Summary of Monthly Update: July 27, 2023

In July's Market Update, Karen Reynolds Sharkey, the Head of Client Advisory and Services at City National Bank, hosted a Q&A discussion focusing on updates to CNR's economic and investment outlook. Joining her were:

- Garrett D'Alessandro
- Charles Luke
- Rachael Crane

Although economic growth has been resilient this far, the majority of economic indicators CNR monitors continue to suggest that a mild recession is likely sometime later this year. With monetary policy entering restrictive territory only recently, and the Fed likely to stay higher for longer, downside risk should become more apparent in the coming months. Equity markets appear to be anticipating a quick return to a low-inflation, lower-interest rate environment and are likely to be disappointed. The speakers advise remaining underweight in stocks, and instead investing in fixed income and cash management returns. They emphasize the opportunities projected in short-term investment grade corporate bonds, high yield bonds and structured credit.

Q1: The US economy has shown surprising strength this year. What has kept growth resilient, and do you still think recession in the near term is a high probability?

Mr. D'Alessandro, the CEO of City National Rochdale, noted that growth has been better than expected so far this year. The resiliency of the economy, along with some recent positive developments, including progress on inflation, an approaching end to the Fed's rate hiking cycle and actions by authorities to contain banking system turbulence, have moderated risks to the outlook.

However, CNR continues to believe a mild recession is in the cards sometime later in 2023 or early 2024. Consumer strength, backed by a strong labor market, has kept the economy from slipping into recession so far, but this strength is expected to be tested in coming quarters. Mr. D'Alessandro highlighted the depletion of savings that were mailed out by the government, and the increase in delinquency rates and household debt payments as building headwinds for households. He also noted that low unemployment is not necessarily a reliable predictor of future economic conditions. Credit conditions continue to tighten, and restriction in credit availability has historically led to a slowdown in the economy.

CNR now sees a 74% chance the economy will fall into recession, down from 78% last month, but has more confidence the recession will be relatively short and mild by historical standards, given the strength of underlying household and business fundamentals.

Q2: Growth has remained resilient so far, and inflation, while moderating, is still too strong. How does this complicate things for the Fed?

Charles Luke pointed out that, although economic growth has remained resilient, and inflation is moderating, it still remains too strong for the Fed. This complicates their decision-making process as they aim to beat inflation. Wage growth is seen as a key factor by officials that can bring down inflation, and, until the job market loosens, it will be difficult for the Fed to cut rates. Mr. Luke also noted that the market's expectations for rate cuts have consistently been wrong, and he advises not to fight the Fed. The overall outlook suggests that the Fed will likely stay on hold for an extended period, and while a sustained slowdown in growth is expected, it may take longer than initially anticipated.

Q3: Given the macro outlook that Garrett and Charles just described, how are CNR Portfolio Managers positioning client portfolios?

Given the highlighted uncertainty and elevated recession risk, Rachael Crane stated that CNR portfolio managers are maintaining their mild defensive positioning with a slight underweight position in equities. CNR currently sees better risk reward and plenty of opportunities in fixed income. It's been a decade since bond yields have been this attractive, and, even though inflation is trending down, various yields have remained elevated, increasing the real rate of return. Short-term T-Bills and cash-like alternatives have garnered the most attention, but short to intermediate yields in both municipal bonds and corporates offer additional opportunities. Bond allocations not only lower overall portfolio volatility, but they also historically perform better than stocks in recessionary periods.

Ms. Crane noted that they are monitoring various factors, such as increased confidence in the economic and corporate profit outlook, signs the Fed might begin easing policy and improvement in geopolitical tensions, to potentially increase equity exposure in the future. Overall, they believe having some dry powder and getting paid while waiting for more attractive opportunities in the equity markets is a sensible approach.

Q4: Growth equities have had a strong start to the year, and conservative and dividend stocks have not performed well. What should we make of this?

Mr. D'Alessandro discussed the strong performance of the S&P 500 this year, but noted that a very large percentage of the index's return has been driven by a handful of mega-cap tech names and enthusiasm over developments in artificial intelligence. Although breadth has improved recently, performance outside tech and a few other growth sectors has been much more muted. CNR will need to see greater participation from more economic sensitive sectors of the market to have greater confidence in the rally. He also noted that, while dividend stocks have not performed well this year, last year's performance was very strong, and, over the longer term, these stocks have provided beneficial contributions to client portfolios. Dividend stocks also look more attractive, relative to the broader market.

Overall, CNR remains skeptical about the sustainability of the current stock market rally, especially given their outlook for a recession in the next few quarters. Investor expectations for economic growth and the path of interest rates is too optimistic, Mr. D'Alessandro noted, and earnings disappointment ahead could be a source of renewed weakness in equity prices.

Q5: Bond markets have also seen a recovery this year. How is CNR viewing the fixed income market and taking advantage of opportunities?

Charles Luke reviewed the recovery of the bond market and the positive impact it has had on overall client portfolio returns. He highlighted the strong performance of high yield corporate and municipal bonds this year, and that CNR expects the fixed income environment to remain healthy. While he expressed caution regarding the current pricing of high yield corporate debt, stating that spreads are too small and may lead to increased volatility in the future, when managed properly, high yield consistently outperforms investment grade and contributes to long-term performance.

In the current environment, CNR believes that investment grade taxable and municipal bonds offer the potential for attractive returns with less risk. Mr. Luke said CNR remains cautious in adding interest rate exposure, especially with signs of sticky inflation and still solid economic data, which will force the Fed to keep policy tight longer than the market expects. At the same time, the competing influences of inflation and growth are expected to keep volatility high in the bond market, so they recommend short-term bonds and a reduction in opportunistic income allocations in favor of investment grade over the next 12 months.

Q6: Putting this all together, how are you managing portfolios to meet client goals and expectations?

Rachael Crane discussed the importance of protecting client portfolios by carefully managing risks and having a disciplined, fundamentally driven investment process. She emphasized the need to avoid knee-jerk reactions and emotional decision-making based on short-term market fluctuations, which can lead to longer term underperformance. Ms. Crane also highlighted the value of intelligently personalizing client portfolios, including considering liquidity constraints and tax management. The overall objective of CNR portfolio managers is to increase the probability of reaching client goals while minimizing volatility.

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