Market Commentary

Third Quarter 2023

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The third quarter of 2023 saw increased volatility in financial markets as mixed economic data combined with a continued rise in interest rates dampened investor enthusiasm. Equities, as measured by the benchmark S&P 500 Index, declined by 3.3% during the quarter, which brought the YTD total return for the index to 13.1%. Although we have been looking for a market pullback for several months, we believe the modest declines during the latest quarter could portend more choppiness in the months ahead. As we write this commentary, Congress has narrowly avoided a potential government shutdown by kicking the can down the road for six weeks. Additionally, we face the unknown impact of the resumption of student loan repayments on consumer spending, and the Federal Reserve has said they do not see any interest rate cuts until the second half of 2024 at the earliest. While corporate earnings have held up better than we expected in 2023, we believe the full impact of inflation on input costs, combined with upward pressures on both labor and interest expense to have a deleterious effect on corporate profits through 2024.

Fixed income yields continued to move higher since the March rate pullback during the banking crisis. Shorter-term Treasury yields tracked the modest moves in Federal Funds during the three-month period. The 1-year Treasury bill inched up to 5.47% from 5.41% on June 30. The 2-year Treasury note began the quarter yielding 4.87% and moved modestly higher to end September with a yield of 5.05%. However, larger moves were seen further out on the yield curve. The benchmark 10-year US Treasury note ended September yielding 4.58%, up meaningfully from 3.85% at the end of June. With many home mortgages tied to the 10-year Treasury rate, home carrying costs continue to increase substantially for many. While the yield curve is becoming less inverted, it is doing so due to an increase in longer-term yields rather than a decrease in short-term rates. As we have written previously, the ability to earn 5% plus in ultra-safe securities provides an alternative to equities and is another challenge to US stocks in the near-term.

Economic and Market Outlook

Despite the likelihood the Federal Reserve is near the end of its tightening cycle, investors remain laser focused on any tidbits of information from the Fed as they try to determine what will spur the Fed to begin cutting rates. We have long counseled that the effects of sustained interest rate hikes take several quarters to be fully evident in the financial system. This means that even when the Fed does begin to reduce interest rates, there will likely be a lag before consumers and companies benefit. Peeking into the high-yield space, we note that in the two years since forward rates began to increase, the average maturity of high-yield bonds has

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declined from about 6.6 years to 5.0 years. This echoes what happened in the mid-2000's decade. As rates rise, borrowers shorten maturities which leads to refinancing needs at higher rates. This is another potential negative for corporations, particularly those with weaker balance sheets.

Earnings estimates for S&P 500 companies for the current year have remained static near 2022 earnings of $218. After beginning the year just over $230, estimates fell during most of the first half of 2023 before stabilizing in recent months. The just ended third quarter may mark the return to earnings growth on a year-over-year basis. Early estimates for 2024 are in the $240-250 range. We take these estimates with caution due to expected margin pressures from higher labor, input, and interest costs. However, the market is currently selling below 18x the bottom of the estimate range, which is near the long-term average. With interest rates expected to be lower a year from now, these factors combine to provide optimism of higher equity prices looking out 12-18 months.

Turning to oil markets, the multi-month downturn in the commodity price has ended. Oil advanced steadily during the quarter. The price for benchmark West Texas Intermediate (WTI) began the recent quarter at $70.46 and moved progressively higher during the quarter on both stronger than expected demand, as well as modest production cuts announced by certain producing nations. WTI ended the quarter at $90.77, up an astonishing 28.8% during the quarter, and likely frustrating Federal Reserve efforts to contain inflation.

Portfolio Positioning

Taking our economic forecast of moderating growth, a slightly weaker labor market, elevated energy prices, and higher than expected interest rates through most of 2024; we continue to believe US equities remain slightly above fair value, particularly when compared to short-term treasury yields. The modest pullback in the third quarter was caused primarily by higher interest rates and energy prices – factors that show no signs of lessening soon.

The Fed should soon give way to the actual economy as the most important factor for investors to study. The Fed has done the bulk of its work raising interest rates and will now watch for signs of imbalances or risks in the financial system. Banks are still holding hundreds of billions of dollars of bonds with market losses. While most of these are marked as "held to maturity," they represent over 20% of total bank equity capital. The Federal deficit is expected to reach $1.4 trillion in the just concluded fiscal 2023 year. $640 billion of that is interest paid on the national debt. The top ten stocks by market capitalization total 31.9% of the S&P 500 – higher than the 27.5% at the dot-com peak. These are some of the concerns that temper our outlook for financial markets in the coming months.

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Conclusion

We continue to see challenges for equities, although there are pockets of value beginning to appear. Our focus on high quality investments with strong balance sheets, robust cash flow, and modest valuations should cushion against volatility and downdrafts. We have been playing "defense" for most of the past year, methodically eschewing fads and preferring to hold income producing assets as valuations revert towards more historical levels.

In closing, we hope that you and your families are healthy and have enjoyed the summer months. Please inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

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