ON THE RADAR

FAQs on the Markets and Economy

October 12, 2023

Will the strong September jobs report force the Fed to raise the funds rate at its November meeting?

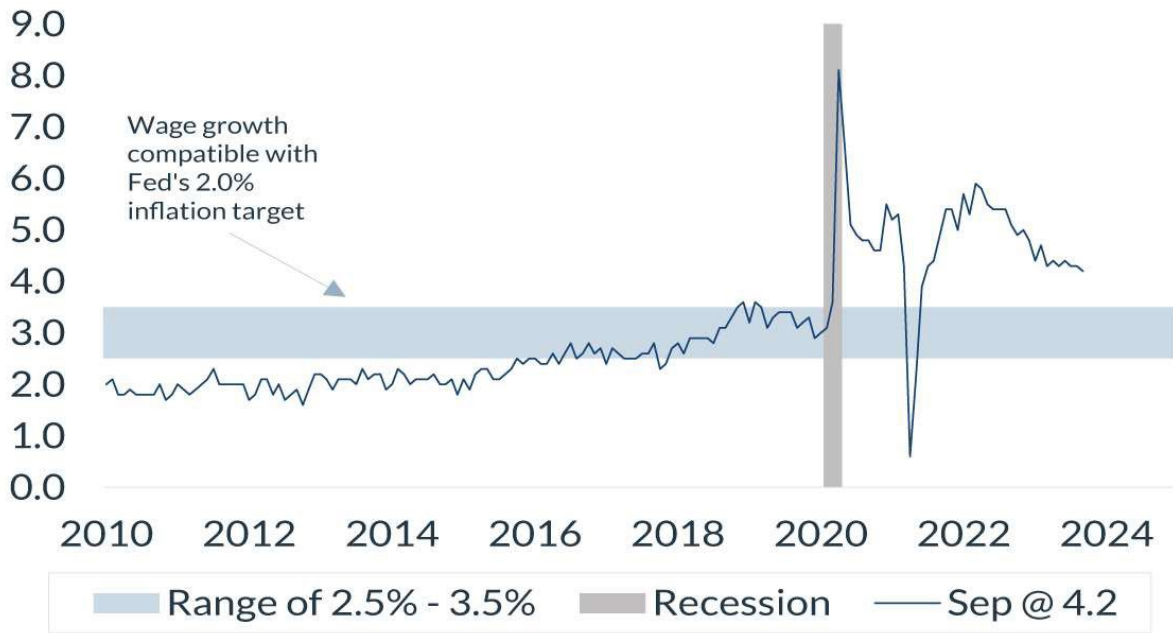
There was a blowout in the September jobs report, with nonfarm payrolls increasing by 336,000, about double the consensus of 170,000 and well above the previous three-month average gain of 150,000. Furthermore, the last two months were revised upward by 119,000, and the gains were broad-based. The unemployment report held steady at 3.8%.

But some of the underlying data wasn't as strong. Average hourly earnings increased just 0.2% for the month and are up 4.2% in the past year, the weakest pace over two years (chart). In the past three months, the annualized gain was just 3.5%, indicating that a further drop in the yearly rate will be coming. The annual rate is still too high for the Fed to get inflation near its 2% goal, but it continues to move in the right direction. As for the revisions in payrolls of the past two months, they came from the government sector, and private payrolls were revised down by 12,000.

This report does not alter our outlook that the Fed will not raise the federal funds rate in November. The Fed is focused on inflation, and the continued wage decline is the good news it seeks in the report. The monthly nonfarm payroll data is volatile every month, but the long-term trend is moderation: again, something the Fed wants to see. But the Fed is "data dependent," and they will be paying attention to several other vital reports including September's CPI report and the Employment Cost Index (ECI) that will be released at the end of the month.

Average Hourly Earnings

% change, y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics, as of September 2023

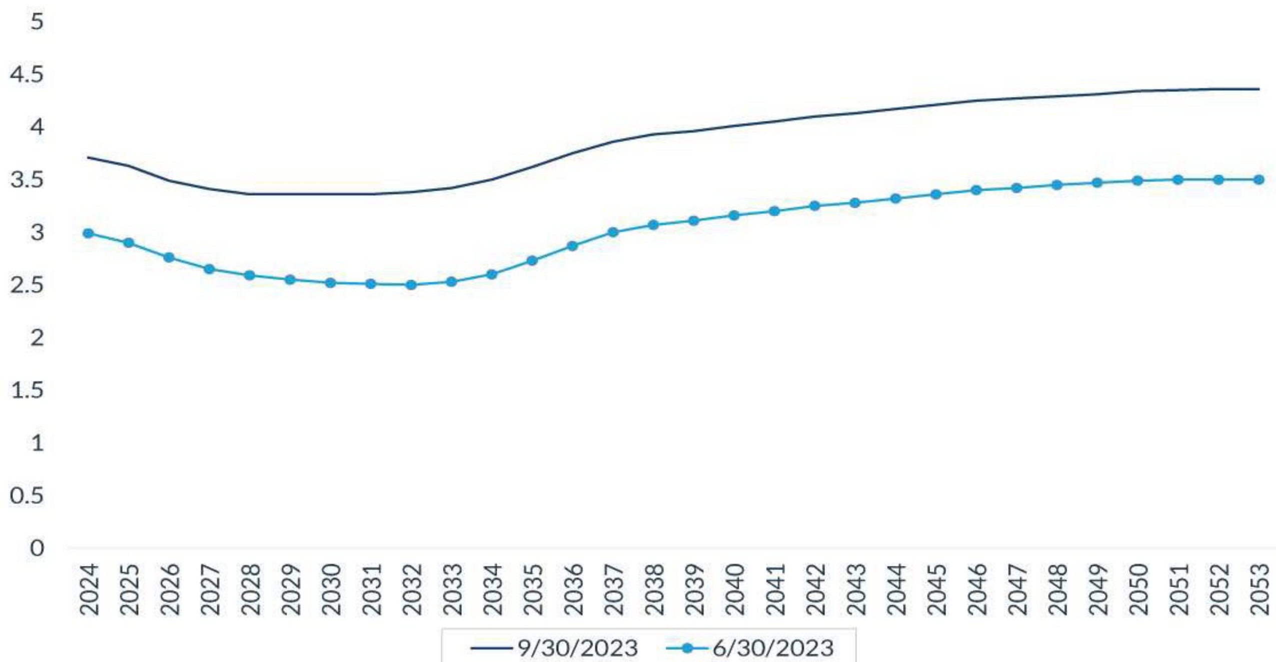
Information is subject to change and is not a guarantee of future results.

Are opportunities arising from recent municipal market dislocation?

Municipal bonds have recently been confronting a sharp rise in yields as Treasury prices declined amid a confluence of factors, including Fed policy, geopolitical events and mixed economic signals. For example, between August and September, 10- and 30-year AAA benchmark municipal bond yields increased by about 90 bps and 85 bps, respectively. The underperformance versus Treasury securities (i.e., municipal yields rose more than comparable Treasuries}, however, improved relative value ratios across key tenors of the curve, thus making municipal bonds more attractive. Favorably, absolute yields exceed levels not seen in at least 10 years, surpassing the October 2022 highs for the current rate cycle.

Despite sector credit spreads compressing since the beginning of the year, partly attributable to a more constructive fundamental backdrop, current municipal bond yields provide long-term investors with an opportunity to lock in robust levels of tax-efficient cash flows. For example, the Bloomberg Investment Grade and High Yield Municipal Indices' yield-to-worst (at the end of the third quarter) generated approximately 7.4% and 10.6% on a tax-adjusted basis, respectively. Given the Fed's expectations of relatively diluted prospects for a shift toward an easing bias, greater volatility is likely to occur. Potential catalysts could stoke demand for municipal bonds over the foreseeable future. These would include a return to a positively sloped yield curve and a sense of stability vis-a-vis a more straightforward policy narrative from the Fed. However, challenges could surface for municipal bonds in the near term, given a weakened technical environment (i.e., marginally negative net supply and bond fund outflows). Should municipal bonds experience intermittent price declines, these disruptions could represent an investment entry point. As the Fed approaches the end of its tightening cycle, the forward-looking performance of municipal bonds could reward investors based on historical experience.

3Q 2023 Municipal Yield Curve Change



Sources: Federal Reserve, Bloomberg as of September 30, 2023

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Tax-adjusted basis assumes 37% marginal + 3.8% Medicare Surcharge.

What is behind the recent decline in stock prices?

After a strong start to the year, equity markets have run up against a number of walls of worry since their summer peaks. The central concern for investors recently has been the sharp rise in interest rates, particularly for longer-term government bonds, with the benchmark 10-year Treasury hitting a 17-year high. Yields have been on the march because markets are increasingly taking the Federal Reserve at its word that it will keep its main interest rate higher for longer in order to drive down inflation. Stocks often struggle when bond yields are elevated, since it means investors can get higher returns on less risky assets. Higher yields also make borrowing more expensive for companies and households across the economy, which can hurt corporate profits.

The jump in interest rates also coincides with a long list of other emerging threats to the economy, from rising oil prices and a stronger dollar to the autoworkers strike to growing U.S. deficits and the potential for a government shutdown next month. Meanwhile, geopolitical risks continue to push higher with the recent attacks on Israel, adding to already elevated concerns over the ongoing war in Ukraine and continuing tensions between China and Taiwan.

The bad news from an investment perspective is that we suspect markets may remain volatile in the near term, prompted by some of these temporary uncertainties, as well as more structural challenges, like higher interest rates. The good news is that the pullback in stock prices is creating more attractive levels on a risk/reward basis to opportunistically begin raising equity exposure. The resiliency of U.S. economic data, along with an approaching end to the Fed's rate-hiking cycle, has increased our confidence that a more normal recession will now be avoided, and we are preparing to look past a mild recessionary valley ahead in anticipation of a recovery in corporate profit growth in the second half of 2024.

S&P 500 EPS Growth

2024 Estimates

Sources: FactSet as of September 2023.

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Will the Fed stick to its goal of 2% inflation or move it up to 3% to help avoid a recession?

"Two percent is and will remain our inflation target." That was Fed Chair Powell's key message at the Fed's annual economic symposium in Jackson Hole last month. He delivered that line with a very stern tone. Hopefully, it puts to bed the many conversations by politicians and some economists about raising the target inflation rate to 3%. The thesis behind the higher inflation target is that it requires the Fed to be less restrictive, allowing for a more robust pace of economic growth and keeping the unemployment rate low. It also reduces the risk of the Fed overtightening monetary policy and causing a recession.

There are several reasons why the Fed will not change its inflation rate away from 2%.

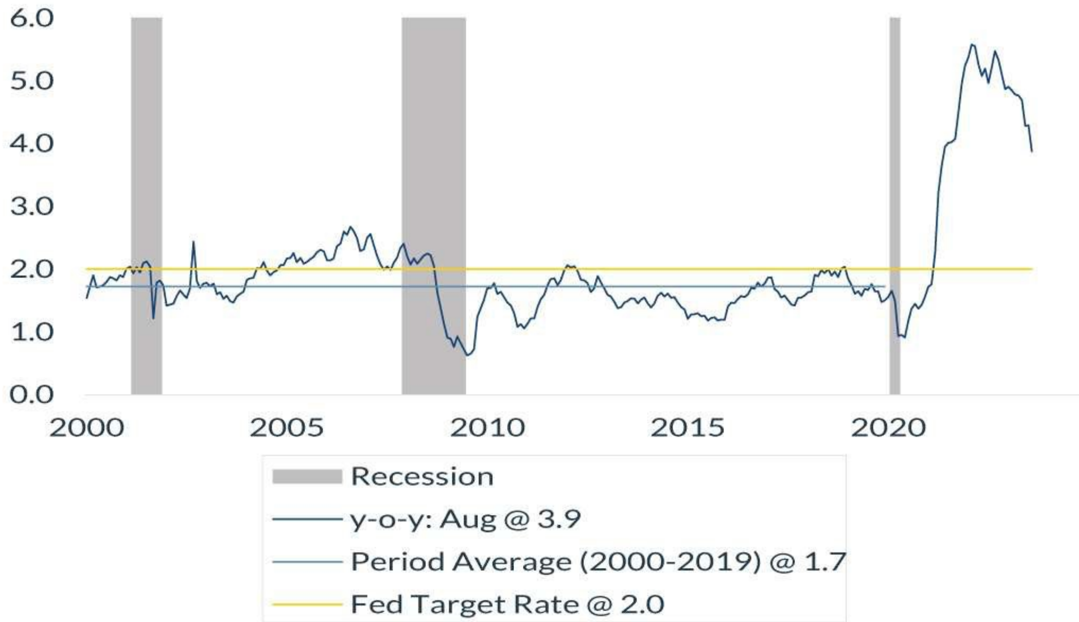
- For the Fed to maintain its hard-won high level of credibility, it cannot change the game's rules halfway through. Ever since Paul Volker broke the cycle of rising prices and wages in the late 1970s and 1980s, the Fed has enjoyed one of the highest levels of integrity of all the world's central banks.

- More importantly, the higher inflation will erode household purchasing power faster, severely reducing the quality of life for most Americans, since wage increases barely keep up. The higher inflation target would be inconsistent with the Fed's goal of broad-based economic growth.

• The 2% inflation rate is the target shared by most central banks worldwide to ground public expectations of an acceptable inflation rate. Interestingly, that rate didn't come from an academic study. Instead, it was an offhanded comment by someone at the Reserve Bank of New Zealand who casually mentioned the inflation rate should be around 2%. At the time, inflation was above 7% and had recently been above 10%. They thought 2% was a suitable rate, and it stuck. This was back in 1990, and other central banks have since jumped on the bandwagon. Under Ben Bernanke's leadership, the Fed officially adopted the 2% target in January 2012.

Inflation: PCE Core Price Index

%, seasonally adjusted



Source: Bureau of Economic Analysis, as of August 2023

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IMPORTANT INFORMATION

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Investment Grade Municipal Index: Bloomberg Municipal Index The Bloomberg Municipal Index measures the performance of the Bloomberg U.S. Municipal bond market, which covers the USD- denominated Long-Term tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

High Yield Municipal:A high yield municipal bond index is a benchmark that measures the performance of non-investment grade and non-rated, tax-exempt bonds issued by U.S. states and local governments.

Bloomberg BVALAAA Callable Curve: The Bloomberg BVALAAA Callable Curve is a standard market scale with non-call yields up to year 10 and callable yields thereafter. It assumes a normalized 5% coupon and is plotted as an offer side yield to worst.

DEFINITIONS

CPI: A consumer price index (CPI) is a price index; i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

PCE: The PCE represents the prices of goods and services purchased by consumers in the U.S. Since inflation is a measure of the trend in rising prices, PCE is an important metric in determining inflation.