September 2023 Capital Markets Commentary

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"Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

Warren Buffett

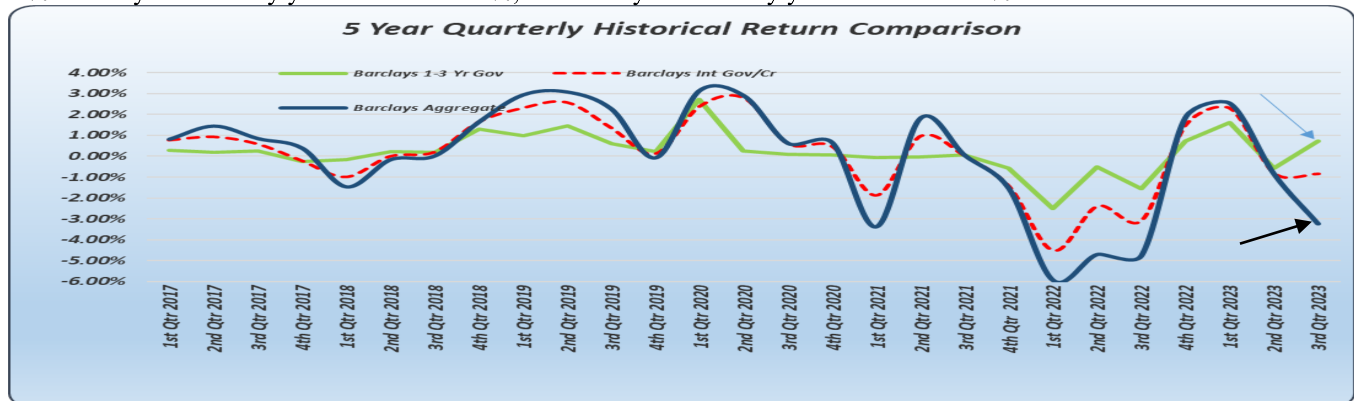
Fixed Income

In the 3rd Quarter of 2023, bond returns took a page from the 2nd Quarter. During the third quarter of 2023, fixed income markets experienced a continued difficult market with the Bloomberg Aggregate Bond Index losing 3.23% as yields rose significantly on the back of a continued hawkish policy from the Fed. The upward rate moves dragged the year-to-date performance into negative territory with a return of -1.21% for the nine months ended September 30th.

Yields increased across the Treasury curve. The 2-Year Treasury increased from 4.88% to 5.05% and the 10-Year rose from 3.84% to 4.58% during the quarter. Interest rates moved higher due to the economy performing better than expected, still-elevated inflation, higher oil prices, a renewed focus on the country's debt and deficit problem, continued strength in the labor market, and the Fed's new "higher-for-longer" outlook combined with their quantitative tightening program.

The FOMC met during the quarter, as scheduled, but only increased the overnight rate by 0.25% in July, targeting a range of 5.25% to 5.50%. The FOMC did pause in September, but with inflation still higher than the Fed would like, the quarter ended with the markets still in flux, and with the Fed stating that rate would remain higher for longer.

As can be seen below, returns were positive on the short end and negative on the intermediate and longer end of the curve during the quarter. The Barclays U.S. Aggregate posted a -3.23% return for the quarter. The Barclays Intermediate Index was at -0.83%, but the short end of the curve was positive with the 1-3 Year Government Index at +1.26% for the quarter. On the truly short end of the curve, the 1 Year T-Bill returned +3.0% for the Y-T-D ending 9/30/23. The 10-year Treasury yield ended the quarter at 4.59%. The 5-year Treasury yield ended at 4.60%, and the 2-year Treasury yield ended at 5.03%.



Fixed Income Markets - Looking Ahead

At the September meeting, the Fed paused. (Why, is another matter. Pure politics involved?)

U.S. Fixed Income markets are grappling with challenges. Anticipation of more Federal Reserve rate hikes has seen the Bloomberg U.S. Aggregate Bond Index on track for its third straight year of losses. However, many believe that, following its aggressive interest rate hikes, the Federal Reserve is nearing the end of its rate hiking cycle. As we have seen recently, central banks worldwide, including the Fed, Bank of England, and Swiss National Bank, seem to be starting to conclude their rate hike phases.

Given the Fed's "higher for longer" strategy and the possibility of more rate increases, bonds may encounter similar challenges in the months ahead. Markets will certainly continue to take their cue from the Fed, but uncertainty regarding the timing for potential rate hikes or rate cuts will be a key aspect for trading activity. Currently, the inverted yield curve offers no urgency to move out in duration. 5.40% in 1-Year securities is historically exceptionally good.

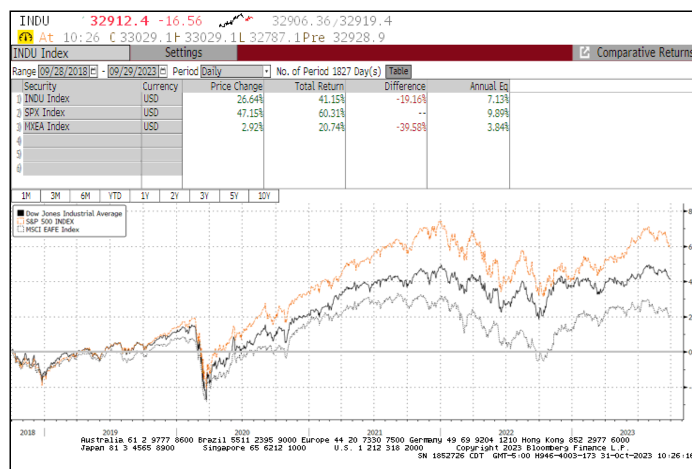
The Fed's top priority remains inflation, and while progress has been achieved, the Fed's desired target of 2% remains a distant goal. Although the Fed has paused on new rate hikes, Fixed Income markets should proceed with caution.

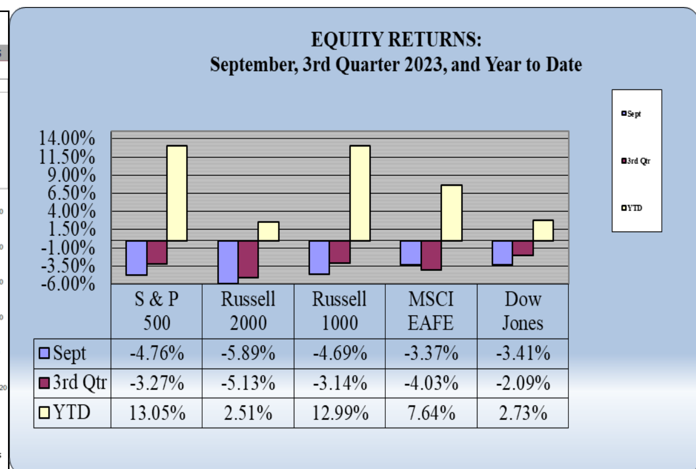
Equity

As the 3rd Quarter ended, equity markets pulled back, with the S&P 500 down 3.6%, the Dow Jones down 2.6%, and the Nasdaq down 4.1%. The quarter began with positive expectations and enthusiastic investor sentiment. The consensus view held that inflation would be tamed while avoiding a nasty recession. Most market participants believed the tightening phase was complete and the Fed would end up cutting rates in 2024. But ongoing economic data did not support these notions. The Fed raised rates at the July meeting and yields on longer-term bonds began to increase. While the Fed held steady at the September meeting, Chairman Powell suggested we should expect one more hike this year, and the holding of rates higher for longer throughout 2024. Not surprisingly, negative investor sentiment increased, and the market closed out the quarter on a down note.

The 3rd quarter began with investors on a high from the 2nd Quarter's strong positive returns. However, this high resided quickly, as rising global bond yields, fears of a rebound in inflation and concerns about a future economic slowdown weighed on the major indices in August and September and the S&P 500 finished the third quarter with a modest loss. In summary, the markets reversed course in the 3rd Quarter with declines across all major indices.

Both U.S. and International equities were negative in the 3rd quarter. On the U.S. side, the S&P 500 ended with a negative return for the quarter, showing a return of -3.27%. The Russell 1000 index returned -3.14%, the Russell 2000 index returned -5.13%, and the Dow returned -2.09%. The International markets were in line with the negative returns, posting a -4.03% for the quarter.





	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
Sept	-4.76%	-5.89%	-4.69%	-3.37%	-3.41%
3rd Qtr	-3.27%	-5.13%	-3.14%	-4.03%	-2.09%
YTD	13.05%	2.51%	12.99%	7.64%	2.73%

Equity Markets - Looking Ahead

<u>2023</u> – How do we end the year.

As we begin the 4th quarter of 2023, the outlook for stocks is still positive, for bonds, not so much. If the year ended in September 2023, we could say it was a pretty good year despite the declines in August and September. Although the major equity indices fell in the 3rd quarter of 2023, much of that was due to rising yields on the 10-year U.S. Treasury note and a 30% increase in the price of oil. The yield on the 10-year U.S. Treasury note rose steadily all quarter.

Despite declining corporate earnings over the past few quarters, the markets expect earnings to have improved and expanded during the 3rd quarter of 2023. Analysts have been revising their forecasts upwards and that development is a positive sign for the stock markets. With the improved earnings forecasts, the market seems fairly valued, and based on the expectation that earnings will continue to grow (as analysts are projecting), projections are that the S&P 500 Index may advance over 10.0% over the next 12 months. Expectations are that a year-end rally could occur in the 4th quarter of 2023 led by value stocks. This is a rally that could and might continue the pattern the markets have seen over the past few years in the final quarter of the year.

As we move into the 4th quarter 2023 and beyond, the markets continue to face continued sources of uncertainty including the path of inflation, future economic growth, the FOMC policy decisions, and the real beginning of the political season. However, the markets have proven quite strong over the past 9 months, even with a little hiccup recently.

The Federal Reserve left the Fed Funds rate alone at the September meeting, but the tone of its commentary was quite "hawkish." Something to worry about and something to think about going forward.

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The Economy

The Economy

Through the first 9 months of the year, the economy has proven stronger and more resilient this year than expected. The economy seems to have misjudged the cushion of savings built up during the pandemic that allowed consumers to maintain their spending habit for far longer than might have been expected in the face of such a rapid rise in interest rates. Combine this with a substantial moderation in inflation, and it has lent credibility to the hopeful view, that the Federal Reserve ("Fed") will be successful in engineering a soft landing, which also helped to propel the stock market higher this year. Just so as not to make everything seem great, surging bond yields, due in part to improving economic momentum, caused stocks to retreat during the third quarter, and this pullback has continued into the 4th quarter.

The FOMC elected to pause at its September 20 meeting albeit with an increasingly hawkish stance as the Fed dot plot removed 100bps of cuts in their forward guidance while also pushing the likelihood of any cuts into the fourth quarter of 2024.

In its September meeting, the Federal Reserve decided to keep interest rates steady with the potential for more hikes if necessary. The Federal Funds Rate is now in the 5.25-5.5% range, 225 basis points higher than one year ago, and futures markets are expecting that this is likely as high as we will get in this cycle. They are also indicating higher rates for years to come, meaning that continued tight conditions could bring more pain before we see more economic growth. Of course, these expectations could change quickly as new economic data comes in. Resilient inflation could require more hikes, but a recession could require cuts, and Fed Chair Jerome Powell recently stated that his base case is not a soft landing.

The Economy - Looking Ahead

Economic Growth? Jobs? Inflation? Recession? Global problems? The same old tune.

Many economists had been forecasting a recession for 2023 due to the continued tight monetary policy by the Federal Reserve, which has now been moved to 2024. But that recession has not arrived yet, and fiscal policy is still stimulative.

Will we enter a long-expected recession in the next few quarters, those questions are still there. However, some cracks are forming, and there are expectations of a slowdown before long. It appears that the average consumer is beginning to run low on the savings they built up during the stimulus era, and the consumer is troubled by mortgage rates at over 20-year highs, increasing gasoline prices, and the return of large student loan payments.

The Fed did not increase rates at either the June or September meetings after raising rates by 25 basis points in July. It may have moved into a tightening cadence, where it targets every other meeting. The odds of a tightening at the November meeting are low as the Fed Chairman stated there may be a pause. With another government shutdown on the horizon, the economy may have problems coming. The November meetings could provide enough economic data points to convince the Fed to remain on hold (tightening more), as core inflation, particularly wage inflation, continues to trend down toward its 2% target. If the Fed skips another meeting, it is probably done with the rate tightening cycle while continuing to reduce its balance sheet. However, the possibility of further hikes makes excessive tightening into an already slowing economy the biggest risk to markets as we approach year end.

The labor market has started to show early signs of easing. While the unemployment rate remains healthy at under 4%, leading indicators such as job openings and quits rates are declining, while labor force participation (workers reentering the workforce) has increased. This may spur a softening in the tight labor market and continue to put downward pressure on wage gains and help the Fed in its goals.

The thinking is that the Fed is near the end of its rate hike cycle, but there is caution that the likelihood of another rate hike is close to a coin toss at this point. The economic data will need to move in the right direction in a big way to convince the Fed.

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