ACIMA PRIVATE WEALTH
ECONOMIC & INVESTMENT PERSPECTIVES
November 1, 2023

OCTOBER: MORE TRICKS THAN TREATS

ECONOMIC GROWTH & INFLATION UPDATE

Figure 1: 10/31/2023 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	-1.6%	-2.6%	0.2%	-8.7%	0.8%
Investment Grade Corp Bonds	LQD	-2.4%	-3.0%	1.8%	-11.9%	0.9%
U.S. Treasury Bonds	GOVT	-1.2%	-2.5%	-0.6%	-8.2%	0.6%
U.S. 20+ YR Treasuries	TLT	-5.5%	-14.0%	-10.2%	-23.8%	1.4%
Muni Bonds	MUB	-1.2%	-2.3%	2.1%	-7.0%	0.1%
US High Yield	HYG	-1.0%	3.1%	4.7%	-6.2%	1.2%
Non-US Corp Bonds	IBND	1.1%	0.3%	9.6%	-7.5%	9.5%
Emerging Markets Bond LC	EMLC	-0.2%	2.3%	11.1%	-9.2%	5.8%
Global Equity						
ACWI Global Equity	ACWI	-2.5%	7.1%	10.7%	-9.6%	12.7%
ACWI Global Equity ex US	ACWX	-3.1%	1.7%	12.7%	-11.2%	11.6%
International Developed	EFA	-2.9%	3.8%	15.4%	-10.5%	15.3%
Emerging Markets	EEM	-3.3%	-2.4%	9.8%	-13.7%	7.1%
Global Equity by Region						
United States	VTI	-2.6%	9.4%	8.3%	-9.7%	11.7%
Europe	IEUR	-3.2%	3.5%	15.4%	-12.3%	15.4%
Asia ex-Japan	AAXJ	-3.3%	-4.7%	12.6%	-15.7%	10.0%
China	MCHI	-3.4%	-11.1%	20.4%	-25.4%	13.8%
Japan	BBJP	-2.1%	9.6%	19.6%	-7.8%	18.6%
Latin America	ILF	-3.0%	10.3%	5.4%	-13.2%	14.0%
US Equity						
US S&P 500	IVV	-2.2%	10.6%	10.1%	-9.1%	13.4%
NASDAQ 100 QQQ	QQQ	-2.1%	32.3%	27.1%	-9.6%	35.4%
US Large Growth	IWF	-1.5%	23.0%	18.7%	-8.7%	26.1%
US Large Value	IWD	-3.6%	-1.9%	0.0%	-10.8%	2.1%
US Eqwt S&P 500	RSP	-4.1%	-2.5%	-0.9%	-12.8%	1.9%
US Mid Cap	IJH	-5.4%	-1.3%	-1.1%	-13.8%	1.9%
US Small Cap	VTWO	-6.8%	-4.4%	-8.6%	-17.2%	1.8%

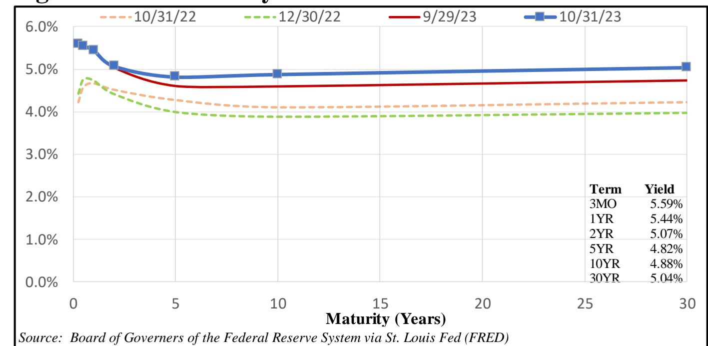
Stocks were down for the third consecutive month, pushing most segments into correction (-10% from recent highs) as the steady flow of strong economic data (growth, consumer spending, employment) solidified expectations that interest rates will remain higher for longer as the Federal Reserve (Fed) seeks to slow the economy and tame inflation. Performance highlights are below.

- Bonds: The US Aggregate index (AGG) fell 1.6% (-2.6% YTD) as yields rose. Long-term Treasuries (TLT) are highly sensitive to interest rates, losing 5.5% (-14.0% YTD). Corporate bonds (LQD) fell 2.4% (-3.0% YTD), while high yield (HYG) fell 1.0% (+3.1% YTD). Emerging markets bonds continue to out-perform due to better yields and stable currencies.
- Global equity (ACWI): -2.5% in October (+7.1% YTD).
- US Equity: The broad market (VTI) fell 2.6% (+9.4% YTD). The S&P 500 (IVV) was down 2.2% (+10.6% YTD) while the average stock in the S&P 500 (RSP) lost 4.1% and is actually down 2.5% YTD. Returns were negative for all major economic sectors except utilities. Small (VTWO) and mid cap (IJH) stocks continue to under-perform and are negative YTD.
- Non-US Equity: Developed markets (EFA) fell 2.9% this month (+3.8% YTD), with losses in Europe (IEUR -3.2%, +3.5% YTD) and Japan (BBJP -2.1%, +9.6% YTD). Emerging markets stocks (EEM) fell 3.3% (-2.4% YTD); Chinese stocks (MCHI) lost 3.4% (-11.1% YTD) amid on-going concerns about economic growth and a troubled real estate sector. Latin American stocks (ILF) lost 3.0% but are still up 10.3% YTD.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Long-term interest rates continued to rise in October as a steady stream of strong economic data (jobs, retail sales, real GDP growth) reinforced the Fed's assertion that rates will remain "higher for longer" to slow the economy and tame inflation. The inverted yield curve (short-term rates > long-term yields) has historically been a recession warning. The 10-year US Treasury now yields 4.88%.

Figure 2: US Treasury Yield Curve

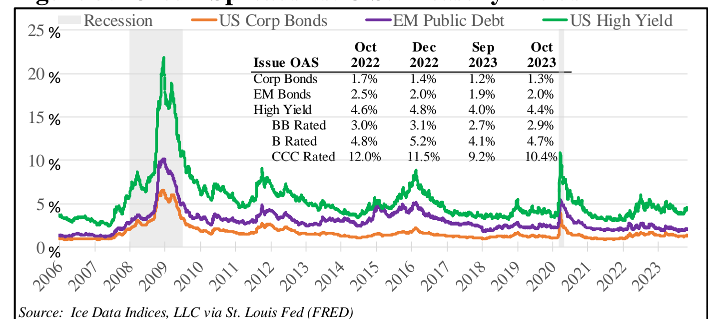


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

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 widened in October but remain at or near historically low levels.

- Investment grade corporate bond spreads widened marginally to +1.3% this month but are below year-ago spreads of +1.7%.
- High yield (non-investment grade) spreads increased to +4.4%, still slightly narrower than a year ago. The riskiest bonds (rated CCC & below) widened to +10.4% over Treasuries but are down from +11.5% this year and +12.0% spreads one year ago.
- Emerging market spreads rose to +2.0% but have been relatively stable this year. Emerging market credit has out-performed US bonds this year despite a stronger US dollar.

Figure 3: Credit Spreads vs. U.S. Treasury Yields

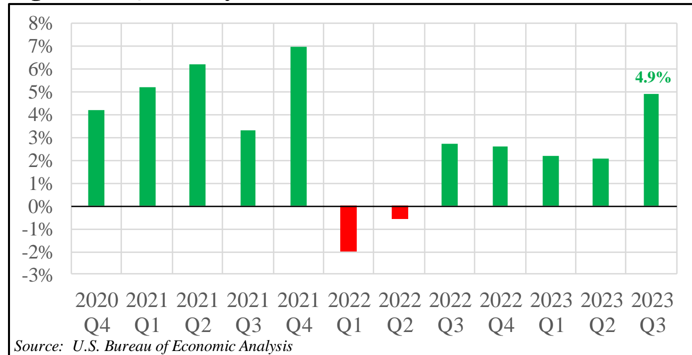


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Growth & Inflation

U.S. economic growth continues to defy expectations for a slowdown. Last week, the Bureau of Economic Analysis (BEA) reported that U.S. real GDP grew at an annualized rate of 4.9% in the third quarter (Q3). (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the U.S., adjusted for inflation.) After uneven but net positive growth in 2022, the economy seemed to slow under the weight of tighter financial conditions (rising interest rates, tighter lending standards, decreasing money supply) only to reaccelerate in Q3. Figure 4 plots quarterly growth rates in the post-COVID era. By comparison, we note that annualized quarterly real GDP growth averaged 2.4% over the ten-year period prior to the pandemic.

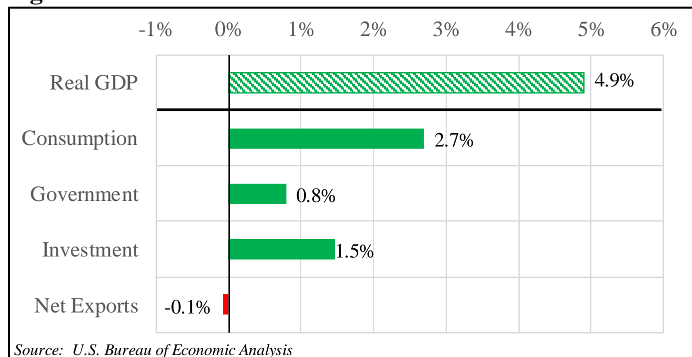
Figure 4: Quarterly U.S. Real GDP Growth (annualized)



Source: U.S. Bureau of Economic Analysis

An analysis of the four primary sub-components of real GDP growth during Q3 is instructive (Figure 5). Consumer spending remains robust and is the key driver of economic growth.

Figure 5: U.S. Real GDP Growth Contribution

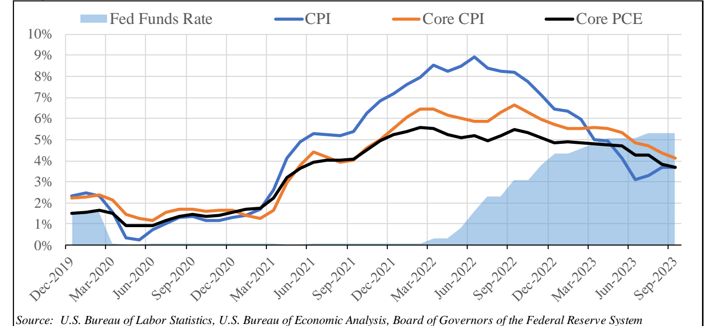


Source: U.S. Bureau of Economic Analysis

- **Personal Consumption:** 68% of the U.S. economy is powered by the expenditures of individual consumers. Strong consumer spending continues to drive positive growth even after adjusting for the impact of inflation.
- **Government expenditures:** 17% of GDP is driven by direct consumption of goods and services by federal, state and local governments, which had a positive impact on overall growth.
- **Private Investment:** 18% of the economic output comes from business spending and investment activity, including construction, equipment, manufacturing and inventories. Q3 real growth was positively impacted by an inventory build-up as businesses increased spending and production to meet strong demand despite tightening financial conditions.
- **Net Exports:** The U.S. has run a trade deficit (the net value of U.S. exports minus imports) since the 1980s, and a larger trade deficit contributed negatively to real growth in Q3.

It is worth noting that nominal GDP growth (not adjusted for inflation) was actually +8.5% in Q3 (annualized). This implies an inflation impact of -3.6%, roughly in-line with the latest CPI (Consumer Price Index) inflation data. Inflation has come down significantly as the Fed aggressively tightens financial conditions by hiking interest rates as illustrated in Figure 6 below.

Figure 6: Inflation vs. Interest Rates



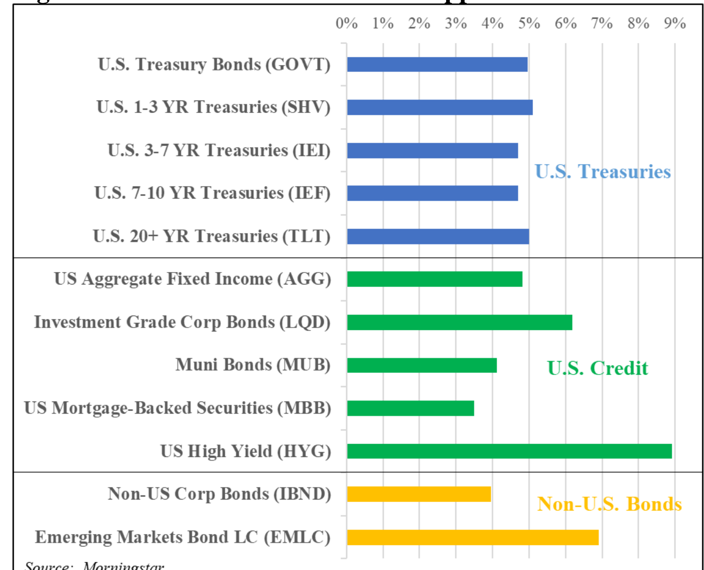
Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Board of Governors of the Federal Reserve System

After peaking at roughly 9% in June, 2022, headline CPI inflation has fallen to 3.7% as of September (latest reading). Core-CPI inflation (which excludes the volatile food and energy categories) is now 4.1% year-over-year. The Fed's preferred metric, core Personal Consumption Expenditures (core PCE) is down to 3.7% as of the end of September, but still well above their 2% target.

Bottom Line

The U.S. economy is surprisingly strong, confounding forecasters even as financial conditions tighten materially. The Fed has increased interest rates aggressively in order to slow the economy and fight inflation. Despite continued economic strength, inflation has declined but remains well above the 2% target. Even so, the Fed left rates unchanged today (5.25-5.50% current range) to allow the impact of restrictive monetary policy to continue to unfold, which can take months, quarters or even longer. Stock and bond markets have been weak in recent months as investors grapple with interest rates remaining high for an extended period. Diversification is critical; attractive bond and cash yields are viable alternatives to stocks. For the first time in nearly 20 years, bonds offer an opportunity to get paid while you wait (Figure 7).

Figure 7: Current Bond ETF Yield Opportunities



Source: Morningstar

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