GW&K MARKET INSIGHTS

Transcript of 3Q22 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 discuss:

- The market correction we saw in 2022 and how that positions us for 2023
- Near and intermediate-term inflation-rate trends
- Pricing pressure globally — including in the energy market
- How China's Covid reopening might affect the global economy
- How a split Congress could affect the economy and markets

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 Fourth Quarter Conference Call for GW&K Investment Management. 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.

My name is Dan Fasciano, and I'm a Director of Wealth Management here at GW&K. Joining me on today's call is Harold Kotler, GW&K's Chairman and Chief Investment Officer, as well as Bill Sterling, the firm's Global Strategist.

Harold, I'd like to start with you. We've closed the books on 2022 — some might say thankfully. Any thoughts as we make our way into the new year?

Harold Kotler: 2022 was an action that needed to happen. There's no way that we could continue with zero interest rates, and so we had a retrofit. Interest rates have risen, and the stock market is going down. And I think it sets up a wonderful time for this year and many years in the future, because things are much more in balance. And I think that's what we should take out of 2022: It was a needed correction, a healthy correction — as most often they are — and we can reassess what values should be as we go forward.

Dan Fasciano: That's great, thank you. Bill, while year-over-year inflation is elevated, the past three months we've seen some prices start to trend lower, and this month we finally saw better-than-expected wage-inflation data. What's your thinking on inflation, or any components of it, and what are the trends suggesting to you?

Bill Sterling: I think the recent trends do suggest that we're on a glide path to get inflation back down to the Fed's 2% target, probably by early next year or so. I like to look at a three-month annualized rate of change of prices. The headline rate, thanks to energy, was actually below 2% — it's been running 1.8% over the last three months. But the Fed is much more likely to focus on so-called core inflation, excluding food and energy, because that's probably a better view of the underlying trend, and that was running 3.1%. Much better than before, but still higher than the Fed would like to see.

If you split that out between goods and services inflation, goods inflation actually had deflation at a 4.8% annual rate over the last three months as firms work through their excess inventories and so on. We've seen kind of a mini-manufacturing recession develop, which is evident on the goods side. But the services side was still running at a 6.1% rate, and services is close to 60% of the overall CPI. So that's where the Fed's concern is, especially because that is very closely correlated with what's happening with wages. The average hour's earnings decelerated in the last three months versus the previous three months to 4.1%. The Fed probably wants to see that number closer to 3%. But other measures, like the Atlanta Fed's Median Wage Survey is still north of 6%. So the labor market is a big focus at this point. But the overall trends are pretty encouraging.

Dan Fasciano: Well, that's encouraging to hear. Do you have any commentary globally on price pressure?

Bill Sterling: Europe has lagged a little behind because they had a much bigger energy shock due to the Ukraine war, and they're still running 9% year-on-year headline inflation rates and 5% or so core inflation. But natural gas prices have come down 80% since last August, so that's going to show up in the numbers within the next six months or so. And most European economists think that with the slowdown in Europe and tighter monetary policy still in play in Europe, that they're likely to get down to the 2% range by early next year as well. And in China, it's a non-issue. Core inflation in China is running seven-tenths of a percent year on year, due to the weak Chinese economy. Although, that's about to change with the Covid reopening.

Dan Fasciano: Great. I'm going to touch on the Covid reopening in a few minutes, so hold that thought. Harold, let me steer it back to you and the Federal Reserve. It continued its campaign of pushing the federal funds rate higher right until the end of the year, right until the December meeting, and our expectations are that this continues at least into the beginning of 2023. Longer rates, however, as we all know, have been declining. Since the October 24 high, the 10-year Treasury has gone from 4.25% down to 3.5% a little more recently. When you think about intermediate and longer-term rates, where do you think they are heading from here, and when you look out 2 – 3 years, where do you see rates generally?

Harold Kotler: That's an interesting question. It was expected that long rates would come down as short rates rise. That's something I've been preaching my whole career, that people don't always grasp. But the higher short rates were going, shorter-term inflation would last because long rates needed to discount the future of inflation. And it was going to come down, sooner or later. It moved very quickly and I'm kind of disappointed because the opportunity to buy cheap bonds really has already, for the most part, passed. The fact that it's moved from 4.25% to 3.5% takes a lot of the opportunity out of the market.

When you look out 2 – 3 years, given what Bill just said, I suspect that long rates may trend lower, marginally but not significantly. If inflation gets to 2% – 3%, 2.5% on the long end discounts 2% – 2.5% inflation. So one could argue that the big rally that we're hoping for in the bond market has already happened. We'll collect the coupon and still have decent cash flow, but this market discounts so quickly that I think you have to be prepared and not wait for the event to occur to take advantage of trends. I think the bond market has demonstrated that once again.

Dan Fasciano: That's interesting, and good context, both near term and longer term. Bill, you just finished that last question with some quick observations about China and price pressures, and you said the Covid word. Let me push you a little bit harder on that one. China lifted their zero-Covid policy. It had been a real drag both domestically and globally for a number of reasons. Now that restrictions are being lifted, what are you thinking? What should we be on the lookout for, and more broadly, globally, what should we be thinking about?

Bill Sterling: China just reported their GDP recently and it was the second lowest since the 1970s — 3% for China is a very sluggish number; they typically do 5 or 6%. They pretty much abandoned, took a 180-degree turn on, their zero-Covid policy, starting in late November. It's now late January, so they're 2 months into that. It looks to us, talking to our emerging markets specialists, that they've had a massive wave of infections already — maybe 80% of the population has been infected, and they're well on their way to herd immunity. It looks like the end of this exit-wave of Covid could be over as soon as next month in February, which could set the stage for what analysts call revenge spending — people going back to normal spending, as we've seen in many other countries. So we could see a big rebound, starting as early as March, but certainly gaining momentum in the second, third, fourth quarter. And there's a massive amount of excess savings sitting on the sidelines in China. We just saw an estimate for about a trillion dollars, or 5% of GDP, which could get deployed as people are more able to go about their normal everyday activities.

This is good news for US corporations that export to China. But there is some concern that people are going to have to watch the energy space very carefully, because a Chinese recovery in travel — particularly in big, international flights — could push up the demand for jet fuel, and you could see the energy market tighten a bit after the very loose conditions we've seen.

Dan Fasciano: Again, kind of setting us up for an interesting 2023 and things to watch. Harold, if we work under the assumption that the Fed does get a handle on inflation generally here in the US and they slow down their hikes at some point during the year, do you think they will have successfully guided us to a soft landing? What's your thinking around a possible recession?

Harold Kotler: You know, Dan, I hate the word recession because it implies various events. The definition of recession is two GDPs in a row being in decline — it could be very minimal declines. It's very possible we'll have a soft landing with a slight recession. I think in the end we will look back and think the Fed did a decent job. Yes they were late, and they could have done things a bit differently, but everybody can second guess. The truth is, inflation is coming down and the economy still has a lot of strength to it. We'll ride it through — I don't think that should discourage people.

Bill suggested the recovery in China is moving quickly, and I suggested the bond market moved quickly. I also think that the stock market can move quickly. I think we are in a period where events really can magnify what happens and we shouldn't wait for the event to occur. We really have to anticipate. I think it's very important to assume that yes, the economy will slow down, inflation will come down, we'll get things more under control, and yes, we may still see short-term interest rates rising this year. But I also think the stock market will celebrate and have quite a decent year in 2023.

Dan Fasciano: Listening to the conversation here, I'm hearing the macroeconomic trends as well as how the market reacts to them along various dimensions. Bill, I want to take that theme and steer it to my next question for you. In about the middle of last year or so, we began to see earnings forecasts for 2023 get revised lower. And now we're starting to see the first wave of earnings season and those forecasts are manifesting. What are you expecting out of, call it S&P earnings, broadly, and do you think they'll be surprises in the year?

Bill Sterling: If you punch up the analysts' databases, the analysts themselves are forecasting something like an 8% increase this year and a 10% increase next year. So it's definitely a soft landing in the analysts' consensus. But every year the trend is the same: these numbers start out strong in the beginning of the year, and they call it an EPS progression — some people call them earnings' squiggles — they trend down. If you adjust for that normal trend, we're probably looking at something more like 3% – 5% as a consensus for fairly soft earnings this year.

In the event of a recession, and nobody knows if that's going to occur or not — flip a coin — it could be down as much as 10% or so, that's what people on the Street are trying to handicap here. So that said, if the Fed starts cutting rates in the second half of the year, which looks highly likely if the economy is this slow, then you set the stage for a better 2024. The market is often so forward looking, even if this year's earnings are a little disappointing, if the bond market is well behaved, you could get some equity market support from rising P/E multiples.

Dan Fasciano: It's interesting to think about the way things might play out when listening to you talk it through that way. That's helpful. Let's stay on you for a moment — I'm not going to let you off the hook here. You mentioned earlier just about energy costs and where they were in August, and now we're in the heating season, and you mentioned Europe. Clearly coming into the winter season there was grave concern for what the heating season would be like, particularly in Europe. It's been a fairly mild winter so far here in the Northeastern US. What's going on in Europe as it relates to energy costs — what's your thinking on inflation there?

Bill Sterling: Well, Europe has really benefitted from a warm winter so far. As I mentioned, the natural gas price is down 80% from the peak last August. That's partly due to conservation efforts — they've filled up storage tanks and they had warmer than expected weather. Going much lower from here may be difficult because Europe only gets about 20% of their energy from the storage tanks. They still depend on the flow, and the flow is down because of Russia, and it will be down for quite a while. So the energy prices may stay elevated, or if they get a cold snap, we could see some upward movement.

The other wild card for energy is China reopening, as I said earlier. That could have a significant effect on jet fuel demand, in particular. We think the worst is over from that massive energy shock in Europe, and we're now seeing a lot of European economists who were expecting a recession this year actually back away from that recession forecast. Not only are the energy prices coming down, but the Europeans have put pretty significant fiscal stimulus in place to help people deal with the crisis.

Dan Fasciano: That's helpful, great context. Alright Harold, I'm going to see if you can get us out of this one, and I'm not going to go easy on you here. The Republicans took back the house during the midterm election. Do you think there's going to be any meaningful policy coming out of Washington? And a little bit more real-time, are you concerned about the debt-ceiling discussions? Do you think that sets us up for any future volatility during the first quarter of the year?

Harold Kotler: I think the stock market always like a split Congress. It means less, not more, policy, which definitely will be the case. I'm sure some things will be passed, but dramatic changes in the fluidity of money availability and deficit spending will be curtailed — there's no question about that. The debt ceiling is just going to be jargon. Sooner or later they'll figure it out. I just can't get bogged down in the politics of Washington. Part of it is that it's just very upsetting, part of it is that in the world that we live in, this country and many other countries seem to be going through very difficult periods of policies from different extremes and really no middle ground. But, the private sector doesn't get bogged down in the public sector.

Capitalism has a way of flexing its muscles and moving forward independent of governments. From time to time, they impact or influence rates, as we saw last year, but that is temporary. I think people should watch the Madoff movie — not so much for the Madoff story, because everybody knows that story — but because you can see the cycles that have happened since the '60s, and you realize that, as the communists always say, capitalism always has these cycles. It gets overheated, it gets corrected, and then we start again. It seems like every 6 or 7 years, if one thinks about the last 40 – 50 years, every 6 or 7 years, we do this. And so this is the cycle we've been through. It will end in 6 months or a year, or it's already ended, and then we'll go on for another five, six, or seven years, and something else will come up. That's the history of capitalism and the markets.

Governments come and go, but capitalism is alive and well. I think it's very important for investors — and I know, you have emotions, and you get bogged down, and you have your positions, and that's all well and good — but the market has a history of its own energy, and it's a capital market of the world, and it will find its way, always, to better places.

Dan Fasciano: Sage words to get us started in 2023. Harold and Bill, I want to thank you, both for sharing your thoughts with us today. I want to thank everyone for listening this quarter. This will conclude our call. If you have any questions, please do reach out. Thank you.

Disclosure