Buckingham STRATEGIC WEALTH

Q3 2023

Quarterly Outlook

Perspectives on Markets and Economic Conditions

Portfolio allocations and investments are not adjusted in response to market news or economic events; however, we evaluate and report on market and economic conditions to provide our investors with perspective and to put portfolio performance in proper context.

Signs of Progress on Inflation Emerge as Recession Predictions Linger

Main Takeaway

Although many economists have predicted a recession for 2023, the economy is proving resilient. Several factors are keeping the economy in expansion mode — the strong labor market, strong corporate and consumer balance sheets and the stabilizing housing market — despite significant headwinds. The Federal Reserve paused its rate hike in June as inflation continued to show signs of steady decline[1], yet it remains well above the central bank's 2% target.

Top Risks

While the trajectory of inflation remains the top story for the economy, one risk that has taken over the spotlight in recent months is the stability of the office sector. With occupancy rates hovering at about 50% on average[2], this segment of commercial real estate is under considerable stress. In response to the heightened risks, as well as spillover from the banking turmoil in March, banks have tightened credit standards, making lending less available and more expensive.

Sources of Stability

Fiscal policy is still stimulative. Many corporations extended the maturity of their loans during the low-rate environment of the pandemic, making them less vulnerable to higher interest rates. Households still have significant savings built up to support spending. Since the pandemic, consumers have ramped up spending on services while cutting spending on goods. However, the services sector is now the sole driver of growth[3] for U.S. business activity.

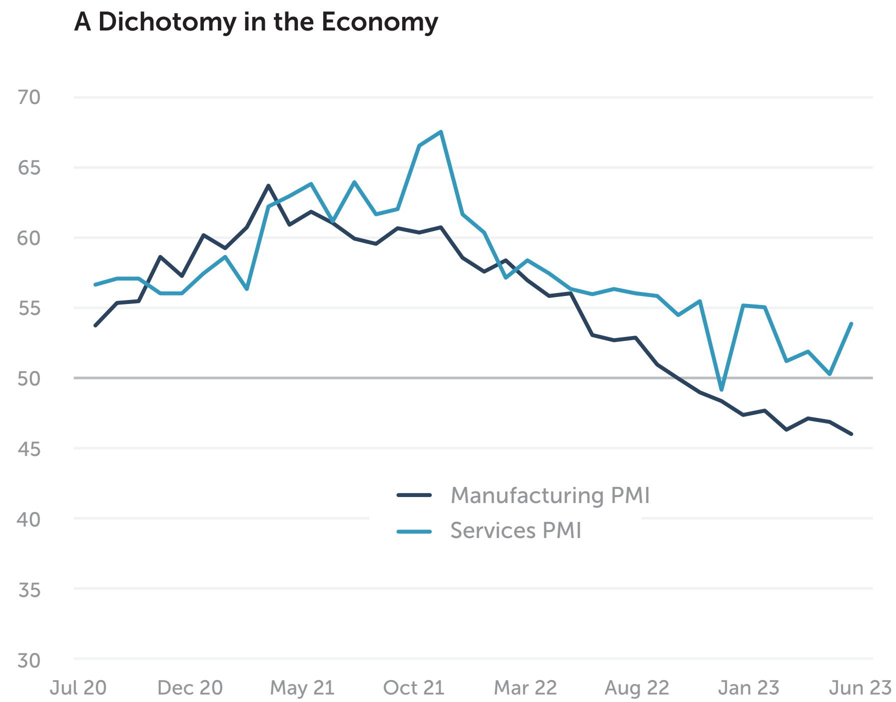
ECONOMIC SPOTLIGHT:

Why Has it Been So Hard to Slow Inflation?

Following the most aggressive interest rate increases in the last 40 years, the Fed decided to leave rates unchanged in June, framing the decision as a pause. Although history shows that changes in the Fed's policy typically take six to 18 months to work through the economy, the Fed's rate hikes have created a dichotomy between different sectors.

Spending on services, which constitute about 78% of GDP, continues to be strong and expansionary even as economic growth has slowed.[4] As a result, inflation related to services remains well above the Fed's target. Alternatively, the sectors most sensitive to rising interest rates have stalled, including manufacturing and the real estate sectors. In fact, the manufacturing sector has been contracting for seven months. So while the Fed's aggressive policies are having an impact on the manufacturing and real estate sectors, together they make up only about 18% of GDP.

Over the last 70 years, manufacturing has declined from almost a third of U.S. GDP to only about 8%. The shift to a much larger services sector, which is much less sensitive to interest rates, means that we now have a historically weaker transmission mechanism of monetary policy. In other words, the long and variable lag of monetary policy may have gotten even longer.



Source: Bloomberg. The Purchasing Managers Index (PMI) is a diffusion index which measures the breadth of changes across different sectors in the U.S. A PMI above 50 indicates an overall expansion of the sector whereas a PMI below 50 suggests the sector is shrinking.

Key Areas to Watch

Inflation Trajectory

Although year-over-year core inflation has declined from the peak in September 2022, inflation has proven resilient. The strong services sector, tight labor markets, continued fiscal stimulus, and trend toward deglobalization means inflation is likely to remain higher for longer than the Fed would like.

Fiscal Policy

The Congressional Budget Office[5] projects a federal budget deficit of $1.4 trillion for 2023, with the deficits rising in future years. For example, it estimates the deficit will swell to 6.1% of GDP in 2024 and 2025 and will reach 6.9% by 2033. While rising interest rates were necessary to combat inflation, this increases the cost of servicing U.S. debt. Evidence shows that high levels of debt to GDP can adversely impact medium- and long-term economic growth.

Global Economy

Economies across the world are facing similar challenges as the U.S. when it comes to tamping down inflation. Core inflation in the eurozone increased by 5.3% in May, compared to 7.1% in the U.K. and 4.3% in Japan.[6] In June, the Bank for International Settlements (BIS) called for more interest rate hikes, warning the world economy was now at a critical point as inflation is remaining stubbornly high worldwide.[7]

Monetary Policy

Markets are expecting the Fed to raise rates by another 0.25% at its next meeting at the end of July, with a roughly 40% chance of a second rate hike before the end of 2023. The Fed is data dependent and will hike rates as needed if inflation numbers come in higher than expected.

Key Areas to Watch (Cont.)

Labor Market

The strength of the services sector has contributed to the strength of the labor market. The May jobs report showed an increase in employment of 339,000. And while the unemployment rate rose to 3.7% from 3.4%, the labor market remained tight, allowing wages to increase at a faster pace (hourly earnings grew 4.3% compared to the same period last year, similar to gains in the prior three months).[8]

Consumer Spending

While households have been running down their excess savings built up during the pandemic, a study by the Federal Reserve Bank of San Francisco found that they still have sufficient savings to support spending through at least the fourth quarter of 2023.[9] But the excess savings eventually will be eroded, and the three-year pause on student loan repayments will end this summer. In addition, should the unemployment rate rise, households are likely to have a greater appetite for savings and significantly shift their spending habits.

Commercial Real Estate

With hybrid work models now well established, a 50% occupancy rate may be the new permanent level for offices in many metropolitan areas. In June, the New York City office occupancy rate rebounded to just above 50% – the first time it crossed that level since the pandemic began. Other cities, such as Washington, D.C. and San Francisco, have yet to break the 50% mark.[10] Because commercial real estate construction is roughly 2.6% of GDP and fewer skyscrapers and shopping malls are being built, the sector is likely to constrain economic growth over the coming years.

Housing Market

Although new home sales are at their highest level since February 2022[11], applications by home purchasers are down by roughly a third compared to this time last year, and refinances are down even more.[12] The combination of rising interest rates and higher home prices has resulted in housing becoming the least affordable in over 30 years. The millions of homeowners that refinanced their mortgages during the pandemic, when rates were at historical lows, are less vulnerable to higher interest rates.[13]

Economic and Market Snapshot

Global stock markets continue to grow, despite headwinds. Optimism around artificial intelligence has boosted stocks: At second-quarter end, nearly 80% of the S&P 500's return was due to the performance of 10 tech-related companies.

Value stocks, meanwhile, continue to trade at valuations that would be indicative of a serious recession.

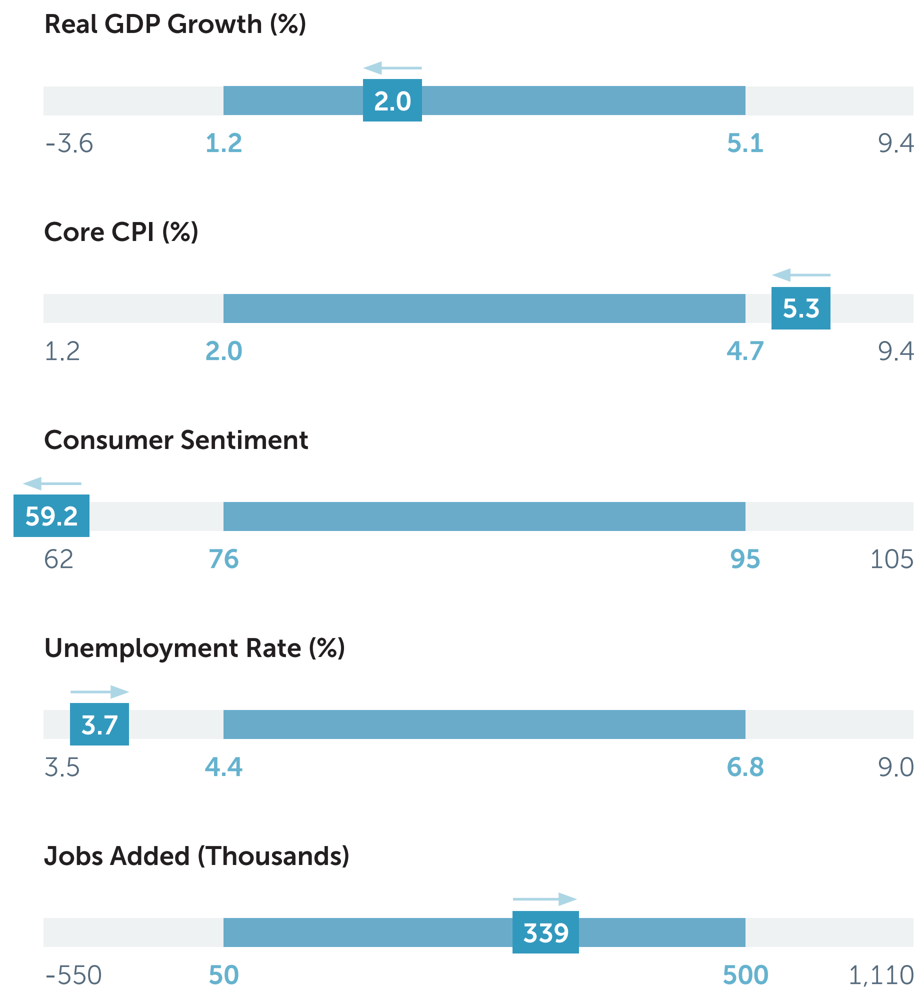
In the bond market, the yield curve remains inverted, meaning that long-term bonds are more expensive than their short-term counterparts. Although this typically precedes a recession, higher short-term yields present an opportunity for long-term investors.

Major Asset Class Returns*

Q2 2023

		Quarterly Return	Past 12 Months
Stocks			
U.S. Stocks	▲	8.4%	19.0%
International Stocks	▲	2.7%	16.3%
Emerging Markets Stocks	▲	1.6%	3.2%
Bonds			
U.S. Government Bonds	▼	-1.1%	-1.0%
Global Bonds	▼	-0.3%	0.3%

Key Economic Indicators*



*See Appendix on page 8.

Investment Planning Implications

Where do markets go from here?

Corporate profits could fall in a recession. In 2022, the S&P 500 earned just over $219 in aggregate[14], and forecasts for 2023 have earnings growing by roughly 1%.[15] Recent earnings growth has been negative, meaning that markets believe the worst is behind and that conditions should improve rapidly. A contraction in the economy could lead to lower sales, and a tighter labor market could lead to wage pressures – both of which could squeeze corporate profits, in turn putting downward pressure on stock prices.

Bond markets have stabilized. High-quality, short- to intermediate-term bonds have been more stable than lower-quality and longer-dated bonds, but bonds across the board have largely stabilized following the significant price swings during the first quarter.

Limited access to capital means an increased chance of defaults in certain sectors. The problems in the banking system earlier this year mean that credit conditions are likely to remain tight for an extended period. Companies that are forced to roll over existing debt and industries more susceptible to interest rate increases could see an uptick in defaults.

What are the investment planning implications?

Don't buy hype. Finance author Morgan Housel aptly stated that "expectations are like a debt that must be repaid before you get any joy out of what you're doing."[16] Certain companies in the U.S. have high expectations embedded in their current prices. Continued high returns will require the companies to exceed the current expectations. In markets, it doesn't matter whether the news is good or bad, only whether it is better or worse than expected.

Bond yields continue to look attractive. With short-term, high-quality bonds yielding well north of 4%, fixed income looks attractive for both income and portfolio protection. If the risks in the economy – and their potential impact on the value of your stock holdings – are concerning, consider discussing a reduction in your stock allocation with your advisor.

Don't try to time the market. The banking crisis is leading banks to tighten lending standards, which slows company investment and increases the likelihood of a recession. However, research shows that recessions are not a reliable way to time the stock market. Rather, stay focused on your goals and remember that your plan is built to anticipate market declines.

About the Buckingham Team

Larry Swedroe

Head of Financial & Economic Research

In his role and as a member of Buckingham's Investment Policy Committee, Larry regularly reviews the findings published in peer-reviewed financial journals, evaluates the outcomes and uses the result to inform the firm's formal investment strategy recommendations.

Kevin Grogan, CFA, CFP®

Chief Investment Officer

Kevin is a member of Buckingham's Investment Policy Committee and helps lead the firm's investment strategy, portfolio management and fixed income teams. He has co-authored three books on investment topics and enjoys educating others on concepts that will have a tangible effect on their financial lives.

Blerina Hysi

Director, Fixed Income

Blerina works with fixed income and advisory teams to help construct and maintain customized bond portfolios, with an eye toward finding the best way to implement comprehensive financial plans. Her duties include fixed income analysis, bond trading and building tailored, client-focused portfolio solutions.

Daniel Campbell, CFA

Investment Strategy Advisor

Dan helps clients and advisors understand and implement an evidence-driven investment strategy. He has a demonstrated ability to understand complex investment topics, but he gets the most energy from conversations with individuals and families in pursuit of financial freedom.

Additional economic and investment resources are available at **buckinghamstrategicwealth.com/resources**

Buckingham's Investment Policy Committee (IPC) is a committee for Buckingham Strategic Wealth, LLC and Buckingham Strategic Partners, LLC (collectively Buckingham Wealth Partners) and not a committee for independent members of the Buckingham Strategic Partners community.

Appendix

Page 1:

1. The Associated Press. "Fed Chair Powell sees progress on inflation, though not quickly enough." June 13, 2023.
2. Apollo Global Management, Inc. "NYC Office Occupancy Rate at 46%." April 15, 2023.
3. Thomson Reuters. "US Business Activity Growth Slows in June but Services Keep Humming Along." June 23, 2023.

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4. Larry Swedroe, Advisor Perspectives. "Second Quarter 2023 Economic and Market Outlook: A Tale of Two Economies." June 26, 2023.

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5. Congressional Budget Office. "The Budget and Economic Outlook: 2023 to 2033." February 2023.
6. Eurostat, Office for National Statistics, and Ministry of Internal Affairs and Communications. Data retrieved on TradingEconomics.com.
7. Thomson Reuters. "Economy at critical juncture in inflation fight: central-bank body." June 26, 2023.

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8. Bureau of Labor Statistics. Employment Situation Summary. May 2023.
9. Federal Reserve Bank of San Francisco. The Rise and Fall of Pandemic Excess Savings. May 8, 2023.
10. Bloomberg. "New York Office Occupancy Breaks 50% for First Time Since Pandemic Hit." June 12, 2023.
11. Census Bureau and Department of Housing and Urban Development, New One Family Houses Sold: United States [HSN1F], retrieved from FRED, Federal Reserve Bank of St. Louis. July 5, 2023.
12. Mortgage Bankers Association's weekly Mortgage Applications data. Data retrieved on mortgagenewsdaily.com/data/mortgage-applications.
13. Federal Reserve Bank of New York Liberty Street Economics. "The Great Pandemic Mortgage Refinance Boom," May 15, 2023.

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Major Asset Class Returns: The index representation for the Major Asset Class Returns is as follows: U.S. stocks are represented by the Russell 3000 Index, international stocks by the MSCI World ex U.S. IMI Index, emerging markets by the MSCI Emerging Markets IMI Index, U.S. government bonds by the Bloomberg Government Intermediate Total Return Index, and global bonds by the FTSE World Government Bond 1-5 Year Index. Past performance is not a guarantee of future results. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Information from sources deemed to be reliable, but its accuracy cannot be guaranteed.

Key Economic Indicators: Sources: Bureau of Economic Analysis (BEA) for real GDP growth. Real GDP is the annual rate of change of real gross domestic product, seasonally adjusted. Bureau of Labor Statistics (BLS) for core CPI. The core consumer price index (CPI) is the annual rate of change, seasonally adjusted, and excludes food and energy. Consumer sentiment is from the University of Michigan's consumer sentiment index. Unemployment rate is reported by the BLS, and jobs added is based on nonfarm payroll employment reported by the BLS. Retrieved from FRED, Federal Reserve Bank of St. Louis. For all indicators, the boxed number reflects the latest reading, and the line above the box shows the change since the last update. The shaded areas reflect normal readings compared to history (based on the 25th-75th percentile of historical measures), while areas outside the dark blue reflect more extreme readings compared to history. The ranges are based on the percentile values of historical readings for each economic figure. The lowest number reflects the 5th percentile value, the bottom of the blue range reflects the 25th percentile, the top of the blue range is the 75th percentile, and the highest value reflects the 95th percentile. All ranges are based on the full period available. To account for population and employment, the ranges presented for jobs added are based on the percent change in employment numbers, using December 2022 as the base year.

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14. New York University. "Historical Returns on Stocks, Bonds and Bills: 1928-2022." January 2023.
15. FactSet. Earnings Insight. June 23, 2023.
16. Collab Fund. "Expectations Debt." May 25, 2023.