ACIMA
PRIVATE WEALTH

ECONOMIC & INVESTMENT PERSPECTIVES

August 1, 2023

JULY: EQUITY RALLY CONTINUES
THE FED'S DUAL MANDATE: INFLATION & EMPLOYMENT

Figure 1: 7/31/2023 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.0%	2.2%	-3.5%	-6.4%	4.8%
Investment Grade Corp Bonds	LQD	0.1%	4.3%	-2.3%	-6.2%	9.6%
U.S. Treasury Bonds	GOVT	-0.3%	1.5%	-4.0%	-6.6%	2.9%
U.S. 20+ YR Treasuries	TLT	-2.5%	2.1%	-12.3%	-17.1%	8.9%
Muni Bonds	MUB	0.0%	2.3%	0.6%	-2.1%	5.1%
US High Yield	HYG	1.1%	5.7%	2.2%	-4.8%	7.2%
Non-US Corp Bonds	IBND	1.7%	5.0%	1.6%	-2.5%	19.2%
Emerging Markets Bond LC	EMLC	1.8%	10.1%	12.9%	-0.8%	15.7%
Global Equity						
ACWI Global Equity	ACWI	3.6%	18.3%	12.6%	-0.1%	31.3%
ACWI Global Equity ex US	ACWX	3.9%	14.3%	12.7%	-0.3%	31.8%
International Developed	EFA	2.7%	15.5%	15.9%	-0.4%	36.3%
Emerging Markets	EEM	6.0%	11.6%	7.4%	-1.4%	25.3%
Global Equity by Region						
United States	VTI	3.7%	20.4%	12.6%	-0.3%	30.6%
Europe	IEUR	2.7%	16.4%	17.7%	-1.4%	40.2%
Asia ex-Japan	AAXJ	6.2%	9.5%	5.6%	-3.2%	30.1%
China	MCHI	11.3%	5.8%	2.7%	-11.2%	42.8%
Japan	BBJP	2.5%	17.7%	14.5%	-1.0%	32.5%
Latin America	ILF	4.8%	26.6%	33.0%	-0.3%	30.9%
US Equity						
US S&P 500	IVV	3.2%	20.6%	13.0%	-0.4%	31.7%
NASDAQ 100 QQQ	QQQ	3.9%	44.5%	22.5%	-1.1%	50.9%
US Large Growth	IWF	3.4%	33.4%	17.1%	-0.8%	40.9%
US Large Value	IWD	3.5%	8.7%	8.1%	-0.5%	21.9%
US Eqwt S&P 500	RSP	3.5%	10.7%	8.1%	-0.6%	24.0%
US Mid Cap	IJH	4.2%	13.4%	10.5%	-0.5%	25.4%
US Small Cap	VTWO	6.2%	14.9%	8.1%	-1.5%	22.4%

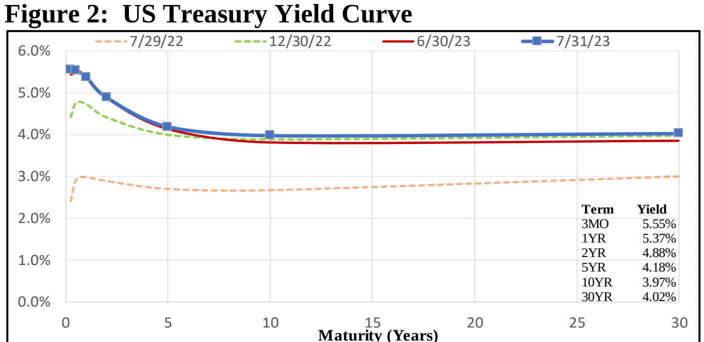
Global equity markets were strong again in July, while bond returns were muted as interest rates rose amid continued economic strength (strong employment and real GDP growth). Performance highlights for the month and YTD are summarized below.

- Bonds: The US Aggregate index (AGG) was flat in July (+2.2% YTD) as interest rates ticked higher. Long-term Treasuries (TLT -2.5%, +2.1% YTD) are the most sensitive to interest rate changes, while corporate (LQD +0.1%, +4.3% YTD) and high yield bonds (HYG +1.1%, +5.7% YTD have benefitted from narrowing credit spreads. Non-U.S. bonds (IBND and EMLC) have out-performed with US dollar weakness in 2023.
- Global equities (ACWI) rose 3.6% in July (+18.3% YTD).
- U.S. Equity: The broad market (VTI) rose 3.7% for the month (+20.4% YTD), and the S&P 500 (IVV) gained 3.2% (+20.6% YTD). Small (VTWO) and mid-cap stocks (IJH) out-performed in July but remain well behind large growth-oriented stocks this year; the Nasdaq 100 (QQQ) has gained 44.5% YTD! All sectors posted gains in July, led by energy stocks (XLE +7.8%, +1.9% YTD) as oil prices bounced off of recent lows amid economic strength and reduced OPEC supply.
- Non-U.S. Equity: Developed market stocks (EFA) rose 2.7% (+15.5% YTD) with gains in Europe (IEUR) and Japan (BBJP). Emerging markets (EEM) rose 6.0% (+11.6% YTD), led by a strong rebound in Chinese stocks (MCHI +11.3% in July, +5.8% YTD), which has struggled this year as their economy re-opens from COVID shutdowns. Latin American stocks (ILF +4.8%, +26.6% YTD) continue to out-perform.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. After pausing in June, the Federal Reserve (Fed) hiked interest rates by 0.25% last week, raising the Fed Funds target rate to 5.25-5.50%. The economy remains resilient (strong employment and GDP growth), increasing the odds that rates will remain high for longer, but the inverted curve (short-term yields higher than long-term yields) continues to warn of recession. The 10-year Treasury now yields 3.97%.

Figure 2: US Treasury Yield Curve

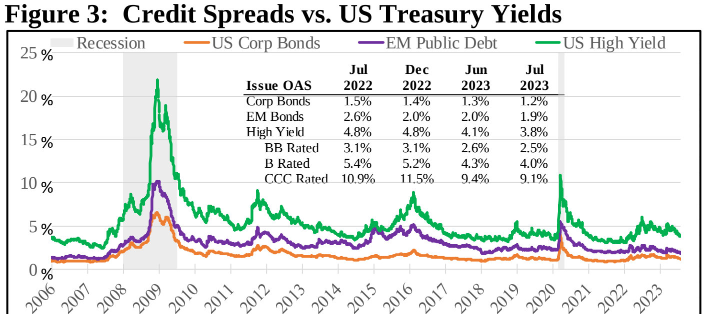


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads narrowed in June and Q2 and remain at historically low levels.

- Investment grade corporate bond spreads narrowed to +1.2% and have marched incrementally lower over the past year.
- High yield (non-investment grade) spreads narrowed to +3.8%, down from +4.1% last month and well below year-ago spreads of +4.8%. The riskiest bonds (rated CCC & below) have declined over the past year and now yield +9.1% over Treasuries.
- Emerging market bond spreads have narrowed steadily as well, now yielding an average of +1.9% over US Treasuries. Returns on non-US bonds have been strong recently as credit spreads fell and global currencies strengthened versus the US dollar.

Figure 3: Credit Spreads vs. US Treasury Yields

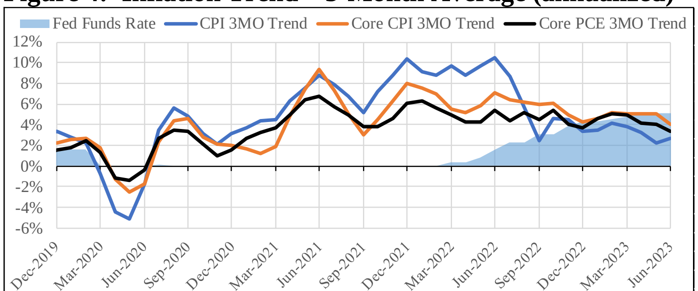


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Dual Mandate: Inflation & Employment

After pausing in June, the Fed raised interest rates by 0.25% in July, increasing the Fed Funds Target Rate to 5.25-5.50% (highest since 2001). In his press conference, Fed Chair Powell noted that while price pressures have moderated, inflation remains the Fed's primary focus, and there is still "a long way to go" toward their 2% inflation target. Figure 4 plots inflation trends in context of the Fed's aggressive rate hike cycle, using a 3-month average of the monthly inflation data to imply an annualized "run rate".

Figure 4: Inflation Trend – 3-Month Average (annualized)



Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Federal Reserve Board of Governors

- CPI: Headline inflation peaked at 8.9% in June, 2022 but has declined to 3.1% as of June, 2023. The current run rate (3-month average of monthly data, annualized) is 2.7%.
- Core CPI: Excluding food and energy, the most volatile components of inflation, the so-called core CPI inflation has declined from a peak of 6.6% to 4.9% for the most recent 12 months. The 3-month average (annualized) run rate is 4.1%
- Core PCE: Core Personal Consumption Expenditures (PCE) excluding food and energy is the Fed's preferred inflation metric. Core PCE has declined from 5.4% to 4.1% year-over-year. The 3-month average now suggests an annualized rate of 3.4%.

Despite the Fed's aggressive efforts to slow growth and inflation by raising interest rates, the economy has remained resilient. Real GDP (Gross Domestic Product, the value of all final goods and services produced in the US, net of inflation) grew at an annual rate of 2.4% in the second quarter, up from 2.0% in the first quarter. The job market is strong, with unemployment near multi-decade lows. Because a tight labor market contributes to inflation via rising wage pressures, Fed Chair Powell stated that they "need to see softening labor conditions." Why has the job market remained so robust? Figure 5 compares current employment metrics versus pre-pandemic data to illustrate the shifting dynamics across gender, immigration and age cohorts.

Figure 5: US Employment Metrics as of June 2023

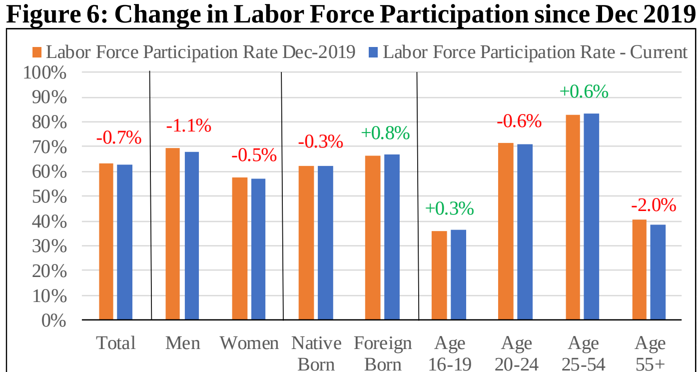
Category	Cohort	Employment (millions)	Distribution (% of Total)	Jobs Gained Since Dec-2019 (millions)	Labor Force Participation Rate	Labor Force Participation Rate Change Since Dec-2019
Total	**Total**	**161.0**	**100%**	**2.2**	**62.6%**	**-0.7%**
Gender	Men	85.5	53%	1.5	68.1%	-1.1%
	Women	75.4	47%	0.6	57.3%	-0.5%
Immigration	Native Born	131.8	82%	0.6	62.1%	-0.3%
	Foreign Borr	29.7	18%	2.5	67.0%	0.8%
Age	Age 16-19	5.6	3%	0.3	36.3%	0.3%
	Age 20-24	14.7	9%	0.7	71.0%	-0.6%
	Age 25-54	103.4	64%	1.8	83.5%	0.6%
	Age 55+	37.2	23%	-0.5	38.3%	-2.0%

Source: U.S. Bureau of Labor Statistics (Household Survey, seasonally-adjusted except Native/Foreign Born)

- 161 million workers are now employed according to the most recent Household Survey from the Bureau of Labor Statistics, an increase of 2.2 million workers since December, 2019.
- Gender: The workforce is 53% male and 47% female; this proportion has remained relatively stable in recent years even with marginally lower growth in female employment levels.
- Immigration: 82% of workers are native born, but nearly 30 million current employees (18%) were born outside of the US.
- Age: The workforce is dominated by prime-age workers (age 25-54), who comprise 64% of current employees. Prime-age employment increased by 1.8 million workers since December, 2019 (before the pandemic). Employment among younger workers continues to grow, but the number of older workers (55+) is shrinking due to net retirements as the workforce ages. (Note: The youngest Baby Boomer is almost 59 years old!)

One reason that the labor market remains tight is that the Labor Force Participation Rate (the percentage of the population that is working or seeking employment) has declined from 63.3% in December, 2019, to 62.6% today (a decline of 0.7% or roughly two million fewer potential workers). Figure 6 illustrates the changes in participation rate across gender, immigration and age cohorts.

Figure 6: Change in Labor Force Participation since Dec 2019



Source: U.S. Bureau of Labor Statistics (Household Survey, seasonally-adjusted except Native/Foreign Born)

- Gender: The Labor Force Participation Rate is higher for men than women (68% vs. 57%); more men have left the workforce.
- Immigration: The participation rate is higher and rising for foreign born workers (67% vs. 62% for native born workers).
- Age: Prime age workers (age 25-54) are the majority of the workforce; their participation rate has increased to 84% over this period. Older workers (55+) make up about a quarter of the workforce, but their share is declining, accelerated by a 2% decline in the participation rate (now 38%) since the pandemic.

Bottom Line

The stock market continues to defy expectations for an economic slowdown even as the Fed aggressively raises rates to tame inflation. Economic data continues to be strong: Real GDP growth for Q2 was 2.4% (annualized), and the job market is robust, with 278,000 new jobs created monthly in 2023 and near-record low unemployment. Inflation is moderating but the Fed has clearly stated that the job market must soften in order to get inflation fully under control. Unemployment must rise (economic slowdown) or more workers are needed, but US demographics are changing: Baby Boomer retirements are accelerating, and foreign-born workers have become more critical to the workforce.

The Fed has a dual mandate: (1) maintain price stability (inflation), and (2) promote full employment. Until the labor market weakens, they will keep rates higher for longer, putting pressure on the economy and markets. Diversification is critical, with attractive bond and cash yields as viable alternatives to stocks.

Disclaimer: