GW&K MARKET INSIGHTS

Transcript of 1Q24 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 first quarter of 2024 and discuss:

- While rates will likely stay higher for longer in the US, putting enormous pressure on consumers and the economy, the worst of the inflationary problem is hopefully behind us;
- Where opportunities exist in the bond and small cap markets now; and
- How immigration has been a cause for upward revisions to the US growth outlook and to the US consumer spending outlook.

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 First Quarter 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.

My name is Dan Fasciano, Director of Private Wealth 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, our firm's Global Strategist.

Lots to cover, gentlemen. And I'll start with you, Harold. Investors' attention remains centered on inflation. You spent some time in the most recent quarterly economic commentary discussing the root causes behind increasing inflation over the past few years. Walk us through your thoughts about inflation and what you believe the most probable endgame will be for the economy and markets.

Harold Kotler: The inflation is compounded by the federal government's willingness to spend money that they don't have and, the Fed's responsibility to try to lessen inflationary impact on the economy, driving up interest rates. So we have the two powers at opposite ends, in conflict. And this conflict is going to continue since deficits are not disappearing and the Fed is committed to reducing inflation. So how does that all work through? It's very, very complicated and very difficult to put a bet on. Clearly, they'll keep interest rates higher for longer to drive down inflation. They will do that, and inflation will moderate to some degree. But the federal government will continue to spend money they don't have, putting money into the system and exacerbating the problem. I suspect inflation is not going away anytime soon. And monetary policy is going to be expansionary, and the Fed will continue to keep interest rates higher, longer.

That doesn't mean they're going to increase interest rates, and it may mean rates will decline slower. But this inflation, even if it comes down, it's still higher than it was prior. The base level doesn't go down. So although the rate of change may be declining, the absolute level is going up, which exasperates the problem which hurts the middle class and it hurts the consumer. It puts tremendous pressure on the economy.

Dan Fasciano: Bill, Harold's using the phrase “higher for longer.” January wasn't too long ago, but the futures market at that point had six Federal Reserve cuts priced in for 2024. You were skeptical then that they would be that aggressive easing. And I'm pleased to report that you're looking to be correct at about the one third mark of the year. What are your thoughts on fed funds, and I guess maybe start out by saying what's priced in at the moment? More importantly, what do you think? And, as you contemplate the rest of the year, what data do you think the Fed's going to be looking most closely at?

Bill Sterling: Dan, I think what's priced in now is one or maybe two cuts by December, and that sounds pretty reasonable to me because they've clearly had to back away from their forecast, as of December and March, of three cuts for the year. This is because the inflation data — which they care a lot about — has gone from looking like 2% inflation at a run rate at the end of last year, to the first three months of this year, the run rate on inflation, whether you look at CPR, PPI, core, or headline, all those numbers are running closer to 4.5%. So that's been very disappointing to the Fed, and they've had no choice but to stay higher for longer.

But I do think there are some signs that the economy is beginning to soften a bit. The Fed's Beige Book report recently highlighted some of the softening of the economy, notably on the consumer side as well. It noted that wages were coming back more in line with historic averages. And I think the Fed, in terms of what data they care most about, clearly inflation is number one at this point, but they have to pay attention to the other part of their so-called dual mandate, which is the labor market. And if they see any signs the labor market is beginning to soften, which I suspect by the middle to later part of the year they will, that would give them the wherewithal to begin cutting rates maybe in the fourth quarter.

I think, though, as Harold mentioned, for a lot of other reasons, if inflation stays higher for longer, this could be a shallow rate cycle: Not 6 or 7 cuts, but more like 2 or 3 insurance cuts over the course of the next 2 to 3 years. And that's, I think, what the market's baking in at the moment.

Dan Fasciano: That's helpful, Bill. And it kind of sets up this question. Listeners now might recall that when we met in January, the 10-year Treasury was around 4% at that moment, and it had been much higher around the middle of 2023, but really rallied into the end of the year. Harold, I asked you what you made of a 4% 10-year when we first sat down in January, and frankly, you expressed some caution about how quickly rates had really rallied into the end of the year. Well, you know, the good news now is rates have backed up again to about 4.63%. So what are you recommending to clients as it relates to their fixed income, or maybe cash, and when you think about municipal bonds or credit or the curve, is there anything that bubbles to the top in your mind in terms of opportunities?

Harold Kotler: I think the recent rise in interest rates creates a much different opportunity. And I really believe that at this point, more than any time in the last 10 years, municipal bonds or bonds, are attractive. How attractive? It's a funny thing. To the extent that interest rates come down, it's a good place to have money and lock in some decent rates for 5 to 10 years. There's a parallel: That money market is so attractive, it's a Venus flytrap that people would then keep money short and not go out and extend. But I think that would be a mistake. I think long rates are not going to go up materially. Inflation is going to be attacked. The inflationary problem is going to be with us, but the worst of it is behind us. Where it goes from here, as Bill suggests, is anybody's guess, but it's behind us. So that means long rates are not going to go up materially from here. So I think there's a great entry point, and I think you can make money in the bond market. And I think when you can think about a return of 4.5% – 5%, especially in Treasuries as a riskless return, it's not so bad.

Dan Fasciano: It's great context, and it's been a while since we've been able to have that kind of conversation, hasn't it? Bill, when we sat down 12 months ago, the observations we were making about what the pundits were debating was whether the US would experience a soft or hard landing by this point in 2024. Just a bit ago, you talked about some of the things related to inflation, employment, and Fed activity. But one thing we've got to narrow in on here is the resilience of the US consumer in the face of higher rates. Do you have any thoughts related to the US consumer specifically? And can you put it into relative context to other developed non-US economies that you would you watch?

Bill Sterling: Well, as you said, if you go back to the beginning of last year, the consensus was that the economy was going to have a mild recession in the second half. In fact, we had an annual GDP growth of 4% — which is booming — in the second half of last year. It was a big surprise, and much of the surprise came from the resilient consumer, as you mentioned. I think one of the big factors there has just been the labor market has been exceptionally strong. Average monthly job gains last year were 250,000; in the first three months of this year, more like 275,000. I think a big part of the story of why folks were surprised was immigration has been much higher than anyone expected. And, with these immigration flows, we used to think prior to this year that 100,000 jobs per month was a sort of stable, level of job creation the US economy was capable of. But now, factoring in immigration, it looks like it might be closer to 250,000 per month. And all those immigrants shop at Walmart and Target and add to the consumer outlook. I think that’s one of the biggest sources of surprise over the last year. In terms of how that compares relative to other non-US economies, we've seen major upward revisions to the US growth outlook and to the US consumer spending outlook, since the middle of last year — partly based on that immigration factor. We've seen nothing like that for the major G7 nations outside the US. Their consumer outlook has been pretty steady at growth rates of about 0.5% to maybe 1% at best, whereas the US is well above 2%. So a big, big change in sort of American exceptionalism based on those economic outlook surveys.

Dan Fasciano: That’s great global context there, and I might come back to it in a moment. But I want to stick with this kind of investment thesis theme with you, Harold. You've counseled me and clients that you need to be a long-term investor. Through that lens, are you thinking more opportunistically or cautiously right now?

Harold Kotler: I guess I'm always optimistic. I was taught when I was 22 years old that if you’re being pessimistic and you’re right, there'll be no one to thank. And you, you might as well be optimistic. Truth be told, the US economy always finds its way and muddles through, which I do believe. I do believe in the system, in the country, in entrepreneurship. I always believe that one should be investing. But to my earlier answer, you could be buying bonds or you could be buying stocks — you could be buying a lot of assets in this economy. And you have to diversify because there's no clear winner in this world, internationally or domestically. It's a complicated world. And you're going to ask me other questions as we go on about the political environment and what's happening around the country. And it all speaks to a time in which, people will be cautious and there's a level of discomfort. So that certainly is the immediate environment. But we have to rise above that, believing that in two, three, five, six — I wrote in the summer that we'll have to wait for the 2028 election. And, I do believe that. I believe for this election, we know who's running, and most of us are disappointed in our choices. But we know that in 2028, neither are qualified to run again. That will be a new beginning. We'll have to muddle through the next few years. What that looks like is anybody's guess, but it's really going to be a complicated time.

Dan Fasciano: Let's stick with markets a little bit, and I'm going to steer it to Bill. Apart from cryptocurrencies, US large cap stocks continue to take center stage from a global investment performance standpoint. As of this morning (April 24), the S&P 500 is up a bit more than 6% so far this year. As you take a look at US large cap stocks, are you seeing any indications of a crack? And extend that out — when you think about other financial markets, is there anything that's on your radar? What do you make of US large caps on a relative value basis?

Bill Sterling: Well, we had a bit of a pullback in early April, with the S&P 500 off, at one point, 5.5% from its all-time high. But that's just, in the scheme of things, a relatively modest move — I don't think it could be called a big crack. When I look at relative value, the Russell 1000 Large Cap Index is trading at about 27 times forward earnings, and that's towards the high end of its historic range, but not in nosebleed territory. Back in the tech bubble of 2000, it was trading closer to 50 times earnings. Value stocks are trading closer to 17 times, small caps are trading around 16 times, and international small caps are trading around 13 to 14 times. I think there are more attractive value opportunities, whether it's in the small cap space or whether it's in the large value index as well.

My guess would be, looking out over the next 3 to 5 years, you are going to see a significant recovery of small caps, both domestic small caps and international small caps. In fact, one interesting point is that, cumulative growth forecasts for earnings for small caps over the next three years, this is the Russell 2000 earnings growth, are about 74%. And that compares to closer to 30% for the large cap index. So relative to growth prospects, small caps seem very attractively priced at this point.

Dan Fasciano: Harold, that's consistent with a theme that you've been sharing pretty much for the year: Small caps — both US and non-US — really have your attention from a long-term opportunity standpoint. Is that still the case?

Harold Kotler: Yes. Small caps are being hurt by interest rates. They have lines of credit which are very expensive. And the big cap stocks are just cash machines and don't rely on capital borrowing. So the small caps have been under that kind of pressure. As rates do decline, they'll give some lift to the small cap market. And I agree, yes. They're undervalued. They've been undervalued a long time. But I still think that the large cap companies, the ones that are just enormous money machines and have the capability of acquiring any minor operating opportunity because of their ability to just use their liquidity, puts them in a very interesting spot. I don't think it's one or the other. I think when rates start to decline, this market will go up across the board.

Dan Fasciano: I'm not going to let you off the hook in terms of my difficult questions. You mentioned the upcoming US presidential election. It's just over six months away, and it's happening at a time when geopolitical tensions seem to be ratcheting higher every month. How much does the election and potential for increased global tensions factor into your thinking, particularly for the remainder of the year?

Harold Kotler: Well, I'm reminded of the protests at the Chicago Democratic National Convention — which election was that?

Dan Fasciano: The riots in 1968?

Harold Kotler: Yes, over the US's involvement in the Vietnam War. It feels to me that what's happening on the campuses around the country is not going to go away. There's a lot of agitation out there. It's going to be directed at both parties, it's not one party or the other, but the political backdrop right now is pretty sad. From my point of view, thank God Congress and the Senate passed this bill to help our allies and a large majority voted for it in both. But the distress that exists in Congress is enormous, and the conversation that's going to happen over the next six to nine months is going to be very stressful. Usually elections don't impact the market because the market rises above it, or discounts it, and the truth is that both candidates' policies could be very similar, both expansionary and consumer driven. But still, the backdrop is going to be complicated. I might be biased, but I think it's a complicated period. And until interest rates, which will drive the market higher, until that starts to occur, I think the market will kind of watch and wait.

Dan Fasciano: That's good food for thought as we approach the summer here. By the way, parenthetically, I was two years old in 1968.

Harold Kotler: I was in the Army.

Dan Fasciano: So you remember better than me. Harold and Bill, I want to thank you both for sharing your thoughts. As always, should anyone have follow up questions, please feel free to get in touch with your GW&K contact. To all our clients and friends who are listening, please enjoy the remainder of your spring months, and we look forward to connecting again in July. Take care.

Disclosure