QUARTERLY

INVESTMENT OUTLOOK

Q3 2023

ANNEX
WEALTH MANAGEMENT

THANK YOU

Thank you for continuing to choose Annex Wealth Management as your partner to help you achieve your financial goals. We appreciate your continued trust as we look towards the future. As we do every quarter, we've prepared some remarks on this past quarter, the things we've seen, and offer our investment-related thoughts.

THE DIFFERENCES MAKE THE DIFFERENCE

Executive Summary:

Growth: Third quarter was stronger than many expected, but we expect some reversal of that strength that could extend into 2024.

Policy: Even if the Fed doesn't hike rates any further, they're shrinking their balance sheet. This is at a time when the government is running elevated deficits. This has an effect like pushing on the gas while pushing on the brakes.

Inflation: It's likely a long and winding road to the Fed's 2% inflation target. We'll have to navigate some temporary increases in energy price inflation.

Looking ahead: Economic challenges tend to start at the bottom and work their way up. We expect the Fed will ignore signs of weakness and it could become an environment that favors larger and higher quality companies.

Last quarter, the big headlines were about the U.S. government debt limit standoff, the subsequent US credit rating downgrade, banks being downgraded, and, finally, the Federal Reserve indicating it is close to (or at) cruising altitude for rates. This quarter, we are watching whether the cooling labor market becomes icy and whether the July surge in retail spending was the feast before the famine for consumers.

Allegedly, the four most dangerous words in investing are "This time is different." What is actually dangerous is not recognizing what is different this time. It's those differences that can make all the difference in the world when it comes to investing success.

Numerous "resets" are taking place across the economy and markets, which could cause the future to feel a little different than the past.

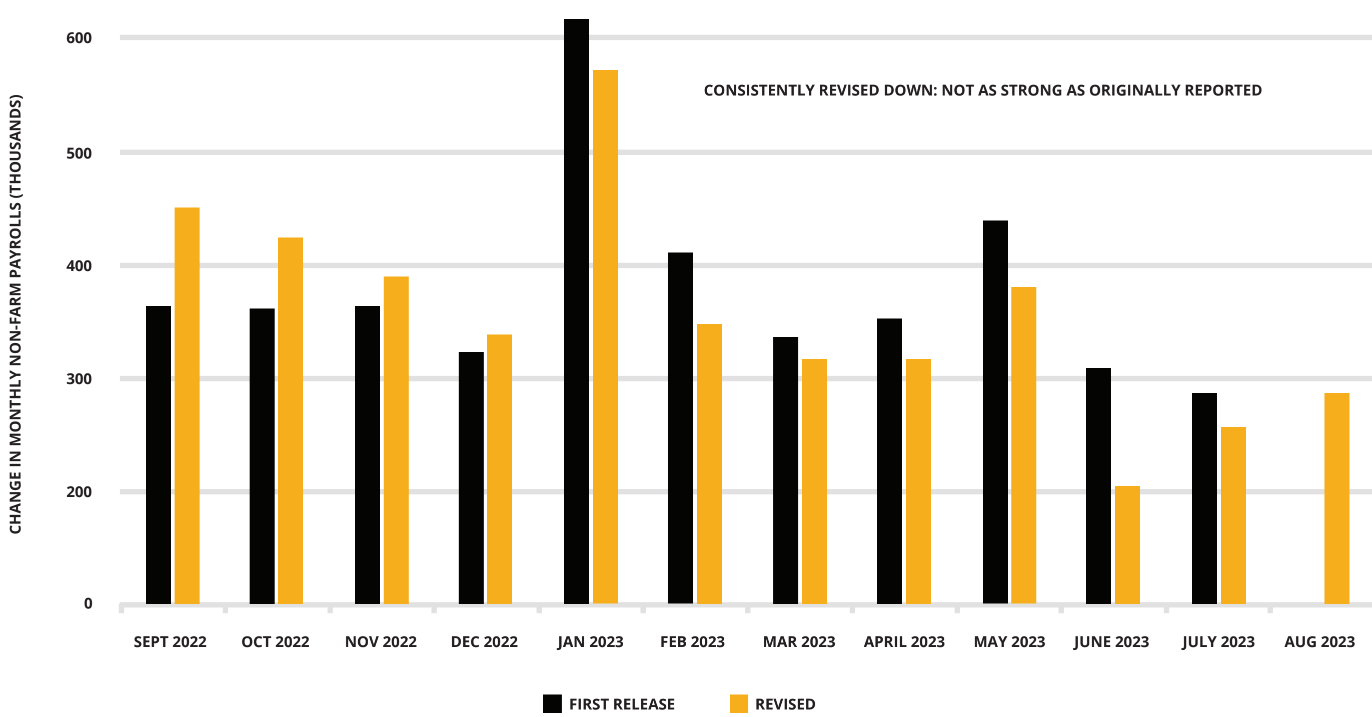
- **Zero interest rates from the Fed?** Gone. Now they're back up to where they were in 2001.
- **Inflation below 2%?** Gone. From 2012 through 2020, the Fed complained about how it was to try to get inflation up to 2%. Now they are struggling to get it down to 2%. Inflation will likely get there, but the struggle is real and will likely persist.
- **Low, but stable growth?** Gone. Instead of the low and stable growth environment of 2010 through 2019 we have erratic growth. It may be low and unstable going forward.

When it comes to the interest rate, inflation, and growth backdrop, there's a lot of things that look new, but are actually old struggles from the pre-2012 or pre-2000 period. One that is brand new is combining these conditions with federal budget deficits that won't go away.

GROWTH: MEAN REVERSION OR MOMENTUM?

The labor market is still healing from the COVID shutdowns with some industries already fully recovered but others continuing to suffer. The overall level of employment in the U.S. is up 3.1% from just before the COVID lockdowns. Construction employment is up 6.2% while employment in the mining and logging sector is down 7.5%. Information technology employment is up 5.5% while leisure and hospitality is just short of getting back to its pre-COVID level. What looks like overheating could be continued thawing from the COVID-induced economic freeze and thawing does not happen uniformly across the economy.

One thing we noticed the market didn't seem to care too much about was how economic data releases were revised lower. Nonfarm payrolls for June, July, and August were all good, but not great. The June and July numbers were revised lower by the government statisticians who gather the data, report it, and then continue to gather more data to revise those numbers. What we thought we knew about job gains just wasn't so after the dust had mostly settled.



SOURCE: BUREAU OF LABOR STATISTICS MONTHLY DATA, COMPARING ORIGINALLY RELEASED NUMBER TO THE REVISED NUMBERS AS OF SEPTEMBER 2023.

The market didn't seem to mind the revisions, though. Perhaps because the silver-lining around the cloud of the labor market slowing is two-fold: job gains are still good and the Fed might feel like it doesn't have to push much harder on the economic brakes.

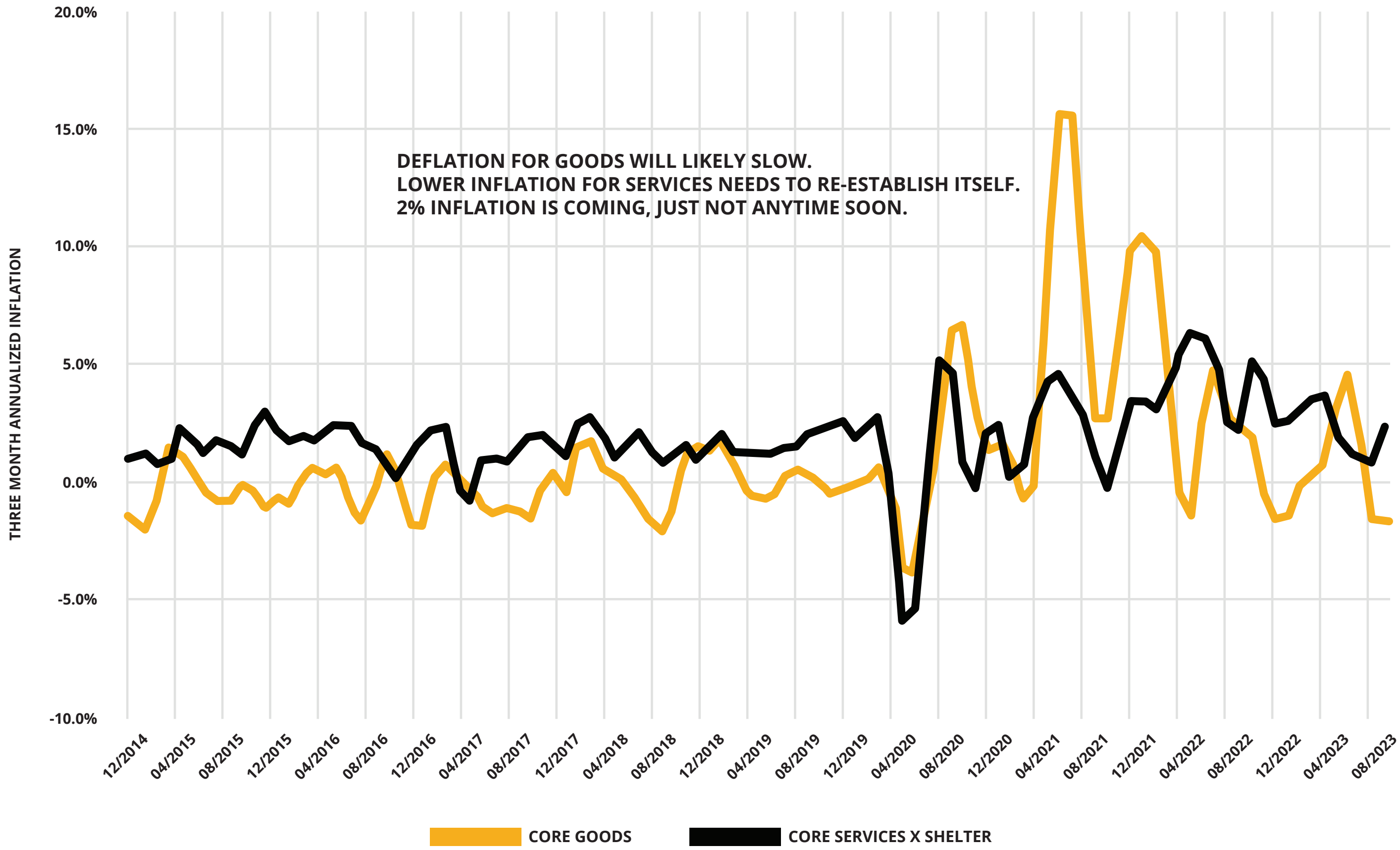
Our concern, perhaps not shared by the market, is that slowing rarely stops where you want it. The economy—and the markets—are prone to overshooting. We think what looks like momentum can turn into "mean reversion." That just means that the really strong retail sales and gross domestic product numbers from the third quarter could reverse, or at least moderate materially, in the fourth quarter.

While Federal Reserve tightening has affected housing and manufacturing, corporate and household balance sheets were strong enough going into the Fed's tightening cycle to withstand rate hikes. In fact, households and businesses that refinanced their debt at millennia low interest rates have benefited by locking in low cost on their debt and investing their savings at significantly higher rates of interest. This doesn't mean the economy isn't sensitive to hikes, it's just that it might be less sensitive than it has been in the past. It's also likely that hikes have an immediate effect on markets and housing and then hikes serve as a slow drag on the broader economy. Tightening still works to slow the economy, but it doesn't slow the economy uniformly nor immediately. Hiking can work fast and slow, depending on the part of the economy you're looking at.

INFLATION: THE LONG AND WINDING ROAD

The Federal Reserve is estimating that it can get to its 2% inflation target by the end of 2025. The financial markets, based on Treasury Inflation Protected Securities, appears to be thinking we could get to 2% a little sooner. We don't see a compelling reason to disagree with the Fed.

While the Fed's track record of forecasting inflation is—to put it politely—not great, core goods inflation has turned to deflation and core services inflation is trending at 2.3%. A risk is that core services inflation has moved slightly higher since March, but a lot of that is due to rising insurance costs. Insurance costs tend to reset higher periodically, but they do not tend to be persistent drivers of inflation.



SOURCE: BUREAU OF LABOR STATISTICS MONTHLY DATA FROM DECEMBER 2013 THROUGH AUGUST 2023.
CHART SHOWS THE ANNUALIZED THREE-MONTH PERCENTAGE CHANGE IN THE PRICE INDEXES.

Food and energy prices have been moving higher, but while these prices are very visible, together they make up about 20% of consumer spending. They also tend to be "mean reverting," where a large increase in prices is often followed by a large decrease. Even if they don't decrease, they tend to be a one-off increase in inflation. Lower inflation does not require lower prices, it just requires them to stop rising as quickly.

Wage growth is not likely to fan the flames of inflation. Wage growth peaked in July 2022 and has been moderating fast. The biggest increases in wages were seen in lower wage industries, like leisure and hospitality. There was also a large gap between wage growth for those who stayed at the same employer versus those who sought greener pastures elsewhere. The growth trend in wages is moderating across the board.

Even if wage growth doesn't slow, that doesn't mean inflation is set to move higher. There are two avenues by which wages can grow and it won't affect consumer prices. One is via productivity growth. If people are paid more because they produce more, that's a good thing. We get more goods and services and it doesn't have to mean higher prices.

Another shock-absorber between wages and inflation is profit margins. If workers demand and get higher wages, consumer prices don't have to rise. Instead, profit margins can compress. Our money is on businesses making less money per dollar of revenues. That's not great for the overall market outlook, but it's not horrible either. As long as revenues grow faster than margins fall, earnings can still move higher.

For some perspective, going back to 2010, the median operating margin (a measure of profit margins) for the S&P 500 was 9.86%. As of the second quarter of 2023, the S&P 500's operating margin was 11.86%. Every sector has margins higher than their historical median profit margins, meaning there's some room for those to fall. We think it makes sense to try to identify companies within any given industry that are likely to have more resilient margins than their peers.

POLICY: RIDING THE BRAKES

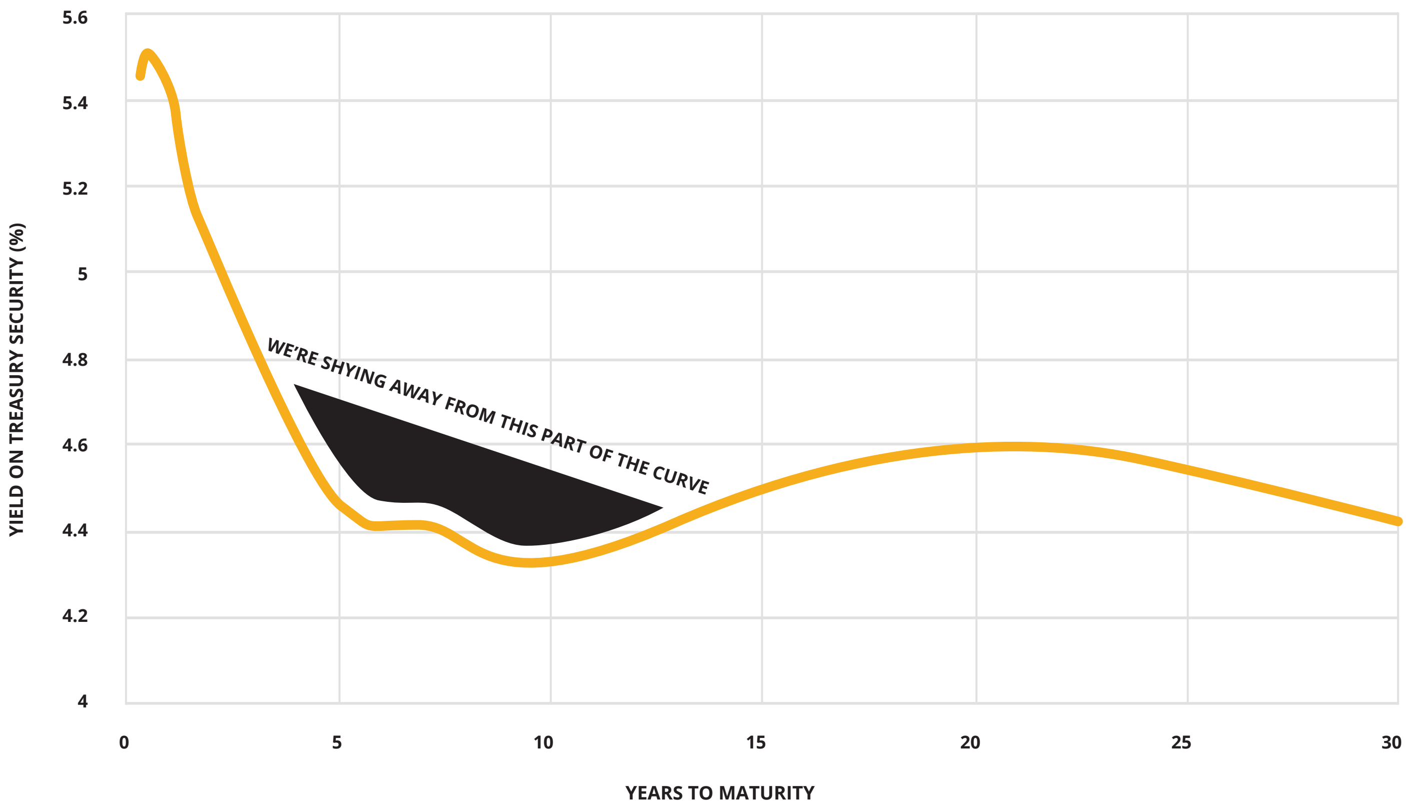
The Fed is (mostly) done with hiking. That doesn't mean it will start cutting rates. As of now, it doesn't seem like there is a good reason to hike; nor is there a good reason to cut. Even if there are signs of economic slowing and inflation makes a miraculous leap lower, the Fed will probably be loath to react with cuts. It is very fast to react to financial system problems, but it is notoriously slow to react to growth and inflation problems. Part of that is because of the data. Financial market data is available in real time. Economic data is not. Plus, it's hard to pick out whether there is a trend forming or not in the economic data. This means the Fed is likely going to send a message that it will keep rates where they are for at least the next 12 months. Yes, things can change, but that doesn't mean the Fed will change its collective mind or messaging. The recent announcement from the Fed about its projections for policy over the next few years prove this as they effectively said they think they'll only need to cut rates twice in 2024. Back in June they thought they'd have to cut four times.

Even if the Fed is done hiking rates, that doesn't mean monetary tightening is over. As inflation has moved lower, real rates have risen. That's just math: nominal rates equal real rates plus inflation. If nominal rates are fixed and inflation goes lower, real rates move higher. That means the real cost of financing investment and spending (and government debt) rises.

Plus, the Federal Reserve is shrinking its balance sheet. How low it will go is anyone's guess. We think they'll keep shrinking their balance sheet until something unexpected happens. That's what will get the Fed's attention and let them know that they went a little too far.

What is that "thing" that needs to happen? One we'd watch for is the continued "bear steepening" of the yield curve. That's just a fancy way of saying that short-term yields stay about where they are and longer-term yields move slightly higher. Given the strange shape of the yield curve (the relationship between yields and maturity), the "belly of the curve" (the middle part) looks like the least attractive part to us. Our thinking is that there will either be an abrupt adjustment to that segment; or, there will be little movement. Either scenario means combining short-maturity with long-maturity exposure to bonds (a so-called "barbell strategy") could give better outcomes than allocating across all the parts of the yield curve.

FIGURE 3: THE YIELD CURVE (THE RELATIONSHIP BETWEEN YEARS TO MATURITY AND THE YIELD) IS DISTORTED, CREATING OPPORTUNITIES AND RISKS.



SOURCE: FEDERAL RESERVE DATA AS OF SEPTEMBER 16, 2023.

As the Fed trims its balance sheet, the Treasury is issuing more debt. At the time of writing, a government shutdown isn't likely to be a major market event, but it could be longer lasting than most previous ones. A deal to fund the government could trigger some "austerity" measures, but it's more like "relative austerity" rather than "absolute austerity." Absolute austerity is actually reducing the deficit. Relative austerity is reducing it relative to some projected future increase so it stays where it is or gets worse, but at least better than what was originally projected. It's like claiming you saved a ton of money by using a coupon to buy something you over-paid for and didn't even need. Without the Fed being a captive buyer of Treasuries, government bonds will likely need to be priced more appropriately than they have been over the last decade.

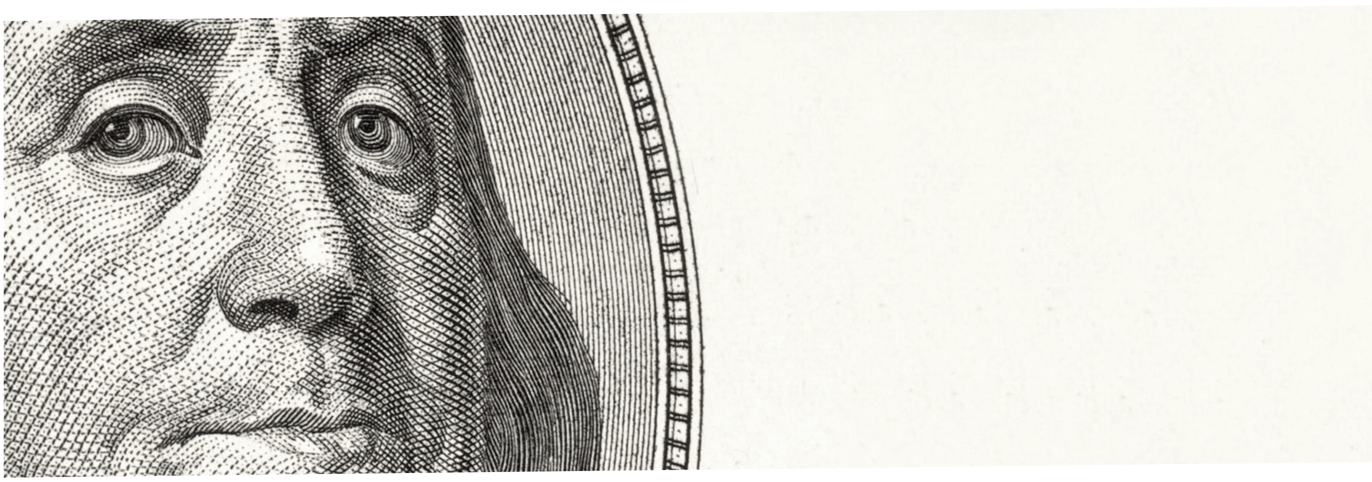
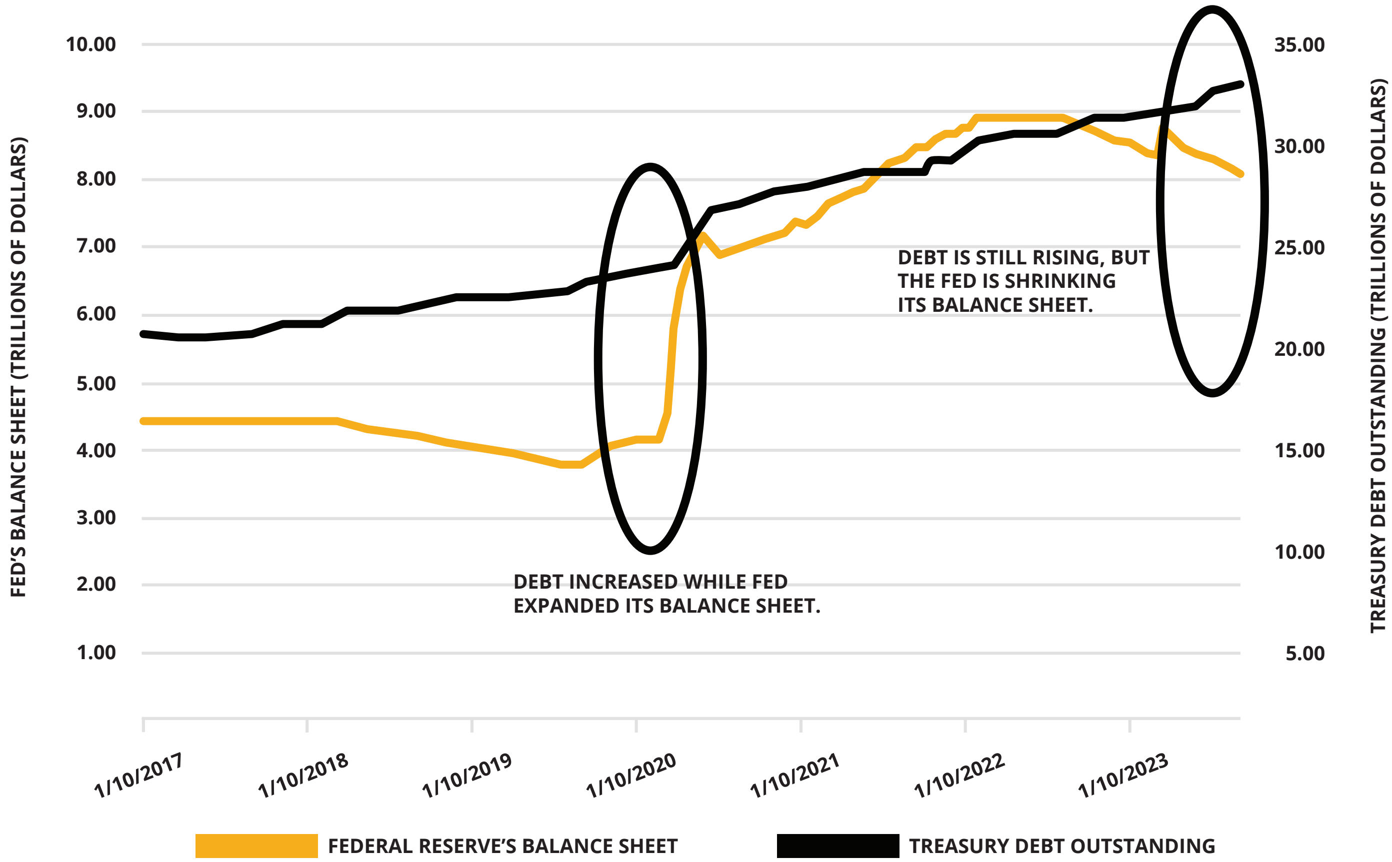


FIGURE 4: DURING COVID, THE FED AND TREASURY WERE PROVIDING STIMULUS TOGETHER. NOW THEY'RE MOVING IN OPPOSITE DIRECTIONS.

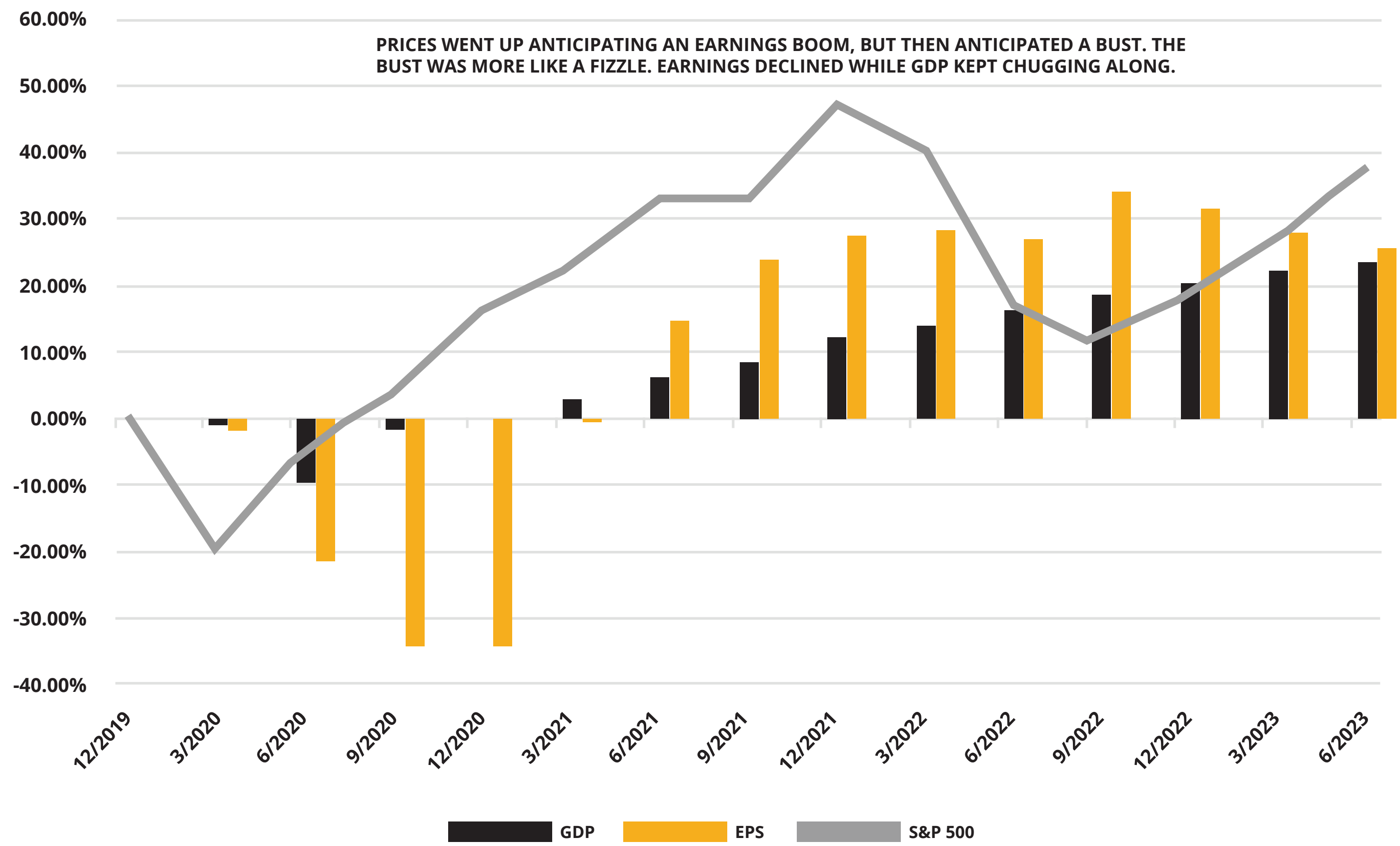


SOURCE: BLOOMBERG DAILY DATA FROM DECEMBER 2016 THROUGH SEPTEMBER 2023

LOOKING AHEAD

GDP is not the same thing as the S&P. That means the economy (as measured by gross domestic product) is not the same thing as the markets (the S&P 500, for example). Markets are forward looking and our measures of the economy are backwards looking. The fortunes of individual companies don't depend exclusively on how the broad U.S. economy is doing. Companies are adaptable with lots of levers to pull to effect revenues and expenses. They also often serve markets outside the U.S. That's why we've had a profits recession, even if the U.S. economy skirted a recession. It's also why an economic slowdown doesn't have to mean another leg lower is coming for corporate earnings. It would be unusual for it not to happen, but it's not a foregone conclusion. We're of the belief that markets might be a bit too optimistic about how well insulated corporate earnings are from broad economic slowing.

FIGURE 5: MARKETS ANTICIPATED THE EARNINGS RECESSION. EARNINGS HAVE FALLEN WHILE THE BROADER ECONOMY HASN'T.



SOURCE: BLOOMBERG QUARTERLY DATA FROM DECEMBER 2019 THROUGH SEPTEMBER 2023.

For consumers, the splurge in spending in July had to shift towards filling up the tank in August. Retail sales rose a lot more than expected in August, but that was almost all due to higher gasoline prices. The government might not be able to shift from profligacy to austerity, but we might be in the early stages of the consumer's shift to austerity. Manufacturing is having a tough time finding a footing. It's been ups and downs for the last year. Hard times will turn to good times at some point, but not yet.

For these reasons, we're looking at opportunities at the intersection of resilient profitability and value for equities. Investors have historically underestimated how persistent profitability can be for well-run businesses. We think that creates opportunities to add to those types of names.

For fixed income we're aware of the risks that an economic slowdown can pose to the riskiest borrowers; and we're aware of the risks that volatile inflation and high Treasury issuance can pose to longer-term bonds. We like the approach of "straddling the fence" with adding more yield in short-term fixed income and judiciously adding exposure in longer-term fixed income to lock in higher long-term rates.

There is an old saying that bull markets climb a wall of worry. There's always something—or many things—to worry about. A lot of what we do from a tactical perspective is to try to figure out not only what is the "fear of the day," but also what will the fear of tomorrow be? On top of it, we have to take a stance on whether the market is overestimating or underestimating whether those fears will become reality. Strategically, over long periods of time, the positive and negative surprises tend to cancel out. Corporate profits and markets tend to march higher. Taking the long view can help get through those short-term periods of unease.

OUR GOAL

As an investment committee our principal goal is to build portfolios that generate attractive risk-adjusted returns. We continually monitor corporate fundamentals and macroeconomic factors as well as ongoing risks and opportunities. At Annex Wealth Management, we take the long-term viability and success of your financial plan very seriously. We are vested in your long-term success and are here for you should you want to discuss your report in greater detail. As always, please feel free to contact us with any questions or concerns.

We would like to thank you for choosing Annex Wealth Management as your wealth advisor. Finally, if you are aware of friends or family members who would benefit from a second opinion on aspects of their financial well-being, please let us know.

We certainly appreciate your business and welcome the opportunity to meet with you to review your portfolio. Please call for an appointment at your convenience.

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