# GW&K MARKET INSIGHTS

Transcript of 2Q23 conversation with Harold Kotler & Bill Sterling

GW&K INVESTMENT MANAGEMENT

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We invite you to listen to our quarterly conversation with Harold Kotler, Bill Sterling, and moderator Dan Fasciano, as they review events from the second quarter of 2023 and discuss:

- The S&P 500 is up by more than 18% so far in 2023. Are market participants looking past a possible recession? How might that play out over the rest of the year?
- Breakeven inflation rates are projecting that inflation will come down to under 2% over the next two years. Does this give the Fed permission to stop hiking?
- About $400 billion of relatively low-interest-rate commercial property debt will mature over the next year. How will the weak office space market affect this section of the market?
- China is on a healthy path to recovery post-pandemic. Is this enough to quell investor concerns?

We are available to answer your questions and address any concerns you may have so please do not hesitate to contact us.

## Edited transcript

**Dan Fasciano:** Welcome to the GW&K Investment Management Second Quarter Conference Call. My name is Dan Fasciano, Director of Private Wealth at GW&K. This call represents the views and opinions of GW&K Investment Management and does not constitute investment advice, nor should it be considered predictive of any future market performance.

Joining me on today's call is Harold Kotler, GW&K's Chairman and Chief Investment Officer, as well as Bill Sterling, our Global Strategist.

Harold, the S&P 500 is up by more than 18% in 2023. In your written quarterly review, you continue to strike a bullish tone. Could you walk us through some of the thinking behind that?

**Harold Kotler:** Sure. The concerns that drove this market down, i.e., interest rates trying to kill inflation over the last two years, is in the late innings and although there may be one or two more moves up on the short end, people are looking beyond that. The stock market obviously discounts the future and doesn't get hung up on the present, and they see that rates will have peaked. Long rates, I believe, already have peaked, and short rates will go up and then back down. How far down they'll go is anybody's guess, but the cycle has shifted. That's the important message, that we're on the other side of the cycle and therefore the stock market is going up. Earnings may not be coming through yet but in a year or two they will. If you're trying to understand the market and to time it, that's a fool's game, but you can look at trends and the trend is moving in the right direction.

**Dan Fasciano:** Bill, let's take Harold's point and steer it to the macro. As we enter the second half of the year, consensus is comfortable with the disinflation, soft landing, peak Fed story here in the US. What are your thoughts around growth, probability of recession, and inflation as we look towards the second half of the year?

**Bill Sterling:** I think there's still a good chance that the economy could contract a little in the second half. But the point is a little is something the market can look right through, as Harold just mentioned. And the consensus, for example, has third quarter GDP growth at zero and fourth quarter at -0.5% annualized, which is next to nothing, on a quarter-to-quarter basis. The inflation numbers have been coming down nicely enough, the latest CPI print for June was 3% year-on-year. The breakeven inflation rates have inflation coming to under 2% over the next two years.

With that kind of inflation progress being made, I think the view is, like Harold said, the Fed probably does one more rate hike, maybe two, but probably not two. We're probably looking at one and done with the Fed with its last rate hike of this cycle in late July and then maybe a modest weakening of the economy for a couple of quarters following that. But in the final rate hike of a cycle in the past, going back to the early 1980s, the S&P has been up 16% over the subsequent 12 months following that final rate hike. If we really are on the verge of one and done, with only a mild slowdown or very modest contraction in economic activity for a couple of quarters, that's an A+ from the Fed's point of view of achieving a soft landing, which the market is obviously looking forward to.

**Harold Kotler:** This reminds me of, if everybody is old enough to remember, Y2K. I mean if you remember 1999 and all the discussion that was occurring about Y2K — and nothing happened. If we have a recession, defined by two weak GDP quarters that are so minor, it will be like it didn't exist. I mean, people hear the word "recession," and what does that mean. Well, there are some deep recessions, it's not a depression, but it's a slowdown. But as Bill suggests, the slowdown could be so minor that it'd be almost nonexistent. But the word, people keep hanging on to that damn word and it impacts psychology.

**Dan Fasciano:** Well, let me take that point and turn it into something actionable. Harold, you know that clients will call and say, you know I can get 4.5% – 5% in a CD or some kind of money market instrument at the same time that muni yields are 2.75% – 3%. What advice are you going to give? And I'm thinking about what you just shared and what a recession might mean here.

**Harold Kotler:** I've tried to teach our clients over the last 50 years, third-grade math. Rate times time equals distance. You can get a nice rate, but how long will you have it for? If you only have it for six months, or a year, a year and a half, versus a lower rate that will be sustainable for 5 or 10 or 15 years, how can you compare the two? If you know that short rate is, by definition, short, then why wouldn't you extend? It's just like the housing industry — people are worried about mortgage rates. You can always remortgage. The home value you lock in, but the mortgage you can refinance. It's just looking beyond the obvious in the moment.

**Dan Fasciano:** Better to get 3% for 10 years than 5% for 6 months or a year. Alright, so you mentioned mortgages. Bill, I want to steer this back to you, because you recently authored a piece on the state of the commercial real estate market. And you didn't just stop there, you talked about some of the implications around that. Share with us your conclusions from that paper and what warning signs should investors be looking for?

**Bill Sterling:** Certainly, everybody knows if you've been to a US metro area since the pandemic, occupancy of office buildings in many downtown areas now is only back to 50%. The whole move towards online shopping means many stores are closed throughout many metro areas.

The commercial real estate sector is around 5% of GDP, but it punches above its weight in terms of a huge share of loans in the commercial banking system. Something like 25% of overall loans in the banking system are to commercial real estate. But for the small banks, who have about 70% of the commercial real estate lending exposure, close to half of their loan books are to commercial real estate. There's something like $400 billion of debt — relatively low-interest-rate commercial property debt — that matures over the next year. It's certainly possible that there could be a "credit event" with some real problems surfacing as lenders try to refinance at higher rates and with many lenders very wary, particularly the small banks, of taking on any more exposure, if not having an incentive to reduce their exposure.

I think the bottom line is that, while predicting credit events is very difficult in terms of the timing, this is indicative of the fact that the Fed did tighten monetary policy a lot. It hiked interest rates from 0 to 550 basis points in a little more than 12 months. One sign of tight monetary policy is money supply is down 4% year on year and credit is getting tighter for a big group of borrowers and commercial real estate is probably number one in the crosshairs.

If we do get any kind of strains that surface — headline events that make people nervous about small banks again — that would be an indication that rates have to come down sooner rather than later and maybe more than people expect, as Harold's been cautioning us. If you look at other cycles that is often the case: Rates, when they do start to decline, come down a lot. I'd be looking for whether there are any headline events or news events of companies and banks that are facing problems as these maturities and rollovers — I think in the next 2 years it's supposed to be $900 billion of debt that needs to be rolled over. If that becomes a problem, it is an indication that monetary policy is probably too tight.

**Dan Fasciano:** If I hear you properly, and I'm linking this to what I heard from Harold a couple of observations ago, we may be out of the woods from a macro standpoint but there will be pockets of weakness/softness within the US. Would that be a safe thing to say, Bill?

**Bill Sterling:** Yeah, and I think that's the history of every tightening cycle. Something breaks, and you know what could break in this cycle is commercial real estate because it's facing these structural problems in the wake of the pandemic as well as very tight monetary policy.

**Harold Kotler:** Also, you have to be careful when you say "commercial real estate," because apartment-housing rents have held up really well because of the inability to have enough housing stock for young people. And, a lot of stuff is being repurposed in very creative ways.

**Bill Sterling:** That's a really good point Harold. I think it's the office space in particular that is the most vulnerable. The Fed cutting rates in response to that, if that happens and if it's one of the reasons they cut rates, actually helps those other sectors recover more quickly.

Dan Fasciano:** Harold, let me keep going with you on the investment landscape. I have the luxury of sitting right next to you here in the office and I see our investment leaders walking in and out throughout the day. As you contemplate where the opportunities are, and you talk with our various investment leaders within the firm, what are you most intrigued by right now? Where do you see the opportunities — particularly for our longer-term investors?

**Harold Kotler:** You know, we just had the investment meeting this morning and I can't help but be totally struck by the idea that the good companies in the US seem to be fully valued, not overvalued but fully valued. And the good companies in the Asian countries are undervalued. Of course, everybody has all the reasons why — you can list them. But if I was George Soros, or if I was 20 years younger, I would go all in and make the swap from the West to the East. It feels so compelling. But of course, no one will agree to that. They'll talk about politics and all the reasons not to do it. Having said that, it's a discipline that you can't always be comfortable where you invest. Good investing is entrepreneurship and looking beyond the obvious. Don't look at today's numbers. If you're looking at today's numbers, you're looking in the rearview mirror.

Small caps have way underperformed large caps, equity dividends have outperformed bonds but underperformed large caps. There's plenty of places in our universe to invest that have yet to hit their total stride. And maybe the ones that are doing well will continue to do well. They have the money, the capital, and the wherewithal to continue pushing on the envelope.

It's a very strange time. I think it's incredibly exciting. I love this business.

**Dan Fasciano:** Harold, trust me, we're all glad you are Harold Kotler and nobody else!

Bill, China does continue to confound strategists and investors. Second-quarter GDP reported earlier this week missed expectations. One thing is clear: any near-term growth surges in response to lifting Covid restrictions failed to live up to the hype. So zoom out for us a little bit here and share your thoughts around China's growth or lack of growth, as we look towards next year.

**Bill Sterling:** You're right that the second quarter GDP numbers were a little disappointing. Retail sales in June, for example, were up only 3% year on year, which is anemic by Chinese standards. They're still growing, however, and there's very little concern about an outright recession in China. We just heard from Pablo Salas, one of our emerging market experts, who thinks that maybe China's growth in the next few years is a 4% type of number, which compared to the 8% numbers we'd become accustomed to, could be viewed as disappointing. But by any kind of global standards, that would be a very healthy trajectory for China to get back onto in coming years. That gets to Harold's observation that this is a very cheap market at this point and expectations have become very low.

The one wild card for China is the property market, which was starting to recover earlier this year, but did take another downturn in recent months. That creates financing problems for local Chinese governments that have historically depended on land sales to finance a lot of their activities. There's a lot of focus, really, on whether the Central Chinese government, which has a pretty clean balance sheet, will come up with projects to stimulate consumption and take some of the pressure off those local governments that are still struggling with the real estate issue. But longer term, I think the potential for China to grow 4% plus for quite a few years is there, and expectations, as Harold indicated, are pretty much rock bottom.

**Dan Fasciano:** Well Harold and Bill, I want to thank you both as always for sharing your thoughts with me and for those listening in. Should anyone listening in have any follow-up questions, please feel free to get in touch with your GW&K contact person. And to our listeners, and to Bill and to Harold, have a safe and pleasant rest of your summer. We all look forward to connecting again soon in a few months. Thank you.

## Disclosure