Q3 IN REVIEW
Q4 IN PREVIEW

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WE TURNED ONE!

As we celebrate our one year anniversary of launching Beverly Hills Private Wealth, we are pleased to introduce our new Chief Investment Officer, Nick Nejad, CFA®.

If you would like to discuss any of these topics in more detail, please call us at 310-388-3800.

Thank you for your support as we hit this first anniversary. We would not be here without you!

Beverly Hills
PRIVATE WEALTH

INTRODUCTION

In many ways, it feels like we are in two very different markets.

In one market, stock indices are up solidly for the year. Unemployment is at the lowest rate it's been since 1969, job openings are abundant, and consumer demand is growing resiliently. That describes the type of ideal backdrop for further portfolio gains.

But in the other market, stocks and bonds both lost ground in the last quarter, finishing with four straight weeks of losses. Consumer sentiment is at recessionary levels, market sentiment indicators point to "extreme fear", and the yield curve is inverted – a harbinger of tough economic times ahead. It also doesn't help that the last time interest rates approached these levels, several banks collapsed spectacularly.

It's hard to fathom that these two very different pictures describe the same environment. But we think investors can start to make sense of these conditions by homing in on two broad themes:

- **First, we are entering a period of prolonged labor market tightness.** The demographics of the world's largest economies are such that they will see their workforces *collectively shrink* over the next 10 years. We don't think the market appreciates the ramifications.

- **Second, to combat this and other inflationary pressures, central banks will need to keep interest rates elevated.** "Higher for longer", as the Fed likes to say.

> *"We expect wages, the economy, and demand for everyday essentials to remain strong, but inflation rates will also stay high, to the frustration of consumers and investors alike.*

As we'll discuss, this type of environment may not be bad for investors. There are sure to be some hiccups and unpleasant adjustments, but over time, we expect investors will realize that strong job markets create a strong economic foundation as well. We'll cover this in more detail below after a brief market recap.

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MARKET OVERVIEW

Stocks and bonds both retreated during the third quarter of 2023, as a steady increase in long-term interest rates took a toll on asset prices. In total, the 10-year treasury rate ended a full 0.8% higher in September than it was just three months prior, as markets seem to have finally received the message that the Fed is serious about "sticky" inflation. Globally, stocks fell by -3.4% for the period as measured by the MSCI All Country World Index ("ACWI"). Losses were fairly consistent across geographies, but sector results showed some wider disparities. For example, interest rate sensitive areas like Utilities and Real Estate tumbled by about -10%. Meanwhile, Energy stocks experienced gains, as oil prices climbed on strong demand and tight supplies.

The third quarter's performance leaves global stocks up about +10% for the year. But that headline figure overstates the experience of the typical security. For example, half of US stocks ended the 3rd quarter *down* for the year, and an equal-weighted version of the S&P 500 is up only +2% to-date. Meanwhile, the seven largest companies in the US are up by +88%, skewing the return higher of any size-weighted indices. Of course, those same "Magnificent 7" companies were also down by -45% last year, meaning they are now just about even over a two-year stretch.

Elsewhere, fixed income also had a rough go of things, with the aggregate bond indices falling by about -3.6%. The culprit: the aforementioned rising interest rates, which have a more mathematical knock on bond market prices. Longer-term maturities were hardest hit, down by double digits in some cases. There were some relative winners though, mostly in securities that were short in duration or high in yield. Importantly, the Q3 losses brought bonds as a whole back to negative for the year.

Sticking to bonds, market commentators had speculated for a long time about when interest rates would "normalize". That seems to have now happened in the blink of an eye, with a 30-year treasury bond currently yielding over 4.9%. To frame that another way: at today's level, the market is projecting that the Fed will keep rates at about 5% *for most of the next thirty years*. It was only two years ago that this very same market expected rates to stay perpetually below 2%. We don't think the average person has fully processed this new reality.

How can we explain such a stunning shift in rates in such a short period of time? We think it's helpful to look at root causes, and in that respect, two broader trends help to frame that discussion. First, we are entering a period of prolonged labor market tightness due to demographic trends. Second, central banks are attempting to combat that and other inflationary pressures, albeit with a limited policy toolkit. We explain the clash of these two forces below.

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LABOR VERSUS THE FED

The labor market is considered tight when there are more job openings than job seekers. By many accounts, that describes the United States today: the Bureau of Labor Statistics just reported that there were about 10 million job openings at the end of August, up 0.8 million versus July. But only 6 million people currently consider themselves unemployed.

Unfortunately, that problem is expected to only worsen. In a typical year, the US adds about 2 million jobs to its economy. But the supply of working adults (those between the ages of 20-64 years old) is only projected to grow by about 400,000 per year. That means the gap between jobs demanded and workers available will likely widen each year.

If that seems daunting, the problem is even worse internationally. In China, the working age population is projected to *shrink* by 18% over the next 30 years. In Japan and Europe, it is projected to fall by -30% and -6%, respectively. In total, 7 of the 10 largest economies will see their workforces decline going forward. Those ten economies account for 66% of global GDP.

A comparable situation of this magnitude really doesn't exist, but if we were to try to estimate the impacts, we would guess that workers will be increasingly pressured for better wages (think strikes). This in turn will put upward pressure on business costs and prices, which is where the central banks step in.

Central banks generally have a dual mandate to fight unemployment and inflation, and they have several tools that they can use to manage that process, such as interest rates and quantitative easing. We have already seen central banks take several actions to fight off higher prices. Collectively, central banks around the world have raised interest rates over 80 times.

In the past, interest rate hikes of this magnitude would have been swiftly followed by a recession. Yet quarter after quarter, economists have been wrong trying to predict our next slowdown. Consumer demand has remained robust, even if there have been some challenges in the more rate-sensitive areas of the economy.

Simply put, the central bank toolkit is not very effective at addressing today's challenges. While higher interest rates can slow economic growth and ease some of the inflationary burden, we ultimately expect inflation and interest rates will remain higher than we are accustomed to.

INVESTMENT IMPLICATIONS

Much of the current market dichotomy starts to make sense when viewed from this lens. Demand is robust and will likely remain high. So will inflation, as wage increases are passed on by businesses. Higher rates will soften this somewhat; it just won't be enough to tip us into a severe recession.

There are several implications of this "new normal".

- As mentioned above, we don't expect an economic crash anytime soon, and to the extent there is a recession, we expect it to be mild and of the garden-variety kind. That is because we very rarely have sharp economic downturns without significant unemployment increases.
- To the extent something does "break" (and that might happen, especially in areas that had become overly complacent to ultra-low interest rates), we are comforted by the fact that central banks now have ample breathing room to deal with a crisis. Think about it this way: would we still be looking for a "market crash" around the corner if rates fell back down to 3%?
- We think stocks and bonds do okay from here, especially over the medium-term. Stocks will benefit from a broadening out of the economy and higher inflation. Bonds will do well simply because their starting rates are much more attractive than they have been in decades.
- We remain very cautious about real estate and related exposures. While cycles in this space may be slower on the downside, that does not change the fact that higher rates are deleterious to the sector. With real estate accounting for almost half of global wealth, we are keeping an eye out for any spillover effects on the broader market.

CONCLUSION

Given the above, what are we doing in our client portfolios?

First, in equities, we think it's important to invest with a scalpel and not a chainsaw. So, we are looking particularly for beneficiaries of higher rates and inflation. In a similar vein, we are also scouring for companies that can capitalize on a secular trend towards productivity, such as through automation, capital efficiency and artificial intelligence. As always, valuations are paramount. Of the companies we track individually, our highest expected returns remain in specific value stocks as well as in FAAM (Facebook, Alphabet, Amazon, Microsoft). We also see attractive opportunities in many international and small cap stocks, although it's important to be very targeted in these spaces.

Meanwhile, in fixed income, we continue to favor bonds that are shorter in duration and higher in spread than the benchmarks. That said, we are looking to lock in yields for longer when the rates are worthy of the commitment. For example, AA-rated municipals are approaching tax-free 5% yields in certain instances. We think that makes municipal bonds a very attractive component of our taxable bond accounts.

As we've said before, the last few years have been tumultuous for both aggressive and conservative investors alike. Thankfully, we expect the path ahead to be a better one, with gains for both stocks and bonds that should fall in-line with their historical averages. Volatility will be a normal part of that process – but timing the market is a near impossibility, which is why it is important to stay invested and focus on the long term. Hopefully, we were able to illuminate why the economic environment before us might just be a bit better than many people predict.

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