Soft, Hard or No Landing?

Actionable Ideas Webinar Series

Wednesday, September 13, 2023

Sandip A. Bhagat

Whittier Trust

Chief Investment Officer

Whittier Trust

Discussion Points

- **Inflation Too High or Low Enough**
    - Higher in July and August
- **Economy Too Hot or Too Cold**
    - Unexpected strength in Q3
- **Earnings High Enough or Headed Lower**
    - Impact of higher interest rates
- **Geopolitics, G-20, BRICS-11 … and the Dollar**

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Poll Response 1

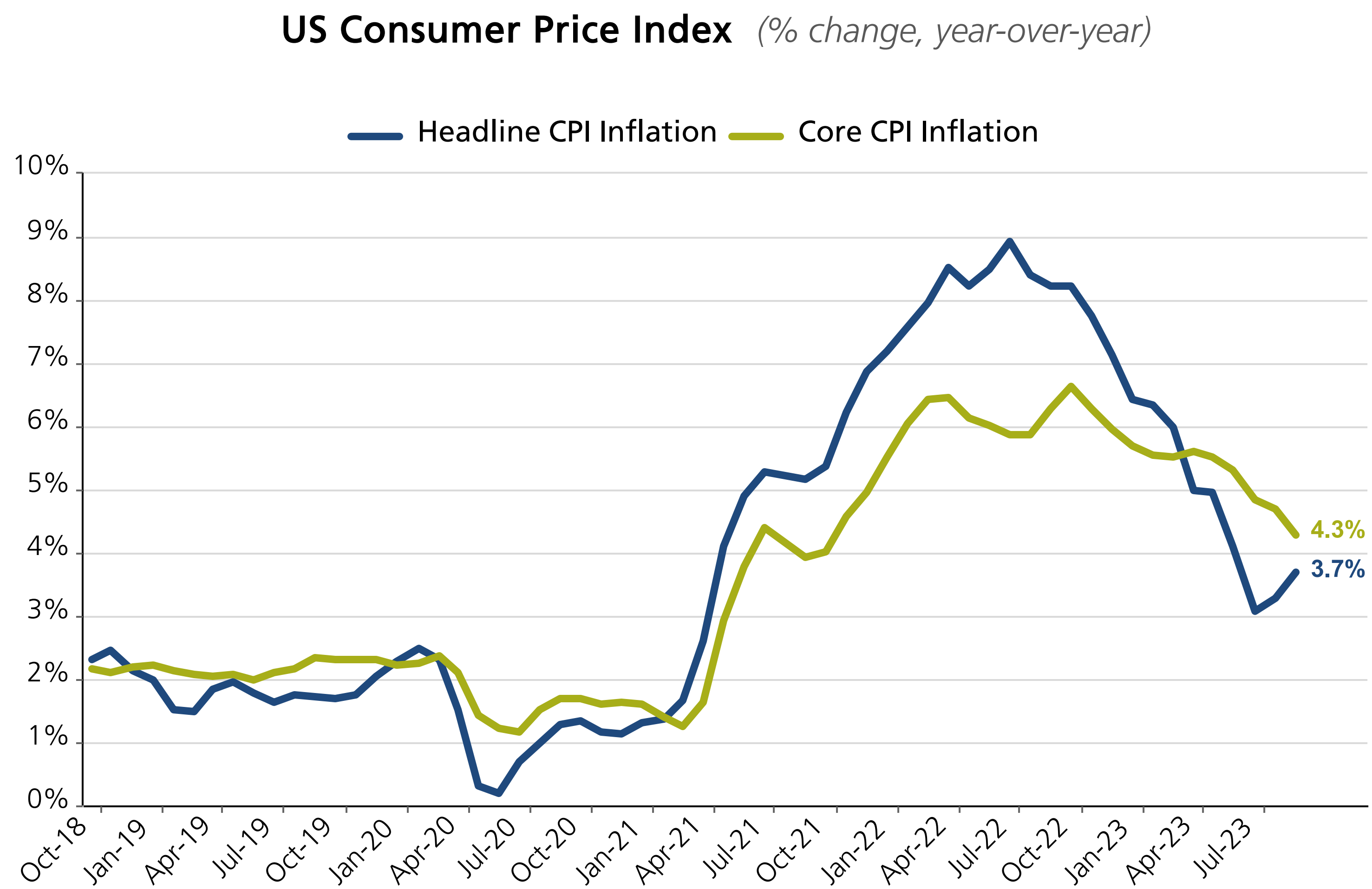
Inflation is …

A. Too high and likely to go back up

B. High but will subside slowly to its target in 2 or more years

C. Low enough and on its way to target by 2024

Inflation Too High or Low Enough: Headline and Core



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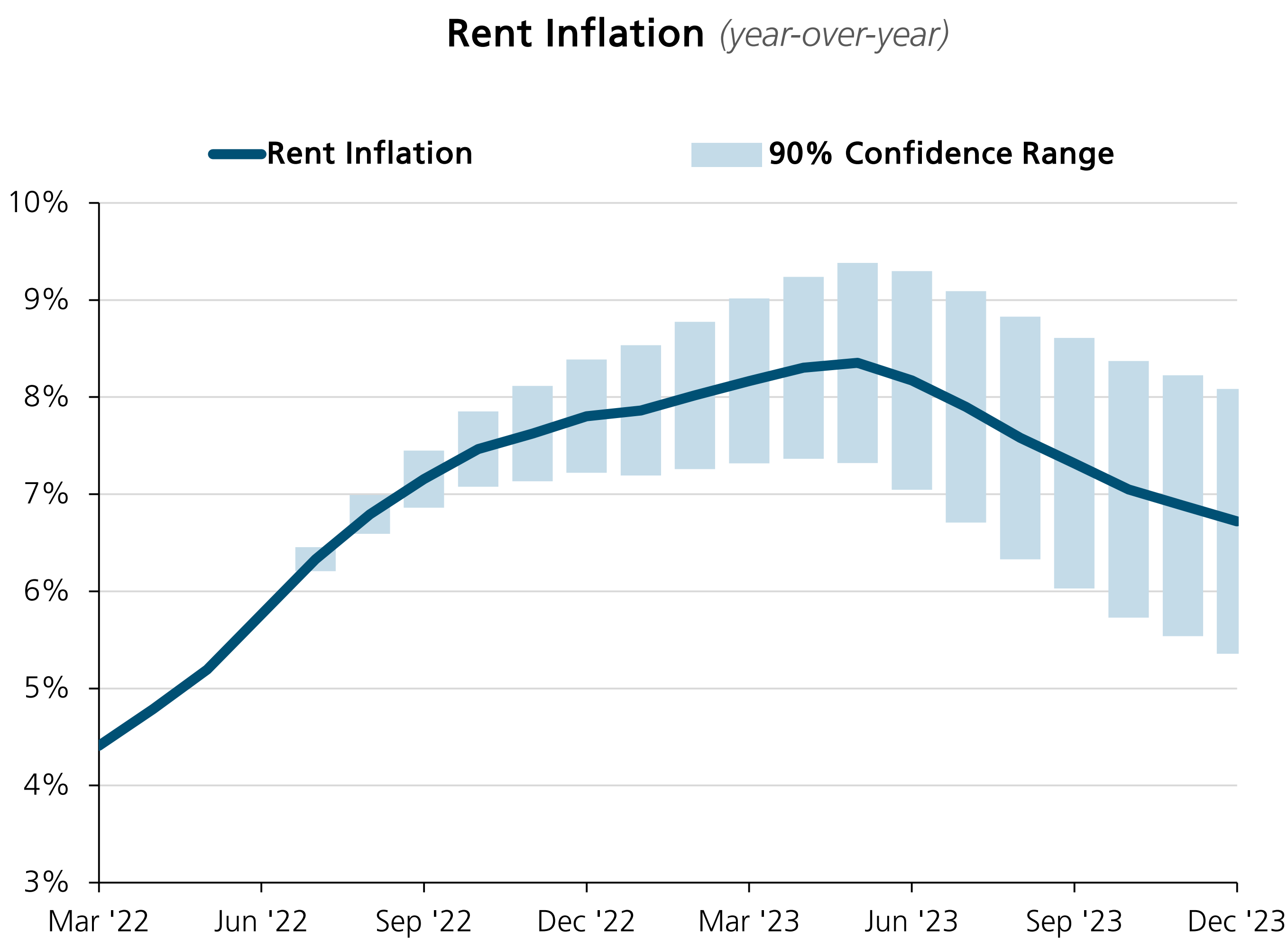
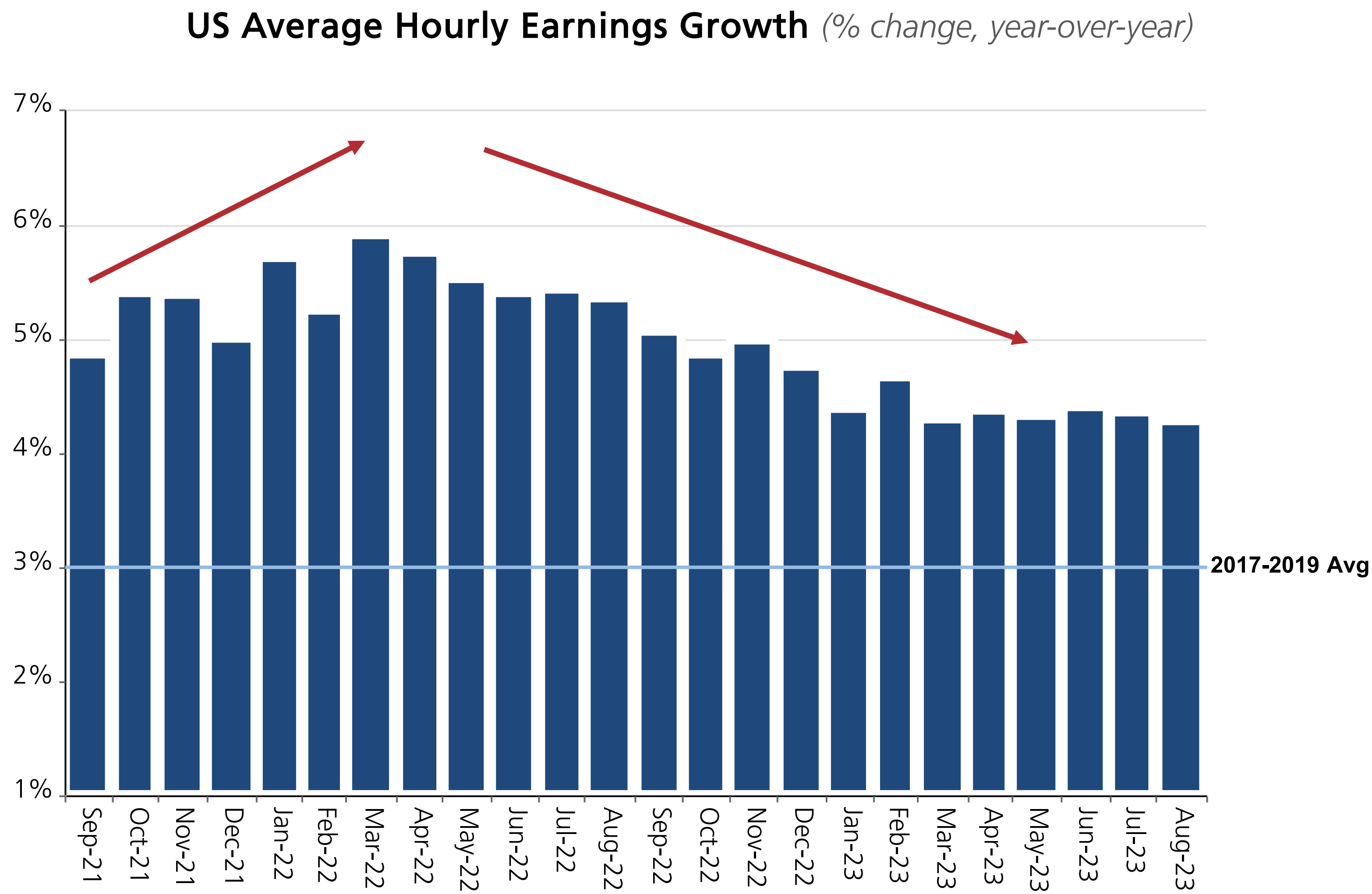
Core CPI excludes food and energy prices.
Source: FactSet. As of August 2023.

Shelter Costs Likely to Decline Steadily



Source: Federal Reserve Bank of Dallas, BEA, Zillow, Haver Analytics. Published August 2022.

Wage Growth Trending Lower …



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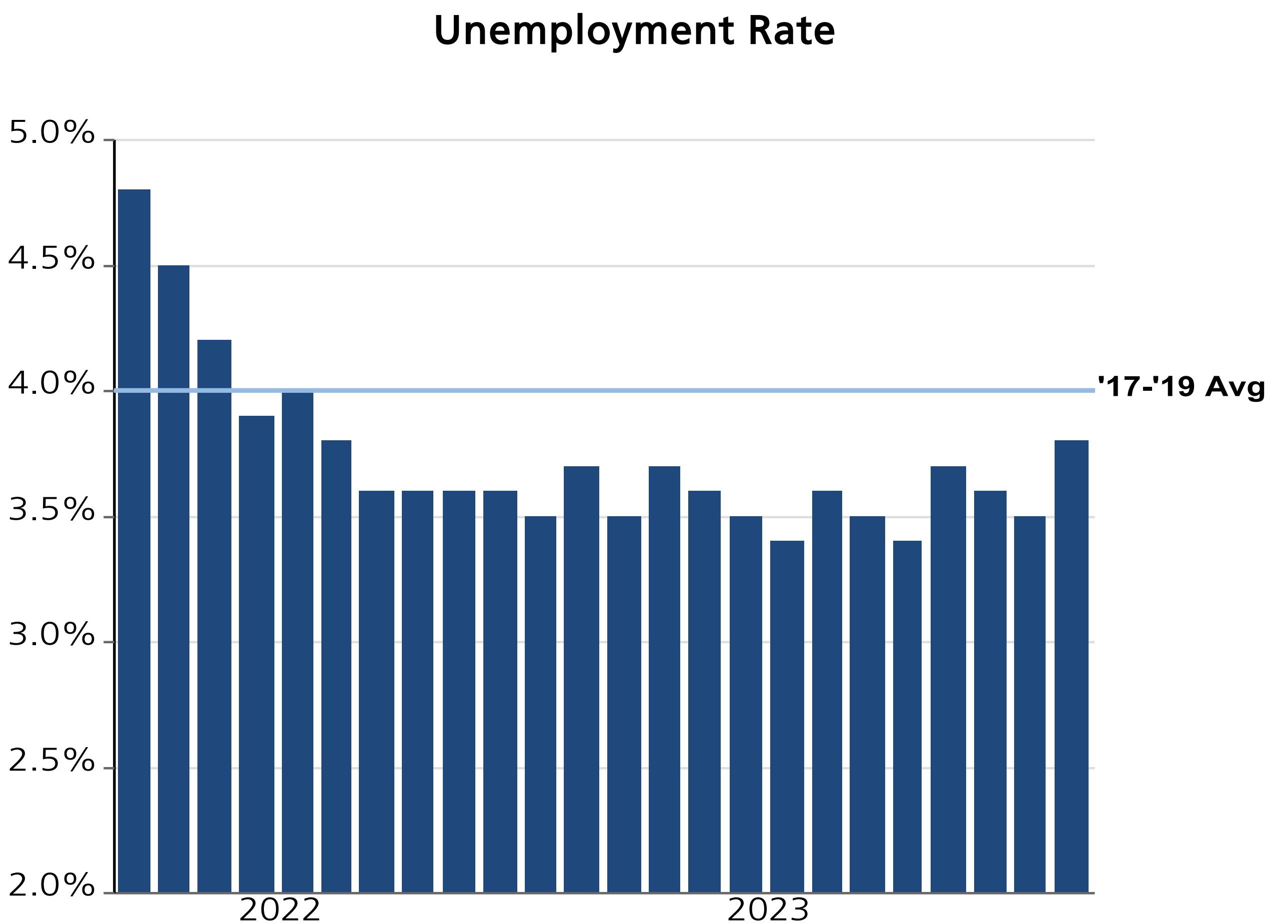
Source: FactSet. As of August 2023.

… Without an Increase in Unemployment

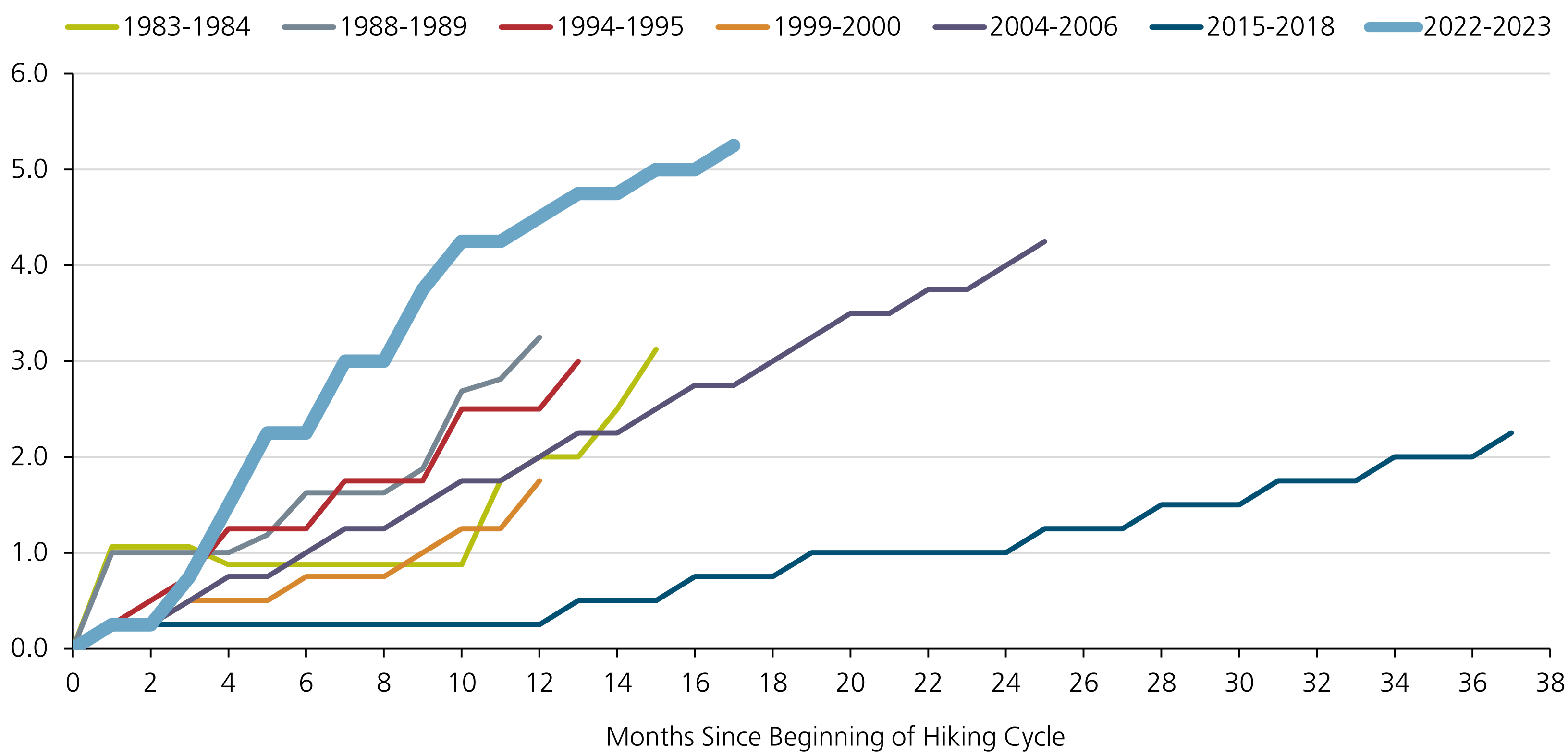


- The unemployment rate is still below levels seen in past cycles

Source: FactSet. As of August 2023. Unemployment rate is US U-3 and job growth is US nonfarm payrolls.

Is It The Fed? Or Is It Transitory?

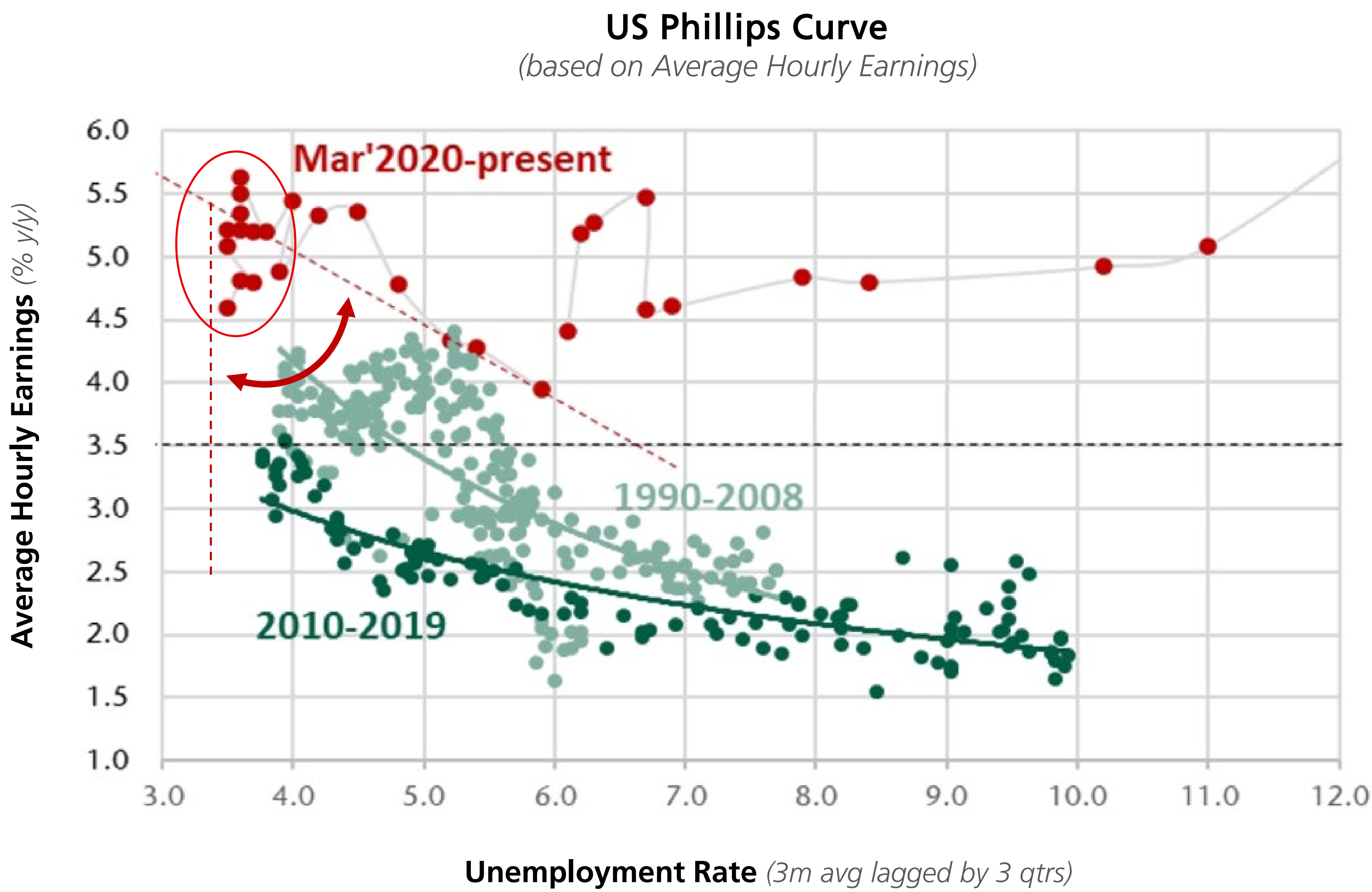
Change in Fed Funds Rate During Monetary Tightening Cycles *(%)*



- The pandemic-induced and stimulus-fueled inflation spike brought on the most rapid Fed tightening cycle in recent years

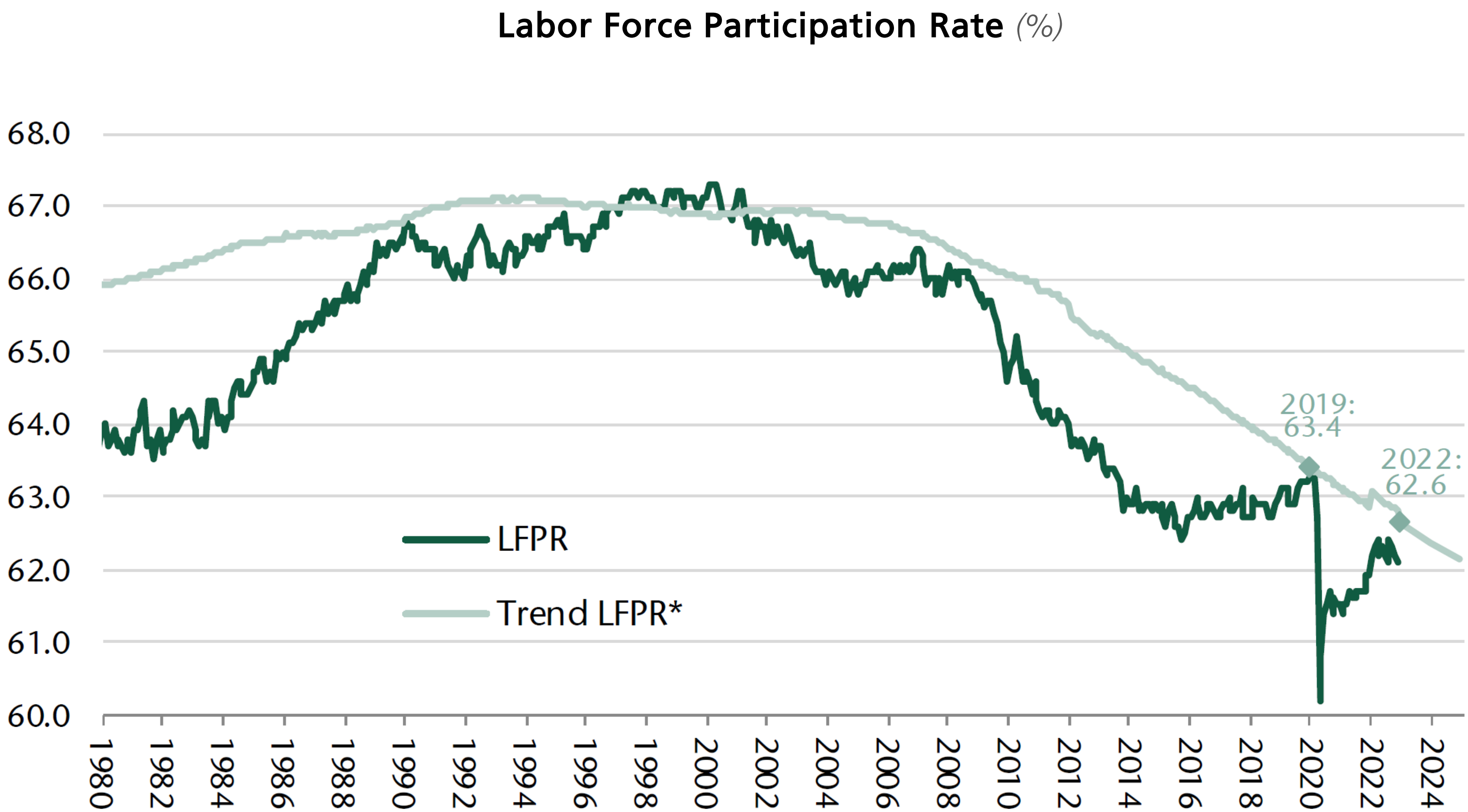
Source: Macquarie, FactSet. As of July 2023.

Inflation Was Meaningfully Transitory



Source: Haver, JEF Economics. Post-pandemic datapoints have no lags.

Labor Force Participation Rate in Secular Decline



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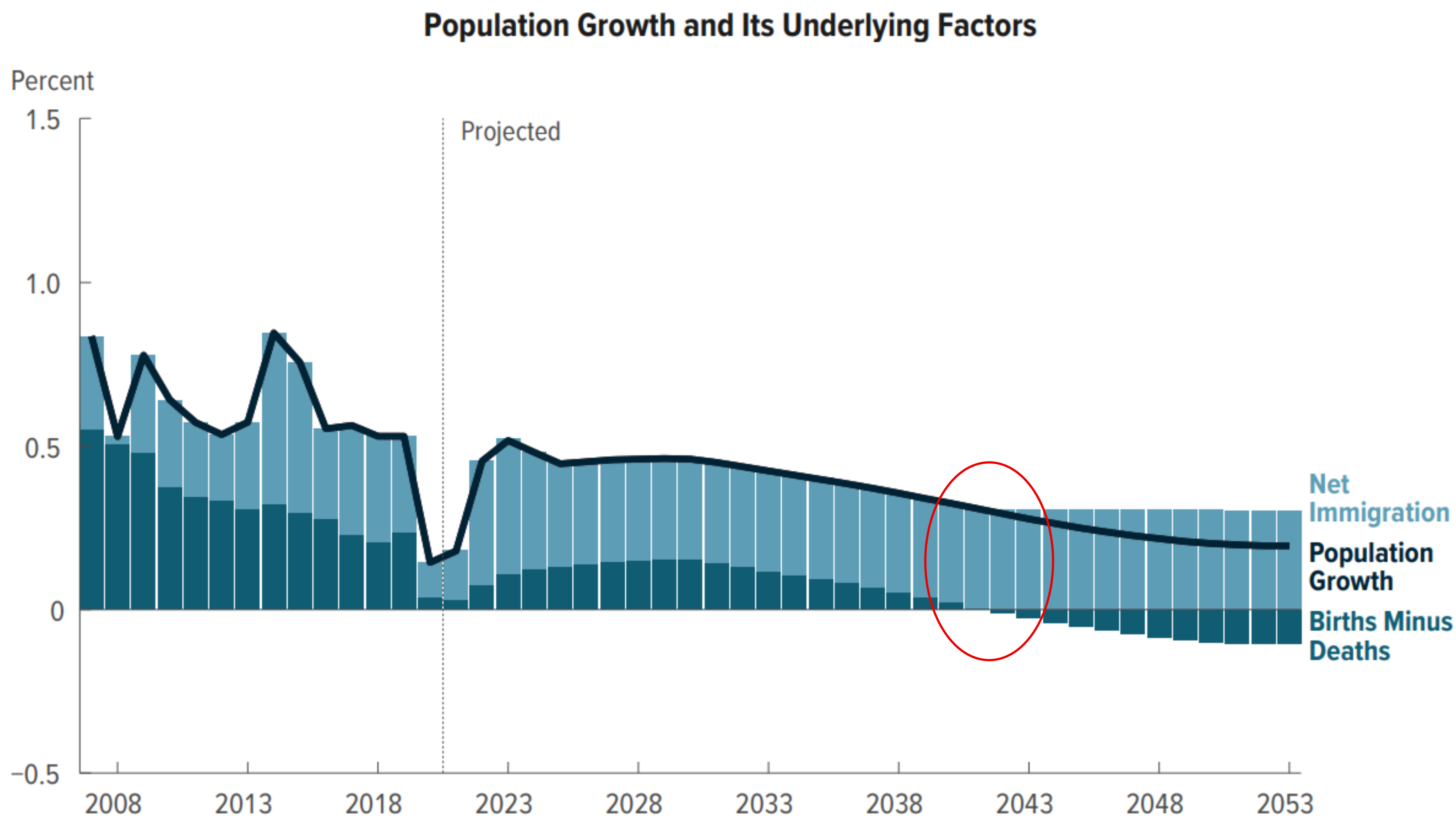
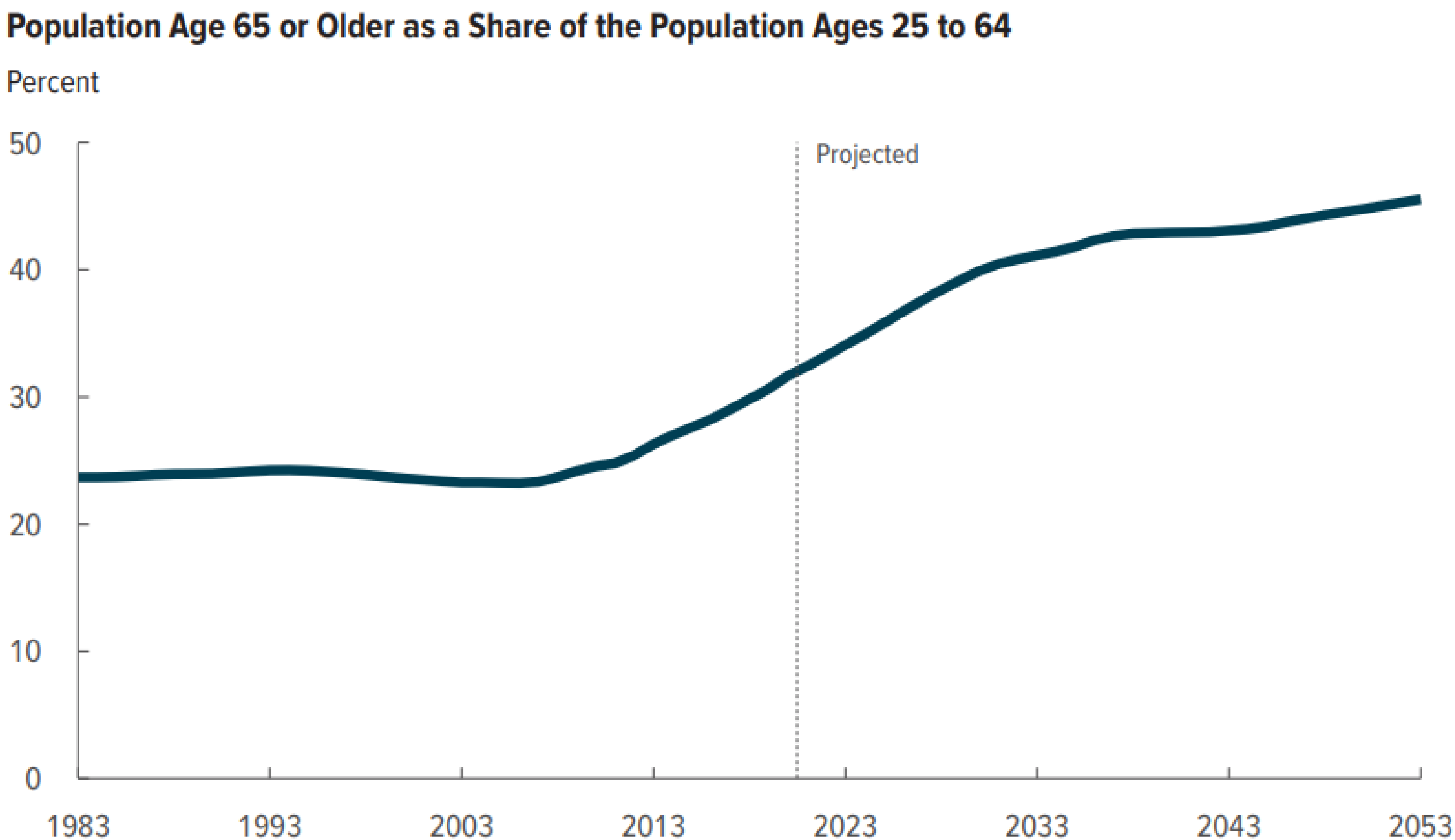
Source: Haver, JEF Economics.

Decline in U.S. Population Growth



Ages 65 and Older as % of Ages 25 to 64



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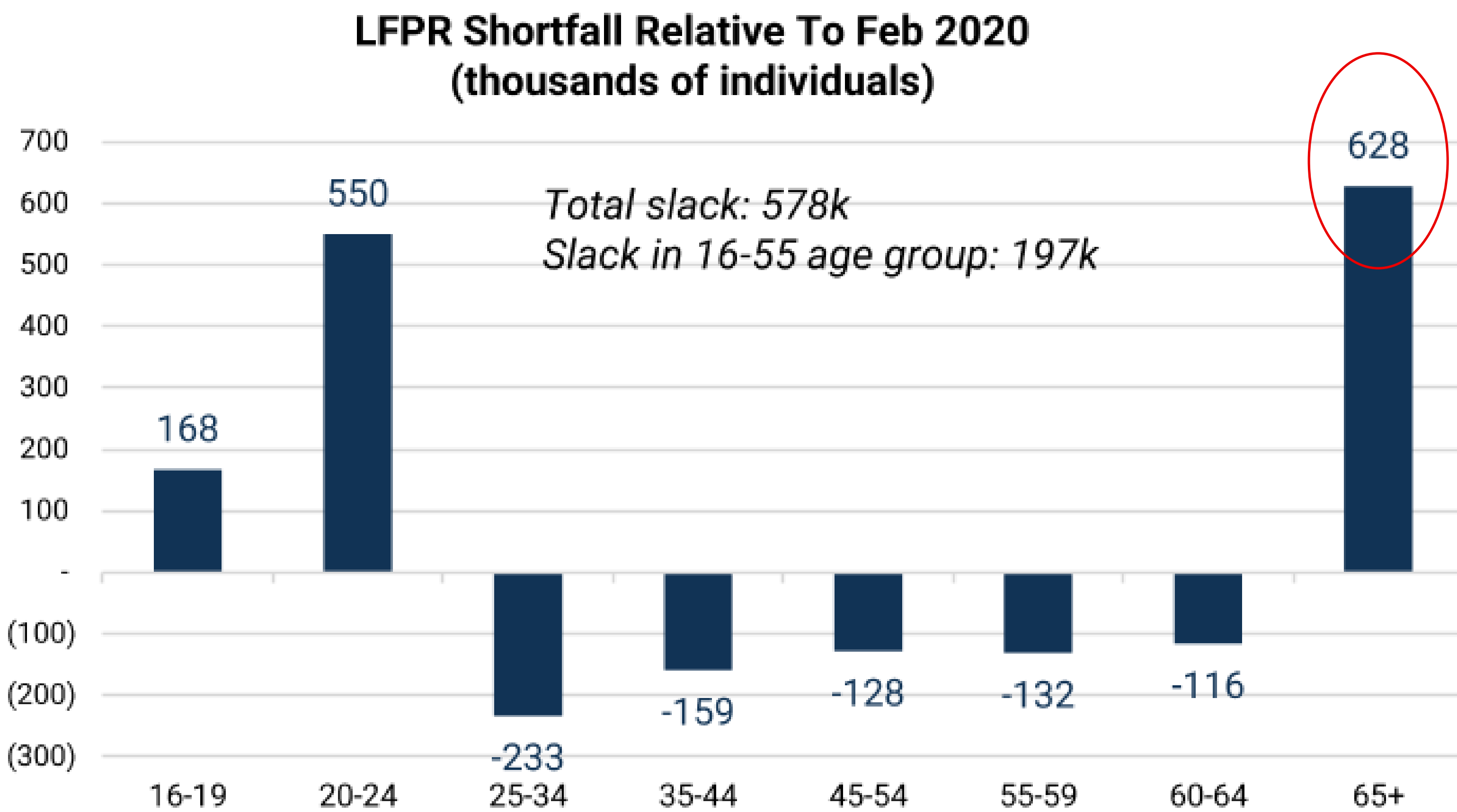
Labor Force Participation Shortfall Post-Covid



Source: Haver, JEF Economics

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Inflation Forecasts and Takeaways

- December 2023 Core PCE
  - Our forecast in January was 3.8%, currently 4.2%

- June 2024 Core PCE – 3.2%

- December 2024 Core PCE – 2.6% … Terminal

- Inflation was meaningfully transitory – excess stimulus created a long lag

- Fed will soon be overly restrictive
  - Forecasting no hikes and **<u>5 or more rate cuts</u>** by December 2024 (consensus 4 cuts)

Discussion Points

- Inflation Too High or Low Enough
    - Higher in July and August
- Economy Too Hot or Too Cold
    - Unexpected strength in Q3

Poll Response 2

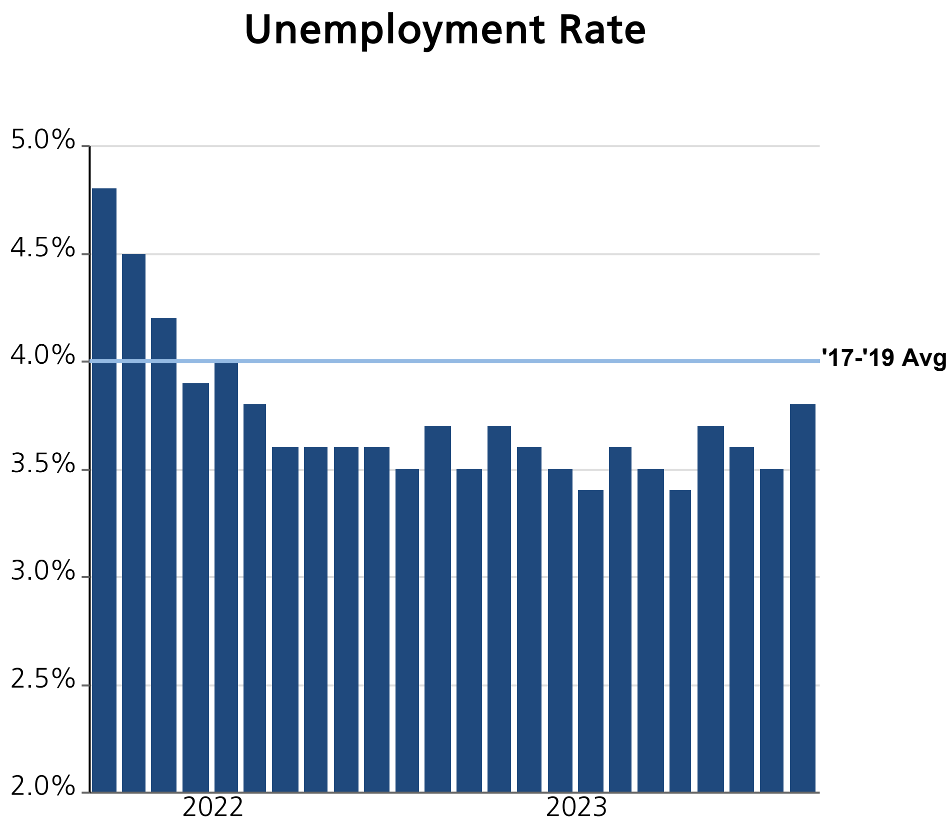
The U.S. economy is …

A. Too hot to allow inflation to come down

B. Too cold now or softening rapidly where a recession is inevitable

C. Not too hot, not too cold

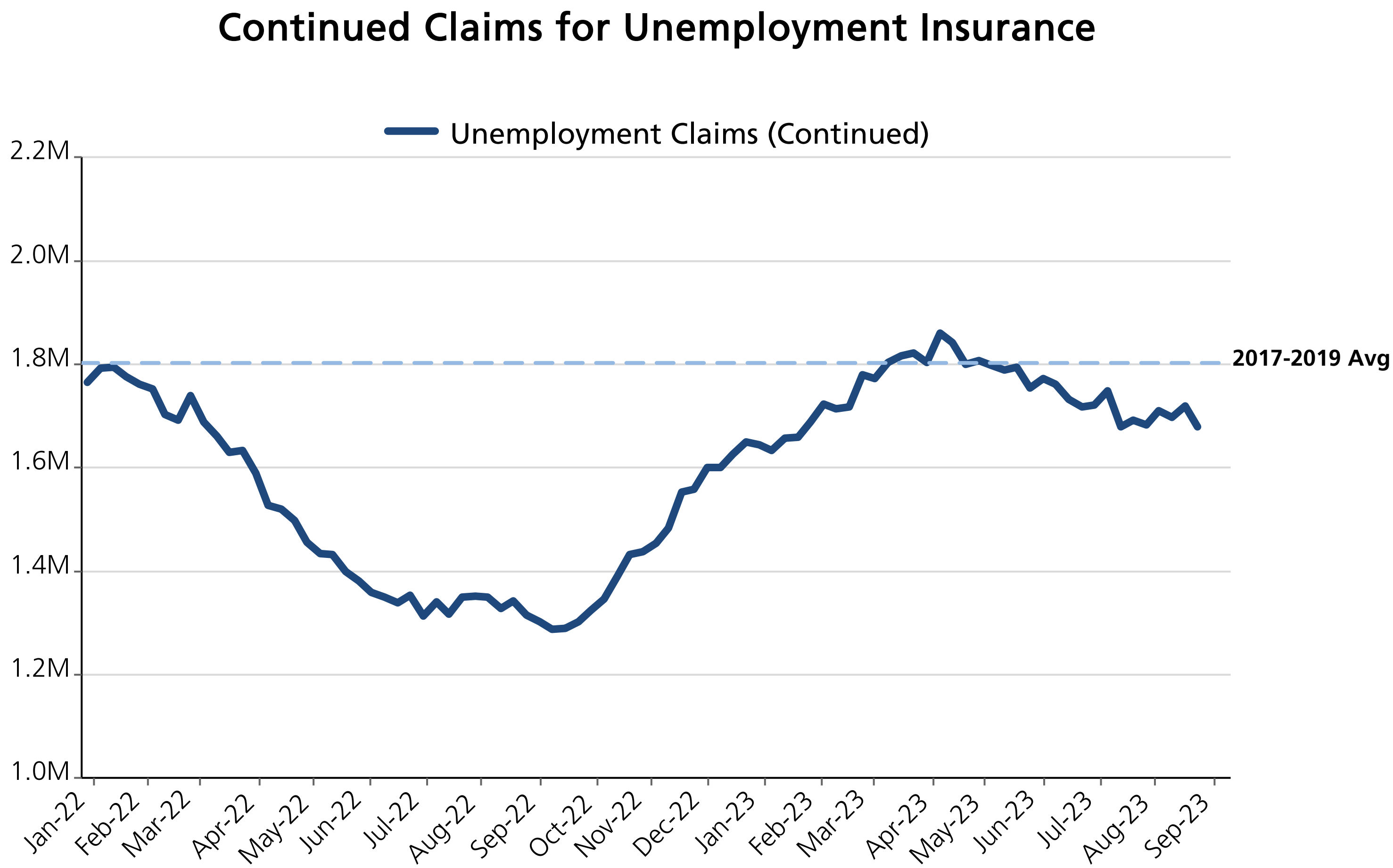
Labor Market Strong but Slowing



- The unemployment rate is still below levels seen in past cycles
- While job growth has slowed, it is still at levels seen during the last economic cycle

Source: FactSet. As of August 2023. Unemployment rate is US U-3 and job growth is US nonfarm payrolls.

Labor Market Slowing but Strong



- Continued claims for unemployment insurance are rising as job losses mount …
- … but still remain below their 2017-2019 levels

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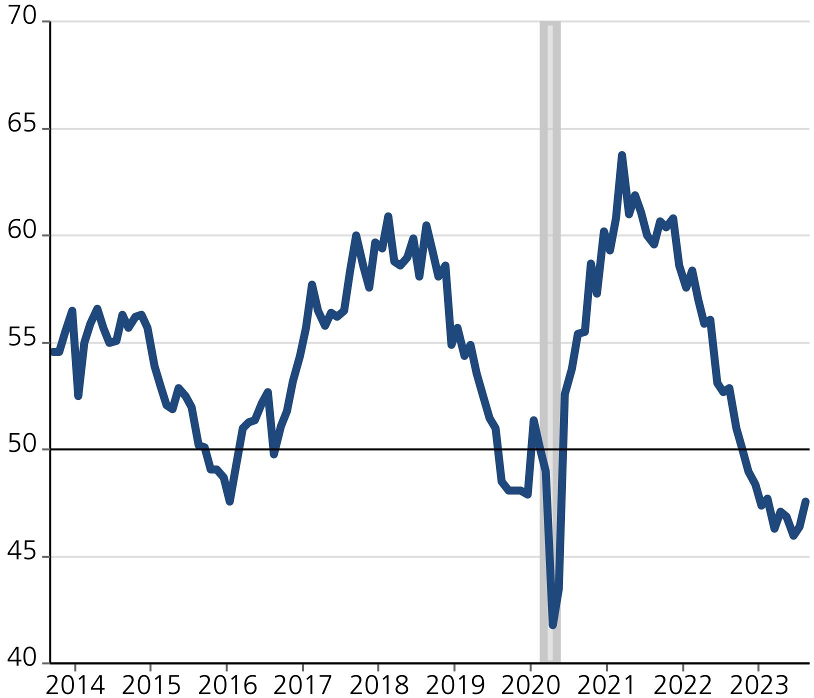
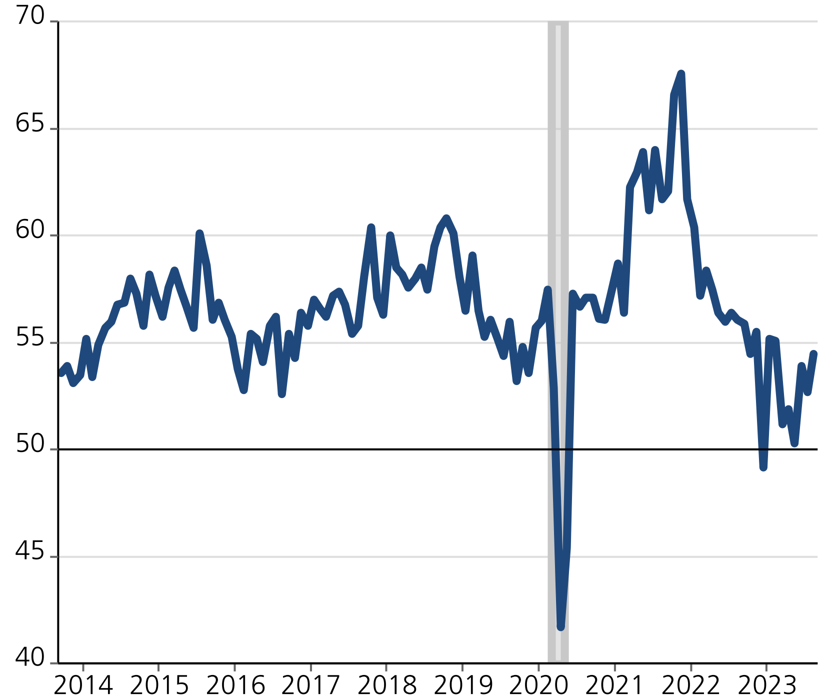
Source: Federal Reserve. As of August 2023.

Weak Manufacturing and Steady Services

US ISM Manufacturing PMI



US ISM Services PMI



- Manufacturing activity in the US is weak and contracting …
- … but the Services sector is still resilient and expanding

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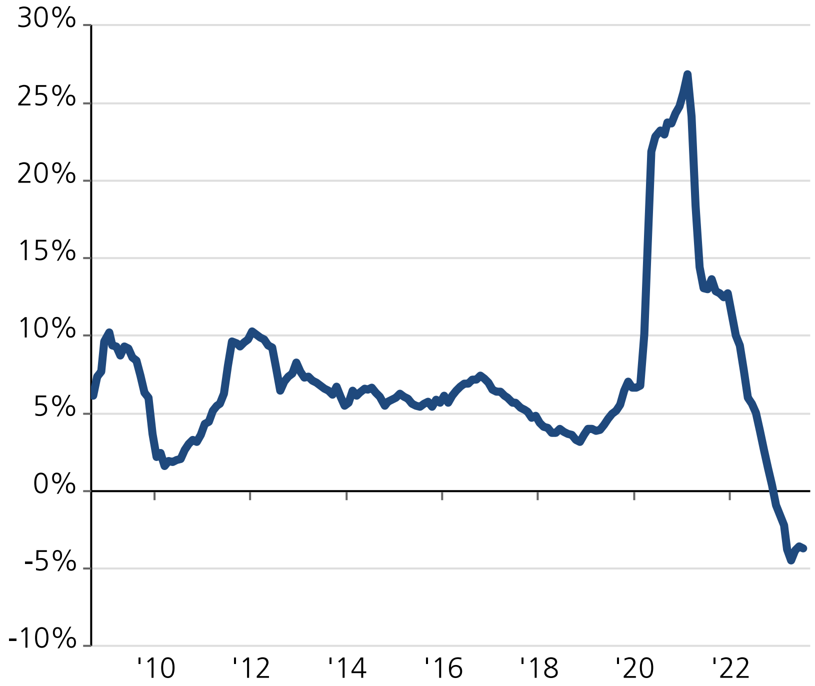
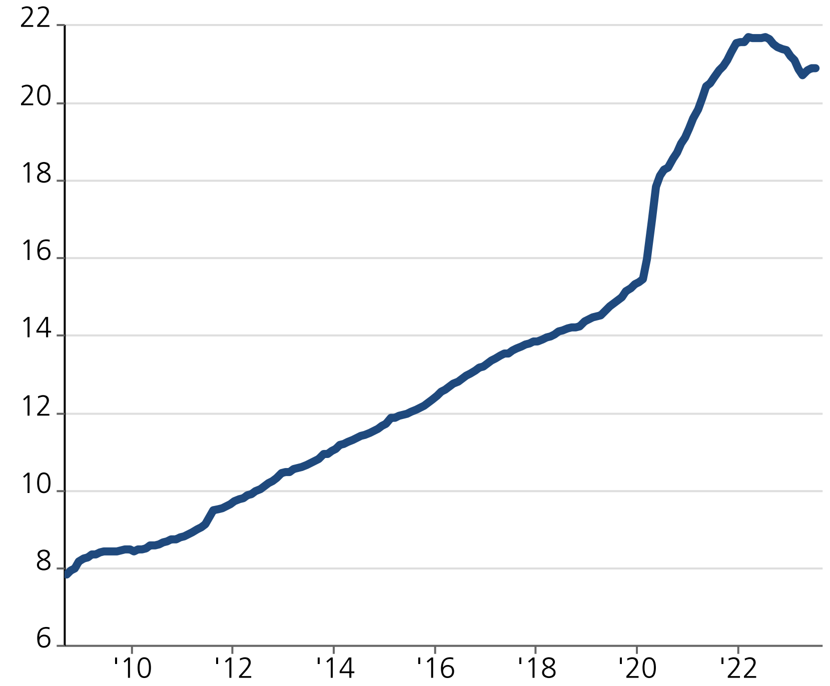
Source: FactSet. As of August 2023.

Money Supply Collapsing … but Still High

US M2 *(year-over-year change)*



US M2 *($ trillions)*



- Money supply is declining year-over-year at its most rapid pace since the 1930s …
- … but nominal money supply is still well above trend and accommodative at the margin

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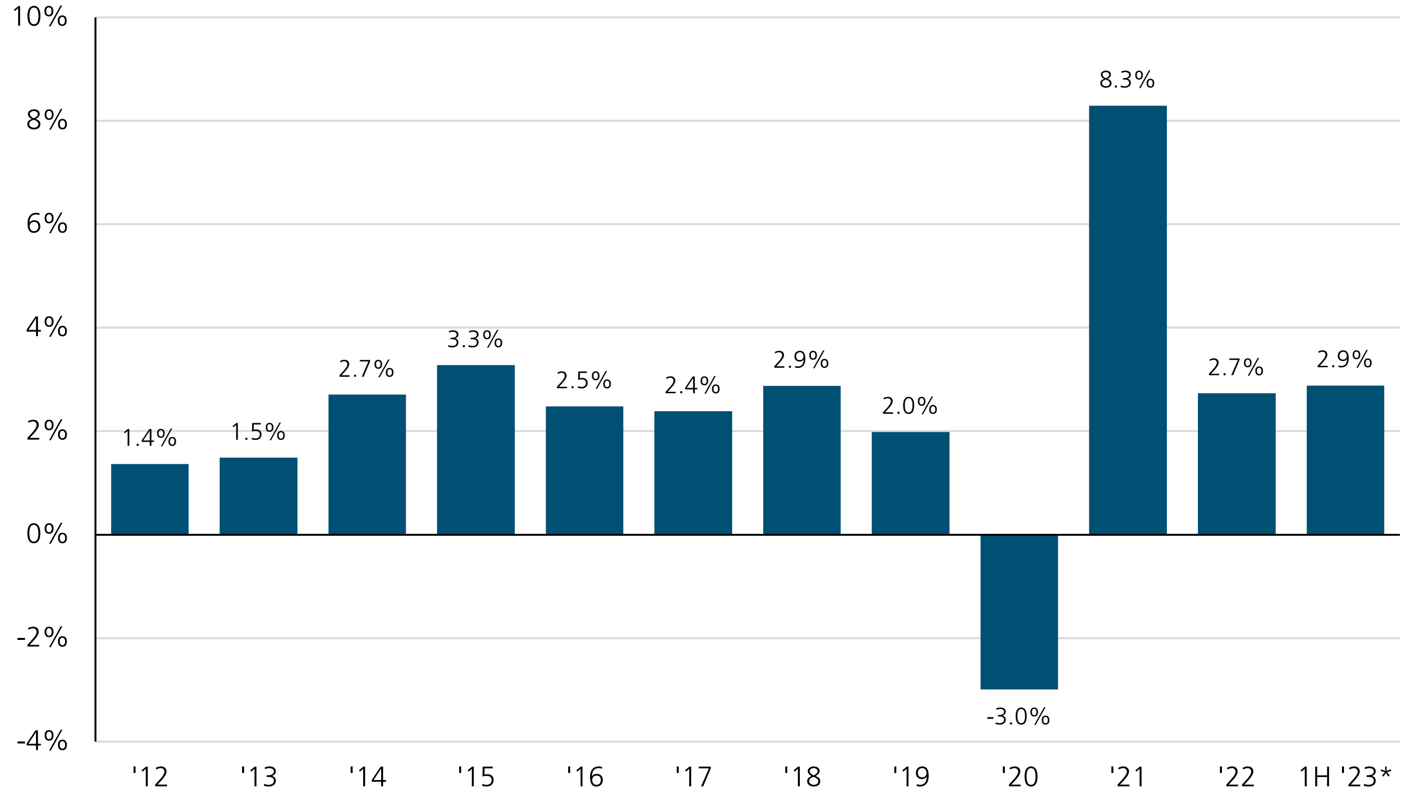
Source: FactSet. As of September 2023.

Consumer Spending Remains Strong

Real Consumer Spending Growth *(% change from the prior year)*



- Growth in real consumer spending is still strong as inflation cools from its peak in 2022

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*First Half 2023 real consumer spending is annualized.
Source: Federal Reserve, real personal consumption expenditures.

Discussion Points

- Inflation Too High or Low Enough
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- Economy Too Hot or Too Cold
    - Unexpected strength in Q3
- Earnings High Enough or Headed Lower
    - Impact of higher interest rates

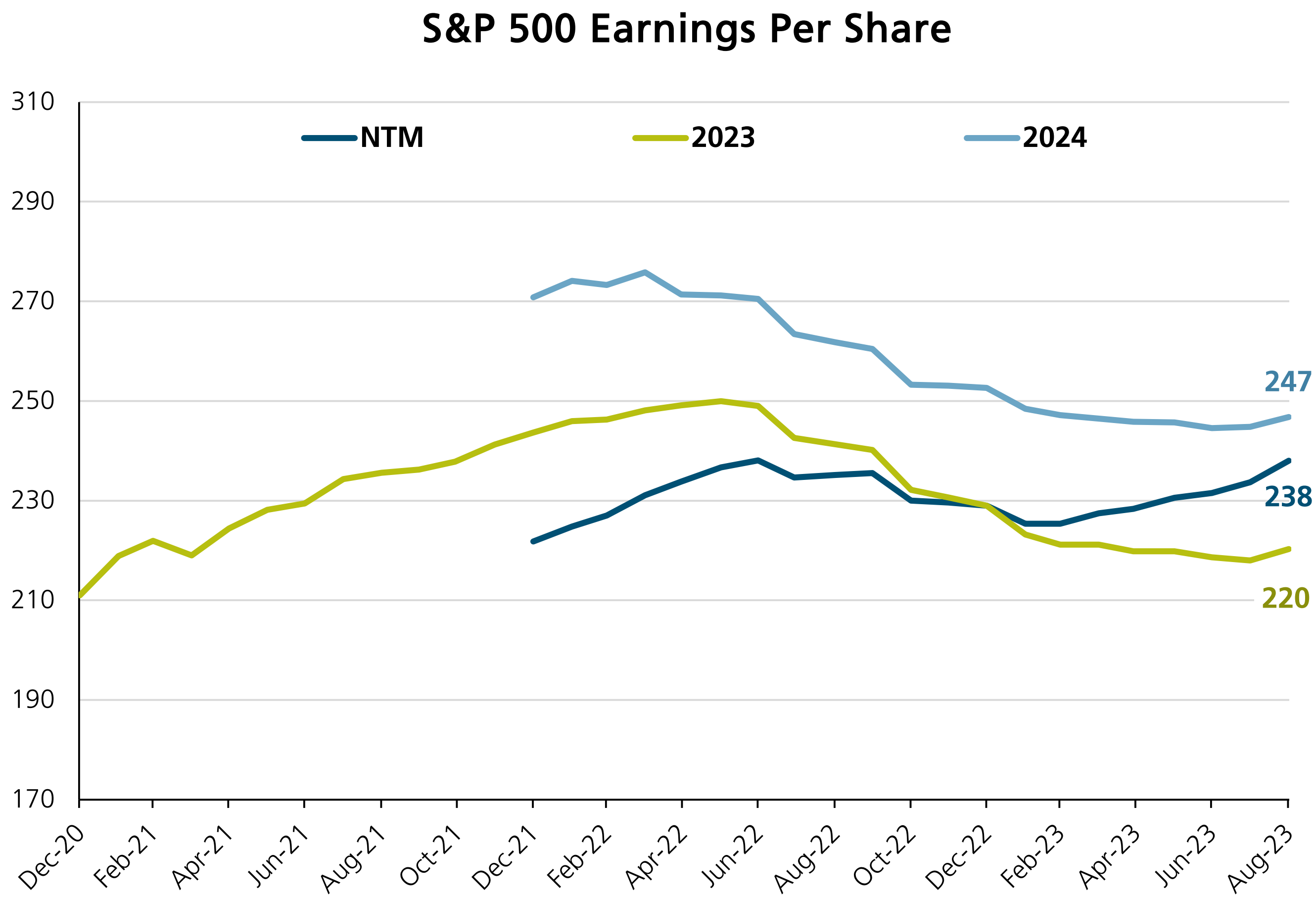
Poll Response 3

Company earnings are …

A. High enough to preserve a bull market

B. Headed lower to trigger another bear market

Earnings High Enough or Heading Lower: Consensus Outlook



- The decline in 2023 and 2024 earnings appears to be bottoming …
- … and earnings for the Next Twelve Months seem to be ticking up

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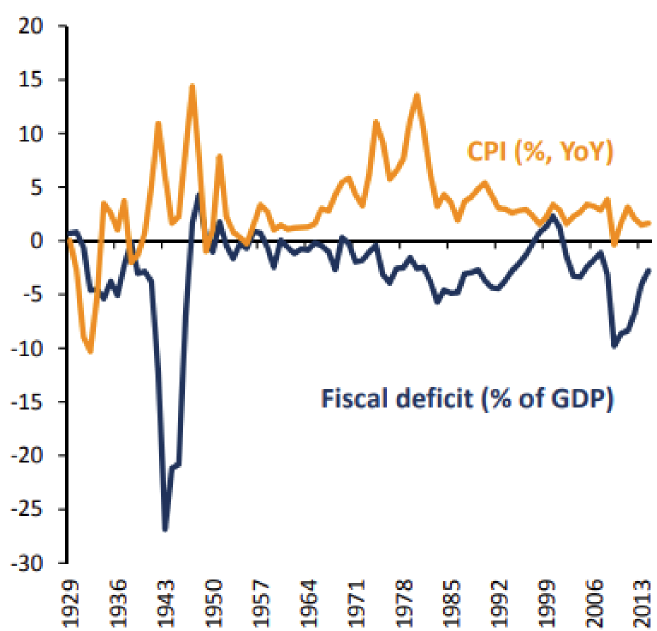
Source: FactSet. As of August 2023.

Inflation Has Been Unrelated to Deficits in the Long Run

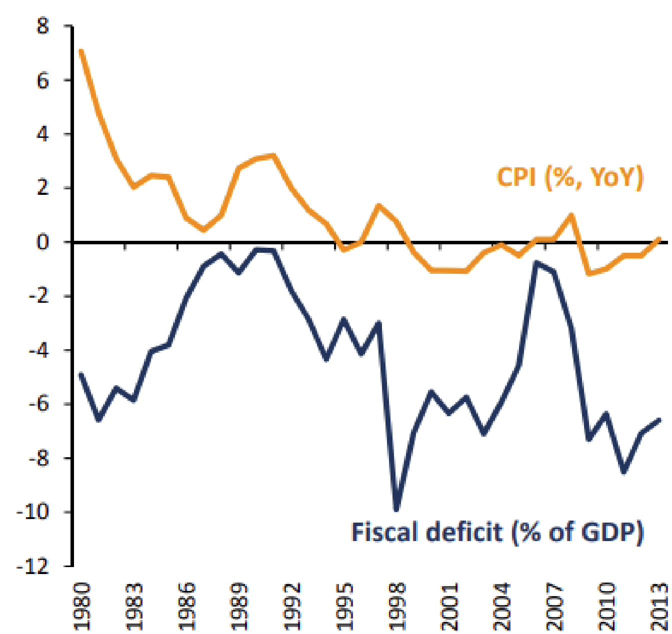
Exhibit 2: Deficits and Inflation – U.S. and Japan

U.S. Deficits and Inflation



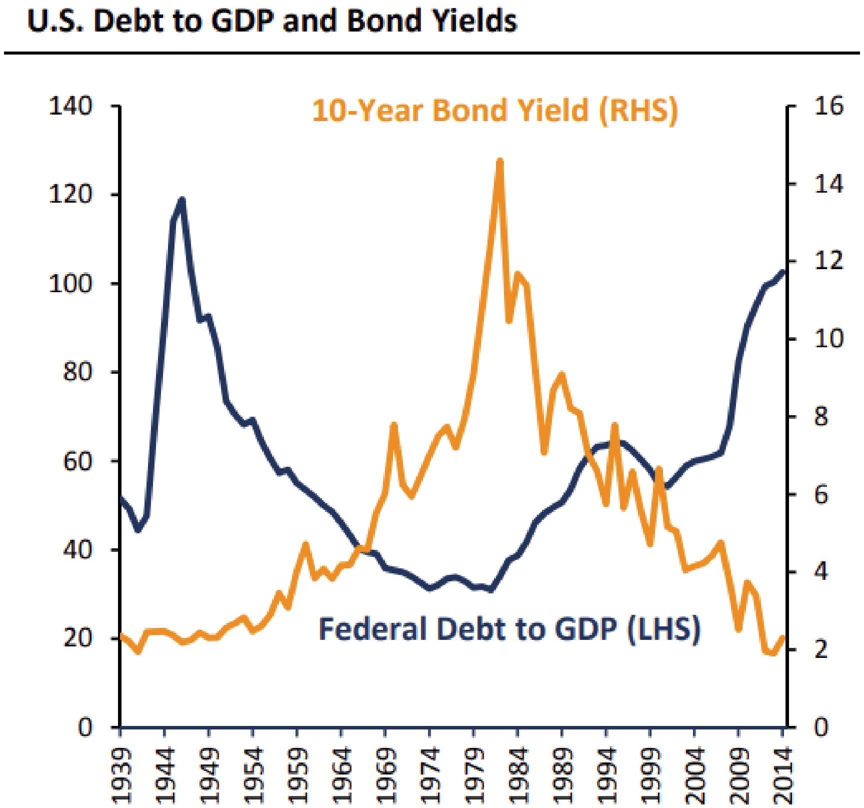
Source: FRED, GMO

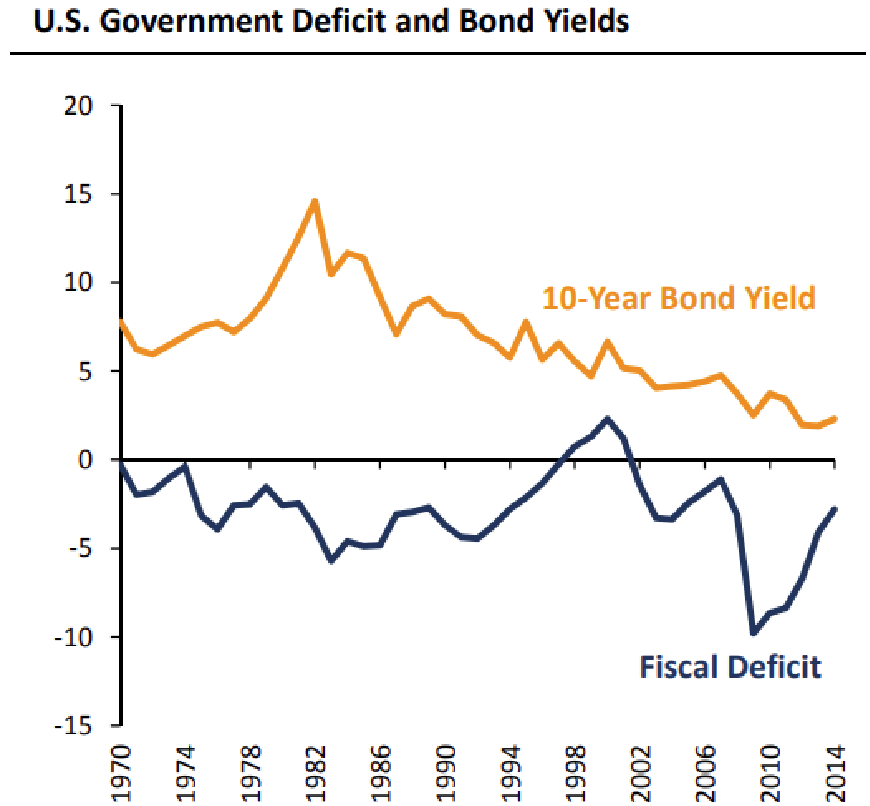
Japan Deficits and Inflation



Source: Datastream, GMO

Debt, Deficit and Interest Rates





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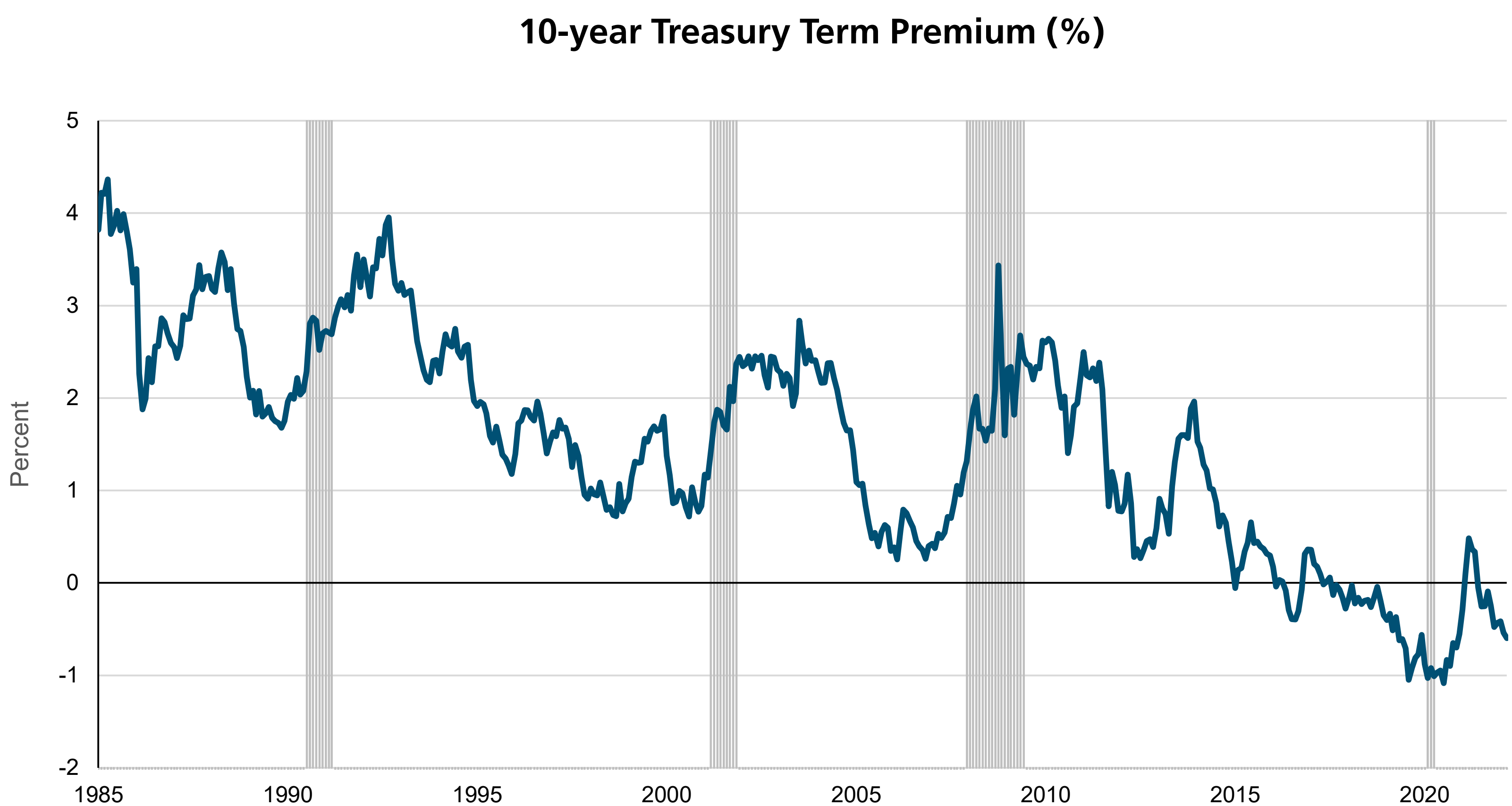
Secular Decline in the 10-Year Treasury Term Premium



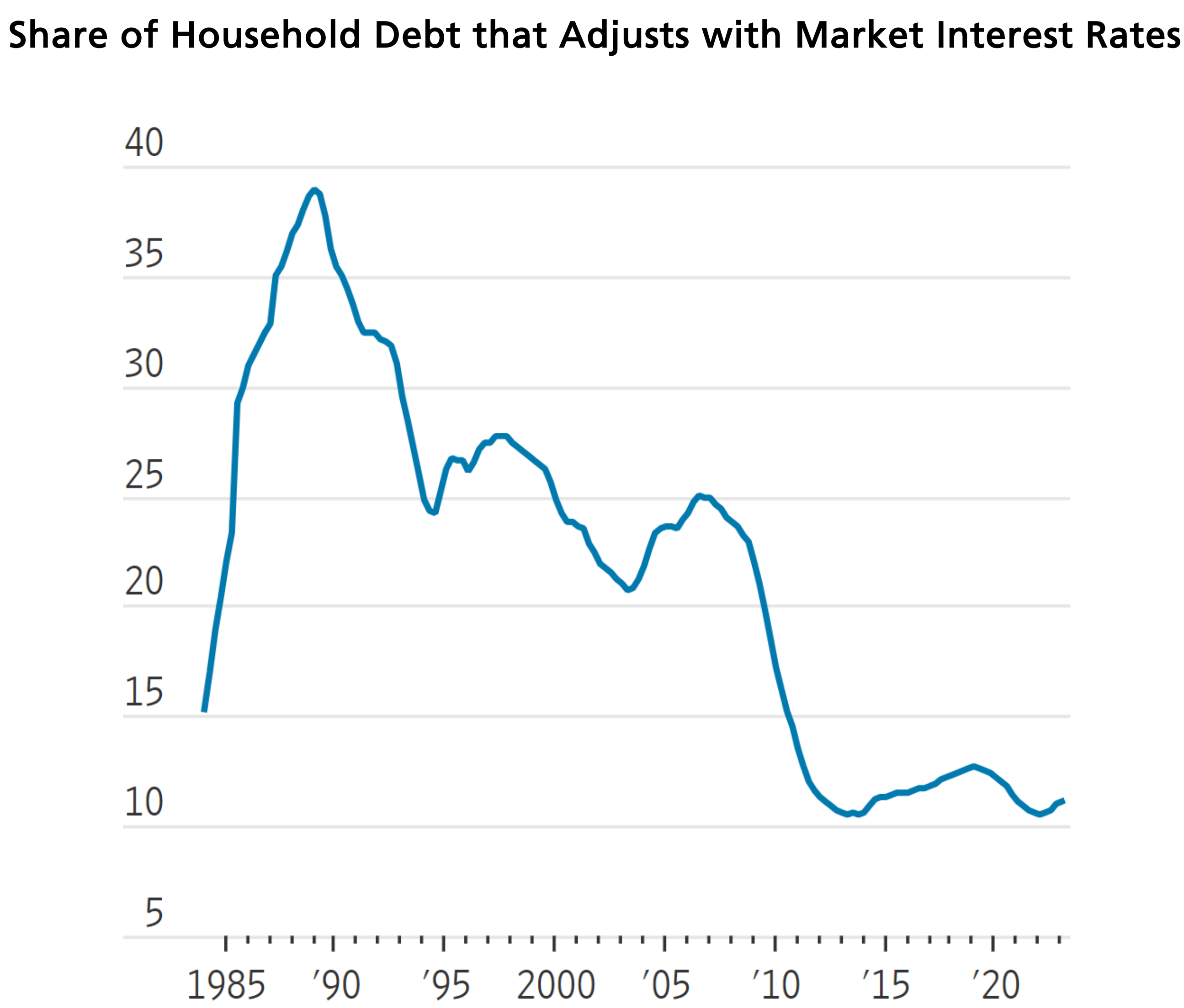
- The term premium has declined steadily since 1985.
  - Central bank asset purchases and forward guidance, glut of global savings, foreign investors, disinflationary pre-pandemic pressures, demand for hedging long duration liabilities
- Low term premium makes inversions more likely and less reliable.

Source: Adrian, Crump and Moench, Federal Reserve Bank of New York

Explanations for the Low Term Premium

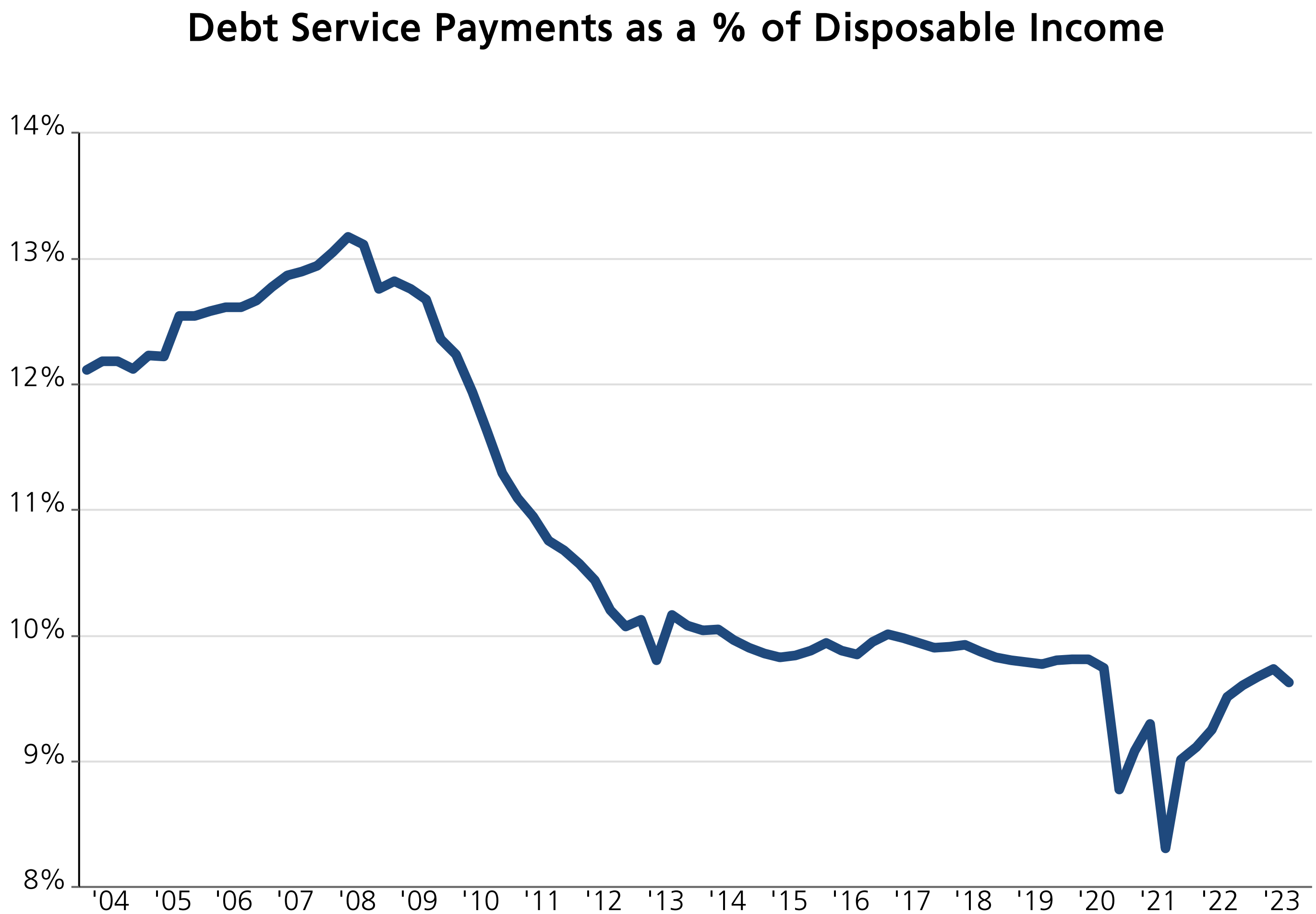
- Central bank asset purchases
- Glut of global savings
- Interest from foreign investors
- Demand for hedging long duration liabilities
- Disinflationary pre-pandemic pressures and forward guidance

Share of Rate-Sensitive Household Debt



Source: WSJ, Moody's Analytics.

Household Debt Service Obligations



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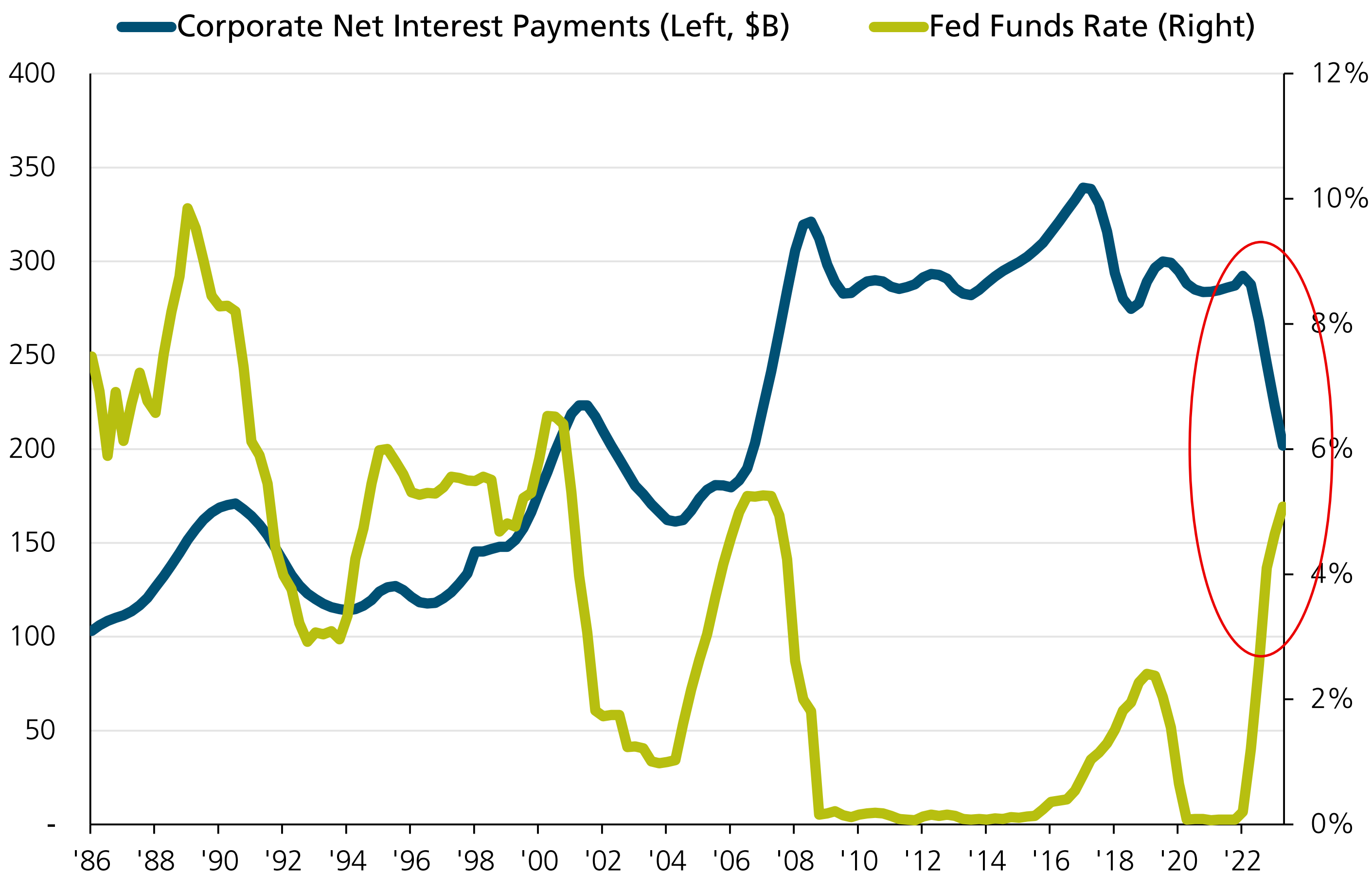
Source: WSJ, Moody's Analytics. As of Q1 2023.

Decline in Company Net Interest Payments



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Source: Federal Reserve, Datastream. Net Interest Payments are from US nonfinancial companies.

Interest Rate and Stock Market Outlook

- Long term interest rates below 5% for most of the next decade
- 10-year yield normalizes at 3.8–4.0%, 30-year at 4.1–4.3% by June 2024
- New equity bull market, December 2024 S&P 500 at 4,800 – 5,200
- December 2023 forecasts made in late 2022
  - S&P 500 to remain above 3,800
  - Trough forward P/E to stay above 14x
  - 2023 earnings to stay above 210

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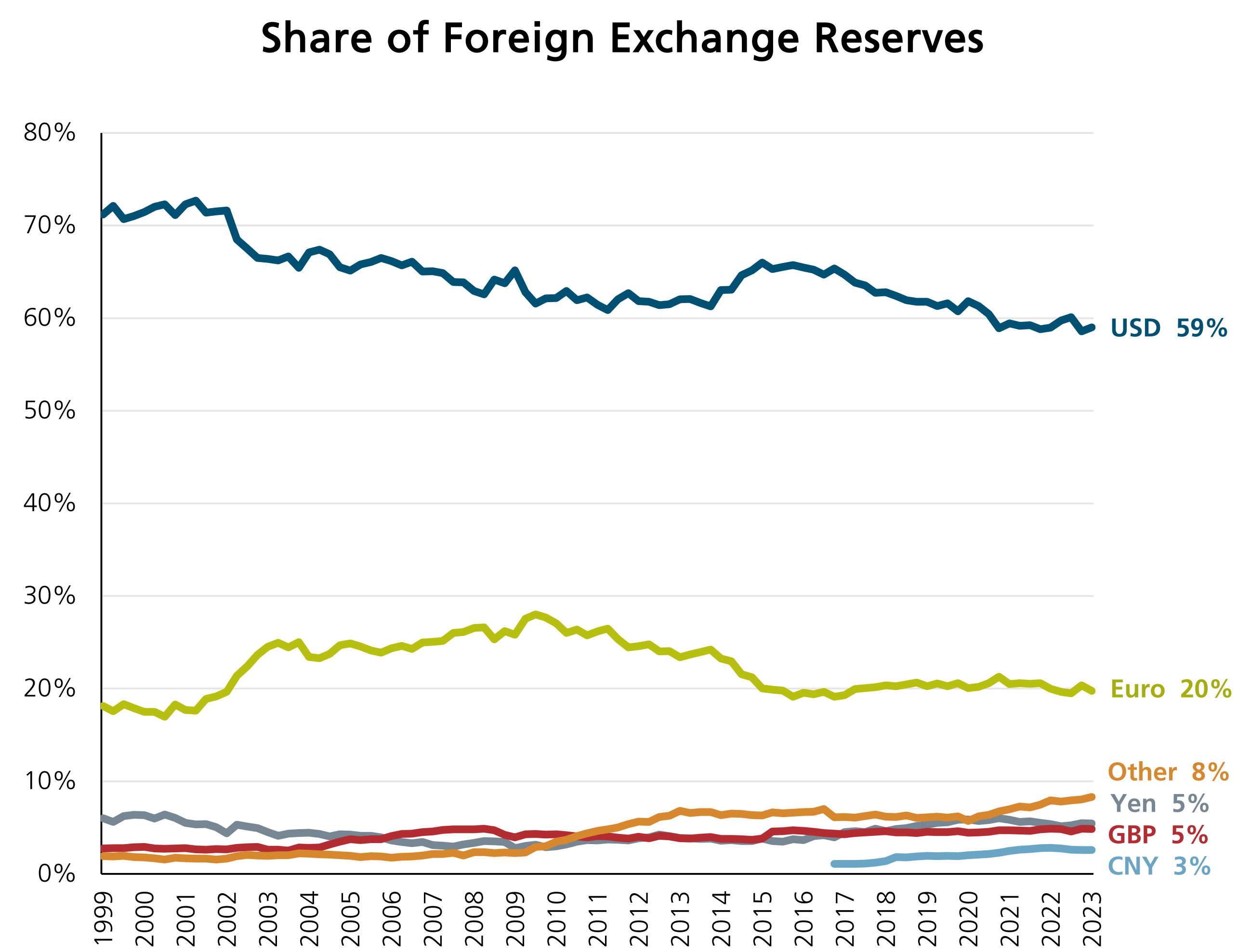
Share of Foreign Exchange Reserves



Source: IMF COFER. As of Q1 2023. Share is % of allocated reserves.

Weak Alternatives to the U.S. Dollar

- Euro
- Yuan
- Basket of Currencies

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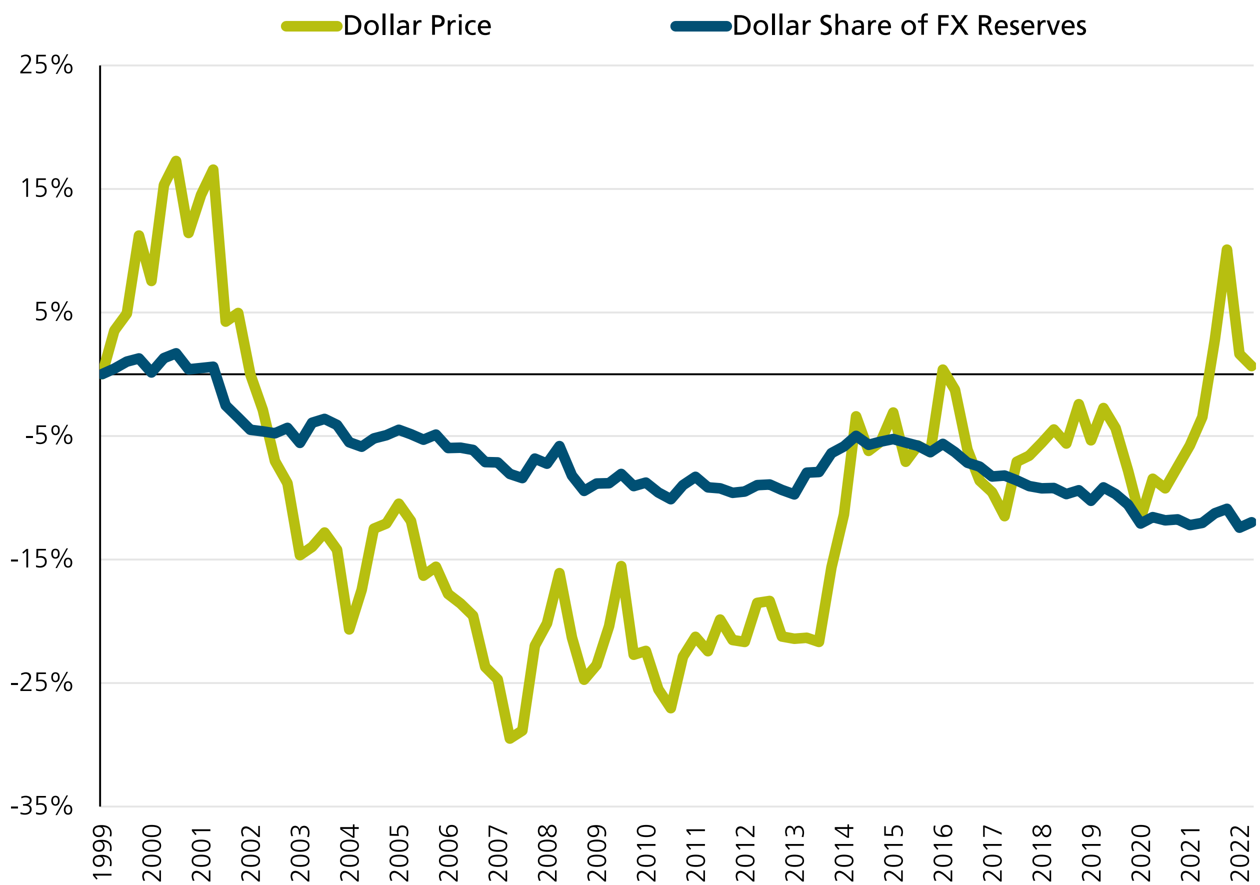
Steady Dollar Despite Lower Share of Reserves



Source: IMF COFER, FactSet. As of Q1 2023. Share is % of allocated reserves. USD Price represents DXY Index.

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Dollar Hegemony Likely to Continue

- Strong economic growth and incomes

- Low inflation
    - Credible monetary policy and technological innovation

- Well-regulated capital markets
    - Deep and liquid bond market

- Convertibility, stability and liquidity of the dollar

Summary and Key Takeaways

- Inflation was meaningfully transitory – excess stimulus created a long lag
- June 2024 Core PCE 3.2%, December 2024 Core PCE 2.6% … Terminal
- Fed will soon be overly restrictive
  - Forecasting no hikes and **5 or more rate cuts** by December 2024 (consensus 4 cuts)
- No landing > hard landing (?) … soft landing most likely
- 10-year yield normalizes at 3.8–4.0%, 30-year at 4.1–4.3% by June 2024
- New equity bull market, December 2024 S&P 500 at 4,800 – 5,200

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South Pasadena 1600 Huntington Dr., South Pasadena, CA 91030 | 626.441.5111

Newport Beach 4695 MacArthur Ct., Ste 1500, Newport Beach, CA 92660 | 949.216.2200

San Francisco 505 Montgomery St., Ste 1200, San Francisco, CA 94111 | 415.283.1850

West Los Angeles 11100 Santa Monica Blvd., Suite 1910, Los Angeles, CA 90025 | 310.943.0750

Menlo Park: 525 Middlefield Road, Ste 110, Menlo Park, CA 94025 | 650.609.2300

WHITTIER TRUST COMPANY OF NEVADA INC.

Reno 100 W. Liberty St., Ste 890, Reno, NV 89501 | 775.686.5400

Seattle 520 Pike St., Ste 1415, Seattle, WA 98101 | 206.332.0836

Portland 111 S.W. Fifth Ave., Ste 3150, Portland, OR 97204 | 503.444.3428

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