Economic and Market Commentary

Q2 2023

# Lingering Late-Cycle, Lagged Headwinds

Late-cycle conditions continue with the economy facing lagged impacts of Fed tightening, tougher lending standards, and declining profits. We continue to avoid or underweight the most economically cyclical parts of the markets.


## SUMMARY

- Late-cycle economic conditions continued in Q2, and appear likely to persist for some time, whether we enter recession or not.
- Despite equity market strength this year, we see significant headwinds to growth for the economy and earnings ahead.
- Even with slowing growth, we see both relative and absolute return opportunities in select U.S. equity sectors and fixed income.


## Q2 2023 REVIEW

The second quarter (Q2) saw a continuation of late-cycle economic conditions with an ongoing mix of positive and negative factors. In the U.S., inflation continued to decelerate on a year-over-year basis, with headline CPI also slowing on a month-over-month basis while core CPI remained more stable. Nonfarm payroll gains reaccelerated in the first two months of the quarter but remained near the six-month average level of about 300K. Other data continued to show deceleration in Q2, such as real retail sales and industrial production.

The Fed raised rates 25 bps for a third meeting in a row in May (the 10th successive hike this cycle), but it paused in June. Subsequent comments from Fed Chair Powell indicated the potential for at least another rate hike this year, disappointing some market participants who had hoped the Fed might begin easing in 2023.

U.S. stocks were positive in Q2, with the S&P 500 returning 8.7%, a little above its Q1 return. The mid-phase Information Technology, Communication Services, and Consumer Discretionary sectors led again in Q2, continuing a sharp Q1 rebound after underperformance in 2022, though leadership was concentrated in a few large tech-related names. All other S&P 500 sectors underperformed the index in Q2, and returns for four of the eleven sectors remain negative year-to-date, split evenly between early-phase, cyclical sectors and late-phase, typically defensive sectors.

Internationally, European data showed the EU had entered a technical recession, with two quarters of negative GDP growth through Q1, driven by weakness in Germany and Ireland. Europe continued to see elevated inflation, and the ECB continued to raise its benchmark interest rate in response. European stocks underperformed the U.S. in both local and dollar terms in Q2. Japan, in contrast, continued to show resilience, with an upward revision to Q1 GDP and relatively moderate inflation. Japanese stocks outperformed the U.S. sharply in local terms in Q2, but this was more than offset for dollar-based investors by yen weakness. Emerging market (EM) economies and stocks were mixed, with declines in Chinese stocks driving underperformance for EM overall, but some areas showed strength outside of Asia, particularly European EM countries as they continued to rebound from concerns tied to the war in Ukraine.

Beyond equities, a modest shift up in interest rates weighed on fixed income, with both investment grade corporate and Treasury securities generally declining. Slowing growth and easing goods demand also weighed on various commodities from gold to grains to energy.

## OUTLOOK

**Lagged Headwinds**

The full impact of Fed rate hikes, tighter lending standards, and declining corporate profits have yet to be fully felt, in our view.

**U.S.:** We continue to see late-cycle economic conditions, with ongoing deceleration in key leading data, despite continued strength in headline employment and consumption. The Leading Economic Index (LEI) is negative on a monthly, six-month, and year-over-year basis. Further, payroll data for sub-industries that tend to lead the broad labor market continues to decelerate, including temporary workers, credit intermediation, and warehousing. Along with this, our economic cycle analysis suggests that the delayed effects of monetary policy tightening, tightening lending standards, and the rolling over of the profit cycle are all likely to be felt more acutely in coming quarters.

*Fed Rate Hikes:* A long history of research suggests Fed Funds rate hikes have a significant but lagged impact on economic growth, with a +100 basis point rate shock creating as much as a -1.5 percentage point drag on cumulative real GDP growth over the subsequent 18 months. In its ongoing fight against inflation, the Federal Reserve has now raised its target rate by a total of +500 basis points over just 15 months. We have already seen some impacts from these sharp rate hikes, particularly in the banking industry, but we believe the full effects of these rate hikes have yet to be felt.

*Lending Standards:* Lending is a key driver of economic growth for both investment and consumption, and we have seen a significant tightening of lending standards. Data from the Federal Reserve shows that banks generally began tightening lending standards for commercial, consumer, and residential mortgage loans in 2022. For example, as of the Fed's most recent loan officer survey in April, the net percentage of banks reporting tighter standards in Q1 had reached levels similar to those at the height of COVID lockdowns and, before that, the 2008 financial crisis. At the same time, rising interest rates have weighed on loan demand. Further, this data likely only partly reflects the incremental impact of the bank failures and related turmoil that arose in the spring. With credit now more expensive (i.e., elevated interest rates) and loans increasingly difficult to get, we expect this to weigh on investment and consumption in the quarters ahead.

*Declining Corporate Profits:* Broad economic measures of corporate profits in the U.S. from the BEA peaked in mid-2022 and have now been in decline for several quarters. S&P 500 earnings for Q1, the most recently reported quarter, were also negative year-over-year. With margins still near historic highs, we see further risk to EPS growth from margin compression. We believe companies will seek to reduce costs, including investment and hiring, to preserve profits and margins, which, in turn, presents a further headwind to economic growth.

Other headwinds that we have cited in recent quarters also remain in play. For example, while inflation has eased a bit this year, it remains elevated, presenting a headwind to real consumption and potentially leading to further rate hikes by the Fed. Additionally, a reduction in the personal savings rate that accounted for much of the growth in consumer spending last year was, in our view, unsustainable and has begun to reverse in recent quarters. This could threaten the relative strength in services consumption, which has held up well this cycle even as goods consumption has declined in recent quarters.

**Late-Cycle, Recession or Not**
We see little chance in the near term of a return to robust growth that tends to benefit early-phase, cyclical sectors.

While all this suggests an elevated risk of recession over the next few quarters, a recession, per se, is not critical to our outlook or our U.S. sector positioning across portfolios. Given the late-cycle conditions in place, we see little chance of a near-term return to the robust economic growth that favors early-phase, cyclical sectors like Industrials, Materials, Energy, and Financials. While leading indicators suggest risks to profit growth going forward, consensus analyst estimates indicate a significant pick-up in EPS growth in the back half of 2023. We see this divergence as a particular risk to the most economically cyclical sectors. As such, we are generally avoiding these U.S. sectors across portfolios.

Whether growth continues to decelerate, as we think likely, or plods along at a middling rate, we anticipate late-phase, defensive sectors like Health Care and Consumer Staples should benefit from investor preference for less economically sensitive earnings growth.

Mid-phase sectors, which have outperformed sharply year-to-date, also provide a desirable mix of exposures, in our view, as they may benefit from easing inflation, have various secular tailwinds supporting earnings, and should also benefit from a cyclical upturn whenever an eventual rebound should occur.

**International:** Foreign economies continue to face many of the same economic headwinds as the U.S., but with some key differences that further dampen our international outlook. For example, we are generally avoiding emerging markets (EM) in global portfolios. Many EM economies are reliant on exports or commodity extraction which can make them particularly sensitive to global economic conditions.

We are also underweight developed Europe in global portfolios, as leading indicators suggest Europe's recession could continue. Monetary and fiscal tightening are ongoing, Europe has less of a savings cushion than the U.S., and it faces greater risks from inflation than the U.S., in our view. From a market perspective, roughly half of European equity market capitalization is from early-phase, economically sensitive sectors like Financials, Industrials, and Energy.

We do maintain an overweight of Developed Asia, and particularly Japan, where economic output remains below potential and stimulative monetary and fiscal policies remain in place. Japan also has lower inflation than most developed economies and, after decades of bouts with deflation, could see a healthy benefit to nominal GDP and earnings growth from a more normalized inflation environment.

**Fixed income and other assets:** We continue to see unusual return opportunity and limited near-term risk in fixed income. We believe upside risk to longer-term interest rates is limited from here, while elevated yields and potential appreciation if interest rates fall present a favorable risk/return profile for intermediate and longer-term bonds. Thus, we are overweight fixed income in traditional balanced strategies and, within fixed income, have increased Treasury exposure, which we expect should outperform corporate bonds in a late-cycle economic environment with slowing growth and tightening financial conditions. In portfolios that can include real assets, we also see opportunity for diversification and appreciation from exposure to gold in the current inflationary environment as well as from select infrastructure exposure.

## CONCLUSION

Whether slow growth grinds on or we enter recession, we believe limiting exposure to the most economically cyclical parts of the market is warranted amid current late-cycle economic conditions. We see relative opportunity in areas of the market with defensive characteristics or moderate economic sensitivity combined with secular growth drivers. As always, we continue to evaluate the evolving economic cycle and stand ready to adjust portfolios as appropriate.

**WestEnd Advisors Investment Team | July 5, 2023**

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