Core Global/Core International Equity Strategies

NCM Monthly Commentary for October 2023

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Third Quarter 2023 Review

After a strong first half of the year, global stock markets took a breather during the third quarter. Equity market indexes were down across the board during Q3 with the S&P 500 returning -3.7%, the STOXX Europe 600 index returning -2.5%, and the Nikkei 225 returning -4.0%. Despite the weakness experienced in Q3, global stock markets have generated respectable gains throughout the first nine months of the year. On a year-to-date basis through September 30, the Nikkei 225 has returned +22.1%, the S&P 500 has returned +11.7% and the STOXX Europe 600 index has returned +6%.

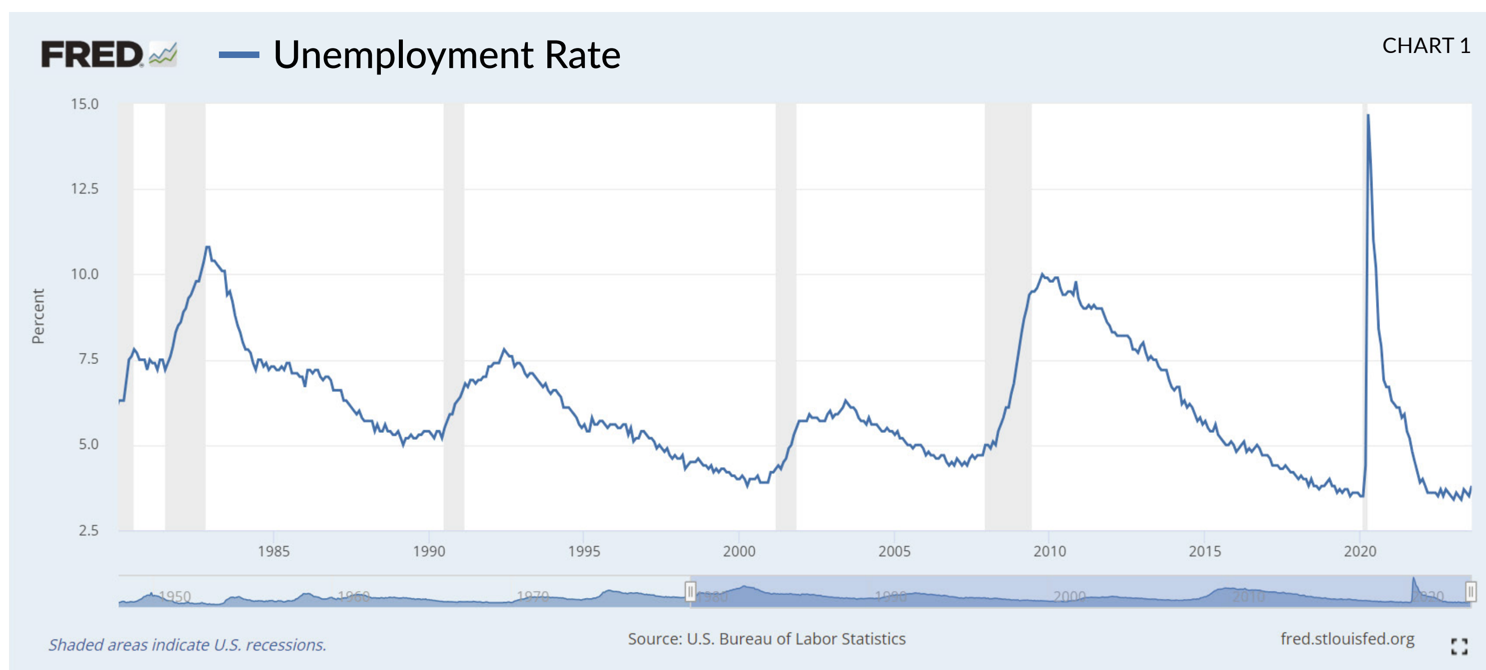
In terms of sectors, Technology has been a strong performer in 2023. During the first 9 months of the year, the Technology-heavy Nasdaq index returned +26.3%. The strong gains in the Technology sector have been boosted by the excitement surrounding artificial intelligence (AI) and the potential productivity gains that AI could generate for the global economy.

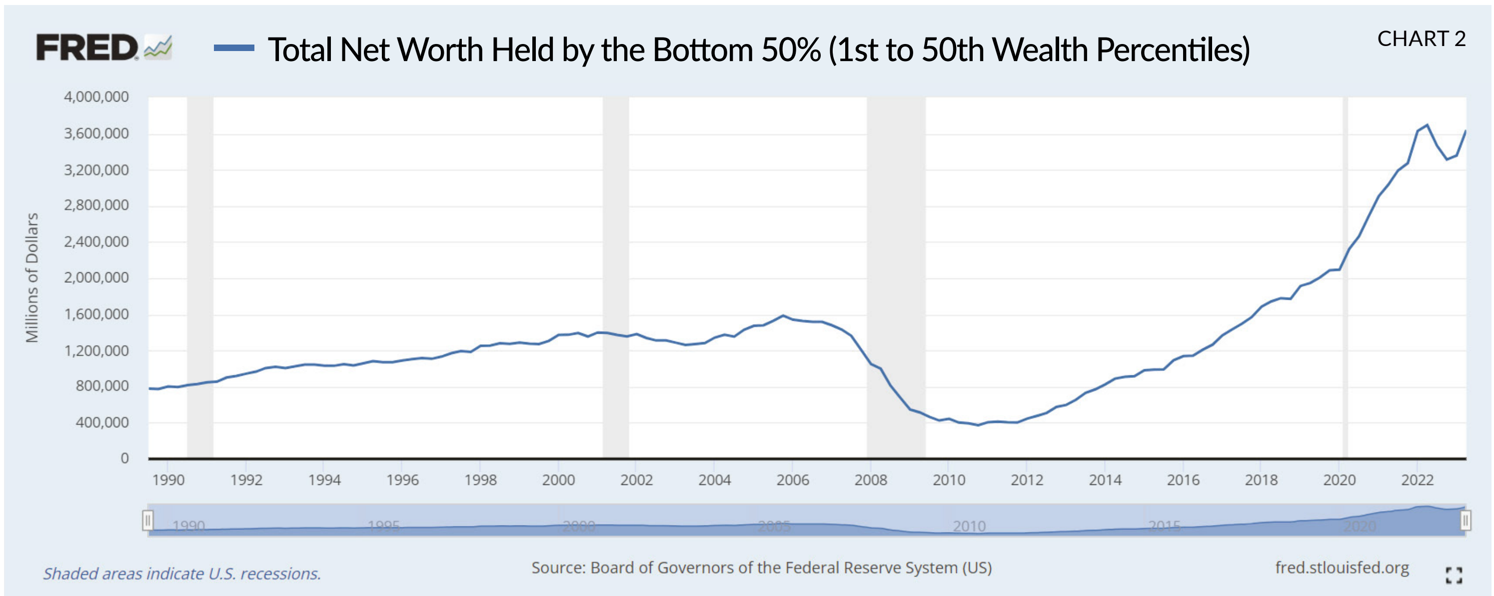
Market Review

One of the biggest surprises of 2023 has been the absence of a recession, particularly in the United States. Given the aggressive interest rate hiking campaign by the U.S. Federal Reserve, the consensus view at the end of 2022 was that the U.S. economy was headed for a recession in 2023. Instead of a recession, the U.S. economy has been resilient despite the most aggressive interest rate tightening cycle since the 1980's. In fact, real GDP growth in the U.S. is on pace to grow by +2.1% to +2.2% during 2023 according to consensus estimates. Not only has economic growth surprised to the upside, but inflation has moderated significantly throughout the year. The decline in inflation is one of the reasons why many investors believe that we are at the tail end of the U.S. Federal Reserve's interest rate tightening cycle.

Why has the U.S. economy been so resilient despite a huge increase in interest rates? First and foremost, the U.S. labour market has been very strong as evidenced by the U.S. unemployment rate, which remains near 50-year lows as seen in Chart 1 below.

Consumers have jobs and that allows them to keep earning and spending money. As excess savings from the pandemic started to run dry, there was an expectation that consumer spending would slow, especially among low and mediumincome Americans. However, workers in this demographic have experienced some of the largest real wage





gains among all workers. As a result of this phenomenon, the net worth among the bottom half of U.S. families has increased by approximately 75% since the beginning of 2020 as seen in Chart 2 above. This is an astonishing amount in such a short time period!

However, it's not only the bottom 50% that have seen a significant increase in their net worth since the pandemic. As seen in Chart 3 below, the average U.S. household has seen a 33% increase in their net worth since the end of 2019.

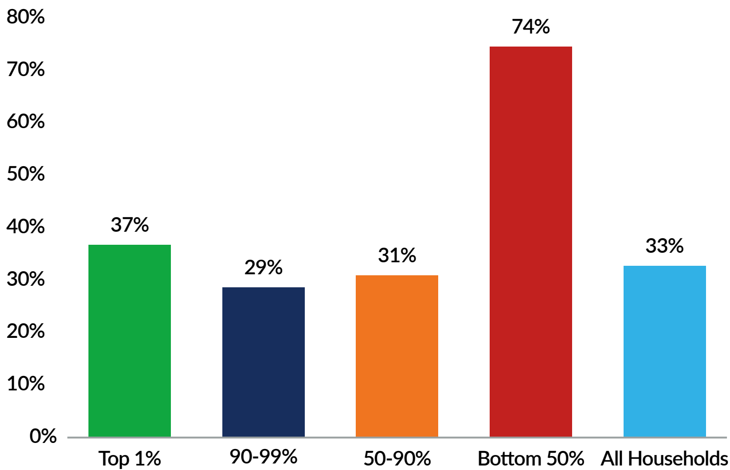
The significant increase in net wealth helps to explain why consumer spending has held up thus far, even as excess savings from pandemic-related stimulus has started to run out.

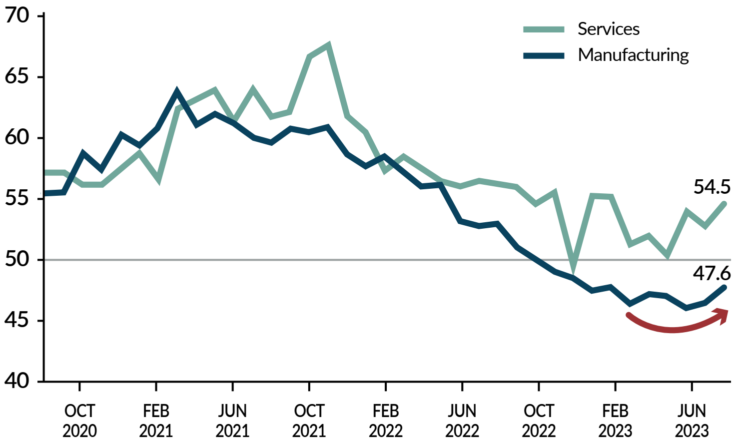
Outside of consumer spending, fiscal spending and various government incentives have provided a boost to the U.S. construction industry. Hundreds of billions of dollars have been earmarked to boost domestic semiconductor chip manufacturing and to rebuild the country's infrastructure. The Inflation Reduction Act and the continuation of the U.S. reshoring trend have also added momentum to economic activity and are also fuelling demand for more labour. All of this is contributing to the strong labour market as discussed above.

While consumers have continued to spend, the manufacturing sector is one area of the economy that has been in a downturn as measured by the Manufacturing PMI index. A measure above 50 signals expansion while a reading below 50 implies contraction in manufacturing. As seen in Chart 4 below, the manufacturing PMI Index (blue line) has been in contraction for almost a full year.

During the month of September, the U.S. Manufacturing PMI reading was 49, which marked the 11th consecutive month of contraction. This 11-month period represents the longest stretch of contraction for U.S. Manufacturing since the recession during the Great Financial Crisis in 2008-09, which is noteworthy.

On a positive note, September's reading of 49 was ahead of the consensus estimate of 47.7 and it also exceeded August's reading of 47.6. September also marked the highest PMI reading since November of 2022. Furthermore, September



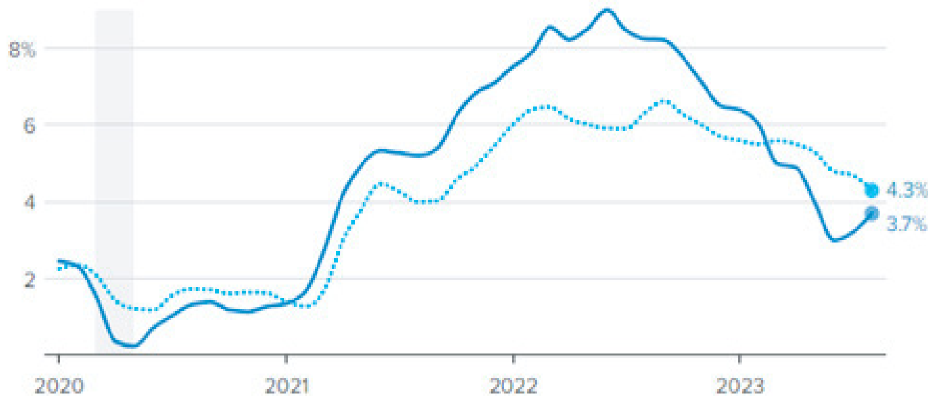


U.S consumer price index

CHART 5

Year-over-year percent change through August 2023

All items ··· Less food and energy



Note: Shaded area indicates recession

Chart: Gabriel Cortes / CNBC
Source: U.S. Bureau of Labor Statistics.
Data as of September 13, 2023

marked the third straight month of improvement reported by the Institute for Supply Management. Another dose of good news came with the survey's measure of prices paid by manufacturers, which fell to 43.8 from 48.4 in August. A large decline in prices paid for inputs by factories bodes well for goods deflation. It's a welcome development, and it's happening at a time when consumer price inflation has fallen significantly relative to where it stood 6 and 12 months ago as seen in Chart 5 above.

The ongoing decline in the consumer price index and the recent data in the producer price index reinforces the view that we are likely towards the tail end of the U.S. Federal Reserve's interest rate hiking cycle. Overall, we are encouraged by the recent manufacturing data and we believe that we are nearing the end of the U.S. manufacturing recession. It's important to note that manufacturing only contributes 11-12% of the U.S. economy as measured by Gross Domestic Product. This helps to explain how we have had a resilient U.S. consumer and a resilient U.S. economy while simultaneously being in a prolonged manufacturing recession.

Outside of the United States, both Europe and China remain in a period of stagnation with sub-par economic growth.

In Europe, the economy continues to be impacted by high energy prices, elevated borrowing costs, and soft demand from export markets such as China. Private-sector activity in the Eurozone region continued to be weak during the month of September with the S&P Global Purchasing Managers survey signalling contraction for the fourth consecutive month. The survey's reading of 47.1 was ahead of consensus at 46.5 and was a slight improvement from August. Having said that, the reading remained below the 50 level, which indicates contraction in the economy.

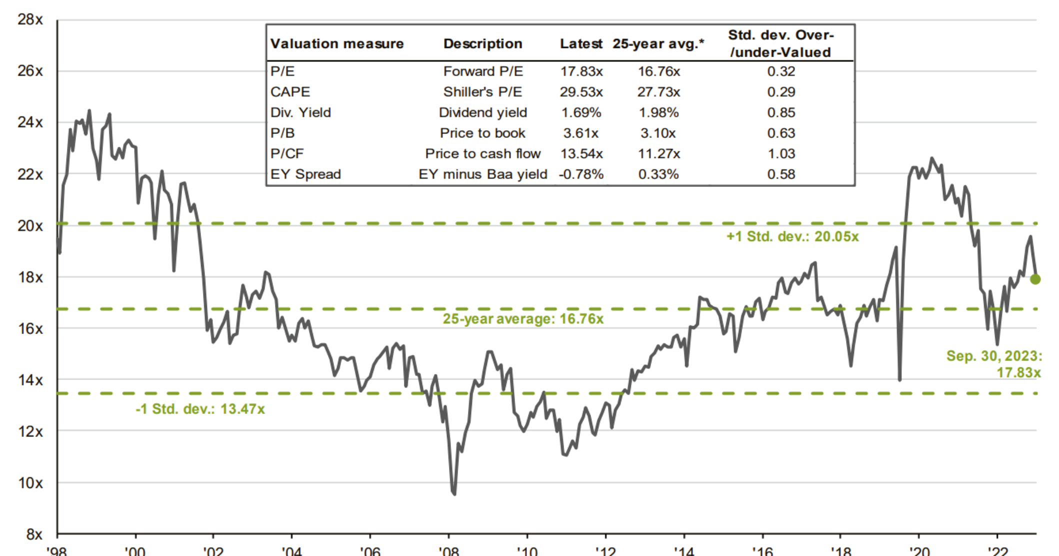
Although the economy in the Eurozone is weak, there is a silver lining. Household and corporate balance sheets are in better shape than normal, so the conditions that are needed to trigger a deep recession are not present according to Philip Lane, Chief Economist at the European Central Bank.

In China, policymakers continue to struggle with various issues related to the property sector. The authorities have recently announced a series of measures to try and stabilize that market. On a positive note, China's factory output expanded in September for the first time in six months, which is fuelling hope that the world's second-largest economy is in the process of bottoming out. The Purchasing Managers Index rose to 50.2 in September, ahead of consensus at 50 and up from 49.7 the previous month. Preliminary signs of improvement had already emerged in August, with factory output and retail sales growth accelerating while declines of exports and imports narrowed. So September's PMI reading above 50 reinforced some of the green shoots that had appeared in August.

In terms of the risks at this time, we are thinking about geopolitics, stock market valuations, and the possibility of a resurgence of inflation in 2024. Given the ongoing tensions between Russia and Ukraine as well as China and the US, we are always mindful of geopolitical risks. In terms of the stock market, the U.S. is a concern given that the S&P 500 is currently above historical levels. As of September 30, 2023, the 12-month forward price-to-earnings (P/E) ratio for the S&P 500 was 17.83x. This is above the 25-year average of 16.76x as seen in Chart 6 below.

S&P 500 Index: Forward P/E ratio

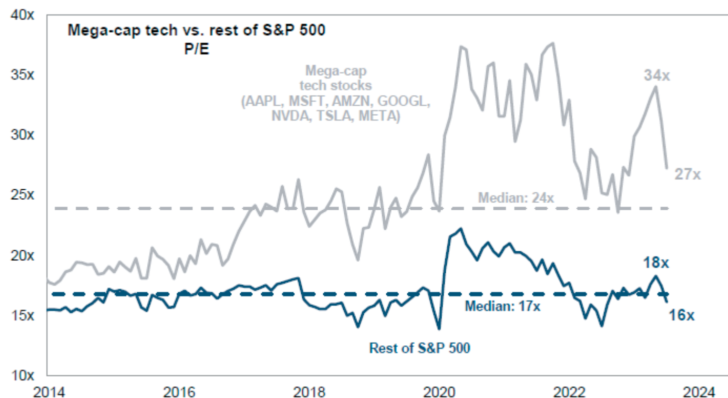
CHART 6



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.83x	16.76x	0.32
CAPE	Shiller's P/E	29.53x	27.73x	0.29
Div. Yield	Dividend yield	1.69%	1.98%	0.85
P/B	Price to book	3.61x	3.10x	0.63
P/CF	Price to cash flow	13.54x	11.27x	1.03
EY Spread	EY minus Baa yield	-0.78%	0.33%	0.58

While we are not alarmed about the S&P 500 trading at a 6.4% premium to the 25 year average, it does represent a risk to the stock market if corporate earnings fall short of expectations over the next few quarters. What makes us feel a bit more comfortable about the valuation for the S&P 500 is that it is skewed by the Magnificent Seven Mega Cap stocks. As seen in Chart 7 below, the S&P 500 was trading at a 12 month forward P/E of 16.0x as of the end of September if you exclude the Magnificent Seven Mega Cap stocks.

CHART 7



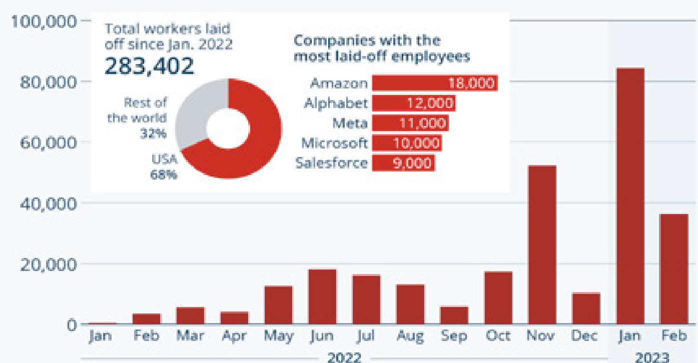
Source: Goldman Sachs Global Investment Research

Outside of geopolitics and valuation, we are also thinking about the possibility of a re-acceleration in inflation next year. Given the ongoing tightness in the U.S. labour market, the potential for a recovery in the manufacturing sector and the recent spike in oil prices, we are carefully monitoring the prospect of a resurgence in inflation at some point in 2024.

Portfolio Review

During the quarter and throughout this year, we have added to our weight in the Technology sector, which we like for several different reasons. The sector generates superior growth to the overall market and over the last few months it has generated the best positive earnings revisions of all sectors in the stock market. The leading Technology companies that we own deliver above average returns on invested capital, they generate robust free cash flow, and they have strong balance sheets. In addition, many of our Technology holdings significantly cut their cost base in anticipation of what was supposed to be a recession in 2023. In the absence of a recession, Tech companies should deliver attractive operating leverage given the substantial reductions in their respective cost bases. A large portion of the cost base reduction was generated through job layoffs. Chart 8 below offers an illustration of the significant job cuts that occurred in the Technology sector and this chart doesn't cover all the losses as some companies announced a second round of layoffs after this data was published.

CHART 8



Source: Layoffs.fyi. As of March 2, 2023

Outlook

We remain cautiously optimistic in our outlook as the final quarter of 2023 gets underway. The global economy continues to grow at a modest pace and inflation has been moderating. After a significant period of pronounced weakness, the U.S. manufacturing industry has improved for 3 consecutive months and could soon move from contraction to expansion. Furthermore, corporate earnings were resilient during the second quarter and were ahead of consensus expectations. Taking all of this together, we remain cautiously optimistic as we head towards the finish line in 2023.

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