James Investment Research, Inc.

Market Commentary

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JAMES
INVESTMENT RESEARCH, INC.

Key Insights

• In August, major market indices experienced a minor setback compared to the overall trend in 2023.

• Throughout 2023, growth stocks significantly outperformed value stocks, particularly among larger companies.

• Bond investors faced challenges due to rising yields, resulting in price declines. Escalating U.S. debt, along with factors such as the debt ceiling and credit rating downgrades, are contributing to upward pressure on yields.

• Inflation exhibited a downward trend since its peak in June 2022, attributed to factors like decreased commodity prices, improved supply chains, a transition in consumer spending from goods to services, and reduced energy costs.

• Possibility of a resurgence in economic growth and sustained inflation in 2024. However, a more probable scenario involves an economic slowdown with inflation around 3%.

• Potential risks to this perspective include increasing oil prices, strong consumer resilience, changes in manufacturing dynamics, and geopolitical uncertainties.

Monthly Recap

In August, stocks experienced a minor setback in comparison to the majority of 2023, as major market indices declined. The S&P 500 Index experienced a decrease of 1.6%, and the smaller stocks of the Russell 2000 Index saw a decline of 5.0%. Notwithstanding the recent setback in August, the stock market's overall performance remains positive, with the S&P 500 still showing a year-to-date increase of more than 18.7%.

On the sector front, Utilities and Consumer Staples were the major underperformers. These interest rate-sensitive sectors lost ground as rates increased and trailed behind the market, declining by 6.1% and 4.0%, respectively. Conversely, Energy was the only sector to achieve a positive return for the month, advancing by 1.7%.

Throughout most of 2023, growth stocks have significantly outperformed value stocks, particularly among larger companies. The Russell 1000 Growth Index surged by 32.2%, in stark contrast to the Russell 1000 Value Index which has only managed a 5.9% increase. While small-cap growth stocks might not be as robust as their larger counterparts, they are still surpassing small-cap value stocks by approximately a 6% margin. Interestingly, during the month of August, both investment styles experienced declines as investors took profits. Growth stocks did manage to hold slightly better as the Russell 1000 Growth Index experienced a loss of 0.9%, whereas the Value Index encountered a loss of 2.7%.

Bond investors also faced slight losses as yields increased, leading to declines in prices. The U.S. Bond Aggregate Index suffered a decline of 0.64%, with more significant drops occurring on the long end of the yield curve. The U.S. Long-Term Treasury Index experienced a decrease of over 3.1%. Recent investor attention has shifted due to concerns about a potential resurgence in inflation, elevated bond yields, and robust economic growth. These factors might lead to the Federal Reserve (Fed) implementing more interest rate hikes in the future.

U.S. Treasury Market and Rising Bond Yields

The growing U.S. debt is weighing on bond investors and is exerting upward pressure on bond yields. The anxiety is reflected in the recent increase in Treasury supply and the rise in the 10-year yield, which recently hit a 15-year high at 4.34%. This rise in yields is also evident in the nearly $700 billion in interest payments the government must make on its debt this year. Unfortunately, this figure is likely to keep growing as government spending rises. The accumulating federal deficits, coupled with a challenging fiscal landscape, and the impending debt ceiling negotiations only contribute to the risks faced by bond investors. Should interest rates increase too rapidly, this would further push down bond prices and potentially even exert downward pressure on stocks.

Furthermore, the recent downgrade of the U.S. credit rating by Fitch is adding to the upward pressure on bond

yields. The present circumstances differ significantly from when S&P downgraded the U.S. debt 12 years ago. The substantial deficits and continual increases in the Debt to Gross Domestic Product (GDP) ratio over the years have placed the U.S. in a considerably more challenging position compared to the downgrade in 2011.

The developments initiated by the Bank of Japan (BOJ) are capturing the attention of U.S. bond investors as well. The recent changes in their monetary policy, involving an increase in the cap from 0.5% to 1.0%, has raised concerns that certain investors might choose to reposition their portfolios and become sellers of U.S. Treasuries. Notably, the Japanese currently hold more than $1 trillion worth of U.S. Treasury debt. Should Japan opt to significantly reduce their U.S. Treasury purchases or initiate sales, it could lead to an uptick in yields on U.S. Treasuries. This situation would pose challenges for corporations and consumers, as borrowing expenses would rise. Consequently, this might exert a negative impact on corporate profits and eventually hinder overall economic growth.

The Economy and the Consumer

In the most recent quarter, the U.S. economy exhibited a robust growth of 2.1%. With this continued strong growth, we are witnessing a stream of positive surprises originating from both consumer and labor markets. The resilience has provided a setting for an economic soft landing, effectively preventing the onset of a recession in the United States. In July, retail sales experienced a 0.7% increase, surpassing the previous reading in June. Spending rose on nondurable goods, and there was a notable 1.4% surge in restaurant and bar sales. However, durable goods data was disappointing, with furniture, electronics, and appliances experiencing a decline during the month.

Overall, the data reflects a robust consumer that remains steadfast despite the presence of inflation and higher interest rates. As we look ahead, a pressing concern is the impending impact of the conclusion of the student loan forbearance program. This could potentially exert a significant influence on consumer spending and the retail sector in the months to come.

The Real Yield

The recent increase in nominal rates coupled with declining inflation has led to a rise in real yields, which denotes the yield on an investment after adjusting for inflation. Real yields hold significant relevance for both investors and the wider economy, as they can influence investment choices, asset valuations, and overall economic conditions. This recent upswing in real yields can be attributed to the interplay of rising interest rates and decelerating inflation. Essentially, this signifies that investors are realizing a greater return on their investments after compensating for the effects of inflation.

Nevertheless, elevated real yields have the potential to result in increased borrowing expenses for consumers, potentially leading to a reduction in consumer spending. These higher costs also exert an influence on corporate investment choices. When borrowing becomes costlier for businesses, they might opt to postpone or curtail their expansion initiatives, thereby potentially affecting overall economic activity.

Topic of the Month: A Bump In the Downward Path of Inflation

U.S. inflation has been following a downward trajectory since reaching its peak at 9.1% in June 2022. This improvement can be attributed to factors such as decreased commodity prices, the alleviation of supply chain bottlenecks, and a lower inflation rate in the goods sector of the U.S. economy. Over the past year, there has been a noticeable shift in consumer spending from goods to services, which has played a role in this transition. Energy costs have seen a notable decline of 16.4% since their June 2022 peak, and food inflation has remained close to zero for the past four months. Additionally, inflation in goods has stayed below the 2% mark over the last year.

However, most of these favorable factors have begun to diminish. Oil prices have been on an upward trajectory since the end of June. Moreover, there are indications of demand stabilizing or even showing signs of growth on the goods side of the economy. For example, sales of home furnishings and barbecue grills have been leveling off. Therefore, it's possible that the headline inflation rate in the August Consumer Price Index (CPI), which will be reported later this month, could experience an increase.

Nonetheless, we hold the belief that following a temporary setback, inflation will maintain its trend of moderation into 2024. This will be driven by the gradual easing of shelter inflation, encompassing increases in housing and rent prices, as this aspect of the economy begins to influence the official government metrics, such as the CPI and Personal Consumption Expenditures (PCE). It's important to note that there exists a 12-month lag effect before the

official inflation indicators start reflecting the subdued inflation in the housing market, as they rely on older lease agreements. These indicators are now starting to capture the subdued growth in new-lease rents from the previous year and the gradual cooling of the housing market following the post-Covid surge as mortgage rates rose.

Inflation Path Ahead: Headline vs. Core Story

As inflation stabilizes in energy, food, and goods prices, we anticipate that the upward trajectory of the headline CPI may come to a halt by the year's end. Yet, of even greater significance, we project the core CPI—excluding the more volatile energy and food components—to sustain its moderation from the current 4% level and gradually reach around 3% by year-end. This projection is based on the anticipation that disinflation in the rent and housing segments, which constitute 33% of the CPI, will start to show up in the official inflation metrics.

The Fed places greater emphasis on core inflation, given that historical evidence suggests monetary policies have limited influence on energy and food prices. If the core inflation metric continues to demonstrate improvements in the coming months, it would signal a positive indication that the previous interest rate hikes by the Fed are beginning to have a moderating effect on the economy. Consequently, any additional rate hikes might potentially cause more harm than benefit.

The Case for a Rebound in Growth Cannot Be Dismissed, Albeit Less Likely

While not our most probable scenario, an alternative viewpoint suggests that the economy could potentially be undergoing a resurgence in economic growth, which might lead to a sustainable rebound in inflation in 2024.

Economists supporting this argument suggest that the U.S. economy might be less sensitive to interest rate changes compared to other economies and prior economic cycles. For instance, in most advanced economies, floating mortgage rates cause monthly mortgage payments for homeowners to rise alongside increases in their central bank rates.

In contrast, a significant number of U.S. mortgage rates are fixed, resulting in existing U.S. homeowners being less responsive to rising rates and thereby mitigating the impact on their income. Moreover, many U.S. consumers have secured low rates during the pandemic for activities like housing and high-ticket items such as appliances. Furthermore, both consumer and corporate balance sheets remain robust. Coupled with a strong job market, these factors enhance consumer resilience, thereby supporting the assertion of a potential scenario of stronger growth ahead.

A Slowdown Instead

In our perspective, the scenario of economic re-acceleration appears less likely. Instead, we anticipate an economic slowdown, though not a recession, alongside near 3% headline and core inflation, to be the most probable outcome in the forthcoming months.

Despite U.S. consumers displaying a relatively higher resilience to rising interest rates in comparison to those in other economies, these elevated interest rates will undoubtedly impact future consumer spending. For instance, credit card rates have adjusted from 14% Annual Percentage Rate (APR) at the beginning of 2022 to over 20% APR at present. Furthermore, U.S. consumers have increasingly turned to debt, evident from the record high of over $1 trillion in credit card debt as of the end of June 2023. Additionally, the excess savings amassed by consumers during the pandemic have already been exhausted, as reported by the San Francisco Regional Federal Reserve.

With the already mentioned upcoming student loan repayments, consumers could face strain in the coming months. Further weakening signs among consumers include elevated rejection rates for credit cards, home loan, and auto loan applications, with auto loan rejections reaching record levels. Overall delinquencies are on the rise, while banks are also tightening loan standards and reducing lending.

Given these factors, we are inclined to believe that a slowdown is more plausible than a re-acceleration in the months ahead, considering that consumer spending constitutes 70% of the U.S. GDP. Therefore, with economic growth decelerating, the path of disinflation should continue, albeit with potential disruptions caused by energy price fluctuations or geopolitical shocks.

The immediate direction of energy prices will largely dictate headline inflation in the coming months. Nevertheless, we maintain the view that core inflation is likely to persist in its downward trajectory due to the factors previously mentioned.

Bond Market Still Seeing Inflation Coming Back To Target

Analysts derive inflation expectations from the Treasury bond market by the difference between the nominal interest rates on U.S. Treasury bonds to the rates on the Treasury Inflation Protected Securities (TIPS) bonds. Plotting this difference over time for any maturity results in what bond investors believe inflation will be over the maturity period. To illustrate, consider the current 2-year inflation expectation (derived from subtracting the 2-year TIPS rate from the 2-year nominal interest rate), which currently stands at around 2%. This suggests that the bond market foresees an average annual inflation rate of 2% from the present to August 2025. Across various maturities, bond investors appear to anticipate inflation reverting to 2% sometime in the next year.

INFLATION EXPECTED TO COME BACK

Bond Investors Expect Inflation To Come Back To Fed's 2% Target In 2024

Source: Bloomberg Past performance not indicative of future results. As of August 28, 2023

Risk To This Inflation Outlook

Continuously rising oil prices pose a potential risk to the disinflation thesis, as they could seep into core items within the consumer basket through heightened transportation costs. Consequently, it's imperative to closely monitor the energy market to assess the duration and extent of elevated oil prices.

Additional risks encompass the possibility of a more robust consumer environment than initially anticipated, and more accelerated manufacturing onshoring. Additionally, geopolitical tensions escalating in regions like Ukraine or Taiwan could introduce further uncertainty. Beyond the immediate year, certain secular factors are poised to influence inflation, including deglobalization, the tightening U.S. labor market due to mass retirements prompted by the pandemic, shifting demographics towards an aging population, the transition to renewable energy sources, and a more confrontational geopolitical environment.

While these factors collectively imply higher inflation in the coming decade, they are predominantly of a secular nature rather than cyclical. As outlined in the preceding paragraphs, the cyclical elements highlighted continue to point towards disinflation in the forthcoming year, according to our analysis.

Conclusion

In conclusion, August marked a minor setback for the stock market compared to its performance in most of 2023, with major indices such as the S&P 500 and Russell 2000 experiencing declines. Despite this, the overall stock market performance remains positive, with the S&P 500 Index showing a year-to-date increase. Throughout the year, growth stocks have outperformed value stocks, although both experienced declines in August as investors adopted a more risk-averse stance. Bond investors faced losses as yields increased, reflecting concerns about potential inflation resurgence, elevated bond yields, and strong economic growth, leading to speculation about future interest rate hikes by the Federal Reserve.

The rising U.S. debt and its impact on bond yields are areas of concern, reflected in the increase in Treasury supply and a potential decrease in foreign demand. Growing federal deficits, coupled with a challenging fiscal landscape and the recent downgrade of the U.S. credit rating, contribute to the risks faced by bond investors. The U.S. economy displayed strong growth, particularly in the consumer and labor markets, providing a buffer against recession. However, there's a concern about the conclusion of the student loan forbearance program and its potential influence on consumer spending.

Regarding inflation, the downward trend since its peak in June 2022 can be attributed to various factors, including lower commodity prices and the shift from goods to services consumption. Despite these challenges, the belief is that inflation will moderate into 2024, mainly driven by easing shelter inflation and the lag effect of housing market changes.

The potential scenarios for economic growth vary, with an alternative viewpoint suggesting a resurgence in growth and sustained inflation. However, the more probable outcome appears to be an economic slowdown alongside moderate inflation. The bond market's expectations reflect the anticipation of inflation reverting to target levels. Risks to this outlook include rising oil prices, robust consumer trends, manufacturing shifts, and geopolitical tensions.

Sincerely,

The James Research Team

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