MIDDLETON & COMPANY, INC.

Investment Update

October, 2023

2023 Third Quarter Update

Review: The S&P 500 was negative for the quarter, as were most other major asset classes. International equities were negative due to a stronger dollar and economic concerns, particularly in China and Europe. Fixed income indices were negative due to rising yields, which have continued to climb as it has become increasingly likely that the Fed will keep rates higher for longer to combat persistent inflation.

	3Q23	2Q23	1Q23	2022
S&P 500	-3.3%	8.7%	7.5%	-18.1%
MSCI EAFE[1,2]	-4.0%	3.2%	8.6%	-14.0%
MSCI Emerging Markets[2]	-2.8%	1.0%	4.0%	-19.7%
Bloomberg U.S. Aggregate Bond	-3.2%	-0.8%	3.0%	-13.0%
Bloomberg Municipal Bond	-3.9%	-0.1%	2.8%	-8.5%

[1]Europe, Australasia, Far East

[2]MSCI returns are in U.S. Dollars

Can the Federal Reserve engineer a soft landing?

Since the beginning of the current rate hike cycle in early 2022, there has been a lot of focus on the likelihood of achieving a soft landing—i.e., a slowdown in growth without a recession at the end of the rate hike cycle. Such an outcome would be ideal for obvious reasons, but history suggests that it is rarely achieved. In fact, in the last sixty years, the Fed was only successful in getting a soft landing once, in 1995. Recently, Neel Kashkari, president of the Minnesota Fed, stated that he believes there is a 60% chance of this cycle ending in a soft landing, and we would argue that the stock market appears to be pricing in an even higher probability than this.

Achieving a soft landing is difficult given the lagged effect of monetary policy on the economy. In other words, it is difficult to know if there has been too much tightening until it is too late, resulting in a recession. Since a soft landing implies slower economic growth than current conditions, it is easy to see how modestly positive economic growth can turn negative due to overly restrictive financial conditions or an economic shock (e.g. war, significant labor strikes, government shutdown). In the current cycle, the soft landing scenario is dependent on inflation coming down fast enough so that the Fed is comfortable cutting rates before economic growth slows too much. However, Fed Chairman Powell has repeatedly said that they would rather run the risk of a slowdown in growth than a resurgence in inflation. This higher-for-longer stance on interest rates makes it much more difficult to achieve a soft landing.

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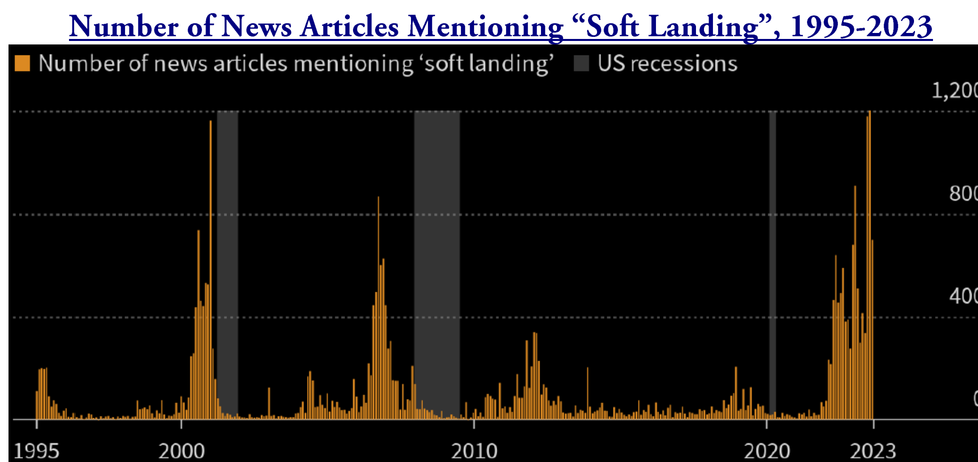
Additionally, it is important to note that the period before a recession will appear to be very similar to a soft landing—i.e., slower job growth, consumer spending, and/or overall economic growth. Therefore, discussions/predictions of soft landings have historically increased before recessionary periods, which one can see in the graph below that shows the number of articles mentioning "soft landing" going back to 1995.

Number of News Articles Mentioning "Soft Landing", 1995-2023



Source: Bloomberg

Outlook: The US economy has continued to be more resilient than expected this year, with Q2 real GDP growth of 2.1% year-over-year. The estimate for 2023 has increased to 2.1% from 1.3% as of July. Q3 GDP growth is expected to be comparable to Q2, but the question now is the level of growth going forward. Although the overall picture of US consumers appears to be fairly healthy, there are signs of weakness that are emerging. Debt delinquency rates have been increasing this year, albeit from very low levels, and student loan payments have now resumed, which puts additional pressure on some households that are already struggling with inflation and higher rates. Additionally, the excess savings built up during the pandemic has been spent by most households, and it is estimated that aggregate excess savings will be fully depleted by year end. Given that personal consumption represents ~70% of US GDP, it is reasonable to expect slower growth going forward due to these headwinds faced by consumers.

Unlike the US economy, international growth has largely continued to disappoint versus expectations. China, in particular, continues to struggle and is at risk of missing its 5% GDP growth target for the year, which was already one of its lowest targets in decades. The strength of the US dollar continues to be a headwind for international markets, and this strength will likely persist in the near term due to the interest rate outlook and relative outperformance of the US economy.

Strategy: We believe that there are attractive opportunities in fixed income, as real yields (bond yields minus inflation) are at levels not seen since 2006-07. Within equities, we continue to have a preference for higher quality growth companies at reasonable valuations. Those types of companies are more likely to deliver sustainable growth in the event of an economic slowdown. Additionally, a disciplined approach to valuation is important since the higher-for-longer rate environment could put pressure on stock valuations in the near term.