INVESTMENT OUTLOOK
A PEAPACK PRIVATE PUBLICATION

THIRD QUARTER 2023 INVESTMENT OUTLOOK: PADAM PADAM, OR THE SEARCH FOR MEANING

I get the shivers when I look into your eyes (padam)
And I can tell that you're all in (padam)
'Cause I can hear your heart beatin'
Padam
Padam
–Ina Wroldsen

Don McLean recorded and released his number one single, *American Pie*, in 1971. Filled with oblique and not so oblique references—to pop culture, to the music scene, to American society—the song was subjected to endless analysis by sociologists, teachers, fans, and mere mortals. Everyone wanted to know what it meant.

What does it mean that the levee was dry? Who were the good ol' boys, drinking whiskey and rye? For that matter, who was the departing Miss American Pie?

Then in 2023 along comes *Padam Padam*, a song gone viral as could only happen in the social media-dominated 21st century. Australian pop superstar Kylie Minogue's electro-pop hit has been streamed millions of times, spurred memes, and inspired choreography videos. Padam has become a noun, a verb, an adjective. Its fans are petitioning to have "Padam Padam" enter the Oxford English Dictionary. More than that, the song has engendered a similar quest of interpretation, an effort to understand its import, despite featuring lyrics that are pared down, elemental, raw. (You can hear it here: *Padam Padam* • Kylie Minogue at spotify.com)

As it is with song lyrics, so it is with economic data. It is in our DNA as market observers to seek meaning in every data point, to try to determine where we are in the business cycle and what it means for future stock and bond prices. The fact that data are often labile does not deter us from the game—our determination made greater by our struggle to understand the environment in which we operate.

MARKETS ARE CHALLENGED: THE PRICE IS WRONG

Come on down!
–Bob Barker

We honor the life of Bob Barker, host of *The Price is Right* for 35 years, on his passing this summer. The show's less than sophisticated format began with an announcer calling out an audience member's name, and then Bob would urge the contestant-to-be to 'come on down' to the stage to guess as accurately as possible the price of a consumer good—a television, a dinette set, or the ultimate, a BRAND NEW CAR.

Market forecasters are a lot like those hapless contestants. They have a vague, general sense of the levels that markets should be trading at, but can get tripped up trying to be precise. Most forecasters have found 2023 to be a particularly challenging time to predict the direction and level of markets.

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	-3.3%	13.1%
US Small-Mid Cap Stocks	Russell 2500	-4.8%	3.6%
International Developed Markets Stocks	MSCI EAFE	-4.1%	7.1%
Emerging Markets Stocks	MSCI EM	-2.9%	1.8%
Real Estate Securities	MSCI US Real Estate	-7.0%	-2.0%
Commodities	Bloomberg Commodities Futures	4.7%	-3.4%
Bonds	Bloomberg Barclays US Aggregate	-3.2%	-1.2%
Cash	FTSE USBIG 1 Month Treasury Bill	1.4%	3.7%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

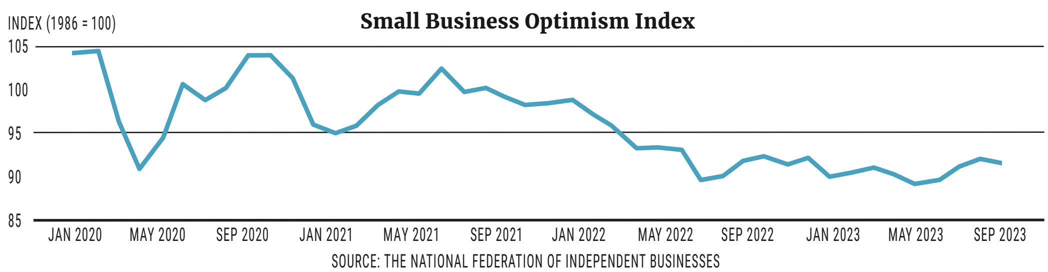
But Bob Barker might have been talking to markets, not studio audience contestants, in saying a final "Come on down!" In the third quarter, almost all asset classes posted negative single digit returns. The driver of declines was higher interest rates, as inflation has been sticky and the Fed has maintained its restrictive stance in both deed and word. Financial markets had been pricing in cuts in interest rates as early as the fourth quarter, an expectation propping up equity markets. Surprising economic resilience helped the Fed's oft-repeated 'higher for longer' mantra to gain credibility, resulting in US stock prices falling back modestly. Internationally, a disappointing China growth story—the relaxation of tough Covid policies producing underwhelming economic expansion—has acted as a brake on both developed and emerging market economies. The only winners for the quarter were commodities and cash. Commodities rose on higher oil prices that resulted from OPEC's supply cutbacks, and cash benefited from rising short-term interest rates.

For the year to date, however, most asset classes are still in the green, with the technology-heavy US large cap asset class gaining the most. Megacap technology stocks pulled the averages up, as they benefited from the enthusiasm for all things artificial intelligence. Continuing a theme from last year, higher interest rates drove down the prices of existing bonds, producing a negative 'total return.'

ECONOMIC EXPANSION AND CONTRACTION

Padam Padam…It's onomatopoeic…like a heartbeat.
–Kylie Minogue

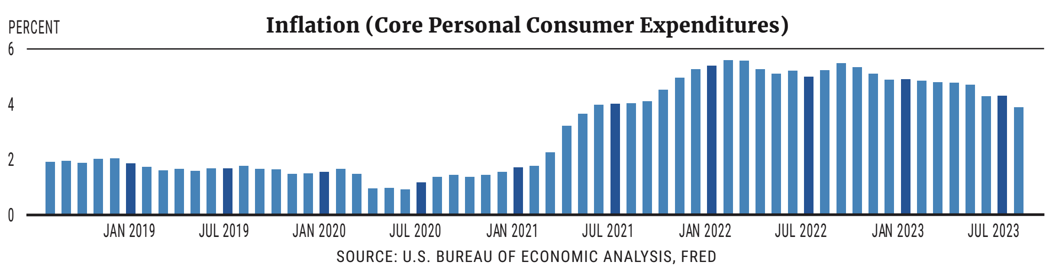
The heartbeat of the American economy is said to be small business, employing 46.4% of private sector employees according to the US Census Bureau. And the news on that front is not great. As the chart below shows, small business optimism has been at depressed levels ever since the pandemic.



Another indication of economic stress: business bankruptcies are rising. Through August 2023, bankruptcy filings are higher than they were for all of 2021 and 2022, according to Standard & Poor's.

It's hardly all bad news on the economic front. The labor market remains healthy. New job creation continues to exceed new entrants to the labor force, and new weekly unemployment claims remain low. And a healthy job market provides solid support for consumer spending.

And even though there is further room to travel, we have seen substantial progress on the inflation front. The Fed's preferred inflation gauge, core Personal Consumption Expenditures, ticked down to an annual rate of 3.9% in August. That's the lowest reading since May 2021.



Even more encouraging, the three-month annualized core inflation rate was 2.2% in August.

Still, these are lagging economic indicators. Looking ahead, we view the current narrative of a soft landing—inflation coming under control while economic momentum is maintained—with some concern. Among those concerns:

• The impact of higher interests has been limited, but seems likely to take a bigger bite out of the economy going forward. Higher interest rates likely explain the dramatic decline in existing home sales, and rising delinquencies for credit cards and automobile loans. Elevated interest rates will adversely affect businesses as they refinance maturing bonds and loans, homebuyers confronted with mortgage rates north of 7% and record low affordability, and the federal budget as the US Treasury issues new bonds.

• Consumer spending has been a bulwark of the fairly robust economy, but may be less constructive going forward. Surplus savings from government support during the pandemic have been significantly spent down, and higher prices for essentials—food, rent, gasoline—are cutting into discretionary spending. The savings rate has dropped to 3.5%, and the moratorium on student loan payments has ended.

• Corporations may encounter shrinking profit margins, as they face constraints on their ability to pass along higher costs to end consumers. Should that prove to be the case, the lack of pricing power will force companies to reduce expenses—primarily by shedding employees, as labor hoarding gives way to the pressure to meet earnings expectations.

Other more topical worries—as we write, an imminent government shutdown, striking automobile workers, an OPEC-induced energy spike—are likely to prove to be transitory from an economic growth perspective, even as they raise other concerns. However, they all, at the margin, slow the heart rate of economic momentum. Padam, padam meets lub-dub: a rapid heartbeat subsides to the sound of the routine filling and emptying of the economic heart's chambers.

MARKET MOMENTUM: STRONG PULSE, WEAK HEART

It means whatever you want it to mean.
–Kylie Minogue

Among the events of 2023 we struggle to understand and interpret (the rise of RFK, Jr.; the view that Taylor Swift and Beyoncé juiced the economy in the third quarter; scientists' discovery of ultramassive black holes) is rising equity prices in the face of higher interest rates.

Technology Returns vs. 10-Year US Treasury Rate

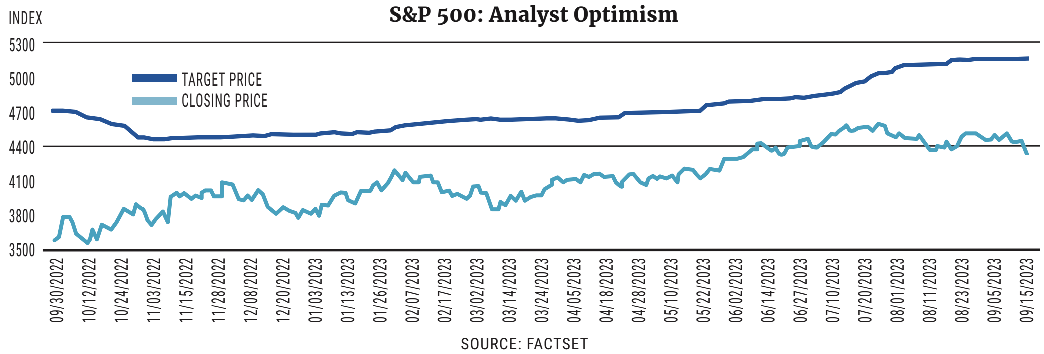
SOURCE: FACTSET

The chart above plots technology stocks against the 10-year US Treasury. Normally, stocks in general, and technology stocks especially, decline in value when interest rates rise.

This is logical. Higher interest rates increase the attractiveness of bonds, relative to stocks. Put in corporate finance terms, higher interest rates raise the cost of capital for businesses—for which investors demand higher returns in the form of discounted stock prices.

So rational market behavior suggests that interest rates and stock prices are inversely correlated. And they were, in 2022. But not in 2023, when interest rates and equity prices became positively correlated.

Other market phenomena this year are head-scratching, too. The heartbeat of the stock market is earnings, and one of the tenets of fundamental investors is that ultimately earnings (or, at least, expectations of earnings) drive stock prices, but year-over-year earnings have fallen for the S&P 500 for the past three quarters, and are expected rise only 1% in the just-completed third quarter of 2023. Granted, the market is forward looking, and analysts project the S&P 500 earnings will rise 12% in the next twelve months. (We view that forecast as aspirational.) But even if earnings come through, consider analysts' target price for the S&P 500 twelve months hence.

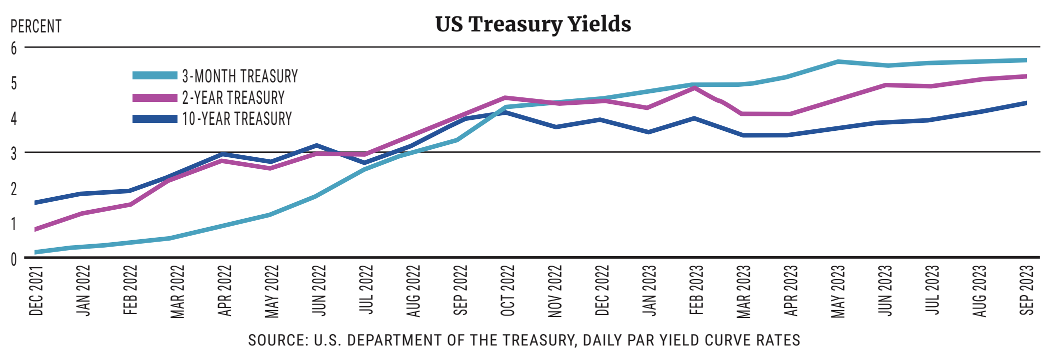


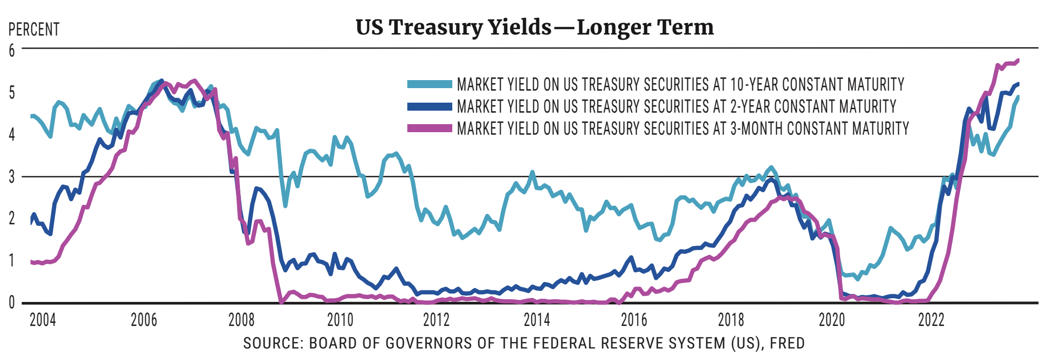
The chart above indicates that market observers see 19% upside from current market levels, vastly in excess of earnings growth expectations. All this, when today's stock market valuations are already lofty, at 18.6 times expected earnings for the next twelve months.

Meanwhile, over in bondland, the 2023 story is a continuation of last year's narrative. Inflation has fallen and is falling, but remains well above the Fed's target. Accordingly, the Fed has continued to lift rates, and higher rates mean lower bond prices.

While mortgage applicants and other borrowers face significantly higher borrowing costs, savers and investors are seeing the richest yields on their savings and bondholdings in 15 years.

The first chart below shows the substantial increase in yields for Treasury debt of varying maturities over the past 18 months, as the Fed began to raise interest rates in earnest. The second chart below shows interest rates for the same duration US Treasurys over the past 20 years. Note current yields are as attractive as they've been over this span of time.





It's a feast for bond investors who suffered from interest rate suppression for over a decade, following the Global Financial Crisis. Yields now north of four and five percent? Padam, padam. Be still, my heart.

TREATING FINANCIAL MARKET HYPERTENSION

Padam, Padam
I hear it and I know…
Padam, Padam
I know you wanna to take me home…
Padam
And take off all my clothes…
Padam, Padam
When your heart goes…
Padam
–Ina Christine Wroldsen

So what does it mean, when economies and markets perform in surprising and unpredictable ways? How should we understand and react to unanticipated developments that appear contrary to reason? These questions seem particularly apt at this juncture, where economic and market information comes at us, fast and furious but also confusing and contradictory.

PADAM PADAM…
It's a greeting. It's a farewell.
There is a call and response.
Say it, then you have to say it back.
Answer, or answer yourself.
–Kylie Minogue

Economies and markets are complex systems, multi-factorial and in constant flux. It makes interpreting them particularly challenging. One technique to help focus analyses is to be mindful of Occam's razor, the philosophical principle that urges seeking explanations that require the fewest possible assumptions (sometimes over-reductively expressed as 'the simplest explanation is usually the best one').

Other tools that help us: the legal standard in civil cases of the 'preponderance of the evidence' (i.e., what's more likely than not), and the corporate finance concept of a weighted average, which considers the relative importance of each value under consideration.

When we run economic data through these various screening and evaluation techniques, we conclude that deceleration is the most likely path for the economy. Forward looking indicators, including yield curve inversion (whereby short-term rates are higher than long-term rates), and the index of leading economic indicators, continue to point to recession, even as coincident and lagging indicators are holding up. The cumulative effect of 525 basis points of interest rate increases may have been deferred but is still likely to take a bite out of economic growth. That plus quantitative tightening—the Fed has reduced its balance sheet by one trillion dollars and is continuing to do so—are likely eventually to offset the fiscal stimulus of the Inflation Reduction Act and infrastructure spending.

When we look at stock market data, we see US equities as fairly fully priced in the context of elevated interest rates. Equities appear to reflect an expectation of interest rate cuts that is not consistent with either current levels of inflation or the Fed's longstanding assertion that interest rates may have to remain higher for longer. They also appear to reflect an expectation that wage inflation will either moderate considerably or that companies will be able to increase prices to cover higher costs. We don't share such a sanguine view of consumers' capacity to lift their spending.

When we look at bond market data, it strikes us that the current level of rates is in restrictive territory. That being the case, the Fed is likely at or near the end of its interest rate increase mode, barring a sustained flare-up in inflation. At the same time, it is not likely to cut rates too quickly as it pauses to see if inflation continues to subside. If it proves true that rates may be peaking, and 2024 brings a less robust economy, investors can enjoy high real yields and venture prudently into intermediate term bonds.

So, risk averse short term investors have an opportunity, for the first time in a generation, to hide out in cash and high quality short term bonds and earn respectable returns. For longer term investors, our cautious economic outlook and our valuation concerns suggest not over-spending one's risk budget. In other words, equity rallies are opportunities to rebalance a portfolio and return equity weightings to no more than neutral levels. Within equities, in a world in which margins may be challenged and earnings expectations are optimistic, our longstanding bias in favor of high quality companies remains a driving force. We also favor higher quality bonds, given where we are in the economic cycle and the attractive absolute yields available in the space.

Sometimes matters are less complex than they may seem, when pared to essentials. Kylie Minogue tells us Padam has taken on its own meaning. A music commentator declares that the two-syllable sound has an untranslatable, universal quality. Sounds mysterious, deep, profound.

But is it really? The singer knows her lover wants to get it on with her. How does she know? It can be heard in a heartbeat. And the sound of the heartbeat drives the song. And we should not be surprised. After all, contemporary music is, among other things, about the dominance of rhythm over melody and harmony. And perhaps that's all there is. It's not that obscure—it's elemental, eternal, profane.

In investing, as in songs, we sometimes torture ourselves trying to interpret complexities. Or see complexities whether they're there or not. When the daily bombardment of data results in seemingly incompatible possibilities, we might pause and ask if we really need to forecast the strength of the US dollar or the level of the S&P 500 on December 31st. Instead, if we refocus on essentials, we emerge from the fog. We figure out our risk tolerance and time horizon. We determine an asset allocation consistent with those parameters. And we monitor our pulse, to make sure our allocation continues to reflect our goals. Because that is where meaning lies—in pursuing and achieving our goals. And, thus, in following our heart. Padam, padam indeed.

PEAPACK PRIVATE

500 HILLS DRIVE, SUITE 300, BEDMINSTER, NJ 07921
TEL (908) 234-0700 • WWW.PEAPACKPRIVATE.COM

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