

# The Immaculate Slowdown

## November 2023 Market Commentary

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## Economic Outlook: U.S. Economy Slowing from Torrid 3rd Quarter Pace But Recession on Hold



### Headlines throughout November 2023:

1. Softer Inflation and Employment Data Move Up Timeline for Fed Easing in 2024
2. Geopolitical Tensions Simmer Down
3. The Comeback of the 60/40 Portfolio as Both Equities and Fixed Income Rally in November
4. Investor Sentiment Continues to Favor Big Tech



### Underneath the Surface:

1. Earnings Releases Remain Mixed (Strong in Tech But Weak More Broadly)
2. Q3 S&P Earnings: 98% Reported So Far w/ YOY 4.5% Increase
3. Consumer Credit Stress Building Up for Lower Income Cohorts



### 2023 GDP Bloomberg Consensus:

1. US: +2.4% (↑ from +0.3% in 4Q22)
2. Europe: +0.5% (↑ from -0.1% in 4Q22)
3. Japan: +1.7% (↑ from +1.2% in 4Q22)
4. China: +5.2% (↑ from +4.8% in 4Q22)

## Positioning Update\*: Focus on the Here and Now

Time Horizon	Risk Category	Positioning Themes / Targets
Current Distribution (1-3 Years)	<ul style="list-style-type: none"> <li>▪ Capital Preservation</li> <li>▪ Current Income</li> </ul>	<ol style="list-style-type: none"> <li>1. Emphasize liquidity over illiquidity</li> <li>2. Favor shorter maturity bonds and TIPS</li> <li>3. Defensive on overall credit risk</li> <li>4. Favor investment grade MBS/ABS</li> </ol>
Later Distribution (3-10 Years)	<ul style="list-style-type: none"> <li>▪ Strategic: Conservative to Moderate</li> <li>▪ Deferred Income</li> <li>▪ Tactical</li> </ul>	<ol style="list-style-type: none"> <li>1. Greater mix of fixed income to equities with some equity buffers</li> <li>2. Strategic: Favor smaller caps, high quality, value and dividend-paying stocks; global diversification</li> <li>3. Tactical: Fully invested across all sectors</li> <li>4. Fixed Income: Defensive on credit risk and rate volatility</li> <li>5. Favor investment grade MBS/ABS</li> </ol>
Strategic (> 10 Years)	<ul style="list-style-type: none"> <li>▪ Strategic: Moderate to Aggressive</li> </ul>	<ol style="list-style-type: none"> <li>1. Greater mix of equities to fixed income with some equity buffers</li> <li>2. Strategic: Favor smaller caps, high quality, value and dividend-paying stocks; global diversification</li> <li>3. Fixed Income: Defensive on credit risk and rate volatility</li> <li>4. Favor investment grade MBS/ABS and taxable municipal</li> </ol>

\*Positioning Update Implied by Freedom Investment Management, Inc. Managed Model Portfolios (Risk-Based ETFs, Risk-Based DFA Funds, Lee Adaptive Large Cap Sector) as of 11/30/2023

### Key Benchmarks: Performance and Characteristics as of 11/30/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	9.1%	6.1%	20.8%	19.0x	14.6x	22.9x	
MSCI EAFE	9.3%	4.9%	12.3%	13.2x	11.2x	18.2x	
MSCI Emerging	8.0%	3.8%	5.7%	11.6x	9.5x	15.3x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg U.S. Aggregate	4.5%	2.9%	1.6%	US REITs	11.8%	8.4%	2.3%
Bloomberg U.S. High Yield	4.5%	3.3%	9.4%	GSCI Commodities	-3.6%	-7.7%	-1.0%
Bloomberg Global Agg ex U.S.	5.5%	4.6%	1.2%	GSCI Prec Metals	3.3%	10.5%	11.0%

Data Source: Bloomberg

### November 2023 Highlights:

- Global equity markets surged in November, recovering much of the losses over the past three months, as prospects of central bank easing and a simmering of geopolitical tensions helped renew risk appetite. The U.S. dollar weakened over expectations of U.S. monetary easing and improving economic conditions across the rest of the world, particularly Europe. The MSCI All-Country World Index (ACWI) returned +9.2% for the month of November.
- Across major regions, European and U.S. equities outperformed Asian and Emerging Markets. MSCI Europe returned +9.9% and the S&P 500 returned 9.1%, outperforming MSCI Japan (+8.6%), MSCI Emerging Markets (+8.0%), and MSCI Pacific ex Japan (+7.4%).
- Within the U.S., small caps marginally underperformed large caps as small caps continue to lag large caps this year, encapsulating the narrowness of this year's U.S. equity advance, primarily from the Magnificent 7 mega-cap tech companies. S&P Pure Value outperformed Pure Growth, with the former helped by a recovery in interest-sensitive financials and beaten down consumer cyclicals. For the month of November, the S&P 500 Index returned +9.1% versus +8.3% for the S&P 600. S&P Pure Value outperformed Pure Growth, returning +10.4% and +5.8%, respectively.

- Across sectors, growth (Technology, Consumer Discretionary) and interest-sensitive Financials and Real Estate outperformed traditional cyclicals and defensive sectors (Healthcare, Utilities, Staples), while Energy was hurt by lower commodity prices.
- Among major risk factors, in November, only Momentum outperformed the broader market. Momentum and High Quality outperformed Value, High Dividend, and Minimum Volatility as high growth risk saw a persistent bid throughout the month.
- Fixed Income markets rallied following a sharp drop in interest rates and narrowing credit spreads. U.S. Treasury yields dropped in anticipation of a slowing economy and government spending as well as expectations of central bank easing throughout 2024. The Bloomberg U.S. Aggregate Bond Index returned +4.5% for the month, as the 10-Year Treasury yield dropped to 4.3% from the 5% peak level seen in early October.
- The Global ex-U.S. Aggregate Index returned +5.5%, outperforming the U.S. Agg, reflecting U.S. dollar weakness. Bloomberg Emerging Market Local Currency also outperformed U.S. fixed income, returning +5.2% for the month, while Bloomberg US High Yield continued its strong YTD performance, returning +4.5% for the month, as credit spread compression helped offset the lower maturity profile of high yield debt.
- Within equity alternatives, Real Estate outperformed, benefiting from the drop in interest rates and relief from expected Fed easing in 2024. Gold prices also rallied from expectations of easier Fed policy, with spot prices rising above \$2000/ounce. Commodities were hurt by lower oil and agricultural prices, even though copper prices turned higher. In November, the Dow Jones REIT Index returned +11.8% and the S&P GSCI Precious Metals Index returned +3.3%. The S&P GSCI Commodities Index returned -3.6% for the month hurt by lower energy prices.
- The worst of the post-COVID surge in inflationary pressures seems to be behind us, and financial assets have discounted the rearview as well as the optimism over U.S. earnings growth and profitability. As valuations rise with the forward P/E of the S&P 500 reaching 19x (close to its peak level of 20x-21x over the past 10 years) and real interest rates drop (along with risky credit spreads), the traditional 60/40 portfolio is re-emerging as the favored strategy for positioning into 2024, but with a smaller margin of error.

## The Immaculate Slowdown



Source: istockphoto.com

*“To understand the Fed's behavior during the late 1990s, it is crucial to recognize that the U.S. economy appeared to be operating in a sweet spot. The economy avoided recession, and core CPI inflation declined quite steadily on a year-over-year basis. This situation — neither too hot nor too cold — came to be known as Goldilocks. Many observers attributed the subdued inflation to increased productivity. Whatever the cause, inflation remained subdued and that gave the Fed additional scope to intervene and supply liquidity to the market.”*

*– The Fed, the Stock Market, and the "Greenspan Put", Federal Reserve Bank of Richmond, 1<sup>st</sup> Quarter 2023<sup>1</sup>*

Immaculate disinflation<sup>2</sup> was coined earlier in the year, conceptualizing an economic and interest rate backdrop that would see current inflationary pressures trend towards long-term targets (2%) without crashing the economy and spiking unemployment. This past summer witnessed investor doubts over the achievement of that scenario as both global equities and bonds sold off with expectations that global central bank monetary policies would remain tighter for longer even as core (ex-energy, food) inflation had been trending lower.

However, this past month saw a return of investor optimism that the disinflation slowdown will ultimately prevail with several Fed governors, notably Christopher Waller<sup>3</sup>, who observed that higher real (inflation-adjusted) interest rates are having a tightening effect on the economy and financial conditions. Higher rates are helping to slow down inflation at a pace the Fed is comfortable with such that further rate hikes may not be warranted. Both global equities and fixed income rallied over prospects that we may be approaching an end to central bank tightening with easing expected in 2024.

As we head into 2024 with consumer spending still quite strong, even with signs of a post-COVID slowdown<sup>4</sup> (**Figure 1**), the economic environment appears to be shifting towards an Immaculate Slowdown, a corollary that sees a meaningful deceleration of economic activity (spending, investing, inventories) without resulting in a recession.

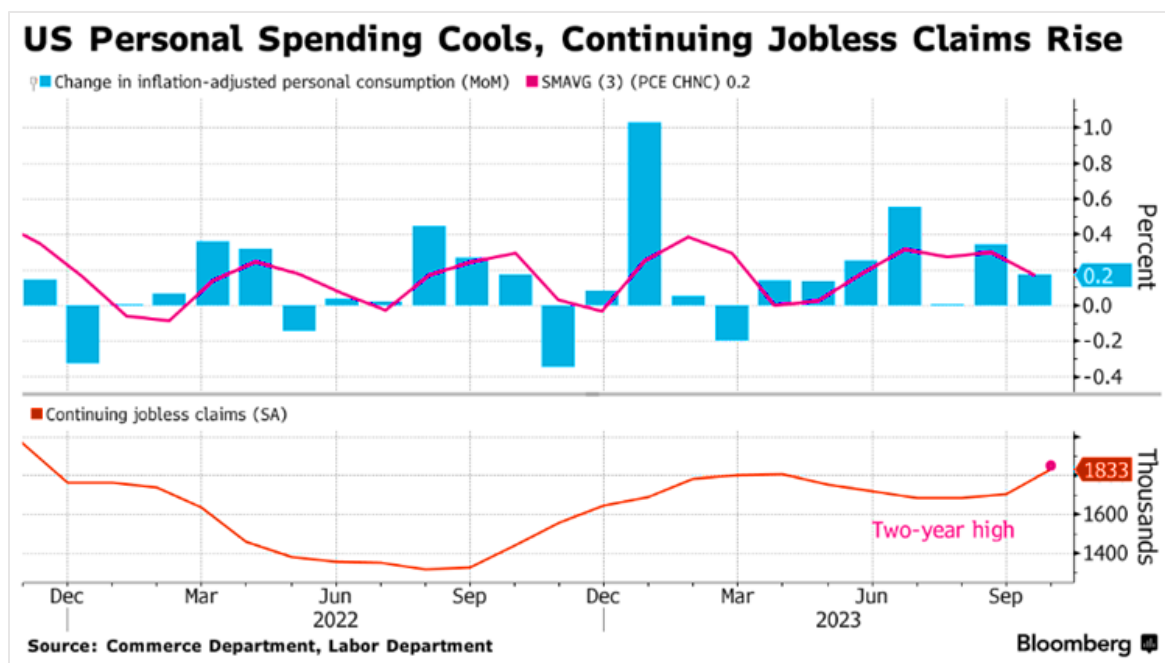
<sup>1</sup> [“The Fed, the Stock Market, and the "Greenspan Put"”, Federal Reserve Bank of Richmond, 1st Quarter 2023](#)

<sup>2</sup> [“‘Immaculate disinflation’ is the new economic buzzword. But what does it mean?” CNN, 9/6/2023](#)

<sup>3</sup> [“Something Appears to Be Giving,” Governor Christopher J. Waller, Speech to the American Enterprise Institute, 11/28/2023](#)

<sup>4</sup> [“Americans Are Finally Turning Frugal After Splurging Over Summer,” Bloomberg, 12/1/2023](#)

Figure 1 – Immaculate Slowdown in Spending and Hiring

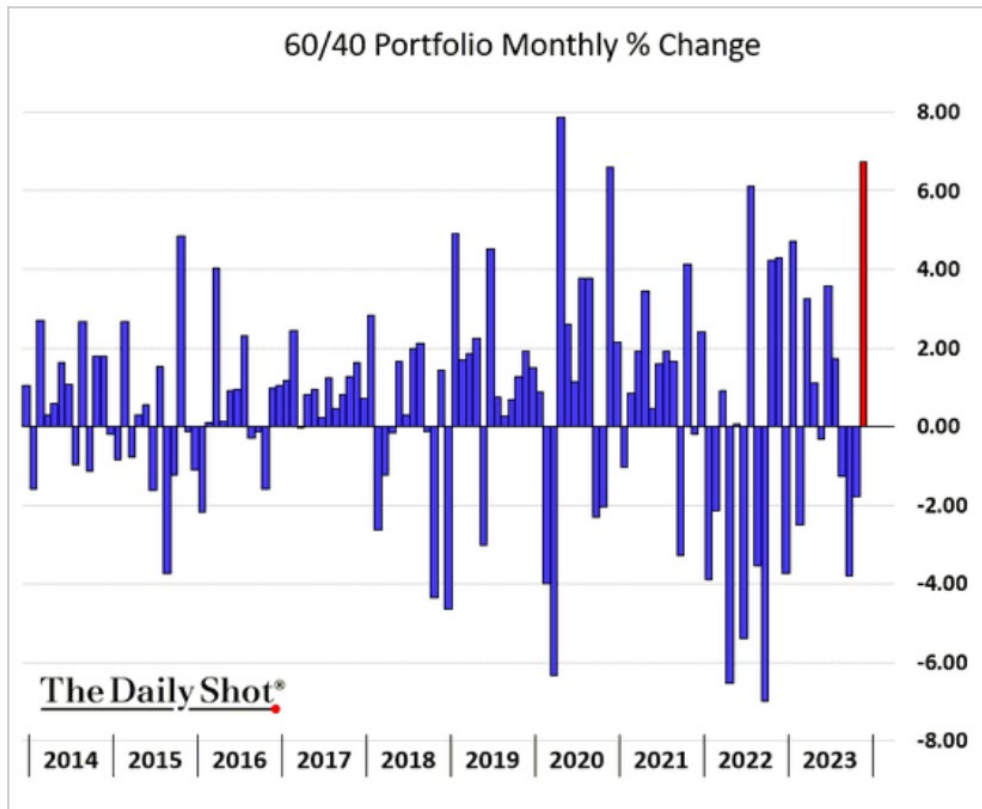


Indeed, the traditional 60/40 portfolio of equities and rate-sensitive fixed income had seemingly been abandoned from the beginning of 2022 through the fall of this year, with investors shifting towards rate-insensitive fixed income (i.e. money market funds) and hedged equities via covered call writing programs. In our [October 2023 Commentary, “Climbing the Wall of Worry Brick by Brick,”](#) [registration required] we had concluded with this remark:

*“The investment landscape is being set up where the classic 60/40 equity/fixed income portfolio has become the new maximum pain trade. Many investors only want to hold cash yielding 5% as opposed to locking in longer-term rates due to higher sensitivity to rate volatility, and investors are increasingly hiding out in the mega-cap technology stocks as valuations between large cap growth and value have only widened so far this year and approaching peak valuation gaps seen in 2020-2021.”*

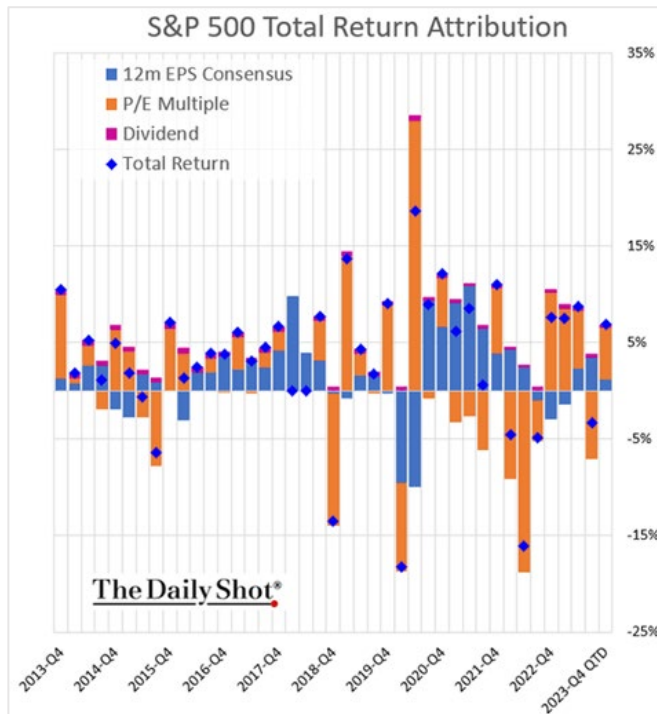
Little could we have foreseen that the timing of that max pain trade (i.e. those abandoning the classic 60/40) to immediately occur with the simple 60/40 (S&P 500/Bloomberg US Aggregate Bond) up 7.3% in November, posting its third best monthly return over the post-COVID period (**Figure 2**).

**Figure 2 – The Revenge of the 60/40 (S&P 500/Bloomberg US Agg) Allocation in November**

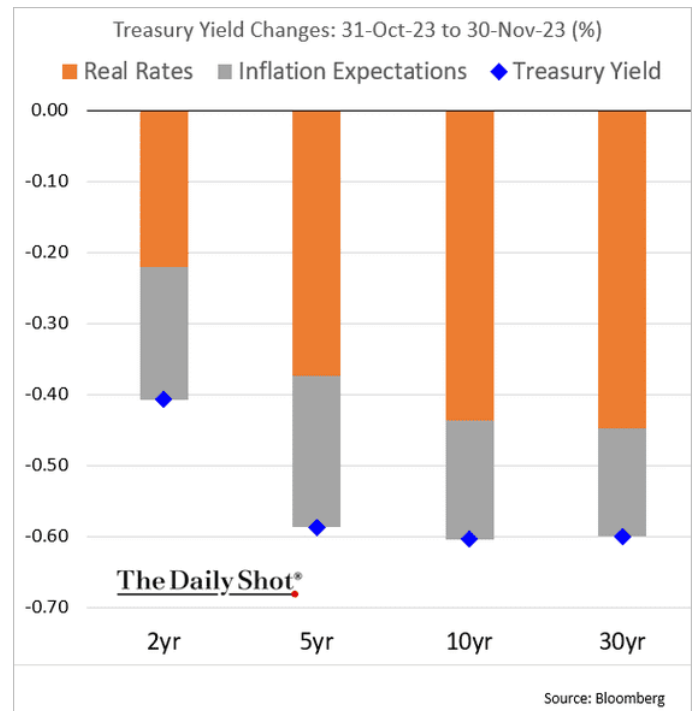


Equity valuations (earnings multiples) expanded (**Figure 3**) and real interest rates (**Figure 4**) dropped producing an immaculate environment of strong positive performance across both risk-on and risk-off asset classes (the exception being commodities dragged down by a drop in energy prices – see the November Market Review section below). The economic soft-landing scenario that many had doubted earlier in the year (see our [August 2023 Market Commentary](#), “Soft Landing in Sight”) has increasingly becoming the base case outlook for 2024, at least through the election.

**Figure 3 – Higher Equity Valuations (Earnings Multiples) Explains Most of the Q4 QTD Return**

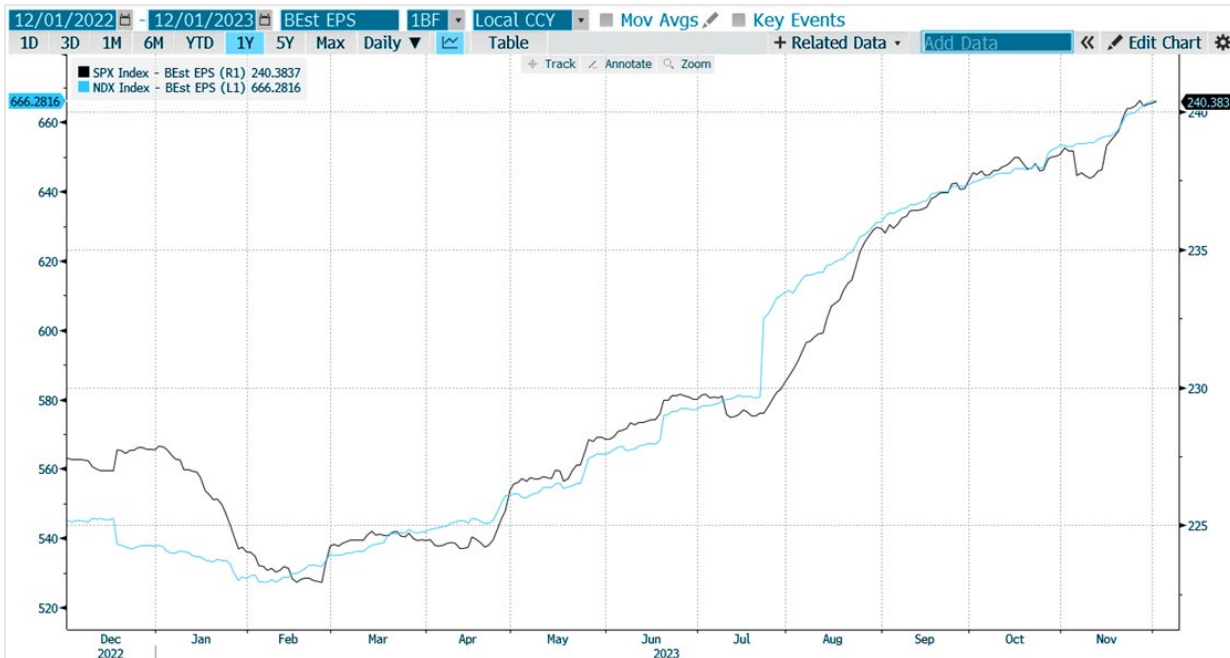


**Figure 4 – Lower Real Rates Explain Most of November’s Lower Move in Treasury Yields**



As the third quarter earnings season wraps up, several industrial and consumer discretionary companies sounded cautious or warned on forward guidance, but overall earnings estimates continue to climb higher, boosted by increased technology spending (cloud, digital, servers, artificial intelligence) (Figure 5, 6, and 7).

**Figure 5 – Sellside U.S. Earnings Estimates Heading Into 2024 Increasingly Optimistic**



Source: Bloomberg Consensus Earnings Estimates (BEst EPS) for the S&P 500 and Nasdaq Index

Figure 6 – Top-Line Growth Optimism Driven by the Magnificent 7 U.S. Technology

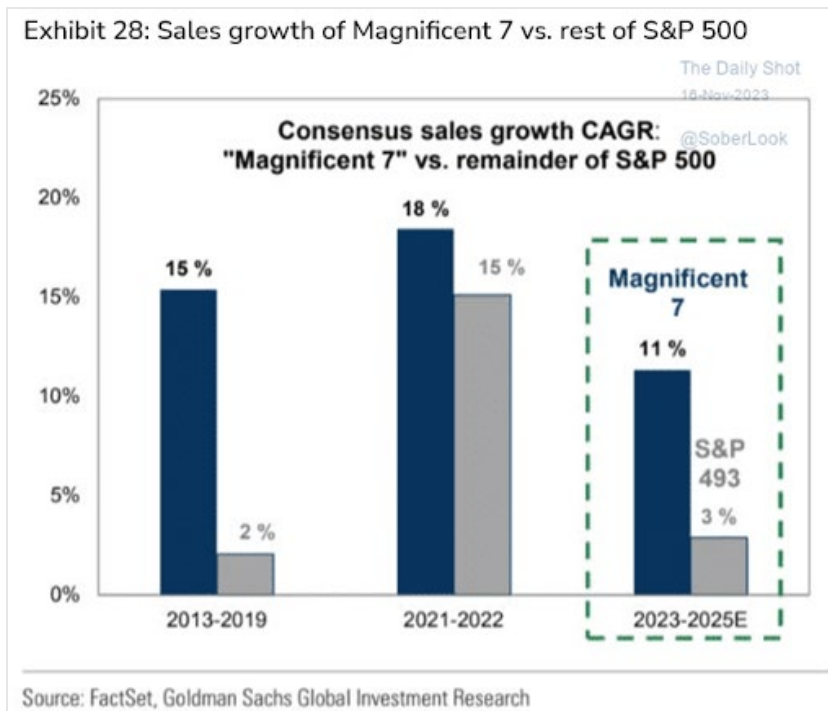
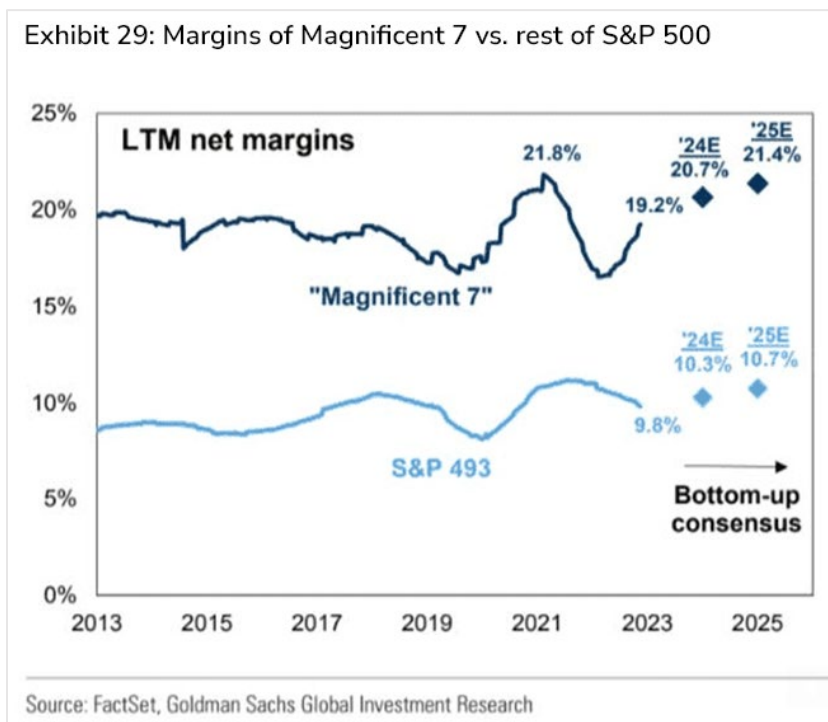


Figure 7 – Profitability Optimism Driven by the Magnificent 7 U.S. Technology



Wall Street had been somewhat cautious heading into Q3 reporting season given the tightening financial conditions from higher interest rates and the borrowing climate becoming more precarious with rising credit delinquencies and defaults. Yet S&P 500 companies reported 4.8% year-over-year growth in earnings with 98% of companies reported so far according to Factset Earnings Insight (12/1/2023)<sup>5</sup>. For CY2023, analysts now project 0.8% earnings growth (2.3% revenue growth) and have raised their outlook for CY2024, projecting 11.7% earnings growth (5.4% revenue growth). Profitability remains resilient with the aggregate net profit margin at 12.2%, above the 5-year average of 11.4%. An earnings recession does not appear to be on the horizon.

### Fed Policy Expected to Moderate Over Slowing Conditions and Higher Productivity

Following Waller's AEI speech, the timetable for the first Fed Funds Rate cut has been moved forward from June 2024 to March/April 2024 with expectations of 4-5 rate cuts priced into the Fed Funds futures curve over the next year (**Figure 8**). Fed easing should help take pressure off borrowers and lenders contending with tightening conditions due to higher rates.

**Figure 8 – First Fed Funds Rate Cut Now Expected in March/April 2024 and Nearly Five Rate Cuts Expected Over the Next Year**

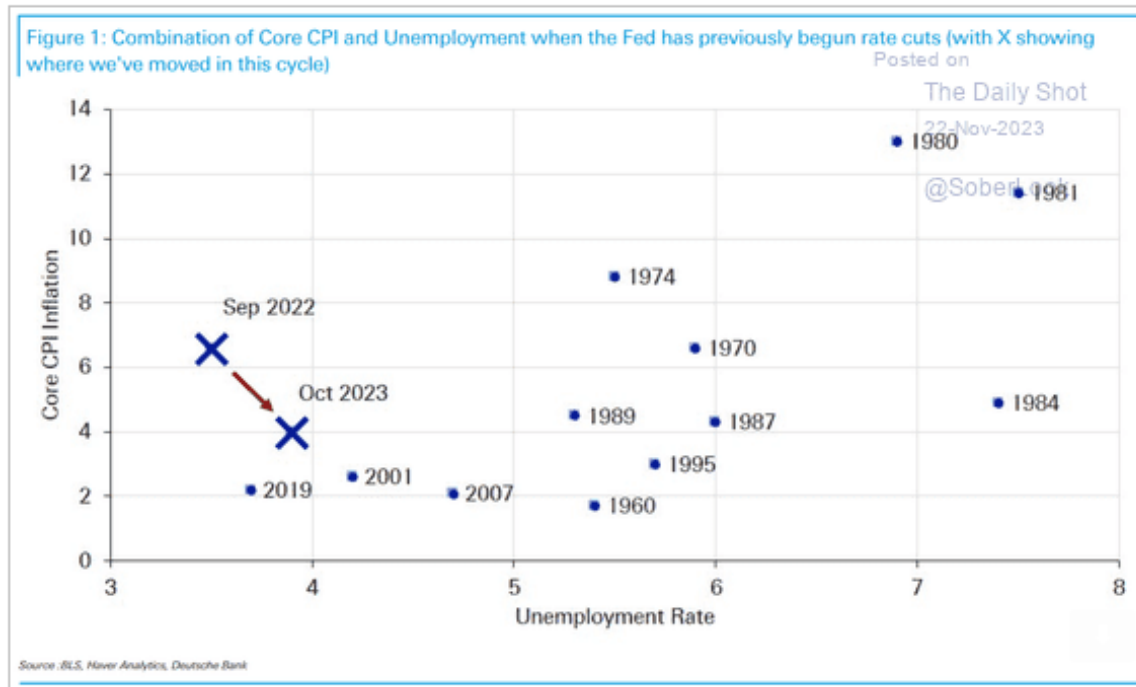
Region: United States »		Instrument: Fed Funds Futures »				
Target Rate	5.50	Pricing Date	11/30/2023			
Effective Rate	5.33	Cur. Imp. O/N Rate	5.329			
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.	
12/13/2023	+0.036	+3.6%	+0.009	5.338	0.250	
01/31/2024	-0.044	-8.0%	-0.011	5.318	0.250	
03/20/2024	-0.528	-48.4%	-0.132	5.197	0.250	
05/01/2024	-1.124	-59.6%	-0.281	5.048	0.250	
06/12/2024	-1.856	-73.2%	-0.464	4.865	0.250	
07/31/2024	-2.544	-68.8%	-0.636	4.693	0.250	
09/18/2024	-3.299	-75.5%	-0.825	4.504	0.250	
11/07/2024	-3.996	-69.6%	-0.999	4.330	0.250	
12/18/2024	-4.559	-56.3%	-1.140	4.189	0.250	
01/29/2025	-5.164	-60.6%	-1.291	4.037	0.250	

Source: Bloomberg World Interest Rate Probability (WIRP)

<sup>5</sup> Factset Earnings Insight, 12/1/2023

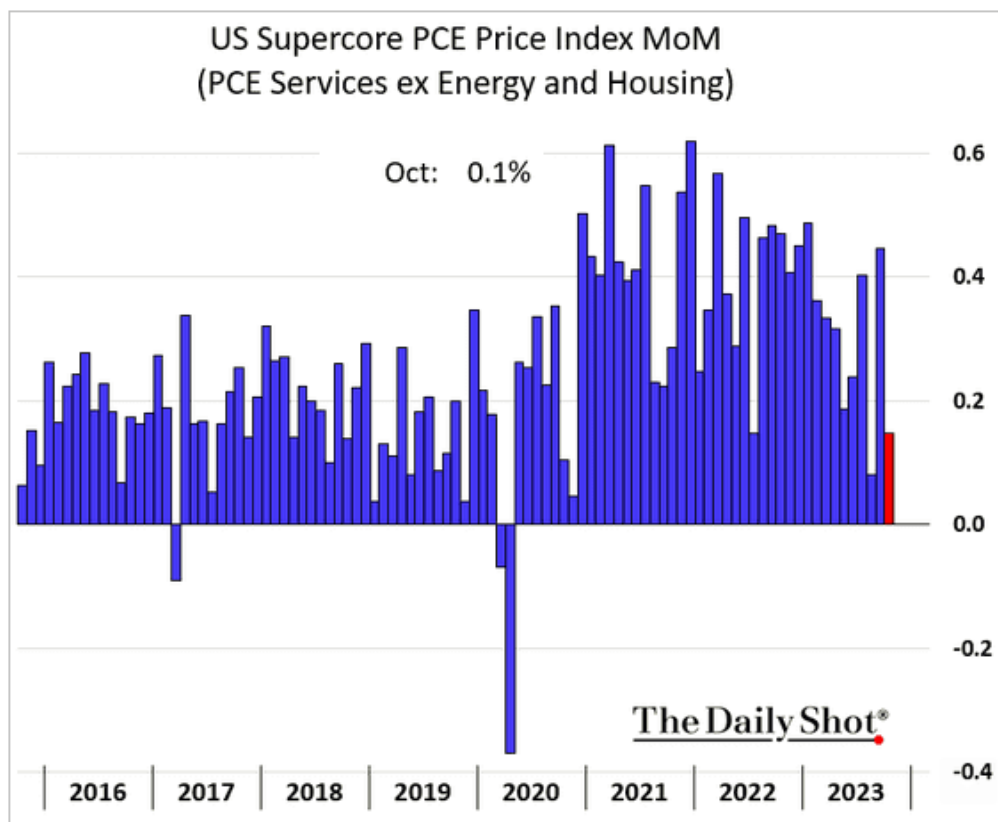
The Immaculate Slowdown represents the backdrop for the Fed to begin easing policy as core inflation moves lower and the unemployment rate moves higher (**Figure 9**), even if core inflation remains well above the Fed's long-term 2% average target and the labor market remains at historically tight levels even as hiring slows down.

### Figure 9 – Inflation and Labor Backdrop Setting the Stage for Fed Easing



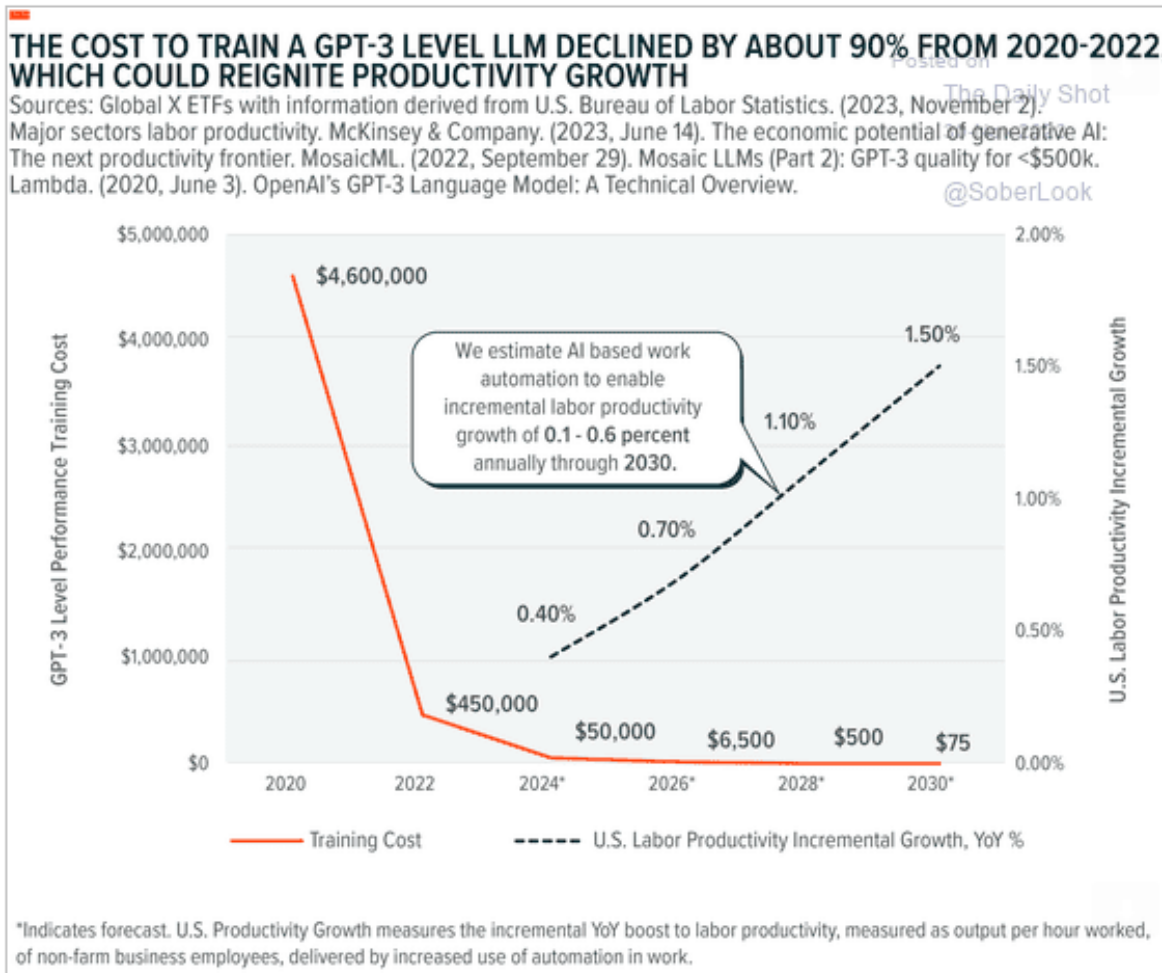
The backdrop for the continued bull run in equities draws similar parallels to that of the mid-1990s when the Fed started easing after its 1994 tightening campaign that helped bring down inflation along with a productivity boom from technology spending. Alan Greenspan’s July 1999 Humphrey-Hawkins speech<sup>6</sup> could be mostly applied for the current environment, leaving out concerns over Y2K. As supercore (core services inflation ex shelter) is slowing down dramatically (**Figure 10**), productivity is expected to receive a large boost from generative artificial intelligence initiatives (**Figure 11**), echoing similar optimism over the tech/telecom spending surge in the late 1990s.

**Figure 10 – Inflation Services (ex Shelter and Energy) Slowing Down from Peak 2021-22 Levels**



<sup>6</sup> “Testimony of Chairman Alan Greenspan – The Federal Reserve’s Semiannual Report on Monetary Policy,” 7/22/1999

Figure 11 – Optimism Over Labor Productivity Boost from Generative Artificial Intelligence



## Valuation Remains the Long-Term Weighing Machine (What You Pay for Today Influences What You Can Earn Tomorrow)

The worst of the post-COVID surge in inflationary pressures seem to be behind us, and financial assets have discounted the rearview as well as the optimism over U.S. earnings growth and profitability. Institutional investor crowding in the Magnificent 7 has reached historical levels of concentration (**Figure 12**) while the prospective returns of the top mega-cap names remains market-level at best (**Figure 13**).

As valuations rise with the forward P/E of the S&P 500 reaching 19x (close to its peak level of 20x-21x over the past 10 years) and real interest rates drop (along with risky credit spreads), the traditional 60/40 portfolio is re-emerging as the favored strategy for positioning into 2024, but with a smaller margin of error should Immaculate Slowdown prove to be anything but.

**Figure 12 – It's Getting Crowded in the Mega-cap Tech Space**

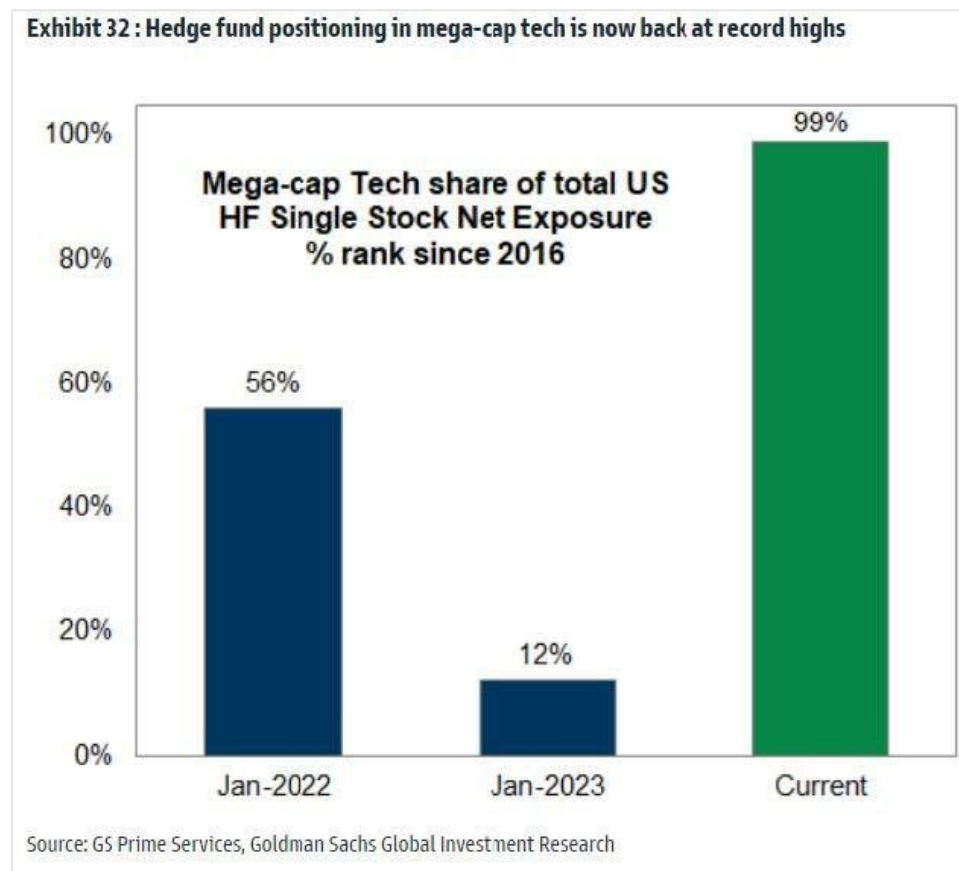
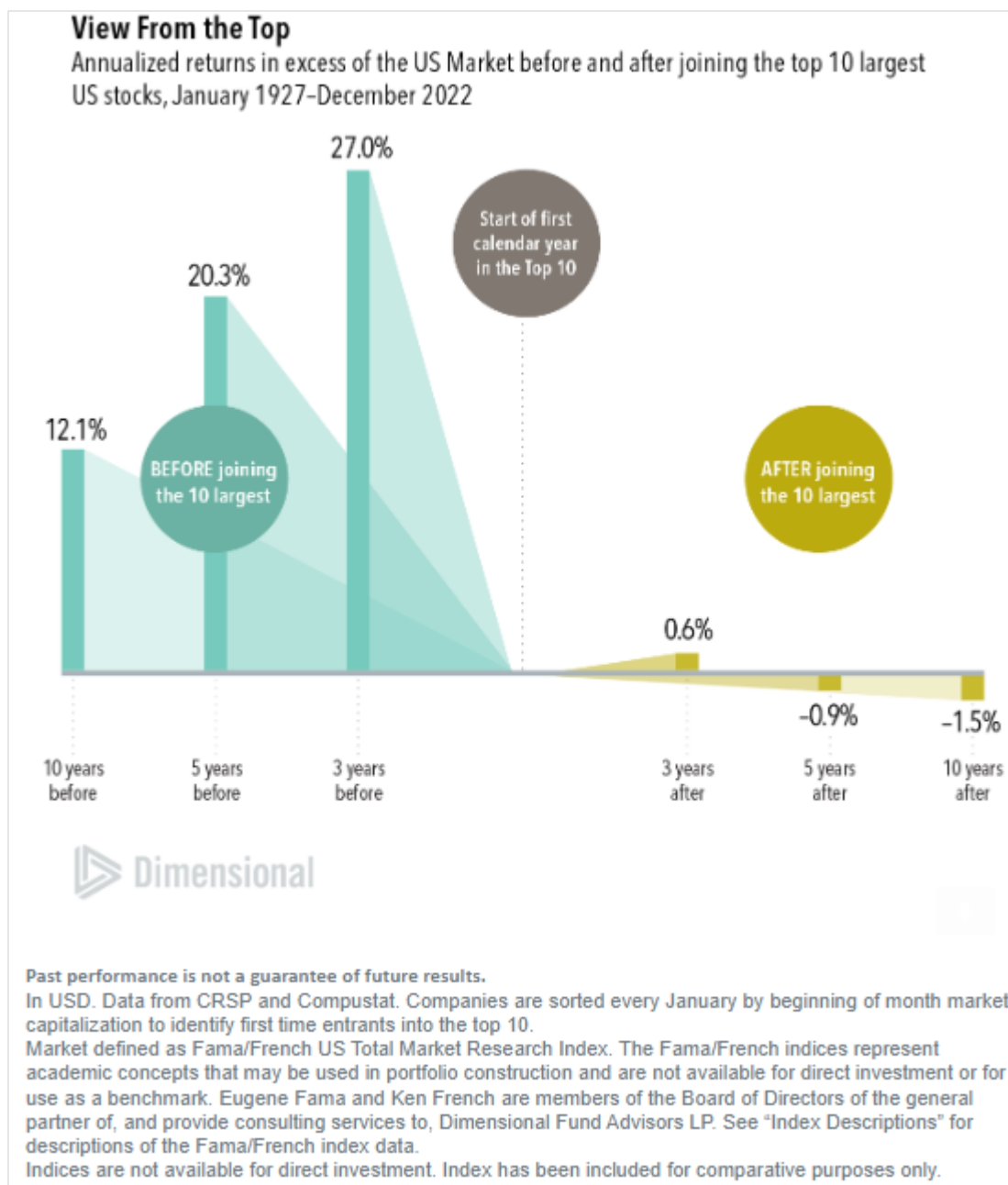


Figure 13 – The Top Names Generally Present a Market-Level Return Opportunity



## November 2023 Market Review

Global equity markets surged in November, recovering much of the losses over the past three months, as prospects of central bank easing and a simmering of geopolitical tensions helped renew risk appetite. Thawing of trade tensions between China and the U.S., following Chairman Xi’s visit as well as increased financial support for the beleaguered property segment helped international equities keep pace with the U.S. The U.S. dollar weakened over expectations of U.S. monetary easing and improving economic conditions across the rest of the world, particularly Europe. The MSCI All-Country World Index (ACWI) returned +9.2% for the month of November.

Across major regions (Figure 14), European and U.S. equities outperformed Asian and Emerging Markets. MSCI Europe returned +9.9% and the S&P 500 returned 9.1%, outperforming MSCI Japan (+8.6%), MSCI Emerging Markets (+8.0%), and MSCI Pacific ex Japan (+7.4%). The U.S. dollar (Figure 15) weakened in November, reflecting a convergence in forward monetary expectations versus the other developed markets. The European Credit Impulse also turned higher (Figure 16), helping to boost sentiment in European assets.

**Figure 14 – Europe and the U.S. Outperformed Asia Developed and Emerging Markets**

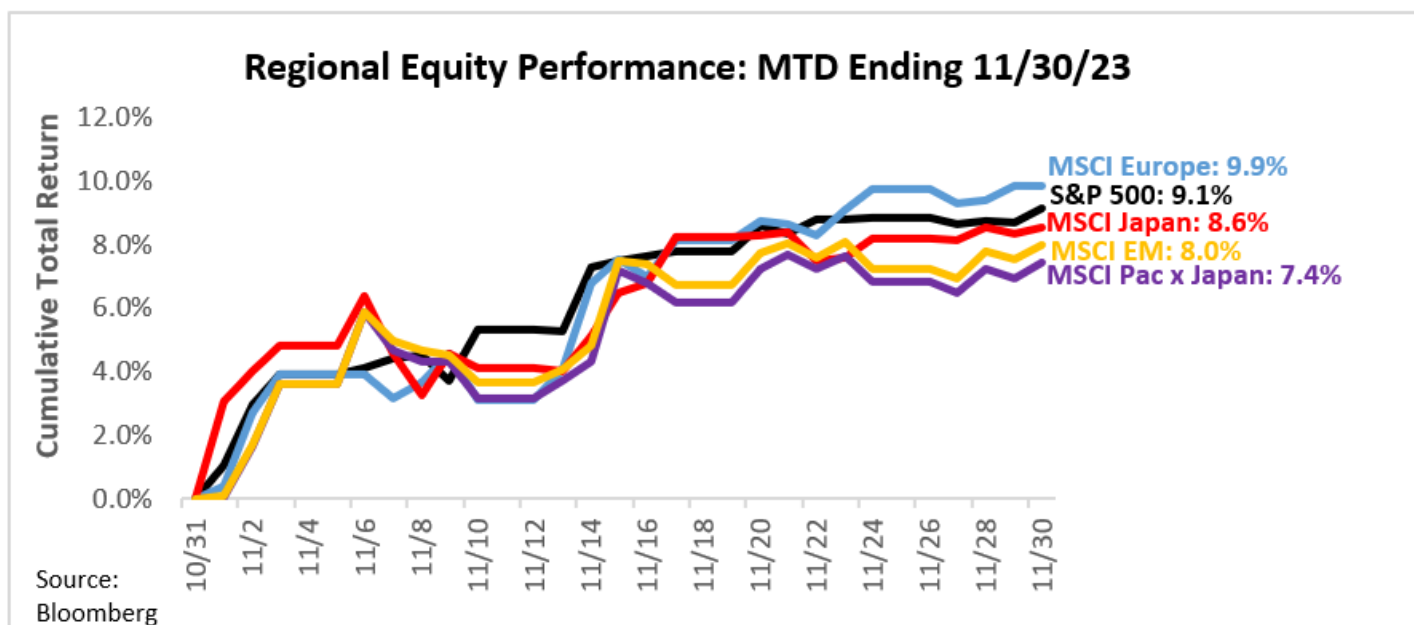


Figure 15 – The U.S. Dollar Weakened Over Expectations of Fed Easing

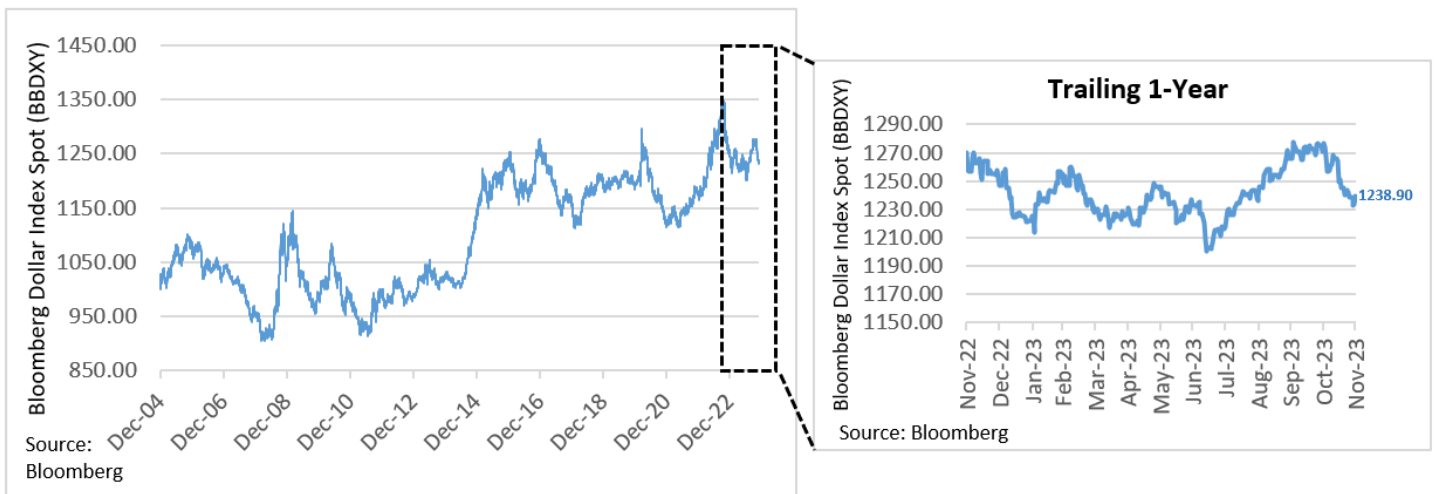
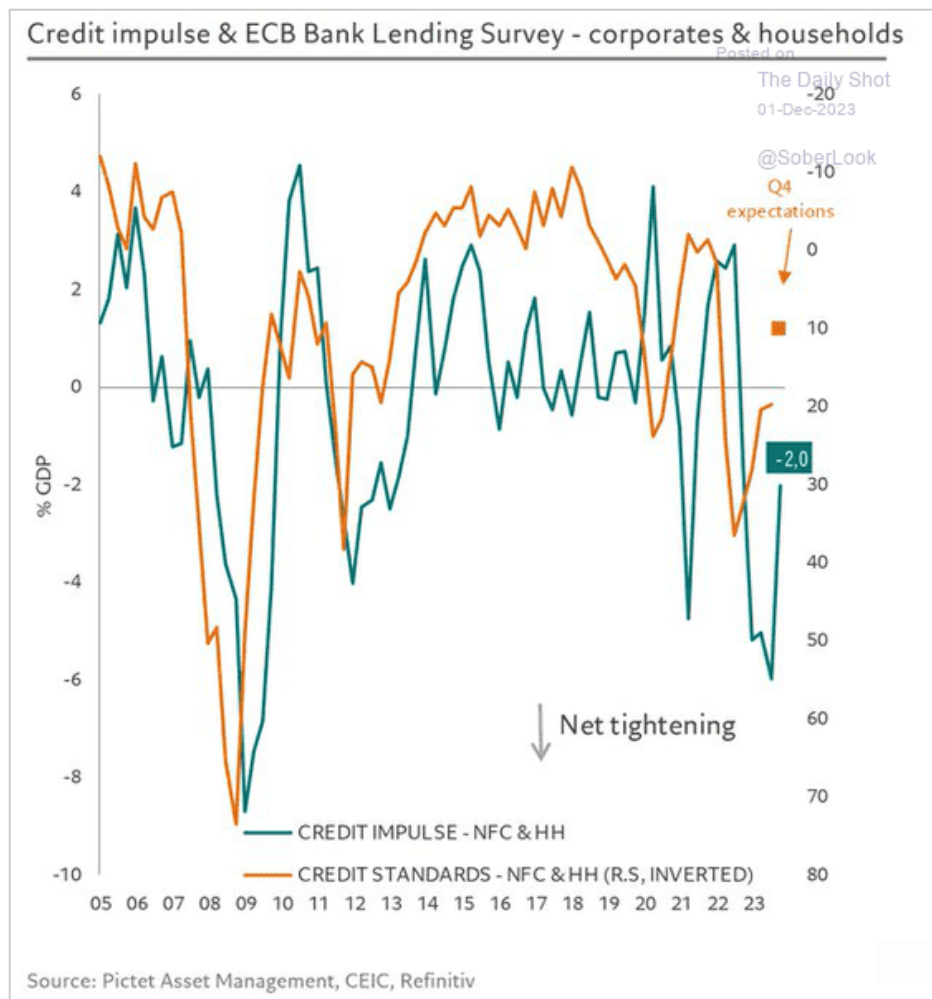
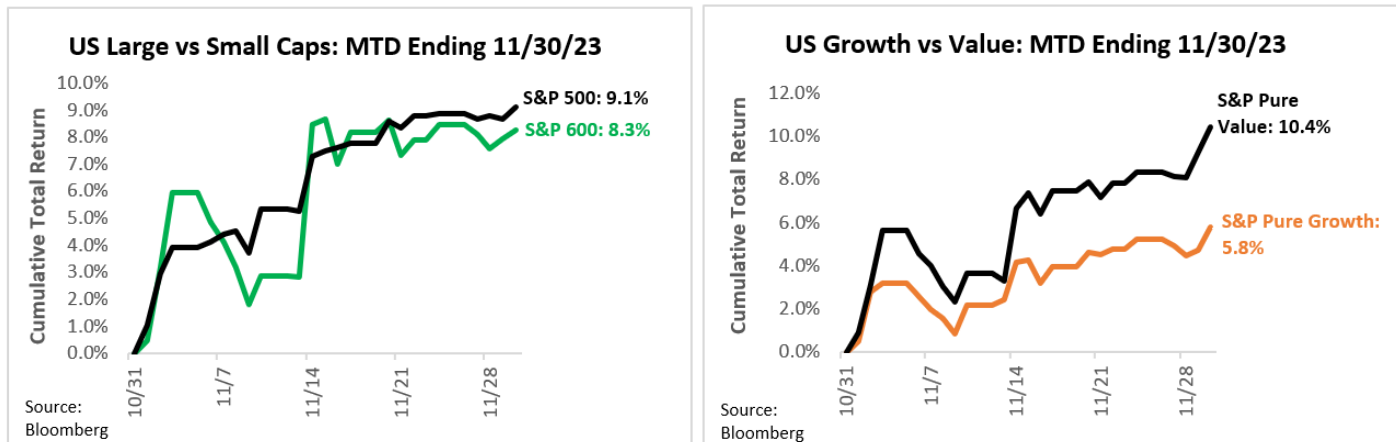


Figure 16 – European Credit Impulse Expected to Turn Higher Over Easing Standards



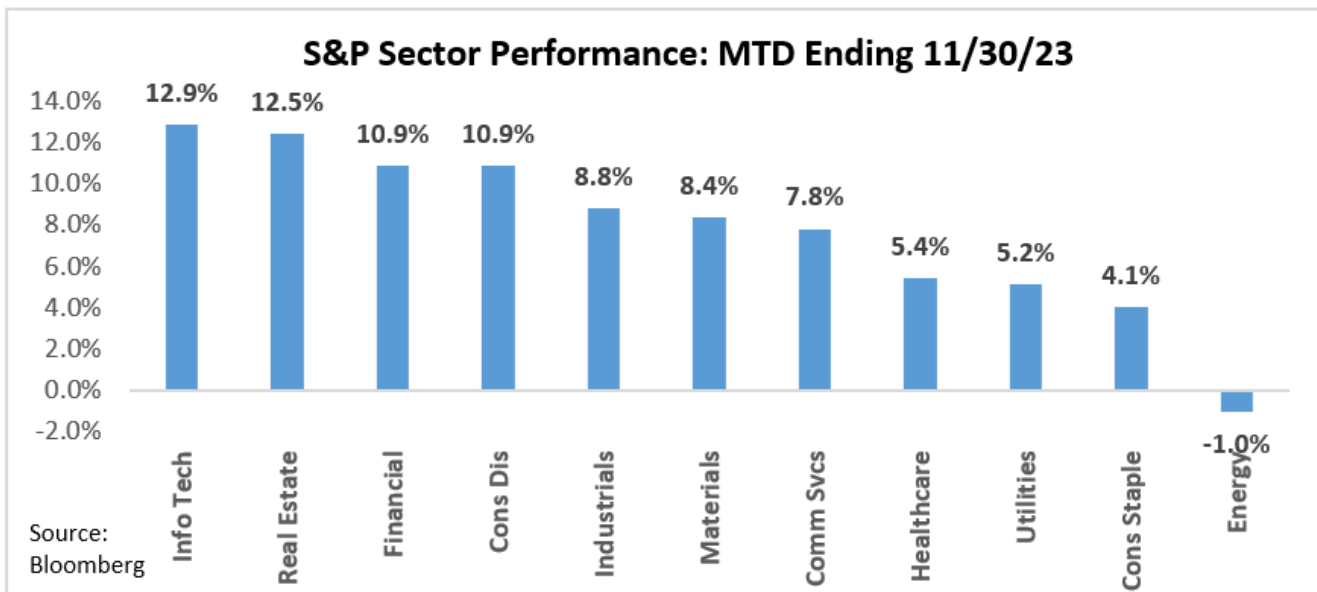
Within the U.S., small caps marginally underperformed large caps as small caps continue to lag large caps this year, encapsulating the narrowness of this year’s U.S. equity advance, primarily from the Magnificent 7 mega-cap tech companies. S&P Pure Value outperformed Pure Growth, with the former helped by a recovery in interest-sensitive financials and beaten down consumer cyclicals. For the month of November (Figure 17), the S&P 500 Index returned +9.1% versus +8.3% for the S&P 600. S&P Pure Value outperformed Pure Growth, returning +10.4% and +5.8%, respectively.

**Figure 17 – Small Caps Underperformed Large Caps and Value Outperformed Growth**



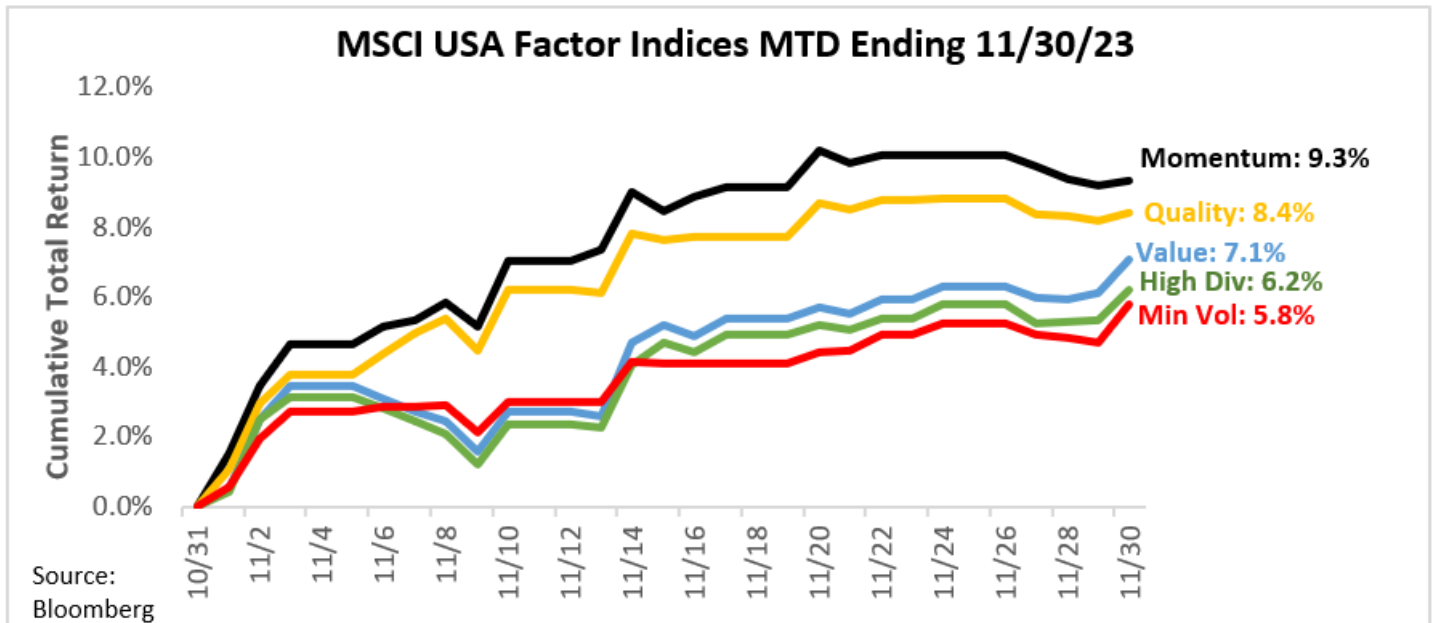
Across sectors (Figure 18), growth (Technology, Consumer Discretionary) and interest-sensitive Financials and Real Estate outperformed traditional cyclicals and defensive sectors (Healthcare, Utilities, Staples), while Energy was hurt by lower commodity prices.

**Figure 18 – Growth Sectors and Financials/Real Estate Outperformed Traditional Cyclicals and Defensive Sectors**



Among major risk factors, in November (**Figure 19**), only Momentum outperformed the broader market. Momentum and High Quality outperformed Value, High Dividend, and Minimum Volatility as high growth risk saw a persistent bid throughout the month.

**Figure 19 – Momentum and High Quality Factors Outperformed in November**



Fixed Income markets rallied following a sharp drop in interest rates and narrowing credit spreads. U.S. Treasury yields dropped in anticipation of a slowing economy and government spending as well as expectations of central bank easing throughout 2024. The Bloomberg U.S. Aggregate Bond Index returned +4.5% for the month (**Figure 20**), as the 10-Year Treasury yield dropped to 4.3% from the 5% peak level seen in early October. Corporate bonds continue to outperform as borrowing spreads (**Figure 21**) narrowed further into Immaculate Slowdown territory. The Global ex-U.S. Aggregate Index returned +5.5%, outperforming the U.S. Agg, reflecting U.S. dollar weakness. Bloomberg Emerging Market Local Currency also outperformed U.S. fixed income, returning +5.2% for the month, while Bloomberg US High Yield continued its strong YTD performance, returning +4.5% for the month, as credit spread compression helped offset the lower maturity profile of high yield debt.

The 10-Year U.S. Treasury yield ended the month at 4.33%, down from 4.93% at the beginning of the month. The 2-10 Year Term structure (**Figure 22**) steepened throughout November while inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields dropped from earlier peak levels, suggesting that the U.S. may be moving towards the long-term 2% inflation level. Global bond yields also dropped from earlier peak levels (**Figure 23**).

Figure 20 – Fixed Income Rallied with this Month’s Drop in Interest Rates

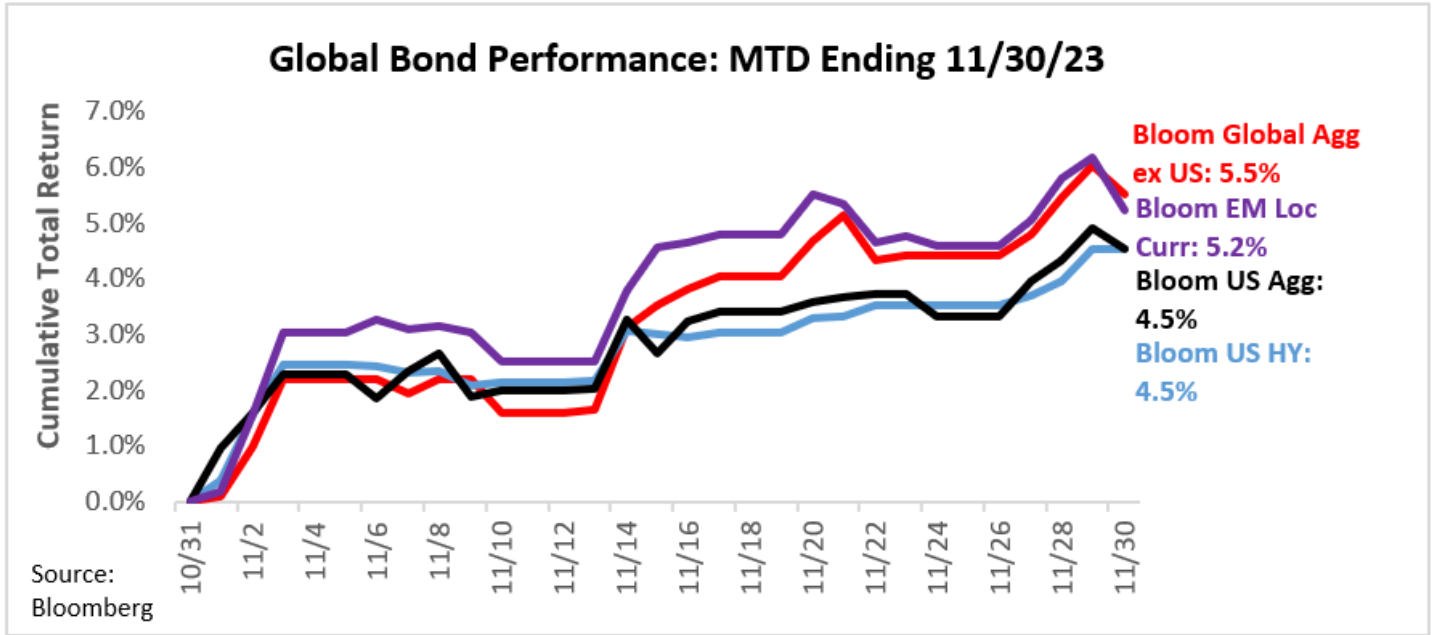


Figure 21 – Corporate Borrowing Spreads Narrowed Sharply in November

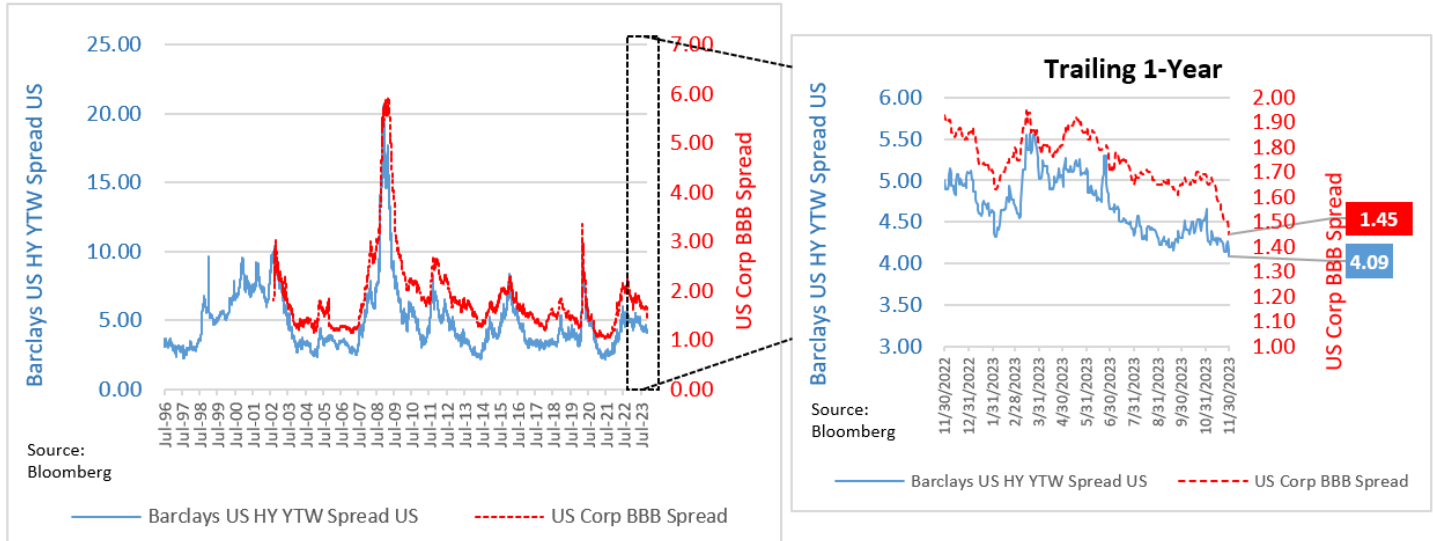


Figure 22 – 2-10 Year Term Structure Steepened While Inflation Breakeven Rates Settled Down

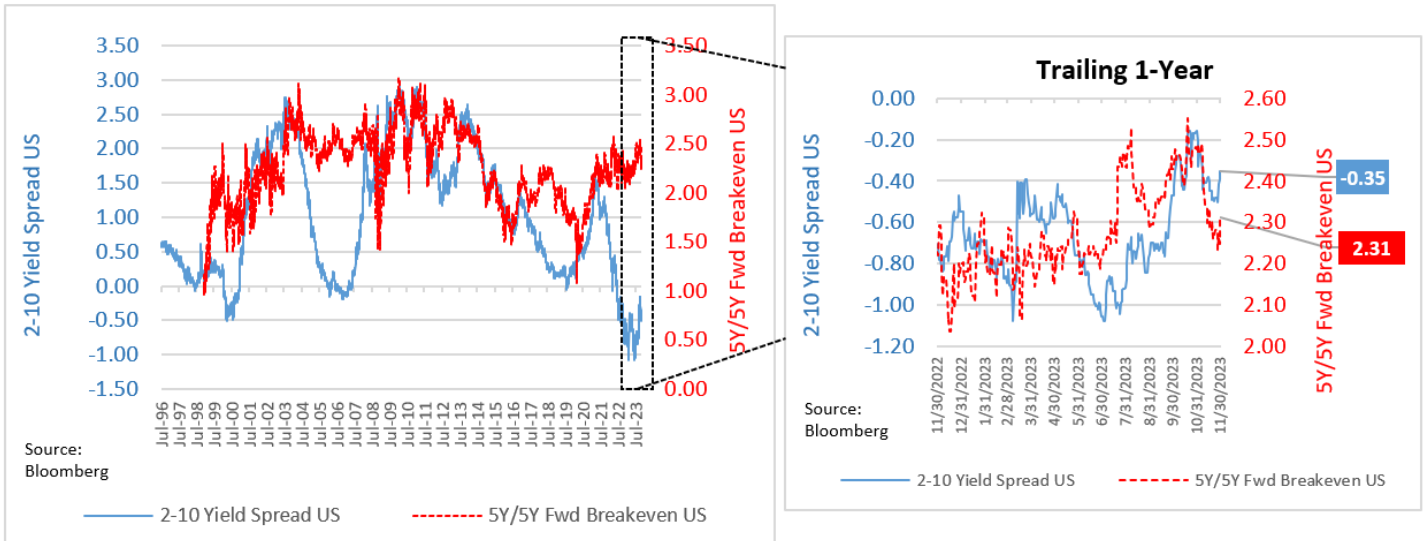
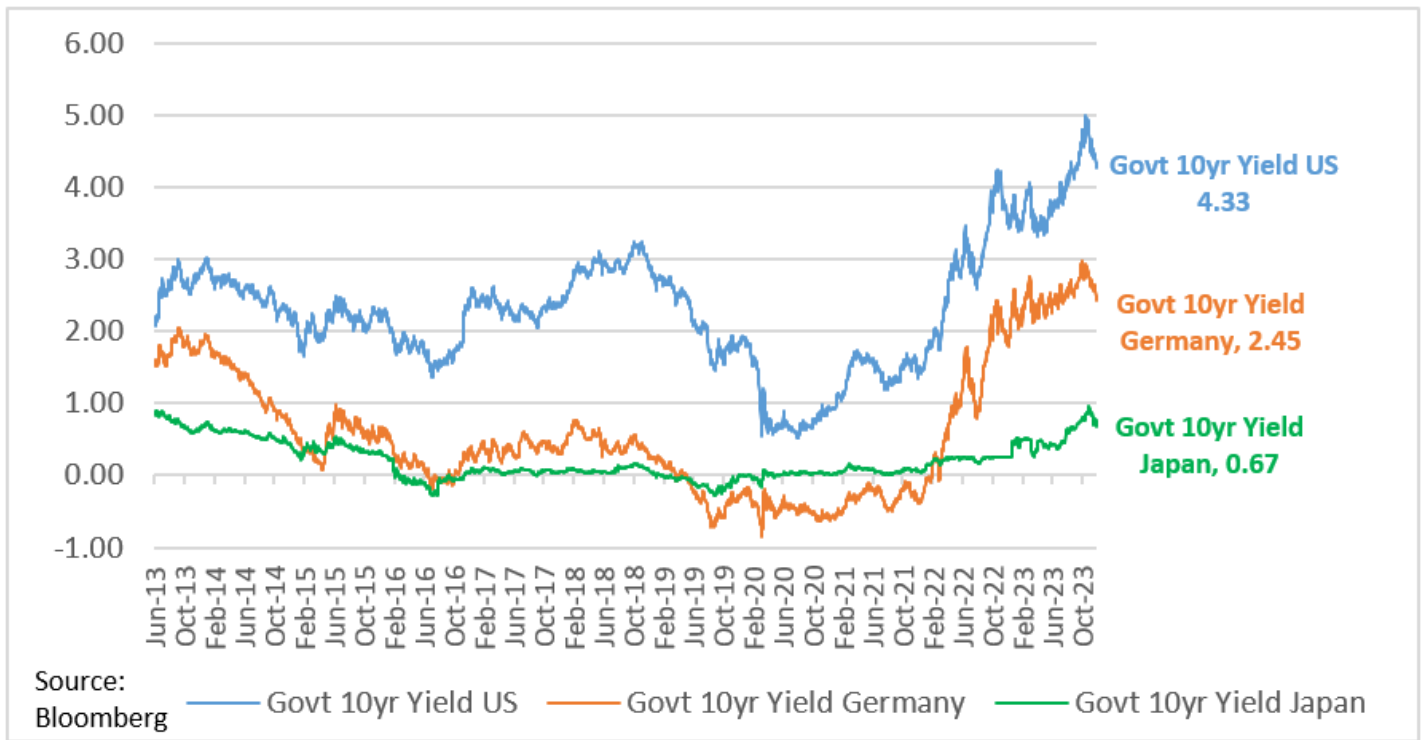


Figure 23 – Key Sovereign Bond Yields Dropped from Their Recent Peak Levels



Within equity alternatives (**Figure 24**), Real Estate outperformed, benefiting from the drop in interest rates and relief from expected Fed easing in 2024. Gold prices also rallied from expectations of easier Fed policy, with spot prices rising above \$2000/ounce. Commodities were hurt by lower oil and agricultural prices (**Figure 25**), even though copper prices turned higher. In November, the Dow Jones REIT Index returned +11.8% and the S&P GSCI Precious Metals Index returned +3.3%. The S&P GSCI Commodities Index returned -3.6% for the month hurt by lower energy prices.

**Figure 24 – In November, Real Estate Recovered Sharply Benefiting from Prospects of Easier Fed Policy in 2024 while Precious Metals Rallied as Spot Gold Rose Above \$2000/Oz**

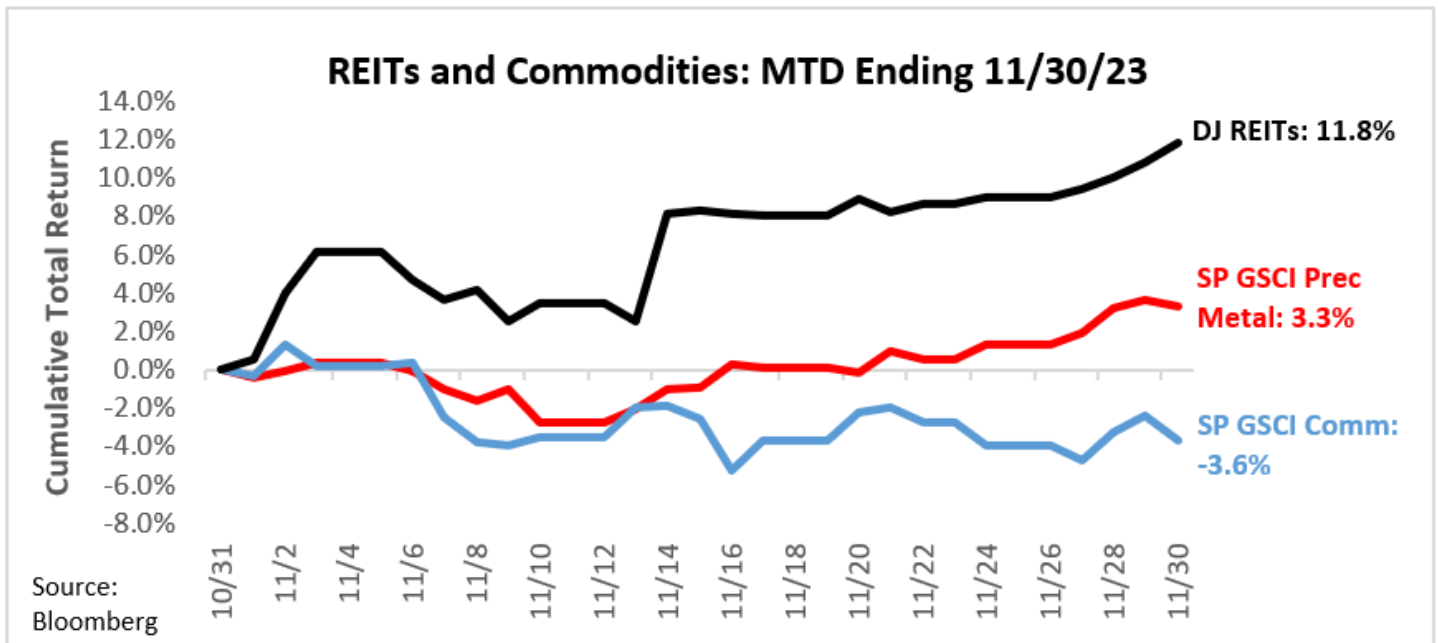
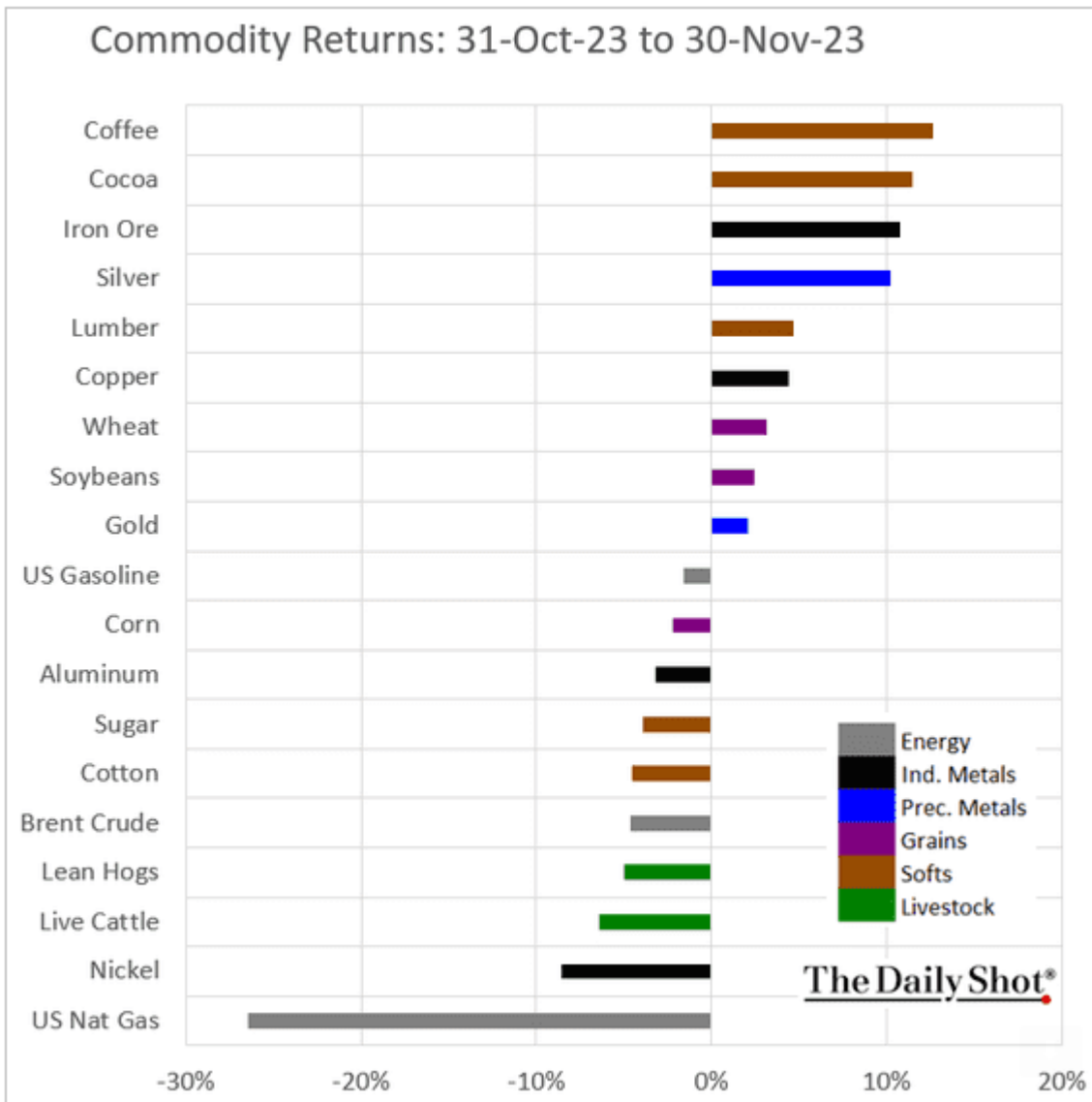


Figure 25 – Energy and Agriculture Weighed Down Commodity Returns





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