CONGRESS ASSET
MANAGEMENT COMPANY

ECONOMIC OUTLOOK & MARKET REVIEW | 4Q23

KEY TAKEAWAYS:

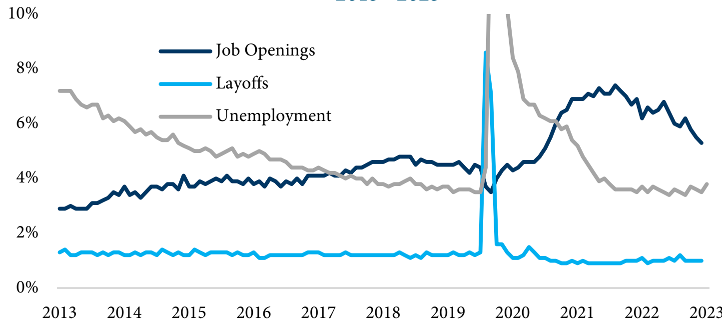
1. Challenges to the U.S. economy appear to be mounting, but the economy remains resilient and real-time GDP estimates forecast growth of almost 5% in the third quarter.
2. While a slowdown is probably inevitable, a recession is not, and opportunities exist for equities and fixed income.
3. We have entered a new era of secular higher interest rates. Inflation is less a concern than the level of government debt outstanding.
4. We continue to believe a diversified portfolio of high-quality companies with a history of established growth provides investors with the best ability to navigate these markets.

Challenges to the U.S. economy appear to be mounting, seeding investor angst. Rising interest rates exemplify these concerns with the 10-year Treasury yield rising to 4.5%, up from 3.8% in early July. The stock market re-trenched in September, largely reflecting higher interest rates and shorter-term concerns about student loan repayments, the potential government shut down, and implications of the auto workers' strike. Yet, the economy remains resilient with real-time GDP estimates forecasting growth of almost 5% in the third quarter.

Growth is likely to moderate as we approach year end, but in the aggregate, the concerns du jour do not present long term risks to the consumer or to the economy. The continued strength of the labor market, despite the Federal Reserve's actions, offsets many short-term challenges. While there have been signs of cooling recently, there is little evidence that employment has weakened as unemployment rates and layoffs remain near historic lows and job openings are elevated. Consumer spending has held up as a result and is tracking in-line with its positive, pre-pandemic trend.

% of Payrolls / Labor Force

2013 - 2023

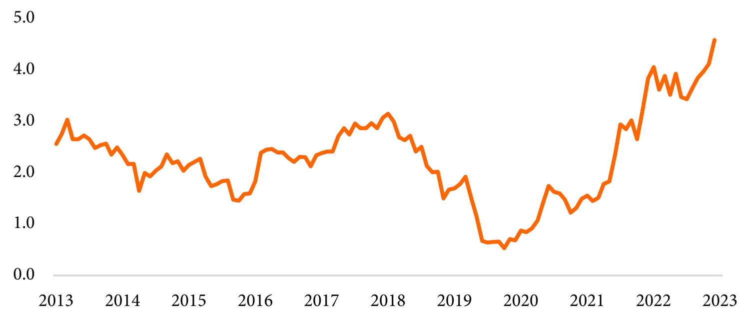


Source: US Bureau of Labor Statistics

The primary economic issue today is the level of interest rates. Inflation was the main concern in 2022. It drove the Federal Reserve's aggressive actions, caused market interest rates to jump with historic alacrity and weighed on financial markets. In fact, when the economic history of the pandemic is written, 2022 may be the final chapter with 2023 the start of a new era, one marked by secular higher interest rates. Short-term interest rates will continue to follow the Federal Reserve's direction, but longer-term rates are subject to the country's overall level of indebtedness. Thanks to the monetary and fiscal policies enacted during the pandemic period, our amount of outstanding debt stands at record highs.

Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity

2013-2023

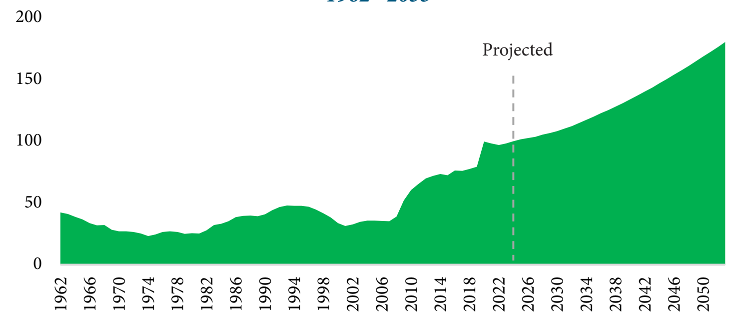


Source: Board of Governors of the Federal Reserve System

Federal debt held by the public as a percent of GDP, which was tracking around 75% pre-Covid, is now closer to 95%. At current spending requirements, the Congressional Budget Office (CBO) projects that debt will grow to close to 200% of GDP over the next 30 years. Interest expense, currently around 2% of GDP and in line with historical averages, is projected to grow to almost 7% by 2053. The era of debt free infrastructure and social engineering is over as the incremental interest burden will gradually sap resources and government spending flexibility.

Federal Debt Held by the Public % of GDP

1962 - 2053

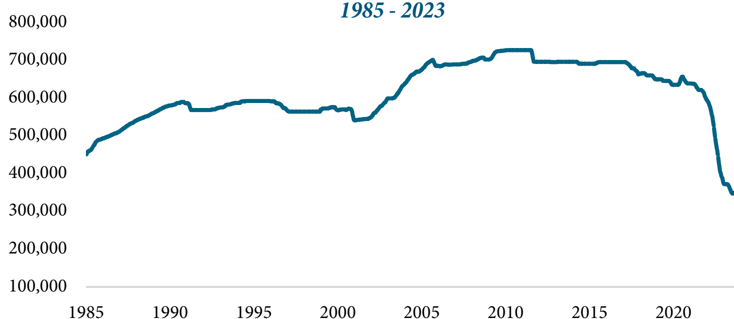


Source: Congressional Budget Office

Corporations are also facing higher funding costs. Debt costs were nominal in the period following the Great Financial Crisis until the end of 2021, with the yield on the Bloomberg U.S. Corporate Bond Index averaging 3%. Companies took advantage of this cheap financing and the market value of the index ballooned from $2 trillion in 2008 to over $7 trillion at the end of 2021. While corporate debt maturities over the next 2 years are near historically low levels, they are projected to exceed $1 trillion per year starting in 2025. With yields currently over 6%, companies that have been reliant on the debt markets to fund operations are destined to see significant increases in interest expense.

Our new era is also characterized by more aggressive government industrial policy. One area of focus, climate change, is having immediate impacts. Oil prices have risen over 30% in the past few months after OPEC and Russia declined to increase production. U.S. producers, including the major oil companies, have been incentivized to invest in more environmentally friendly activities such as carbon capture and alternative energy sources. As a result, the U.S. has ceded energy independence to foreign actors giving up pricing power and allowing less environmentally sound drilling techniques to prosper.

The Biden administration has used the Strategic Oil Reserve to temper oil price swings. However, the Reserve is now at mid-1980's levels, about half of where it stood in 2010, and thus has a diminished capacity to smooth prices going forward. Oil prices are known to be volatile, but this round has a more lasting feel to it and could negatively impact corporate earnings in 2024. Higher energy prices act as a tax on the consumer, especially the lower income brackets, and bleed through to everyday products and services.



Source: US Department of Energy

The global growth picture remains challenged. China continues to face secular headwinds including aging demographics, a growing property crisis, and a decoupling with the U.S. These issues are unlikely to be remedied quickly and the current solution of reducing economic transparency won't help. China has accounted for roughly a third of global economic growth over the last decade, and any slowing will weigh on broad longer-term growth prospects.

Despite the recent and current challenges, the U.S. economy has not cracked and remains well-positioned relative to peers. While a slowdown is probably inevitable, a recession is not, and opportunities exist for equities and fixed income. Corporate earnings are poised to grow next year, which should broadly benefit stocks. The new era of higher rates makes fixed income investments more attractive and offers the prospect of positive returns. A sustained period of higher interest rates introduces new risks that will require companies to adapt. Companies reliant on credit markets for capital will face higher costs relative to better heeled peers. We continue to believe a diversified portfolio of high-quality companies with a history of established growth provides investors with the best ability to navigate these markets.

Investment Oversight Committee
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