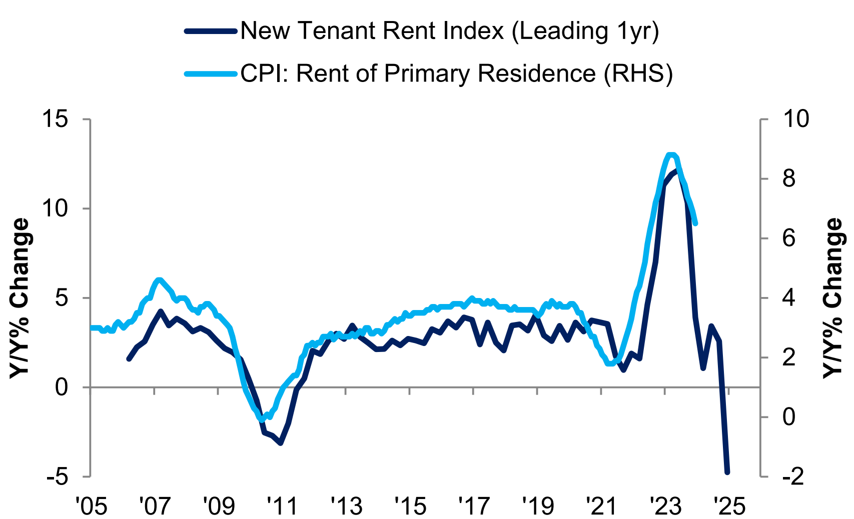
Source: Haver Analytics and International Monetary Fund (IMF) as of February 8, 2024.

Inflation Remains Tame

On the inflation front, our data sources point to a 2% inflation rate later in 2024. US goods prices are near deflation levels as falling import prices for finished goods and materials are benefiting US industry. In real estate, rear view mirror housing data and backwards calculation methodology for the US Shelter CPI suggest further downward surprises for these core inflation measures over the year ahead (**FIGURE 5**).

Markets are beginning to see results from the higher growth/lower inflation combination. Large-cap US industrial sector shares have already risen 21% since October 27 and trade at 21x estimated EPS for 2024. There has been a strong historical relationship between manufacturing sentiment and the outperformance of Industrials versus defensive sectors like Consumer Staples. Performance over the past 12 months suggests that Industrials are pricing in an earlier, more robust recover than we thought likely. US small and mid-cap industrials having risen just as rapidly over the same period. All this while shares in other regions, foremost China's, lag.

FIGURE 5: US CPI Shelter vs New Tenant Rent Index (Leading 1-Year)



Source: Haver analytics and Bureau of Labor Statistics as of February 8, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

As Earnings Rise

As we noted in our latest Quadrant, the strong earnings per share (EPS) "surprises" in last quarter's earnings releases were actually predictable. 80% of companies reported "above consensus" gains relative to analyst expectations as reflected in the Institutional Brokers Estimate System as of February 8, 2024. Even as managements stuffed unwelcome news in their calendar fourth quarter reporting, they were often able to exceed meek analyst expectations. We believe the first quarter 2024 results should be even stronger on a relative basis.

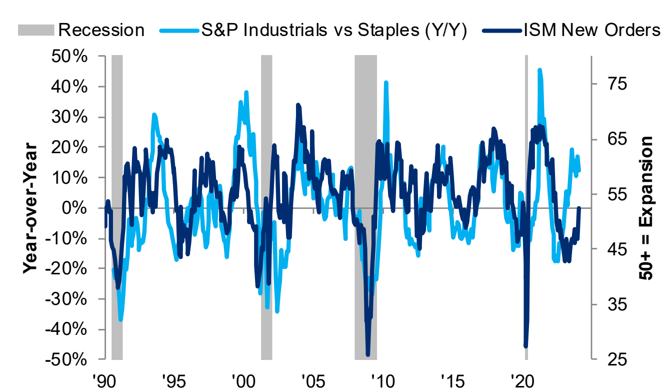
And then there are unexpected market anomalies. Homebuilders, another highly cyclical group of stocks, have surged since mid-2022 despite a doubling of mortgage rates. Structural demand for housing, coupled with a sustained shortage of supply and falling cost pressures, have led to a de-coupling of the typical relationship between home builders and interest rates. Again, we see a cyclical recovery priced into these shares.

Finding Value in a "Grow then Grow" US Economy

When we look at sector performance since late last year, we can see that investors have already begun to price in elements of a cyclical recovery. But like most of the post-pandemic period, this is not a typical cyclical rebound. While sectors tied to manufacturing and housing have surged, other traditionally high beta segments remain in the doldrums.

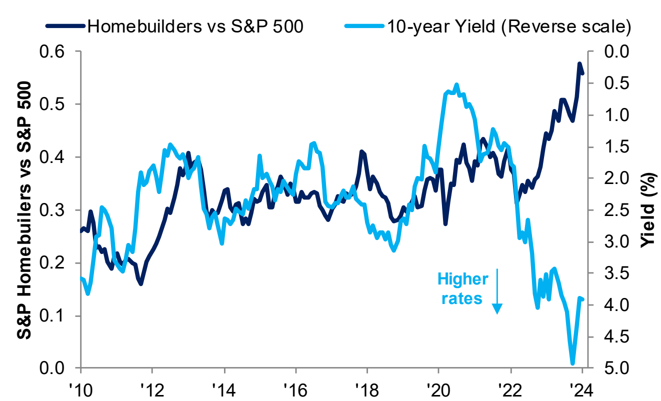
As we show in **FIGURE 6**, there has historically been a close relationship between manufacturing sentiment and outperformance of Industrials versus defensive sectors like Consumer Staples. Performance over the past 12 months suggests, however, that Industrials are already priced for a fuller cyclical recovery. Homebuilders, another highly cyclical group of stocks, have surged since mid-2022 despite a doubling in mortgage rates (**FIGURE 7)**. Structural demand for housing, coupled with a shortage of supply and easing of cost pressures, have led to a de-coupling of the typical relationship between home builders and interest rates. Again, we see a cyclical recovery already priced into shares.

FIGURE 6: Industrials outperform defensives when manufacturing sentiment improves



Source: Bloomberg as of February 8, 2024. S&P 500 industrials and consumer staples industry indices were used. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

FIGURE 7: Homebuilders relative performance vs 10yr UST



Source: Bloomberg as of February 8, 2024. S&P 500 homebuilding sub industry index was used. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

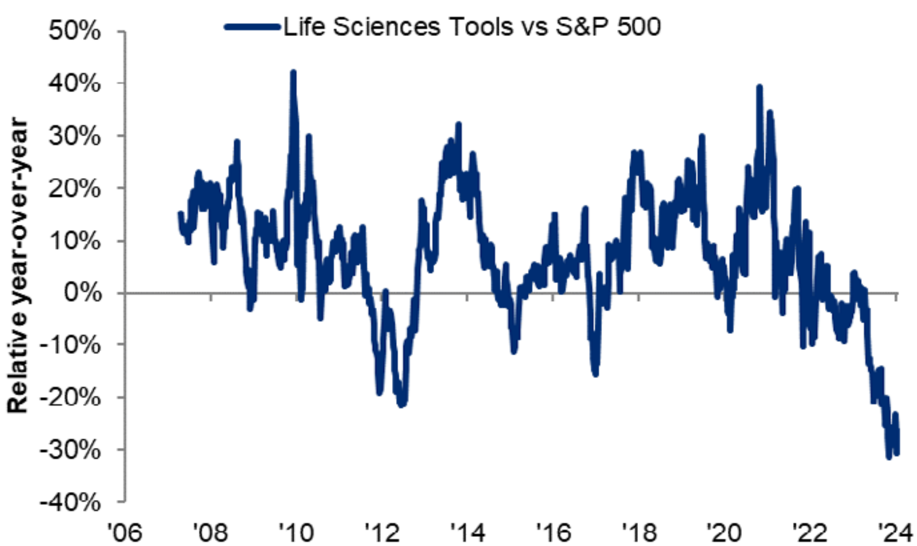
Healthier Health Care and MedTech

Last year, the health care sector underperformed the broader market by 24%[1] (+2% VS +26% for the S&P 500), impacted by a perfect storm of US drug pricing reform, COVID hangovers and disruption from the excitement related to GLP-1 weight loss drugs. As we highlighted in our recent CIO Bulletin, we now view health care innovation to be on "sale."

The health care sector is highly diverse. Within the sector you will find defensive value in large cap pharma and highly speculative growth in small cap biotech. Straddling these two extremes are medical devices and life sciences tools companies, who focus on the equipment and tools needed to operate a hospital or undergo a drug trial. This group tends to be somewhat more cyclical than pharmaceuticals and is well-placed to benefit from continued normalization in the health care sector post-COVID.

Similar to how solid earnings growth has been realized in our high conviction investments - global semiconductor equipment and cybersecurity - we believe medical technology is another area that may benefit from broadening in earnings. The segment remains under-appreciated by the market while also exhibiting low sensitivity to interest rates (**FIGURE 8**).

FIGURE 8: Life Sciences Tools have underperformed the S&P 500



Source: Bloomberg as of February 8, 2024. S&P 500 Life sciences tools index as proxy for Life Sciences. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

Rate Beneficiaries

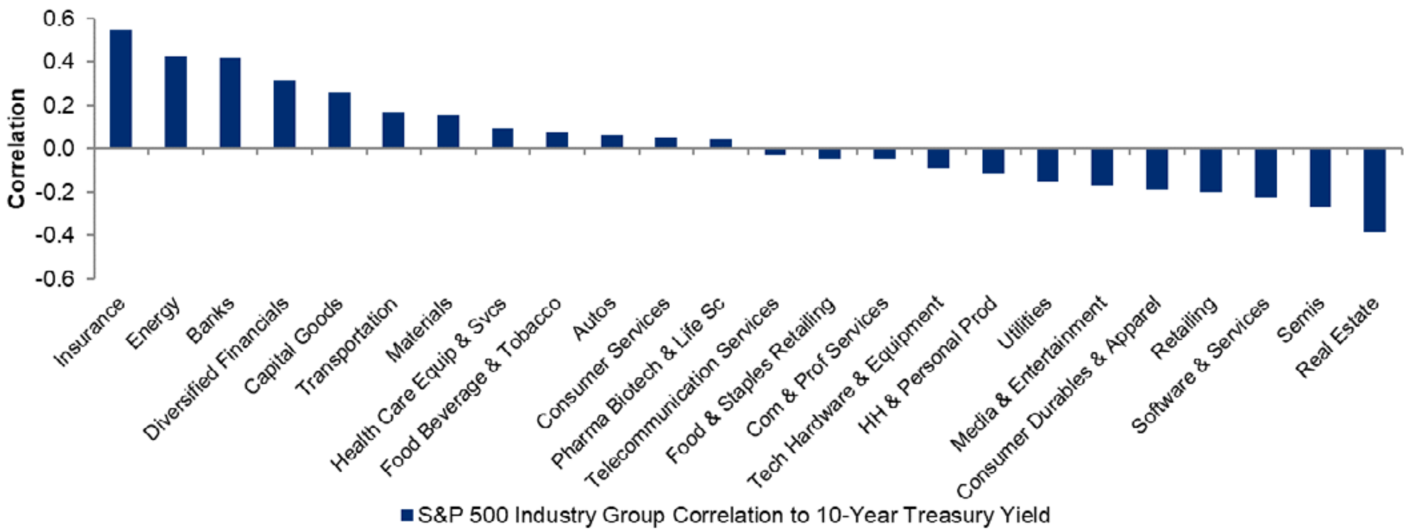
Readers worried that the Fed will never lower rates should be mindful that it is unlikely the US can sustain its galloping January employment growth (+353,000, but -2.6 million prior to seasonal adjustment. Please see last week's Data Watch). Similarly, for the "recessionaires," there is also no reason to expect a sudden aggregate employment contraction that would cause the Fed to ease rapidly.

Some cyclical shares are already priced (or even over-priced) for a stronger-than-expected macro environment. Others face ongoing property-related risks in the US and China. We cannot count on a big bond rally bailing out the market's most rate-sensitive sectors. The eventual broadening in markets will be led by corporate earnings but will benefit more slowly from falling rates and a yield-curve normalization.

[1] Source: Bloomberg as of February 8, 2024. S&P 500 healthcare index as proxy for the health care sector.

The strongest global beneficiaries of a goods sector recovery and most vulnerable industries to "firm rates" are easy to document on a historic basis (**FIGURE 9**). However, unique issues are present in every cycle. Some undiscounted opportunities and risks for the present environment are discussed below.

FIGURE 9: Industry correlations to US 10yr Treasury yield



Source Bloomberg as of February 8, 2024. Note: correlations calculated us monthly data from January 2016 to present. S&P 500 industry Group indices were used Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

What Growth Means for Non-US Shares

This may be the wrong time to give up on select non-US equities. Amidst last year's recession in global trade, investors flocked to US technology where growth was abundant. We expect market returns to broaden out not just at the sector level but also geographically. Global shares that are benefiting from the same secular growth trends should be rewarded like their US peers. Moreover, a further recovery in global manufacturing and trade could benefit industrials in Japan and Europe, which have lagged their US counterparts. While much further off, an eventual Chinese recovery may also benefit its closest trading partners in Asia and Europe.

A Moment of Caution Even as Growth Picks Up: Regional Banks

A higher-for-longer interest rate backdrop heightens risks for over-levered segments of the economy.

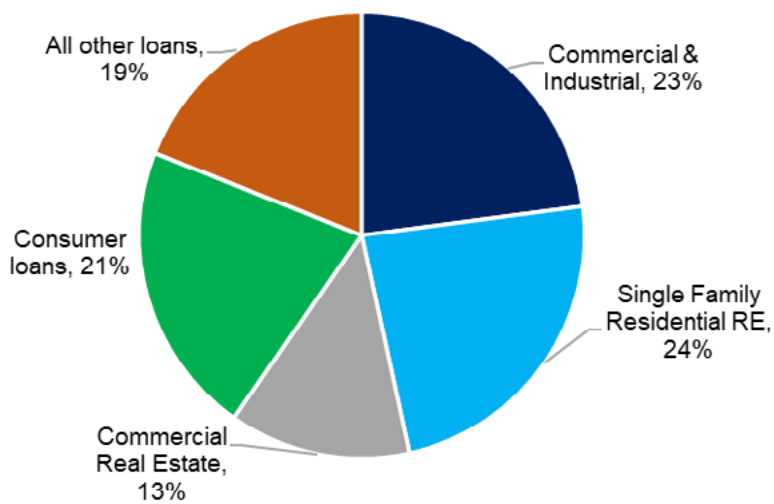
Over the past two weeks, regional banking concerns have resurfaced bringing consternation to those expecting bank shares to sustain their recent rise. The broader regional banking complex has sold off after a community bank based in New York was forced to slash its dividend and raise loan loss reserves against its commercial real estate portfolio. Even though this particular situation is idiosyncratic, impacted more forcefully by changes to rent control policy in New York City, it comes at a time when the market was already re-assessing the Fed's downward rate trajectory in 2024.

Following the regional banking crisis, a year ago, we do not view the $25 trillion US commercial real estate sector as a monolith. For sure, pockets of office, multifamily, and retail face secular pressure. Commercial office makes up 15% of the total commercial real estate space2. Indeed, in the publicly traded Real Estate market, segments like industrial and data centers have rallied over the past two weeks, showing that the market will discern where distress may be exhibited.

[2] Federal Reserve Bank of St. Louis. https://www.stlouisfed.org/on-the-economy/2023/jul/commercial-real-estate-stress-poses-challenge-banks#:~:text=Thus%20far%2C%20most%20of%20the,San%20Francisco%2C%20Austin%20and%20Houston.

While we do not rule out further volatility within the regional banking space from here, we remain much less concerned about a broader banking crisis akin to 2008-09. Total commercial real estate comprises just 13% of large bank loan books (FIGURE 10). Many systemically important banks have negligible office real estate exposure. And the Fed and Treasury are vigilant with Jerome Powell noting some small banks may fail, but regulators are prepared to handle their orderly resolution[3].

FIGURE 10: Large bank loan book exposure



Source: Haver Analytics as of February 8, 2024. "RE" represents Real Estate.

[3] Source: CBS News, 60 Minutes, February 4, 2024. https://www.cbsnews.com/news/full-transcript-fed-chair-jerome-powell-60-minutes-interview-economy/

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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