November 3, 2023

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

- How the Israel-Hamas war may affect markets
- What the current rate environment means for investors, including the outlook for consumption and residential housing amid high rates
- The narrowness of the US equity market, and where investors may find value in 2024

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 third quarter GW&K Investment Management client call. This is Dan Fasciano, director of private wealth at GW&K. Joining me as always, is our Chairman and Chief Investment Officer, Harold Kotler, as well as Bill Sterling, our firm's Global Strategist.

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Harold, I'll start with you. Obviously, Israel is on people's minds. When you think about the conflict and its potential for regional expansion, what advice would you share with clients?

Harold Kotler: I need to first make a comment. I thought about this, I knew Dan was going to ask me this question, and without being political, I needed to figure out a clear answer. Hamas is engaged in the elimination of the state of Israel since its inception, it's in its charter. There's been many incursions but this last one is a full-scale war. During war, unfortunately, innocent people are killed, whether it be Hiroshima, Nagasaki, Pearl Harbor, or Afghanistan, Iraq, Vietnam, etc. It is a war and Israel will not stop until they eliminate Hamas. I promise you that. And whatever repercussions they're about to have to absorb from world attitude and psychology, they will, they will not stop. And as a result, I'm sure many of the Arab governments will go on the line and say they want to disrupt their relationships with Israel. They have to keep the streets quiet. I really understand why they need to do this. Whether it's Egypt or Jordan, or any of the Emirates. So that's the reality of it. And as it relates to the antisemitism, most of us realize that it's alive and well, and just now obnoxiously on the top of everybody's minds.

So what does it mean? It means more stress in the system. More separation between people, and a very disjointed world that we're living in. And I think it really has significance on our recovery and the economy as we go into this election year.

Dan Fasciano: You touched on a number of obviously emotional and political and global topics there. Bill, we can't model exogenous events. You are the firm's global strategist. When you look at

geopolitical tensions or other events like that — we understand they're difficult to model — are there scenarios that you're seeing that have larger financial or economic ramifications? And as you move forward, is there anything that you can monitor or see that would affect your thinking, going into 2024?

Bill Sterling: Sure. Well, you know, I think, as Harold alluded to Dan, there's always a risk of the war widening, and for financial markets that would probably end up focusing people on what it meant for oil prices. It's pretty remarkable when you think about it, that we're still trading at the mid $80 level on Brent Crude Oil, which is up only $2 from before the brutal attack and I think that indicates that the markets are fairly confident that this will be contained to a war on Gaza without broader global macro implications. Now, that could be wrong, of course, and there was some buying of call options on oil prices for people trying to protect themselves against the risk of a big spike if, say, Iran was to become fully engaged in the war directly. It's obviously behind the scenes, very engaged indirectly. But I think the markets are really having to grapple with, what does it mean for oil prices? Because if we look at other Middle East crises in the past, they've been associated with big macro shocks to the US and to the developed world, it's always been due to a spike in oil prices. In 1973, I think they tripled after the Yom Kippur War. But that so far that doesn't seem to be expected. There's even some speculation that the Saudis may increase output to put downward pressure on oil prices in some sense to punish Iran, because they know they've been the big spoiler in this whole event. But monitoring oil prices, I think, will be pretty critical in thinking about the overall effect. And actually, gasoline prices have been coming down over the last six weeks in the US. So far, I think the markets are viewing this as something that will be contained without a big macro impact on the US economy.

Harold Kotler: I think it's very important that people realize that the tension between Iran and Saudi Arabia is serious. It's two different worlds. and although Saudi Arabia won't come out and support Israel's position, I think they were very much looking forward to having some diplomatic relationship with Israel, knowing full well that the oil and gas industry in 20 or 30 years will disappear. And they need Israeli intelligence and technology to develop their economy. He understands that. And in the long run, that's what's going to happen. So I think you're right. I think Saudi Arabia, in its own way, will keep from exasperating the problem.

Dan Fasciano: That's great perspective and context from the two of you. Harold, I don't know if I can make an elegant pivot, but I want to bring it domestically for a moment if I could. I certainly don't want to cut the conversation off short. But the Fed recently met, and for a second time in a row they kept rates steady. So if we were to use the 10-year Treasury as a proxy for rates, it's now north of 4.75%. That's a percentage point higher than where it was when we started the year. And it's 4% higher than it was 3 years ago. When you talk to clients, given that, what are you telling them to do?

Harold Kotler: I'm telling them this is the last opportunity lock in long-term rates at these high levels. In some period of time — and you know I think it's ridiculous to try to forecast three months, six months, nine months, a year — long rates will peak, if they haven't already. And they hit 5, and now they're below 5, and people are getting caught in being solicitous by their short-term interest rates. I've taught my people over my 50 years that rate times time equals distance.

You can get 5% for one day but how does that compare to 5% for 10 years, and it's so easy to get caught in thinking that you're investing in a money market of 5%. But that's not investing. It's speculating. It's all right to keep some money there. But to invest? That is not investing.

Dan Fasciano: You've been pretty consistent with that, and I think at some point we're going to hit everybody, and they're all going to listen. So I appreciate you saying it again.

You know, Bill, I want to stay on the rate topic with you, but I want to steer your attention in a slightly different direction. Two areas where higher rates seemingly haven't had a bite are consumption and residential housing. When you think about both, are we missing anything? And what are you looking for in either those sectors or to the larger macroeconomic environment when we go into 2024?

Bill Sterling: I think the strength in consumption has surprised pretty much everyone this year. The third quarter GDP numbers just came out, and it was up running at a 4% annual rate. I think it's largely been supported by the tight labor market. But there are numerous signs, we think, that the labor market will cool in coming months and quarters, and that will probably dampen consumption. Consumption's also going to be challenged by the sharp rise in debt-servicing costs outside of mortgages. And what's interesting about mortgages is because so many people took advantage of the low rates of the last few years. They locked in low-rate mortgages. The average outstanding mortgage rate is something like 3.5%, even at a time when the new mortgage rates are approaching 8%. So that's kind of frozen the housing market had a counter intuitive effect on home building because people aren't willing to sell their existing home because they'd have to abandon their low-rate mortgage and as a result, the supply of housing has been restricted, which has kept housing prices up, and home builders have stepped into that frozen market to say, "Well, we can supply homes, and we can also offer concessionary rates on financing." So that sector, surprisingly, was up in the third quarter as well — residential housing, particularly single-family housing. But that sector probably will face challenges as these new and higher mortgage rates continue. And I think, if the Fed is truly committed to this higher-for-longer scenario, then it would almost necessarily dampen the residential housing sector going forward.

But much depends on you know, as Harold says, you often in these periods of inverted yield curves and Fed tightening, that the Fed has to turn on a dime, and rates start coming down. So that's what we're going to be monitoring carefully.

Harold Kotler: You know, if you think about the homeowner with this low mortgage, and now his cash is earning 5%. It's a double positive impact for consumption. It's really a windfall. Never mind the amount of money that was distributed from the federal government. So there is a window that is very unique, and I agree with you completely: No one's going to walk away from a 2.5% mortgage, not willingly, at least. So there's an economic windfall to that, but I think it has its own short-term phenomena and sooner or later reality sets in, and the savings dissipate and loans increase — credit cards and everything else — and there will be some pressure on the consumer.

Dan Fasciano: I'm just starting to see those savings that were accumulated during the pandemic start to get depleted. You're saying it's a temporary event, and it seems to be playing out that way.

Harold Kotler: In my last quarterly letter, I compared Covid to World War II, in that it was a total anomaly of events. I know it's hard to compare the two, but it changed the playing field dramatically, and it took time for it to balance out. And after World War II, it took 7 or 8 years. Now, we're only 2 – 3 years into this evaluation, but it will find its way to some normal behavior.

Dan Fasciano: Harold, I'm going to stay on a topic here that Bill raised, and that is debt servicing. We're hearing more and more about the federal debt and deficit recently. What's your take? When you think about what the implications might be for investors over the next several years, do you draw any conclusions?

Harold Kotler: I think it's very important. Well, the level of debt is not important. While everybody was refinancing their homes at 2%, the federal government, foolishly, didn't lock in long-term debt at the same time, and they kept their duration short. So they're going to get hit continually with higher and higher interest rates, and that debt-service coverage is a big deal that takes away discretionary spending. It puts pressure on the budget. It means you have to borrow more to meet the demands of society, and it exasperates. Just like anybody else who is in debt and can't pay the interest, and they borrow to pay the interest, and next thing you know, they're bankrupt. The US government may not go bankrupt, but it will certainly impact how their budget is forthcoming, and which services will be provided. I think it's a very big deal.

Dan Fasciano: It's certainly something to keep an eye on, particularly with quarterly refunding right around the corner here, and beyond.

I'm going to step off of rates for a bit. I have one question that I want to ask both of you. Bill, I'll ask you first, and I'll let Harold get the final word in. The market's been pretty narrow for some time, but particularly so this year. You've done some interesting work on that, Bill. What do you make of the narrowness on the US equity side? And I want to use that question, Bill, to kind of expand out to include: And where do you see value going into next year?

Bill Sterling: Well, Dan, you know it has been extraordinary how concentrated the gains in the US equity market have been. At the end of October, the S&P was up almost 10% for the year. But if you take out the top 10 mega cap stocks, those accounted for 96% of the gains of the market. The equally weighted S&P, which includes the vast majority of stocks, was down something like 4%. So that's just an indication that things have been extraordinarily narrow. And now, of course, why are those top stocks up so much? The so-called magnificent 7: Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla. The AI stocks were up almost 90% through mid-October for the year to date. And probably for a good reason. We've never invented anything as fundamental as AI before historically, so there is some legitimate fundamental story there of why this is such an extraordinary situation. But the key thing when we look at what this means for valuations is, because the market has been so narrow and those leading stocks are trading at something like 45 times earnings, the rest of the market, the equally weighted S&P, is only trading around 15 times earnings. The Small Cap Russell 2000 Index, when you focus on the profitable firms in that index, is trading at around 12 times. The international markets are trading 12 to 13 times earnings. So equity markets are really overall, very, very fairly valued here, and if the Fed eases over the next

year, which seems pretty likely, those sectors that have lagged could be the ones that lead coming out of this.

Dan Fasciano: Helpful context there. Harold, similar question for you, I mean one of the benefits I've mentioned on past calls sitting next to your office is seeing the stream of investment people walk in and out throughout the day. You also chair the investment policy meeting. When you think about next year, and all the conversations and thoughts you're having, what most intrigues or interests you?

Harold Kotler: Well, it's very interesting, because I agree with exactly what Bill said about the market. We had a conversation with one of our young portfolio managers who said she's having lots of conversations about those top seven stocks, and what should she say, since we own a couple of them but not all seven? I said to her, and this is important: If any individual wants to participate in those six or seven stocks, they should do it with some of their money. But those valuations are very high, and we, as an institution and a fiduciary, are not going to pile into those stocks at these values. Just like cash, there's nothing wrong with owning some cash at 5%. There's nothing wrong with owning Tesla and Nvidia, and Microsoft, or any one of these stocks on your own. But as diversification is still the key to success, and we don't know whether this is 2000, or if these companies with great cash flow will be the leaders in AI — which they may be. I can't deny that. The cash flow of these companies are in the billions. So there is that out there: It's not companies that aren't worth their valuation. It's just how expensive is expensive? I would give permission to everybody to participate with their own money. But you come to us for a diversified portfolio that keeps you intact, whole, and safe. And we're not going to chase. That's not who we are. We're disciplined.

Dan Fasciano: Gentlemen, I want to thank both of you for sharing your thoughts with all of us. I never exactly know where the call is going to go, but I always get a lot out of them. I appreciate that, and I hope others do as well. For everyone listening in, many thanks for your time. Please have a safe and happy holiday season, and the three of us will be back next quarter. Thank you.

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