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FINANCIAL ADVISORY GROUP LLC

Third Quarter 2023 Economic and Market Outlook

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THIRD QUARTER 2023 ECONOMIC OUTLOOK

The widely anticipated post-pandemic recession has yet to occur and many hope for a rare soft landing, but signs suggest that economic growth may be cooling as lagged effects from the Federal Reserve's aggressive monetary policy begin to bite. Higher bond yields have already impacted the regional banking sector, causing stress on certain banks' balance sheets with the potential to slow loan growth – particularly within the commercial real estate sector. In addition, domestic political uncertainty and rising geopolitical tensions introduce additional risks to the outlook.

From a purely economic perspective, evidence of a slowdown can be seen in the U.S. housing market. Mortgage rates are at their highest levels since the start of the millennium and home sales are on track for their slowest year since the 2008/2009 Great Financial Crisis given the combination of higher borrowing costs, higher home prices, and limited inventory. While we do not anticipate rates reaching the levels they did in the late 1970s and early 1980s, the high cost of homeownership has led to a significant drop off in transaction activity, which has the potential to negatively affect consumer sentiment and spending across the rest of the economy.

Figure 1: Rising 10-Year Bond Yields Have Led to the Highest Mortgage Rates in 23 years

Source: Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, October 17, 2023.

Another bright spot in the U.S. economy has been the employment situation, which has benefited from a healthy demand for labor so far this year, particularly within the travel and leisure industry as post-pandemic travel rebounded. As a result, the unemployment rate remains below 4.0% and the labor force participation rate is holding steady at 62.8%. These conditions suggest that the U.S.

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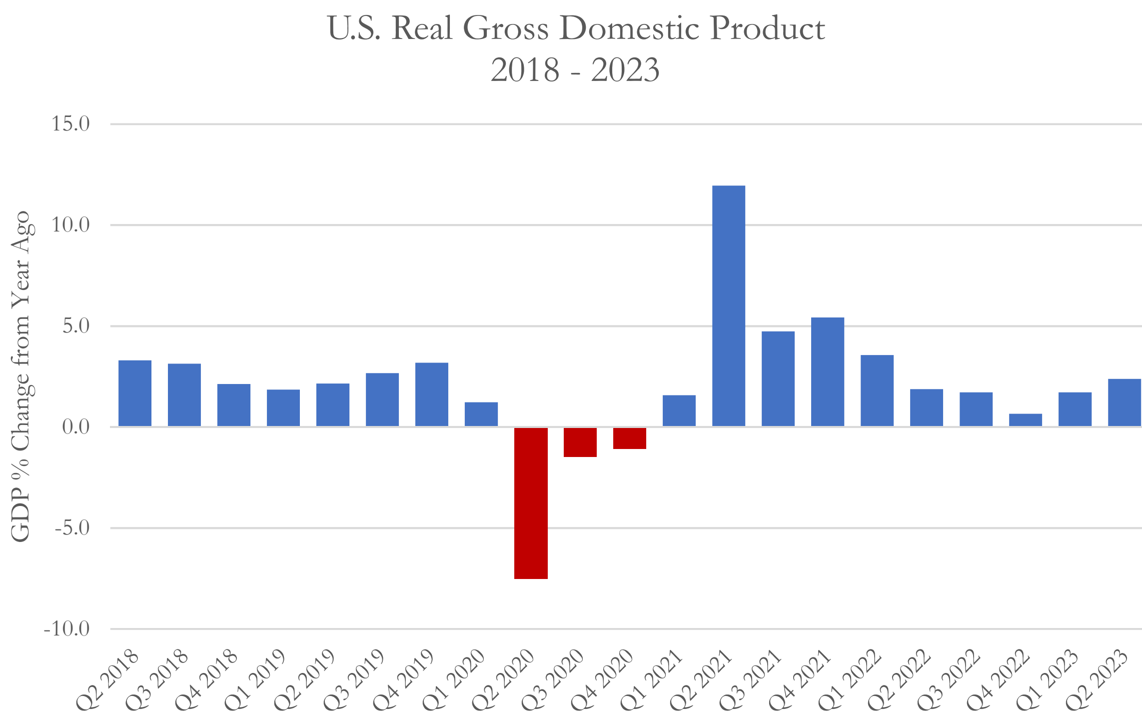
economy is near or at full employment, but there are indications that the U.S. labor market is slowing.

While there are still more job openings than the supply of skilled workers, the gap between the two is narrowing. In addition, the Employment Cost Index, which measures the changes in wages and salaries for private industry workers, is growing at a slower rate according to the latest data from the U.S. Bureau of Labor Statistics. Both are signs that the current state of full employment may not last.

If the economy cools as a result of higher borrowing costs, job openings will likely decline and workers may start to lose their jobs. If the unemployment rate rises, consumer spending will likely slow, which could put further pressure on the labor market. This negative feedback loop has the potential to push the U.S. economy into at least a mild recession next year given the fact that consumer spending accounts for nearly 70% of U.S. GDP according to the U.S. Bureau of Economic Analysis.

Figure 2: U.S. Economic Growth Stable at 2.4%, Although Risks are on the Horizon



Source: U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPC1, October 18, 2023.

If the economic situation were to deteriorate further, we would expect the Federal Reserve to change course and cut rates, despite the fact that 2024 is an election year. Even though they have increased rates to their highest level in a decade means that if the U.S. were to enter recession, the Fed would have scope to loosen monetary policy in an effort to lower borrowing rates again to limit its impact.

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RISING POLITICAL AND GEOPOLITICAL RISKS

The potential for an economic slowdown in 2024 has increased with the additional uncertainty of the current political and geopolitical environment. In addition to the ongoing conflict between Russia and Ukraine, the brutal attack in Israel on October 7, 2023 and the Israeli counteroffensive since has further increased tensions in the Middle East. If, in addition to Hamas, other Iranian-backed groups such as Hezbollah in Lebanon get involved, there is the potential for a wider conflict and the impact on global markets would be hard to predict.

Historically, unrest in the Middle East has raised the risk premium for stocks, led to a flight to quality in the bond market and the pushed price of gold and key commodities, such as oil, higher. Oil prices were already rising this year as a result of the extended supply cuts by OPEC+ members, specifically the reduction in crude oil production by Saudi Arabia and Russia. This combined with escalating geopolitical tensions have the potential to cause a significant oil shock to the global economy.

Political gridlock in the U.S., the unprecedented ouster of Rep. Kevin McCarthy as Speaker of the House of Representatives, as well as the threat of a lengthy government shutdown have also contributed to heightened uncertainty. While the next U.S. Presidential Election is still over a year away, the issues shaping the race are already beginning to take shape. According to current polls, and despite the political and legal challenges facing both candidates, it looks as though the race will be a rematch between former President Trump and current President Biden. In addition to the geopolitical environment at the time, overall economic conditions including the employment situation, inflation expectations, borrowing rates and whether or not the U.S. will experience a recession are likely to be important factors when voters head to the polls next year.

OUR OUTLOOK

The global economy and financial markets are at a crossroads. Inflation is moderating after an aggressive shift in monetary policy and the employment situation remains healthy. However, any uptick in inflation may lead to more aggressive Fed policy while rising bond yields and higher borrowing rates may ultimately cause growth to falter. In either case, a recession may be inevitable unless the Fed can manage to achieve a soft landing. The emergence of political and geopolitical tensions add additional risk.

As we look ahead to the last three months of the year, we anticipate continued volatility and temporary uncertainty in the markets. However, we believe that the markets could present some compelling opportunities as we look further into 2024, and that a portfolio well diversified by investment approach, investment style and geography is the most effective way to capture return opportunities that may emerge and manage the risks associated with a rapidly changing environment.

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