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Q4 2023 Economic outlook

Dodged or delayed?

The economy continues to surprise to the upside, but lingering inflation, policy uncertainty and shadow tightening are all challenges markets will have to navigate in the coming quarter. Looking into 2024, investors will increasingly ask if an economic slowdown has been dodged, or merely delayed.

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The economy is roaring into Q4 as growth continues to surprise to the upside. Beneath the optimism, growth comes at a cost—inflation, policy uncertainty and shadow tightening are all challenges markets will have to navigate in the coming quarter. Looking into 2024, investors will increasingly ask if an economic slowdown has been dodged, or merely delayed.

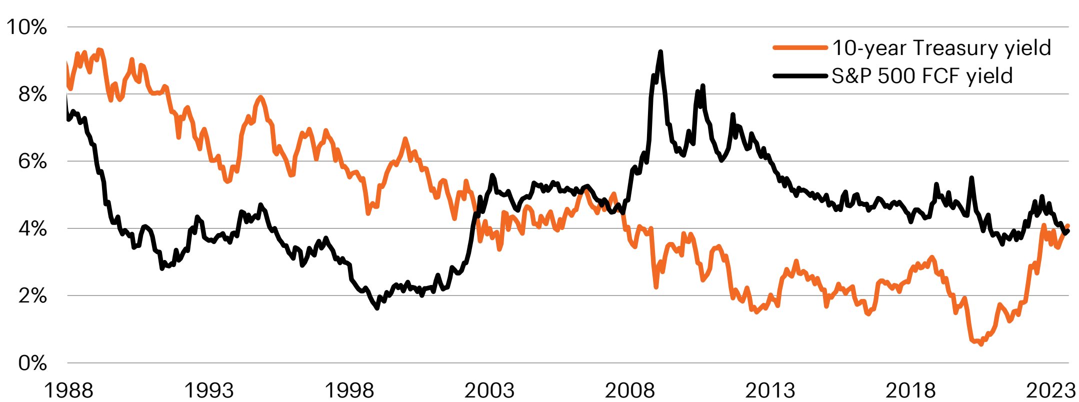
Key takeaways

- The rapid rotation in expected economic scenarios has caused a significant mismatch between equity and bond markets, which is now undergoing a painful correction.
- Inflation could re-emerge (enough) to keep Fed policy unexpectedly hawkish.
- Economic tailwinds have proven powerful but are losing gusto. We expect slower growth ahead.

The U.S. economy continued to defy gravity in the third quarter, and high frequency data point to real GDP growth of at least 3%, far hotter than the Fed's estimate of our long-run potential. The powerhouse remains consumer spending, with personal consumption jumping 0.8% in July and retail sales for both July and August far surpassing expectations. The labor market is fuel for this engine, and while the labor market is renormalizing after COVID disruptions, by virtually every metric it remains strong. This economic resilience has caused consensus expectations to reel from concerns about recession to hope of a soft landing to optimism that growth will continue at the current breakneck pace.

But this rapid rotation in economic expectations caused a significant scenario mismatch in markets. Equity valuations soared on economic optimism and earnings expectations for next year continue to imply still further acceleration in growth—from levels that are arguably unsustainable. The bond market, however, has been stuck in a recessionary scenario, pricing in rate cuts for next year. The Fed has worked hard to close this gap, by tempering expectations about growth while also pushing back against rate cut expectations. The result has been an increase in long-term interest rates to 15-year highs, which now match the free cash flow of the S&P 500. In short, the equity market is not sufficiently compensating investors for the material risks present in the current economic backdrop. This is the painful reconciliation investors will need to navigate in the fourth quarter.

Relative yields of equities and 10-year Treasury

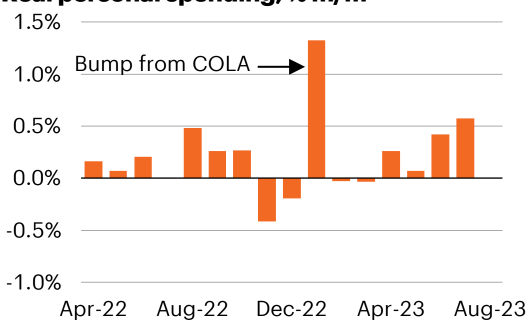


Source: Bloomberg Finance, L.P., as of September 27, 2023.

Growth headwinds versus tailwinds

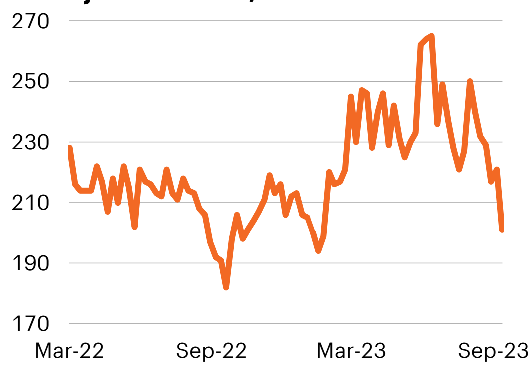
We find ourselves in the same place at the start of Q4 as we did at Q3—with solid growth powered by strong tailwinds but concerns that headwinds loom. We expected the balance to tip earlier than it has, and this dynamic remains our key theme into the end of the year. Consumer spending has defied expectations, and despite higher credit card payments, reduced excess savings and the specter of student loan payments, real personal spending accelerated sharply in Q3.

Real personal spending, % m/m



Source: Bureau of Economic Analysis, as of September 25, 2023.
A cost-of-living adjustment (COLA) is an increase in Social Security benefits to counteract inflation.

Initial jobless claims, Thousands

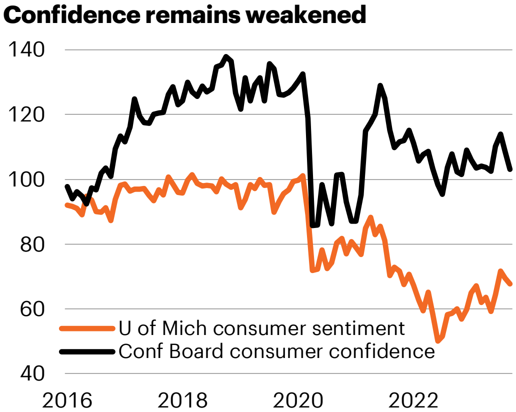


Source: Department of Labor, as of September 25, 2023.

The update on the employment front is upbeat. There are some signs of normalization to pre-pandemic trends. Job opening data is a key example—the JOLTS measure has fallen in five of the last six months to 8.82 million in July, and the participation rate has recovered to 62.8%. But renormalization should in no way be interpreted as a weak job market. Initial jobless claims—our favorite indicator of labor market conditions—briefly jumped above 250,000 for several weeks in June, a threshold we had highlighted as one that could lead to a more significant increase in layoffs. This proved a head fake, however, and claims have trended sharply lower as Q3 winds down, a sign employers are reticent to lay off employees.

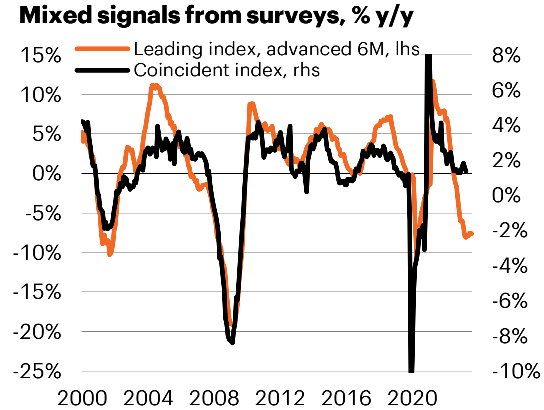
Outside of the strong fundamental picture, our dive into the state of the **household** focuses on two key areas. First, we break down where households stand with excess savings, which has helped push spending into overdrive. Second, we dissect where households could be vulnerable, outside of incremental headwinds like student loan payments and increased interest payments (albeit on a small portion of household debt). It is notable consumer confidence remains diminished in the wake of the pandemic, despite positive fundamentals. The University of Michigan consumer sentiment plunged to 50 in June 2022, lower than the depths of the Great Recession, at which time job losses were north of 500,000 per month and the unemployment rate was 6.8%.

Confidence remains weakened



Source: Conference Board, Univ of Michigan, as of September 27, 2023.

Mixed signals from surveys, % y/y

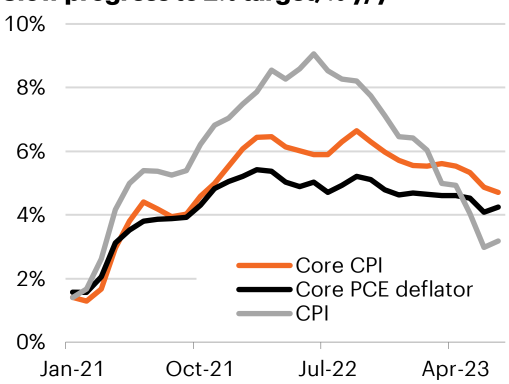


Source: The Conference Board, as of September 27, 2023. Y-axis truncated due to COVID distortions.

There remains a fundamental disconnect between hard data and survey data that is difficult to ignore. Surveys from the Senior Loan Officer Survey of consumer banking institutions, conducted quarterly by the Federal Reserve, have continued to show further tightening in lending conditions historically consistent with recession. The manufacturing PMI has been below 50 for 11 months in a row, and the NFIB small business index has been stagnant around 90, averages that were seen last in 2011 and 2012.

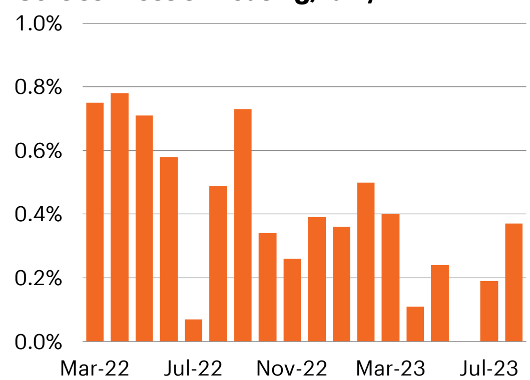
These doldrums may be due in part to the lingering hangover of **inflation**. Several sectors that had helped quicken the disinflationary trend have recently reversed—namely oil prices. Rents work their way through CPI data slowly over the course of a year, and while the Fed can rightly show progress on inflation, it is way too early to declare victory. Case in point, the recent reading on "supercore" inflation (core services excluding shelter) just delivered an upside surprise in July after rising less than expected for four months. We look at what the current trend in rents implies for the long-term direction of shelter inflation. At the end of the day, while the Fed or economists may pat themselves on the back that the year-over-year rate of price increases has slowed, we look at why the sticker shock of inflation is still a clear and present pain point for households. And could still be impacting confidence.

Slow progress to 2% target, % y/y



Source: Bureau of Labor Statistics, as of September 27, 2023.

Core services ex housing, % m/m

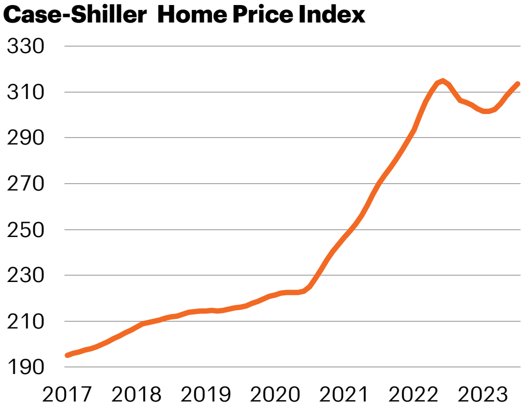


Source: Bureau of Labor Statistics, FS Investments, as of September 27, 2023.

The cost of tighter monetary policy and deglobalization

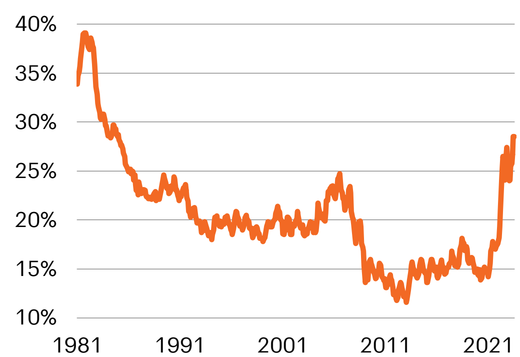
The impact of Fed rate hikes continues to be felt in the **real estate** sector. We offer our update on the residential and commercial markets, where higher interest rates continue to impact affordability and transaction activity has slowed as buyers and sellers find a new equilibrium. We look at structural changes that make the response to each market different from the last cycle. Notably, the correction lower in home prices has not materialized; indeed, prices have risen the last six months.

Case-Shiller Home Price Index



Source: Macrobond, as of September 27, 2023.

Housing affordability
Mortgage payment, % of household income



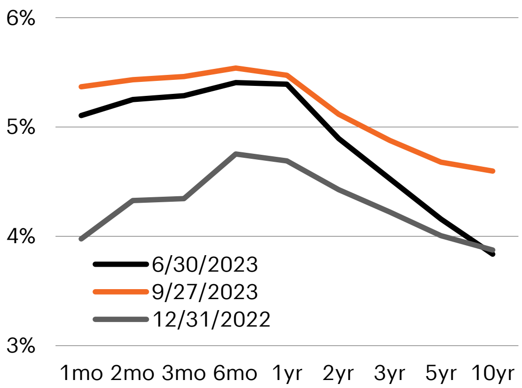
Source: National Association of Realtors, as of September 27, 2023.

Developments in **China** over the third quarter warrant an update, as the Chinese economy buckles under a systemic real estate crisis, low unemployment and weak consumer confidence. While we see limited direct impact on the U.S. economy, we look at secondary effects that could impact investors. We also include work presented at Jackson Hole on the state of deglobalization—or rather, the great reallocation—and what long-run impact this could have on U.S. inflation.

Fed pauses, but the markets keep tightening

The Fed is nearing the end of this extraordinary tightening cycle, but that doesn't mean tightening has ended. In contrast to most prior rate hike cycles, long-term interest rates lagged the Fed's rate moves at the start of the cycle, and now are rising far faster than the policy rate. The Fed's hawkish posture, economic projections and guidance around future actions all seem designed to keep pushing market rates higher.

Yield curve higher and flatter



Source: Bloomberg Finance, L.P., as of September 27, 2023.

Real 10-year yields

Source: Bloomberg Finance, L.P., as of September 27, 2023.

Indeed, even after the Fed included another rate hike in the dot plot in Q4, markets are not convinced and have priced only one in five odds the Fed raises rates again for this cycle. To us, this means the bond market sell-off could even continue a little further. The increase in **real interest rates** is another important form of tightening, as it changes the asset allocation decisions around risk, particularly as it comes to equity markets. The bond market has decisively broken out of its four-decade downtrend (to some degree, it simply ran out of room), and we unpack the implication of having two-way risk in bond prices, and what that means for fixed income returns. This leads us to **credit markets**, where fundamentals remain positive and spreads have stayed tight. We look at the impact of duration in corporate credit markets, and where to look for outperformance.

Equity markets are getting a real rate shock

Equity markets find themselves under pressure at the start of the fourth quarter as the correlation to bonds that dominated 2022 re-emerges. We look at historic returns over various time frames when the starting point is valuations in the top quintile. Even now, a hallmark of the continued scenario mismatch is optimistic earnings estimates that look for an acceleration in earnings per share (EPS) in 2024. This brings us full circle to our theme of delayed—but not dodged—as this scenario for accelerated growth is hard to square with intensifying economic headwinds and Fed hawkishness.

Households hold the key to the cycle

Key takeaways

- The foundation of household spending is strong, including real income growth.
- The auxiliary tailwinds, however, may have finally lost their gusto.
- Consumers are largely insulated from higher interest rates, but confidence remains anemic, nevertheless.

If it feels like a lot is riding on the consumer, it's because there is. The household remains the powerful engine driving GDP growth and has both fuel in the tank and a notable—although diminishing—tailwind. In Q3, the consumer has defied expectations of moderation by spending at a more rapid rate, driving GDP estimates up sharply. In the fourth quarter, we expect a deceleration to more sustainable trend-like pace spending as nascent headwinds become more immediate.

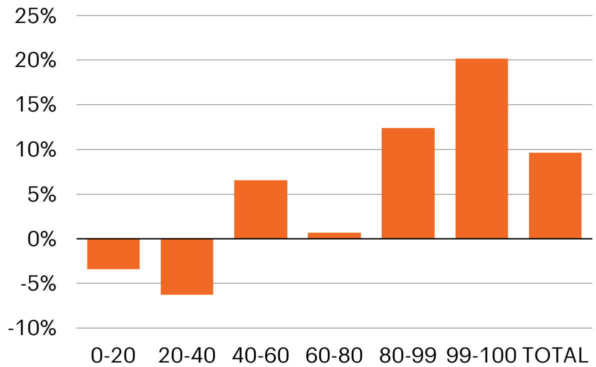
Fundamentals are still rock solid for households. Employment is key, and while there are signs employment is normalizing, the labor market remains extremely tight. Easing inflation has helped real wage growth finally turn positive in May.

And yet what has truly supercharged consumer spending in the post-pandemic economy is savings. The debate now centers around when this excess savings will be exhausted, and where spending will subsequently trend. The model that is ubiquitous from the San Francisco Fed[1] shows excess savings still lingers at approximately $350 billion, although that is still being spent down. However, a breakdown of deposits by income cohort shows most households have already spent this excess savings. The wealthiest households that still have extra savings may not spend it all. In all likelihood, the spending boost from savings gave its last gasp in the third quarter.

Outside of savings, a closer examination of the household balance sheet looks healthy. Delinquencies on auto and credit card payments have risen, but remain in line with the pre-pandemic trend, and in and of itself is not a reason for concern. Households de-levered in the wake of the global financial crisis (GFC), and 85% of household debt is fixed rate, largely insulating households from higher interest rates. Headwinds are looming, although do not look strong enough to derail consumption, merely slow it. While insulated from higher interest rates, households are not immune. Credit card payments have risen sharply, as have auto loan costs. The resumption of student loan payments casts a big shadow—although data may show this is an incremental impact on spending at the macro level.

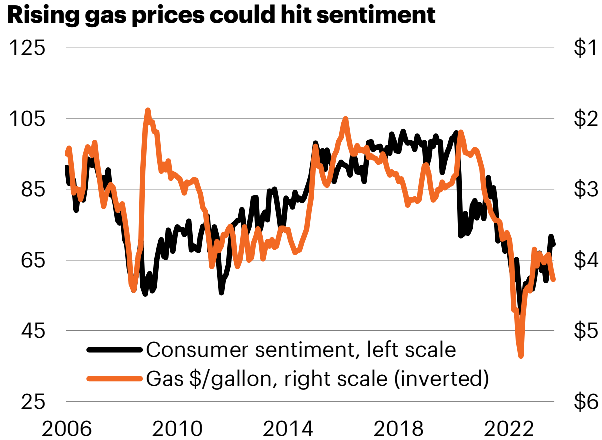
For all of the reasons to be optimistic about household spending, there are vulnerabilities. It is notable consumer confidence remains diminished in the wake of the pandemic, despite this long list of positive fundamentals. The University of Michigan consumer sentiment plunged to 50 in June 2022, lower than the depths of the Great Recession, and has only recovered to 67.7, versus an average of 96.0 in 2019. The answer may be the lingering pain of inflation, where the sticker shock is still fresh and painful. Gas prices are a unique flashpoint for the U.S. consumer. Ultimately, the animal spirits of households will hold the key to the business cycle.

Real deposit change by income cohort
% change since Q4 2019



Source: Macrobond, BLS, FS Investments, as of September 25, 2023.

Rising gas prices could hit sentiment



Source: Macrobond, Bloomberg Intelligence, as of September 23, 2023.

1 "The Rise and Fall of Pandemic Excess Savings," Abdelrahman, Hamza, et al., Federal Reserve Bank of San Francisco, May 8, 2023.

Inflation: It's back (at least, it's not gone)

Key takeaways

- Disinflation has progressed, but some sectors are seeing inflation bubble up again.
- We expect inflation to remain high enough to limit the Fed's room to cut rates into 2024.
- For households, the sticker shock of higher prices has lingered, and is a vulnerability if prices reaccelerate (especially gasoline).

In the second half of the year, inflation data have been on or below consensus, reinforcing hopes the Fed will be able to cut rates soon and raising expectations that policymakers will achieve a soft landing. But some components that caused deflation to slow are bubbling back up as we head into Q4. Outside of the component-related price pressures, households are still dealing with a painful inflation-related hangover.

The good news is disinflation is clearly progressing. CPI peaked at over 9.1% y/y in June 2022, but a year later had decelerated to 3.0% y/y. The energy component peaked at over 40% y/y and plunged to –17% y/y, greatly helping bring inflation down. Most major sectors of inflation have decelerated, if not quite so dramatically. The sticky piece in the spotlight has been shelter. Owners' equivalent rent (OER) peaked at over 8.1% y/y and is decelerating very slowly—in OER was still up 7.3%. Short-term rent indicators have fallen significantly, and the expectation is the OER component will continue to decelerate. But this is a slow process and could take up to a year. This piece alone implies we will end 2024 with core CPI still around 4.0% y/y, far too high for comfort.

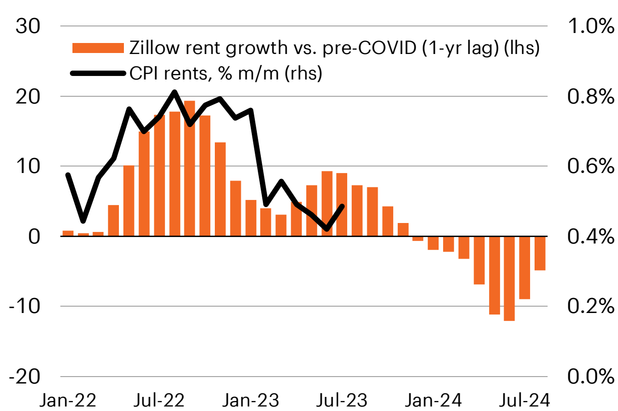
We have long written there needs to be a perfect storm of good news on the inflation front to return inflation to 2%. Looking ahead to Q4, however, some components are looking troublesome.

Energy prices have risen again, driven by oil prices. Gasoline prices were up significantly over the last two months and have a uniquely debilitating effect on U.S. household sentiment (headlines were ubiquitous when average gasoline prices rose over $5 a gallon).

Rents are expected to fall over the next several quarters, but ironically, the Fed's rate hike cycle both impacted housing affordability and has slowed new construction, reinforcing housing supply limitations. In other words, it is far from certain whether rents will settle neatly back to their pre-COVID trend of 3.2%. The Fed has focused on services prices, excluding housing (now known as "supercore"), which rose 0.44% in August, the highest in four months. The auto workers' strike will impact new auto production and could put upward pressure back on used cars.

More broadly, while policymakers and markets may breathe a sigh of relief inflation is down to 3.6% y/y, for households, the sticker shock of recent price gains is still a clear and present pain point. We see household confidence as vulnerable if progress on inflation stalls or prices reaccelerate. For policymakers, stubbornly higher inflation limits room to cut rates. Inflation dynamics will remain critical to the business cycle in Q4.

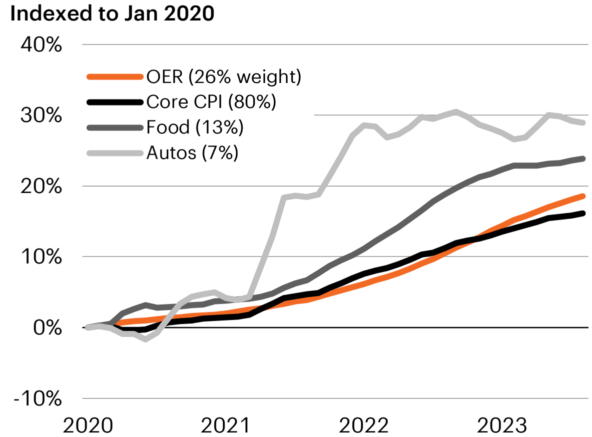
Zillow Rent Index vs. CPI rents



Source: Zillow, BLD, as of August 31, 2023. Note: Zillow data shown as number of std deviations away from pre-COVID of monthly rent growth

Sticker shock lingers

Indexed to Jan 2020



Source: Bureau of Labor Statistics, FS Investments, as of September 23, 2023.

Real estate: Check in on ground zero

Key takeaways

- Fundamentals in both the residential and commercial real estate markets remain solid.
- Activity has slowed, and buyers and investors recalibrate to higher interest rates.
- Structural changes make the response of each market different from last cycle.

The reaction of real estate markets to higher interest rates has been among the most interesting—and perplexing—trends of the past two years. Tighter policy hit activity hard starting in mid-2022 as sales of existing homes and commercial real estate (CRE) properties plunged, and construction detracted 70 bps from full-year GDP growth, the most since 2009. The path of property values and construction activity over the past couple quarters, however, has been more nuanced and deserves closer attention.

In the housing market, mortgage rates in the mid-7% range have driven home affordability to the lowest point since 1985. The household income required to purchase the median home sits at $105,000, more than double the level from year-end 2019. Despite that, national home prices have rebounded and sit only -1% below the June 2022 all-time high.

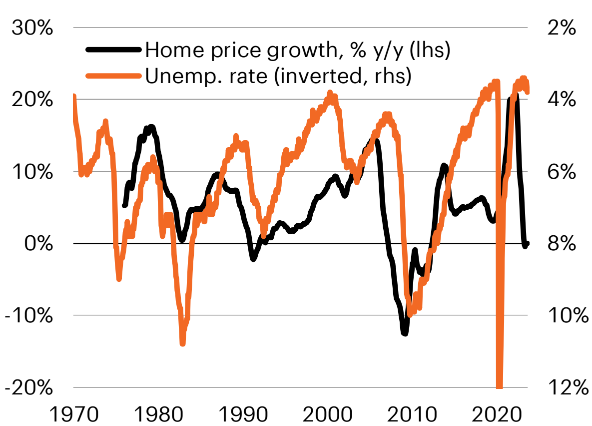
The reasons for this are well-covered. The average existing mortgage holder pays only a 3.6% interest rate, and most homeowners opted for 30-year fixed rate debt. And 57% of real estate wealth is owned by people over the age of 55—a group much less likely to move—compared to 43% two decades ago. These dynamics have combined to decrease the supply of existing homes available for sale. Given a robust labor market and demographic tailwinds, the demand for homes remains solid, which has ultimately led to resilient new residential construction and home prices.

On the CRE side, challenging deal economics are keeping activity slow this year. Property values have thus far fallen about -10% in response to higher financing costs, but the pace of declines has slowed in recent months. Strong fundamentals outside the office sector, combined with a high level of capital waiting to be deployed into property acquisitions, have kept the market resilient despite higher rates.

The path forward for both residential and CRE remains uncertain. However, it seems clear that unless interest rates go materially lower, property values are unlikely to go much higher from here. That said, the housing market has never seen a protracted *decline* in values without a meaningful rise in unemployment, and the same can be said for the CRE sans a significant credit cycle. For now, the labor market remains strong, and credit quality outside certain parts of the office sector is solid.

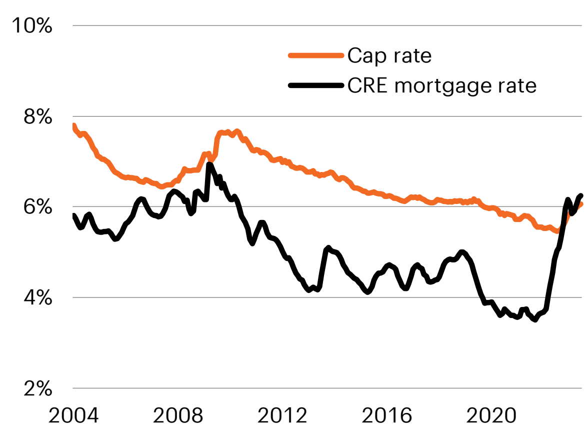
What does an outlook for higher-for-longer rates mean for each market? For housing, it likely means persistently low supply of existing homes, which should keep prices from cratering but affordability poor for first-time buyers. This sets up a strong backdrop for the multifamily (apartment) sector, the largest area of the CRE market. The combination of solid fundamentals in multifamily, industrial, retail and hotel properties and higher rates has, in our view, shifted the CRE investment opportunity from price appreciation to income generation, with CRE debt the optimal way of playing this change.

Home price growth tracks labor market



Source: S&P Case/Shiller, Bureau of Labor Statistics, as of September 15, 2023.

Yields on CRE equity, debt now equal



Source: MSCI Real Capital Analytics, as of June 30, 2023.

China: Breaking up is hard to do

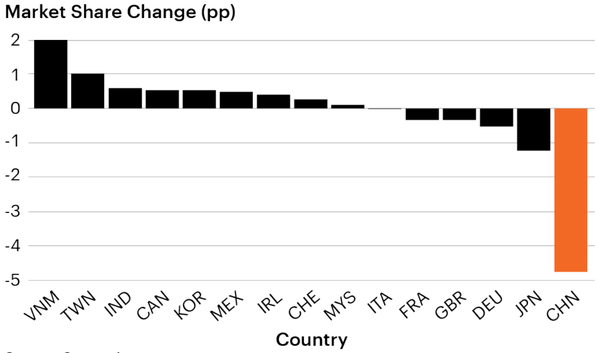
Key Takeaways
- A reallocation away from trade with China to "friendly" countries has begun and implies higher import prices going forward.
- The direct impact of China's economic doldrums on the U.S. economy is limited.
- Traditional equity investments have significant revenue exposure to China.

While U.S. economic growth seems unstoppable, China's economy is buckling under systemic real estate problems, low employment and weak consumer confidence. Deglobalization has dominated the post-pandemic lexicon but is showing up more in the form of reallocation. The U.S. economy remains relatively insulated from the Chinese business cycle, but second order impacts should be noted through our key trading partners, and through traditional equity investments.

A quick look at trade volumes would debunk deglobalization: U.S. trade volumes hit a record high in 2022. The U.S. still imports 13% of its goods from China, though it is reallocating toward other trade partners, intensifying other direct trade relationships at the expense of trade with China.

This comes at a cost, however. In a paper presented at Jackson Hole, researchers observed there was "evidence of rising unit values from Vietnam and Mexico,"[2] a critical development because cheap goods imports from China have been a key reason the U.S. has been able to sustain inflation at 2%. Outside of this powerful deflationary impulse, the U.S. domestic services economy has experienced inflation closer to 2.6% (from 2010–2019).

US Import market share change for top 15 importing countries (2017–2022)



Source: Comtrade

2 "Global Supply Chains: The Looming Great Reallocation," Alfaro, L., et al, Jackson Hole Symposium, August 2023.

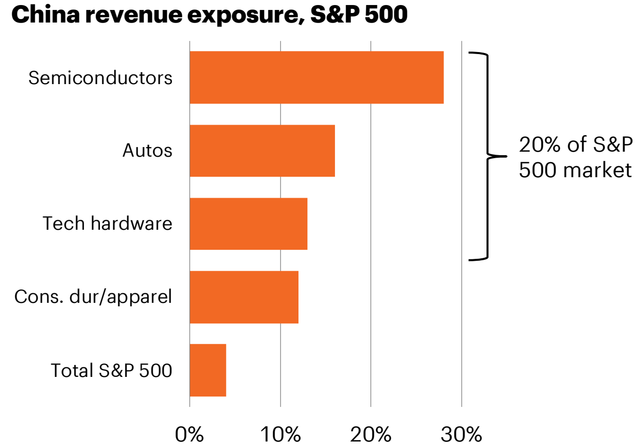
China's economy is facing multiple challenges. The systemic threat posed by large defaults at major real estate companies has been a recurring theme for the past year, and feeds directly to slumping consumer sentiment. And yet much of the nonperforming debt is owned by Chinese local governments, not foreigners. In other words, while a serious challenge to domestic growth, it is unlikely to cause global financial contagion.

China recently dipped into deflation, in contrast to most developed countries that are still fighting inflation that is too high—in August, China's CPI was up just 0.1% y/y. This is another sign of domestic economic doldrums, but we don't expect this to trigger the U.S. to import deflation from China. Ironically, we already do import deflation via goods imports, and for years this occurred against a backdrop of healthy Chinese inflation.

The U.S. has begun the long and slow process of reallocated direct goods trade and supply chains away from China, but still has significant secondary exposure. While the U.S. has shifted toward "friendshoring" and importing more from Vietnam and Mexico as well as other major trading partners, those countries are importing more from China over the past five years. A slower Chinese economy impacts global growth and is particularly painful for developed countries—Germany first and foremost—that send exports to China.

Finally, investors have exposure to China's economy through the S&P 500, including the most highly valued part of the stock market—tech firms—which carry a greater market cap exposure than the index.

China revenue exposure, S&P 500



Source: Morgan Stanley, Bloomberg Finance, L.P., as of September 25, 2023.

The Fed: Wringing out rate cuts

Key takeaways

- The Fed's hawkish posture has slowly dragged market expectations more in line with the dot plot…
- … yet there could be further to go.
- Inflation dynamics could significantly limit an eventual rate cut cycle.

Markets keep convincing themselves the Fed is done with this extraordinary rate hike cycle, and the Fed keeps sending warning signals that more rate hikes may be coming. The dot plot from the September 20 FOMC meeting included another rate hike this year to 5.50%–5.75%. And yet, at time of writing, Fed funds futures pricing still only prices in 20% odds of a rate hike at the November 1 meeting. Indeed, throughout this rate hike cycle, markets have lagged what the Fed has signaled for future rate hikes.

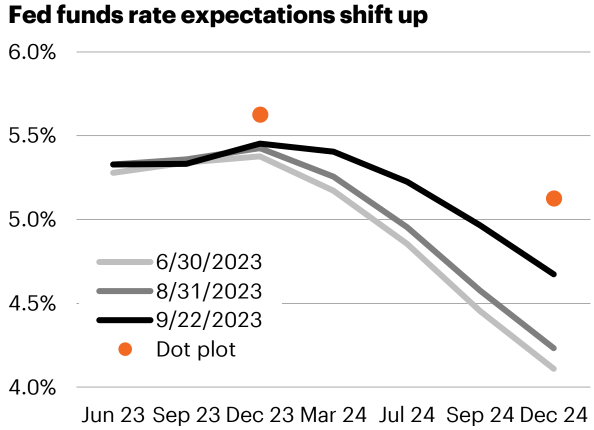
For the economy, another 25 bps change in the overnight rate likely has less impact than what the Fed is signaling about the trajectory and timing of possible rate cuts. With the consensus increasingly coalescing around a "soft landing," the rate hike cycle of the mid-1990s—the other episode in this modern monetary regime when a rate hike cycle was not followed by recession—is being more closely examined. Note then the Fed held the policy rate in restrictive territory for three years—a possibility markets are nowhere close to pricing in.

There are two key differences between then and now: In the mid-1990s, the yield curve never inverted. And, that rate hike cycle was relatively tame at 300 bps spread over 13 months, versus 525 bps (so far) over 17 months.

Fed Chair Powell had mentioned their forecasts including a recession at the post-meeting press conference in March. Now, however, this sentiment is gone. The most recent economic projections more than doubled the GDP forecast for this year from 1.0% to 2.1%. Importantly, next year, while the median Fed forecast is for the economy to grow below potential at 1.5%, no participant reflected in the economic projections forecast the core PCE deflator to rise less than 2.3%. In other words, unless there is a recession, the Fed likely won't have room to maneuver in rate cuts. This was also reflected in the dot plot, which left the 2023 dot unchanged at 5.6% but increased the median Fed rate expectations for 2024 and 2025 by 50 bps.

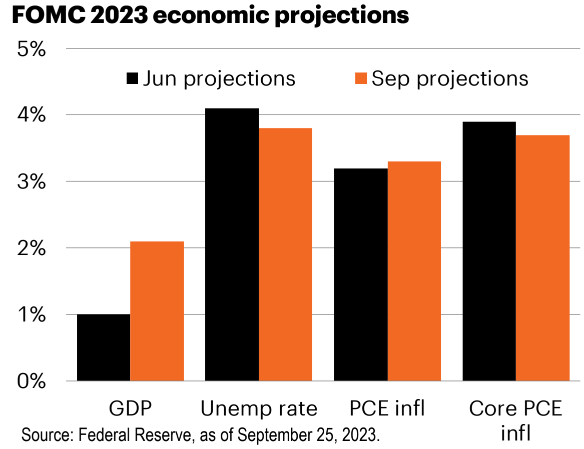
One scenario the market does not seem to be contemplating: If the economy stays as strong as it is, and if inflation accelerates again or remains around the year-end 2024 pace of 4%, would the Fed continue to nudge rates higher in 2024? We place a low probability on this as well, because we see the economy slowing next year. However, there is an inherent disconnect between those who are increasingly convinced there will be "no landing"—i.e., the economy won't slow at all—and the current Fed funds futures curve. Should this economic outcome materialize, even the current dot plot could need to be revised up further, with the possibility that rate hikes—not cuts—continue into 2025.

Fed funds rate expectations shift up



Source: Federal Reserve, Bloomberg Finance, L.P., as of September 22, 2023.

FOMC 2023 economic projections



Source: Federal Reserve, as of September 25, 2023.

Interest rates: It's getting real

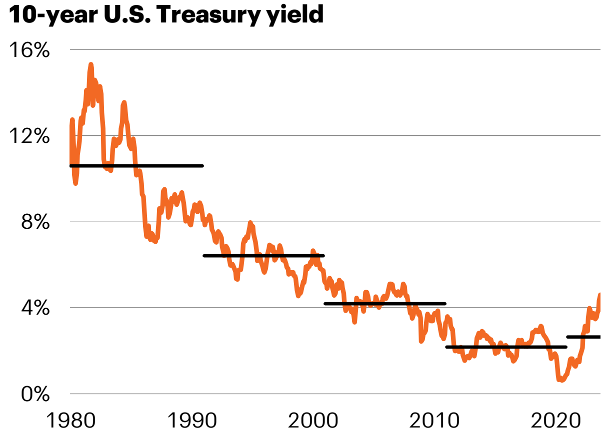
Key takeaways
- Tightening could continue after the Fed ends the rate hike cycle via higher real interest rates.
- Higher oil prices and a stronger dollar are also headwinds to growth.
- An end to the multi-decade trend of lower rates has big implications for traditional fixed income and equity investors.

In addition to changes in short-term interest rates that are largely driven by Fed policy, a tectonic shift is under way, which has wide-ranging market implications for investors. Long-term interest rates are up sharply, real interest rates are at the highest in 15 years and other "shadow tightening" is under way. The ramifications for risk allocation are only just beginning to be felt and is a theme we expect to dominate investing conversations for the foreseeable future.

The rise in long-term interest rates has lagged the short-term policy-driven increase, meaning while Fed rate hikes wind down, financial conditions are still tightening. The bulk of the short-term rate increases are behind us. From here, the Fed has a median expectation of one more 25 bps rate hike, and markets are pricing less than that. But while the Fed funds rate has risen 50 bps over the past two quarters, Treasury rates from the 2- to 10-year tenor are up over 110 bps. These longer-term rates impact a broad range of consumer and business loans.

It isn't just interest rates that are rising. The dollar has increased 6.9% in Q3 and is up 5.9% year to date against China's renminbi. Oil prices have risen 41% since June. This shadow tightening is also a headwind to economic growth.

10-year U.S. Treasury yield



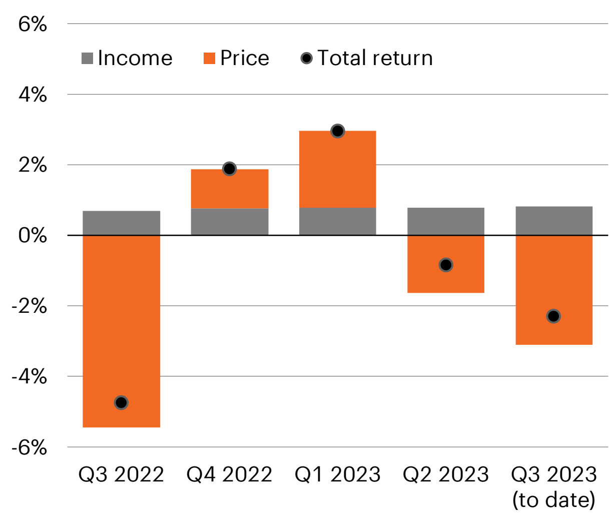
Source: Macrobond, FS Investments, as of September 27, 2023.

Real yields are also rising as inflation falls. When the Fed funds rate is 5% and inflation is 5%, the real rate is zero. When inflation is 3%, however, the real Fed funds rate rises to 2% without the Fed having to tighten further. As inflation eases down, this increase in real rates is likely to continue.

For investors, there are multiple takeaways, both in the coming quarter and into 2024. First, investors have experienced zero real interest rates for years. This has habituated investors toward allocating assets further out the risk curve. This means the yield in the equity market—which we reflect with free cash flow yield—is now below the yield on the 10-year Treasury. Theoretically, investors should demand more return for more risk, implying growth in equities will be great enough to reward investors. The equity market is not sufficiently compensating investors for the material risk of a slower economy in 2024.

Higher yields have hammered fixed income investors. In 2022, the Bloomberg Agg lost 13%, and at time of writing is down –1% year to date. More broadly, the four-decade downtrend in interest rates ran out of runway. During this time, if an investor could hang on through volatility, they were rewarded by both income and price gains. Now, persistently higher inflation, government debt dynamics and underlying demographic changes, mean benchmark yields could move sideways for some time. It's a subtle shift with big implications: If investors are less assured of price gains, they are reliant *only* on income. In this environment, active investing deeper into the capital structure is a reallocation worth considering.

Barclays Agg return composition



Source: Bloomberg Finance, L.P., FS Investments, as of September 25, 2023.

Credit outlook: Riding the wave

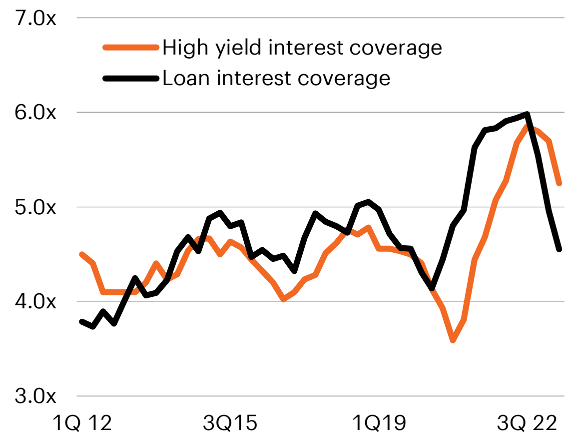
Key takeaways

- Economic growth has supported relatively steady corporate fundamentals.
- Market technicals continue to provide a solid underpinning for prices.
- Rising long-term rates could favor riskier CCC-rated assets compared to higher quality, more duration-sensitive BBs.

A strong economy, rising interest rates and a wobbly equity market have caught credit markets in the cross-current. Corporate fundamentals remain supportive, with low levels of leverage and high levels of interest coverage. Default rates have risen to 2.4% for high yield but remain below the historic average of 3.2%. The number of issuers trading at distressed levels is also low, signaling an expectation that default rates may not rise much from current levels.

Looking ahead, corporate fundamentals have remained strong, but are moderated somewhat. Interest coverage ratios for high yield remain elevated at over 5x, while for loans, interest coverage is around 4.5x, a normalized ratio in line with historic averages. This resilience in the face of rising rates reflects the fact that companies have been able to grow earnings and limit new debt issuance. However, Q2 saw the first year-over-year earnings decline in high yield and the weakest growth in loans since 2020. Going forward, while companies are entering a period of potentially softer earnings from a solid base, we will be monitoring these statistics for any material deterioration.

Fundamentals: Healthy but moderating

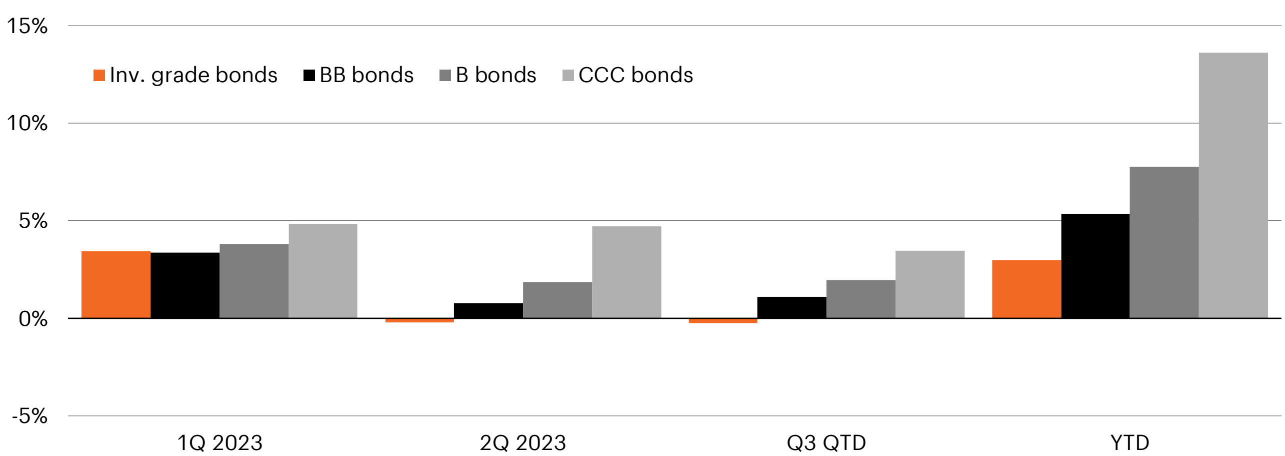


Source: J.P. Morgan, as of September 15, 2023.

In Q4, a possible further increase in long-term core interest rates will be a key consideration. Duration is a tricky stat in corporate credit markets. While high yield is a fixed rate market, historically, rising rates have coincided with favorable economic environments and have been a positive to credit spreads and returns. The impact to credit has been steady outperformance of loans versus bonds, as investors have been attracted to high short-term rates, and CCC outperformance vs. BBs, as BBs mathematically have higher duration.

We will be watching what happens to the curve moving forward. Higher yields in the middle and long end of the curve could continue to favor CCCs vs. BBs, while expectations for Fed rate cuts—which is not our base case—could tilt the market back to favoring fixed rate high yield bonds versus loans.

Credit investors have continued to reach for risk



Source: Bloomberg Finance, L.P., ICE BofA U.S. Corporate Index, ICE BofA BB US High Yield Index, ICE BofA B US High Yield Index, ICE BofA CCC US High Yield Index, as of 9/26/2023.

Equities: Great Expectations

Key takeaways
- While stocks have enjoyed a strong year, valuations are creating a challenging hurdle for further gains.
- Analysts expect double-digit EPS growth in each of the next two years.
- Market trends, such as small caps lagging and the Low Volatility factor outperforming, are sending concerning signals.

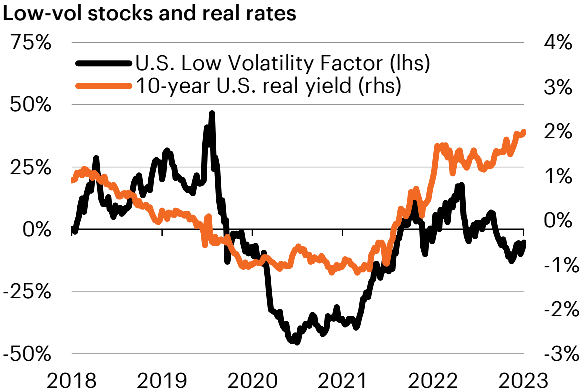
Following their second-best first-half performance since the mid-1990s, U.S. stocks merely treaded water during Q3 as rising yields stalled the tech rally. If price action over the first six months of the year was a reflection of receding recession fears, the last three have displayed a recognition that a resilient economy will mean higher interest rates for the foreseeable future. While there is still no obvious impetus for risk appetite to crater in Q4, the reality of elevated valuations remains a limiting factor for medium- and long-term return expectations.

Coming into the year, there was a sense among investors that the consensus analyst estimate for S&P 500 full-year EPS of around $228/sh was too high. While we broadly agreed with that sentiment, we believed weakness in fundamentals would become clearer in the second half of the year rather than the first. While 2023 EPS is indeed set to come in below expectations—the current consensus is $218/sh—much of that can be attributed to the energy sector, where earnings have been affected by (until recently) lower oil prices. For the most part, earnings results have been resilient this year thanks to robust consumer demand. However, we believe the weakness in fundamentals has been delayed rather than dodged entirely.

While returns this year have been strong, this is not a market without warnings signs. Small-cap stocks, which are generally more cyclically sensitive due to both their industry makeup and their domestic focus, have lagged well behind this year. The Russell 2000/S&P 500 ratio has fallen to its lowest level since 2002 as large-cap tech stocks have driven most of the YTD gains. After underperforming through July, the Low Volatility equity factor has since rebounded sharply, suggesting investors are beginning to favor defensiveness. None of this suggests a market capitulation is imminent. However, it does signal to us the market is searching for a new catalyst as the AI and "no recession" trades have largely been priced in.

Our leading cause for concern remains the lofty valuations being assigned to U.S. equities. The S&P 500 trades near 19x forward 12-month EPS, which is firmly in the top quintile of history. With nominal and real 10-year yields around 4.30% and 2.00%, respectively, low rates are not a justification for these levels. Rather, it must come from a belief that earnings growth will be robust in the coming years; right now, it appears investors are willing to believe the consensus estimate for 12% EPS growth in each of the next two years. But the reality remains that forward returns from these valuation starting points have historically been mediocre, at best. Our core equity views are: 1) there is downside risk to fundamentals and, by extension, valuation multiples, and 2) we are likely entering a multiyear period of more subdued equity returns.

Market finally reacting to higher yields?
Low-vol stocks and real rates



Source: Bloomberg Finance, L.P., as of September 19, 2023.

Valuations imply muted forward returns
Average S&P 500 forward returns (annualized)

Starting P/E range	6.2x–10.9x	10.9x–13.9x	13.9x–15.4x	15.4x–17.6x	17.6x–26.1x
Quintile	1	2	3	4	5
1 year	20%	15%	11%	13%	5%
2 years	18%	16%	10%	13%	3%
3 years	17%	16%	10%	13%	2%
5 years	17%	15%	12%	9%	2%
10 years	16%	14%	10%	8%	2%

Source: Bloomberg Finance, FS Investments, as of September 15, 2023.