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We invite you to listen to this dynamic conversation with Harold Kotler, Bill Sterling, and moderator Dan Fasciano as they review events from quarterly call and discuss market sentiment and portfolio positioning, the macro outlook for growth and inflation, and key themes in rates, credit, and the AI-led investment cycle.

Edited transcript

Dan: Welcome to the Quarterly Client 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.

To our friends listening in, I hope you're enjoying your fall season. My name is Dan Fasciano, Director of Private Wealth. Joining me on today's call is Harold Kotler, the firm's Founder-Chairman and Chief Investment Officer, as well as Bill Sterling, our Global Strategist.

Harold, I'll start with you. In your [quarterly letter](#) you describe two different plays unfolding simultaneously. On one hand, we have persistent inflation and geopolitical conflict in the midterm elections. On the other, we have an economy in growth mode, strong corporate earnings, and the extraordinarily potential of AI. How do you reconcile these two competing narratives and what should long-term investors be focusing on?

Harold: I'm not going to reconcile the two. I don't need to reconcile the two. I don't think they can be reconciled. The two plays are running independent of each other and they will play themselves out. There is an economy that is the old economy and there's a new economy. And I think it's very important that we recognize that it's neither/or, it's both, but we have to be focused on how we deal with the investment environment that considers both areas and how we make our investments relevant to the times. And I'm not reconciling the two. They're going to stay that way probably for the foreseeable future.

Dan: Well, let me press on that a little bit, then. You've said that a lot of the challenges we're facing today are going to be temporary. What gives you the confidence to say that?

Harold: Well, first of all, the world is going to change. And we have two wars going on that won't continue indefinitely, obviously. And as those find their way to some solution, there will be major changes in the price of oil and inflation and attitudes and behavior patterns. So, we're in a little

window of an old economy to be struggling big time. And that will that will ease. But that doesn't mean the new economy won't continue to grow.

Dan: Bill, Harold just said the world's constantly changing. Around this time last year, markets were pricing in about 100% probability of rate cuts. Fast forward 12 months to now, and here we are talking about tightening rather than easing. And this whole time the economy has really remained remarkably resilient. As you look towards 2027, to what extent do you view today's inflation pressures as temporary, and how much of that relates to energy prices, rather than something, say, more structural?

Bill: Well, Dan, I don't have any great crystal ball to tell me how long the conflict with Iran is going to last, but I do think the energy shock to inflation, as Harold just mentioned, is likely to prove temporary rather than structural. So, for what it's worth, you know, both futures markets and energy analysts do expect crude oil prices to decline pretty substantially over the next couple of years as some kind of resolution to the Iran situation is worked out.

But that said, we have other issues boosting inflation, such as tariff hikes and the AI data center boom. So, the Fed can't just sit back and ignore that issue, which is why most members of the FOMC seem to support at least a modest upward adjustment in interest rates as some kind of insurance against the higher inflation dynamic becoming more persistent and becoming structural. The Fed got burned in 2022 by calling inflation transitory. So, I think for them it's a case of once burned, twice shy.

Dan: So, we're talking about energy, and you also mentioned infrastructure — as we head towards the end of the year, and I suppose with the Fed and in the back of our minds here, are there any economic releases or indicators that you're monitoring a little more closely to think about growth and inflation into next year?

Bill: Well, I think one very encouraging indicator is that unit labor costs are not an issue. They've risen only by about 1% in the first half of the year. So although the unemployment rate at 4.2% is historically low, the labor market is nowhere close to overheating. Wage gains have been moderate. Productivity growth has also been strong so that means the Fed is not in any kind of position of having to create a recession to slow labor cost inflation, and puts it in a position to only make modest adjustments to interest rates while it waits to see if the energy price shock proves to be temporary.

Dan: Well, Harold, we're on the inflation topic here and when I was reading through your quarterly letter, one of the observations that jumped off the page to me was your enthusiasm for bonds at today's levels and you were kind enough to talk about periods when investors passed up attractive interest rates because they were convinced rates were going to go even higher. Are there lessons from those prior periods that we should be applying today, and particularly when it comes to balancing fears of further

rate increases, like Bill and I were just talking about or, or I suppose, kind of juxtaposed against the ability to lock in attractive yields.

Harold: Well, having been in the business as long as we have, we know we can't be exact in our estimates. The important point in all of this is to understand the opportunity. So, when interest rates rise to this degree, yes, they may go higher, but whether they go higher or not, it's a very compelling level of return and competes with the stock market, and for the first time, I think in 20 years, I'm enthusiastic about bonds. It doesn't mean vis a vis stocks, it just means that for those who need cash flow, a good income, and will the rates go higher? And will you get higher rates in six months or a year? Maybe. Maybe not. Is it important? Not so much. The point is, you lock things in. You refer to those years when people refuse to buy because they knew rates were going to continue to go up and up and up and up and up. And of course, that doesn't happen. And of course, sooner or later, they come down again. So you can't be too cute.

On the other hand, you have to be open to the opportunity and see it. And not try to catch the high or the low, however you think about it, and start migrating into the bond market. All I'm saying is it's a valid place for capital.

Dan: Well, it's important context. Although inside of your answer two times I think you mentioned, vis a vis stocks or where equities are. How much of where equities are today gets into your mind when you take a look at the level of rates? I think you might have even said, well, it's an attractive return, all things considered. Do equities factor into your thinking when you look at rates right now or do you just know, in an absolute sense, I like where yields are.

Harold: I think the latter. I think in the absolute sense, it's an attractive return. If you can get 4%, 4.5% tax free, 7 or 8% pretax equivalent, over time, that's not a bad return. Is it going to compete with the stock market over the next 2 or 3 years? I have no idea. That's not relevant to my point. My point is it's an attractive asset class that one can participate in.

Dan: Well, Bill, Harold and I are doing a little bit of a kind of flyby on stocks. But in your recent paper, the [Midterm Market Pattern](#), you highlighted a pretty remarkable historical statistic. Since 1950, the S&P has gained an average of nearly 30%, if I recall correctly, in the 15 months starting in October of a midterm election year, which we're currently in, and in all 19 observations, there were positive returns for that time period.

Are you able to explain, or at least talk to, why that pattern exists? And I suppose the more important thing, contemporaneously, is how much weight should investors be placing on that, given the unusually strong market performance we have going into the election cycle here?

Bill: Well, you know, the statistical pattern has really been striking, and I think is much stronger than can be explained by chance alone. Some common theories as to why are that policy stimulus can be expected ahead of the next presidential election and that begins to make itself known in the year ahead of the election. Or there could simply be relief as uncertainty lifts following the midterms and the jitters that have often been accompanied by those midterm elections. Those are just theories.

They're hard to prove with only 19 observations, but whatever the cause is, I think the historical patterns worth keeping in mind for investors who are extremely worried about political uncertainty. I'm not sure I'd build an investment strategy just on that calendar anomaly, but I think it is worth keeping in mind that things often work out better than people think when they're in the middle of a lot of negative news in the media.

We even looked at those few episodes where both chambers of Congress flipped, and there were four such episodes in the last 75 years, but there was no conclusive pattern of returns related to those episodes and they also have positive returns to some degree. So, the history is pretty remarkable.

Dan: Well, we centered on US stocks. If we were to put the election calendar just aside for a minute when you think out over the next 12 to 24 months, are there any particular asset classes or sectors or areas of the global markets that investors are overlooking in your mind?

Bill: Well, I'd say that even with a few rate hikes by the Fed, the odds of a recession in that time frame should remain pretty low. And that means that prospects for continued economic growth would be constructive for the outlook for both corporate profits and for equity markets.

That said, I agree with Harold that bond yields have become much more attractive, especially when you have tax-equivalent yields on muni bonds close to 8%. I'm not sure that warrants a reduction in equity exposure for investors who would have to pay capital gains taxes to adjust their portfolios, but for investors with new money to put to work, bonds look attractive after the recent selloff.

I'd say also that for investors who are concerned about the size of their exposure to mega cap tech names in their large cap US equity portfolios, the more attractively priced candidates to hedge that exposure are small cap equities and international equities. We've been talking about that theme for a while.

Dan: Harold. We're talking about bond yields, and Bill's kind of echoing that observation. More recently coming out of the summer months there's been a lot of attention — or more attention — put on the federal debt overall, the fact that we are running substantial deficits and, not lost on higher yields is that borrowing costs for the federal government, and everyone, have gone higher. Through all that, financial markets are remaining remarkably resilient. At what point in your mind, and you've been

around a while, do fiscal challenges become an impediment to growth to financial markets? Or do you think the strength of the economy is going to somehow get us through or manage us through these imbalances?

Harold: I think the latter will take place. Look, deficits are not ok and to your point, they keep on going up because of the administration and the wars. So I guess what I'm hoping for, and I do believe that the AI revolution will increase profit margins dramatically in the economy, and we're going to really be able to buy ourselves out of this deficit issue with higher revenues for the government, and that would be the really only healthy solution to this problem.

Obviously, it can't continue forever. So we need to get out and it has to be through profit margin. We're not going to reduce expenditures, so it has to be growth and margin expansion and better revenue stream for the federal government to pay its bills.

Dan: So Bill, you've spent decades studying global economies and financial markets. We've discussed inflation, interest rates, political uncertainty, and technological change, and you've helped us understand what to make of them. As you reflect back, what do you think investors most consistently misunderstand about markets? And more importantly, what advice would you leave us as we navigate the next few years?

Bill: Well, I think I share a strong conviction with Harold that most investors are overly influenced by the overwhelmingly negative coverage in the news media regarding both economic and geopolitical news. You know, lots of good things happen every day that get little coverage in the news, because bad news is what generates media engagement.

So to be sure, you know, the world is complex and difficult to forecast and there's always something to worry about, but over time, the trend in economic growth and profits has been positive and it pays to be optimistic despite the ups and downs of business cycles. I think the best way to express that optimism is to maintain a well-diversified portfolio of stocks and bonds, and to stay the course during the inevitable challenging periods. So that may be boring advice, but I think it's far better mindset than to think that you can outwit markets with big market-timing bets.

Dan: Well, instead of just closing on that, and I suppose you've kind of answered it, but is there one lesson about successful long-term investing that you believe is just as relevant today as when you began your career?

Bill: Well, I'd say two things. You know, when I studied modern portfolio theory in grad school, one line that stuck with me was that "diversification is the only free lunch in investing." I think that was Harry Markowitz. And that's true now as it was then.

Another line that stuck with me, though, from my early days at Merrill Lynch, was from a coworker who said, "I've never met a rich pessimist." And while that might have been an exaggeration, it's, I think, both good investment advice — and for that matter, good life advice.

Bill: Well said.

Harold: I had a boss when I was 25 years old and I always was worried about the market and he said, Harold, if you're always going to be worried that the market's going to go down, and you're right, there will be no one there to shake your hand — you'll be all by yourself. There's no advantage of being negative and I'm trying to be positive and have a forward looking attitude. It was such great advice.

Dan: Well, it seems to work for both of you, and I appreciate you sharing that with me and us now. Gentlemen, I want to thank both of you for sharing your thoughts.

As always, should anyone listening in have follow up questions, please feel free to get in touch with your GW&K advisor. To all our clients and friends, please enjoy your holiday season and the balance of your year. We look forward to reconvening in January.

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