



## **Lingering Inflation and Higher Gas Prices Reintroduce Risk to Investors**

### **October 2023**

Dear Client:

Investors entered the third quarter of 2023 with optimism and confidence of no recession, seeing that the year-to-date highs were reached in July. Through the rest of the quarter, stock and bond markets realized that aggressive rate cuts penciled in for 2024 are unlikely – and, most importantly, “higher for longer” (an extended period of higher interest rates) is no longer ignored. Accepting higher interest rates for longer (with a nudge from rising gas prices) sent equity markets lower and bond yields higher in August and September.

Overall, the U.S. economy remains very strong. But according to the Bureau of Labor Statistics, the unemployment rate rose 0.3 percentage points to 3.8% in August. The number of unemployed persons increased from 514,000 to 6.4 million. The U.S. composite flash purchasing manager’s index (PMI) fell to 50.1 in September, down marginally from 50.2 in August, emphasizing that the US economy is cooling. (The PMI indices are based on survey data from companies in the manufacturing and services sectors. A reading below 50 indicates contraction; above 50 signals expansion.)



In the third quarter, the Standard & Poor’s 500 hit a year-to-date high in late July before its quarterly decline of -3.7%. The Nasdaq lost -4.1% during the quarter, led by lagging performance from big tech. The Dow had the smallest drawdown, falling -2.6% during the quarter.

More broadly, developed market equities fell -3.4% over the third quarter, taking year-to-date returns down to a still strong 11.6%. Value stocks were more resilient than more expensive growth counterparts, returning -1.7% as opposed to growth’s -4.9%. The outperformance gap between the two styles remains massive, with growth stocks having a more than 18% lead on value in 2023.

Energy stocks were the clear standout and one of the few bright spots in a quarter where few sectors avoided declines. Most of the “Magnificent Seven” – Apple, Microsoft, Alphabet, Amazon, Tesla, Nvidia, and Meta – declined, weighing on the overall market. In the market so far this year, about 70% of the total market returns were driven by those seven megacaps. The IT sector overall was one of the weakest areas over the quarter, along with the less-influential sectors of real estate and utilities.



Inflation, trending downward though up in August, remains well above the Fed's target. The Consumer Price Index report showed a jump in inflation largely due to the increase in energy prices. Inflation remains a problem in the services sector, with the ISM service index remaining unchanged in September at 58.9.

The Federal Reserve's closely watched "super-core" rate of inflation, which excludes volatile items (food, energy, and housing), shows no signs of moving quickly toward the Fed's 2% target. The core inflation year-over-year was at 4.3% in August and 4.1% in September. A revised Fed "dot plot" showed rates in 2023 and 2024 higher than market forecasters were betting. Fed policymakers suggest a further rate hike is to come before the end of the year, while the dot plot – a chart showing each Fed policymaker's forecast for interest rates – now illustrates a higher median rate for 2024 (5.1% vs their consensus 4.6% projection this past June).

### **Domestic equity market**

For the third quarter, the broad stock market, as measured by the Russell 3000 was simply down (-3.3%). Yet compared with last quarter, this was a whiplash of 11% from positive to negative. Growth-style and value-style stocks had declines in every cap size in U.S. markets. In Large Caps, the Russell 1000 Growth and Russell 1000 Value were nearly identical, losing 3.13% and 3.16% each. Small Cap Growth had the worst performance, down -7.3, measured by the Russell 2000. The Russell 2000 Value index was -3%.



Considering sector returns, Energy was the only shining star, surging more than 12% amid rising oil prices during the three months. Higher energy prices have been a net negative for the rest of the market, with nine of the 11 S&P 500 sectors posting negative declines for the third quarter. Communications Services (+1.1%), Financials (-1.1%), and Health Care (-2.7%) were the next-strongest performers. Materials (-4.8%), Consumer Discretionary (-5.0%), Industrials (-5.2%), and Tech (-5.6%) were bunched. Consumer Staples (-6.6%), Utilities (-9.3%), and Real Estate (-8.9%) were the worst relative performers.

While stocks are certainly not tumbling off a cliff, the fourth quarter begins with investors on less-solid ground courtesy of rising bond yields and clarity that Federal Reserve rate cuts are not on the table for 2023 and are likely to be much less and later in 2024.

Many investors have been talking about market seasonality. Bespoke Investment Group noted that typically September weighs on stock performance. Yet on average, the last three months of the year historically have been some of the most bullish for the market. For example, the last three times the S&P 500 lost more than 1% in August and September, it saw a bounce in October of 2011, 2015, and 2022. Further, when the S&P 500 has been up 10% for the year coming into

the fourth quarter, the index has been positive 12 out of the last 13 times, with an average gain of 6%.

We will see if this optimism about historical seasonal returns plays out during the fourth quarter.

## **International Markets**

International developed, U.S., and emerging equity markets all had a negative third quarter, from worst- to best-performing.

Growth-style stocks significantly underperformed value-style in international developed and emerging markets. Multiple factors – most important being growing acceptance of higher rates for longer – led equity markets lower in August and September.

International developed markets, as measured by the MSCI EAFE Index, fell 4% for the quarter; MSCI Emerging Markets Index lagged 2%. Surging energy prices were also seen as threatening consumers and the market-themed potential soft-landing recession scenario. Further, weak economic data from China undercut Beijing's rescue for global economies.



The U.S. dollar has notably strengthened since July, as markets reflected a lower likelihood of imminent U.S. rate cuts and economic data weakened in other large economies. Despite climbing oil prices, inflation in most European countries dropped in September: The overall rate dipped to an estimated 4.3%, its lowest level since before the start of Russia's invasion of Ukraine.

Core inflation, which strips out volatile food and energy prices, has also eased. The European Central Bank (ECB) raised interest rates to 4% in its last meeting. Slowing inflation will bolster assumptions that the ECB may pause its rate hiking, but it also may not begin bringing rates down soon.

According to the Organization for Economic Cooperation and Development (OECD), global growth national product (GDP) growth is estimated to slow from 3% in 2023 to 2.7% in 2024. In the Eurozone, where demand is already subdued, the ECB has forecasted GDP growth to ease to 0.7% in 2023 and then edge up to 1% in 2024 as the adverse impact of high inflation on real income fades. The OECD also forecasts that growth in China should be held back, easing to 5.1% in 2023 and 4.6% in 2024, due to subdued domestic demand and structural stresses in the property market.



A key factor shaping global growth remains the rise in interest rates in most major economies since early 2022. Even if policy rates are not raised more, prior rate hikes will continue to work through economies for some time as the rates on existing mortgages and corporate loans are adjusted or rolled over. Interest rates are at or near peak in most economies, including the U.S. and Eurozone. Still, monetary policies will remain restrictive until signs of underlying inflation pressures have durably abated.

Risks remain tilted to the downside.

## **Bond Markets**

Bond prices were generally lower as yields raced higher during the third quarter, as the bond market continued to grapple with high inflation and the Fed's attempts to reign it in with higher interest rates: It raised the target range on the Fed funds rate to 5.25%-5.5% from the prior range of 5%-5.25%. The Fed signaled that an end of the hiking cycle was near but also that rates would remain higher for longer than previously expected, reiterating its commitment to bring inflation back to 2%.



Treasury yields climbed steadily for the month and quarter as the 10-yr rose 46 bps in September and 73 bps in Q3. The curve became notably less inverted as the term premium for longer maturities grew, meaning investors demanded additional income to extend the duration. Treasury 2s vs.10s (spread between interest investors received for 2yr debt vs. 10yr debt) slope hit its cycle low of -108 bps in early July and ended September at -48 bps.

The Fed's Summary of Economic Projections (SEP) underscored these views, as rate cut expectations by year-end 2024 fell to 50 bps from 100 bps in June's SEP. The Fed also acknowledged stronger-than-expected growth this year: Real GDP forecasts were revised upward to 2.1% for 2023 from 1% in the June SEP.

The bond market, as measured by the Bloomberg U.S. Aggregate bond index, was -3.23% for the quarter, bringing YTD returns to -1.21%. Residential mortgage-backed securities underperformed on reduced demand and higher rate volatility.

Excess returns of -0.81% and -0.85% for the month and quarter, respectively, were lowest among major sectors. Investment Grade Corporate excess returns were strong for the quarter (+0.84%). Taxable municipals offered strong excess returns for the month (+0.49%) and quarter (+1.45%).

Another complication for the economy was the debt ceiling debate/drama. The now-former Speaker of the House negotiated a short-term spending deal to fund the government and avert a





shutdown. Congress has 45 days, until mid-November, to pass a budget or create another short-term extension.

Housing continued to feel the weight of higher mortgage rates, as existing home sales fell in August to their second-lowest rate in the past decade. Mortgage rates have also now exceeded their 2022 peak. Homeowners that had previously locked in low mortgage rates (around 3%) have a strong disincentive to sell, keeping inventory tight and prices up. Existing home sales for August (the latest monthly data available) were lower by 0.7% to an annualized rate of 4 million units, down some 15.3% from year-ago levels.

The inventory of existing homes remained at 3.3 months of supply, down slightly from the prior year. Existing home prices in August increased 3.9% from August 2022. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 45, down from 50 in the prior month. The index fell below 50 for the first time in five months. A reading below 50 indicates poor building conditions over the next six months.

I'm summarizing some recent thoughts from colleagues at Bespoke Investment Group-  
*The perceived availability of credit among U.S. consumers fell to the lowest level in over a decade during September. According to a monthly survey from the New York Federal Reserve, 60.8% of consumers reported that credit was either somewhat (41.8%) or much (19.0%) harder to get compared to just 7.8% who reported that credit was somewhat (6.5%) or much (1.3%) easier to get. (Source: New York Federal Reserve)*

*For most of the 45-year period from 1976 to 2020, fixed income investors enjoyed a backdrop of declining interest rates and rising bond prices. In fact, the Bloomberg U.S. Aggregate (U.S. Agg.), the benchmark for core, high-quality fixed income in the U.S., only had 3 calendar years of negative returns and posted average annualized returns of 7.3% over that period. However, this was abruptly interrupted in 2021 as inflation began to accelerate and was followed by the worst performance year on record as the Federal Reserve embarked on its most aggressive hiking campaign since the late 1970's. The bond market is flirting with its third straight down year, even as fixed-income markets are offering their highest yields in over 15 years.*

The Fed expects the Fed funds rate to end the year at 5.63%, some 0.25% higher than current levels.

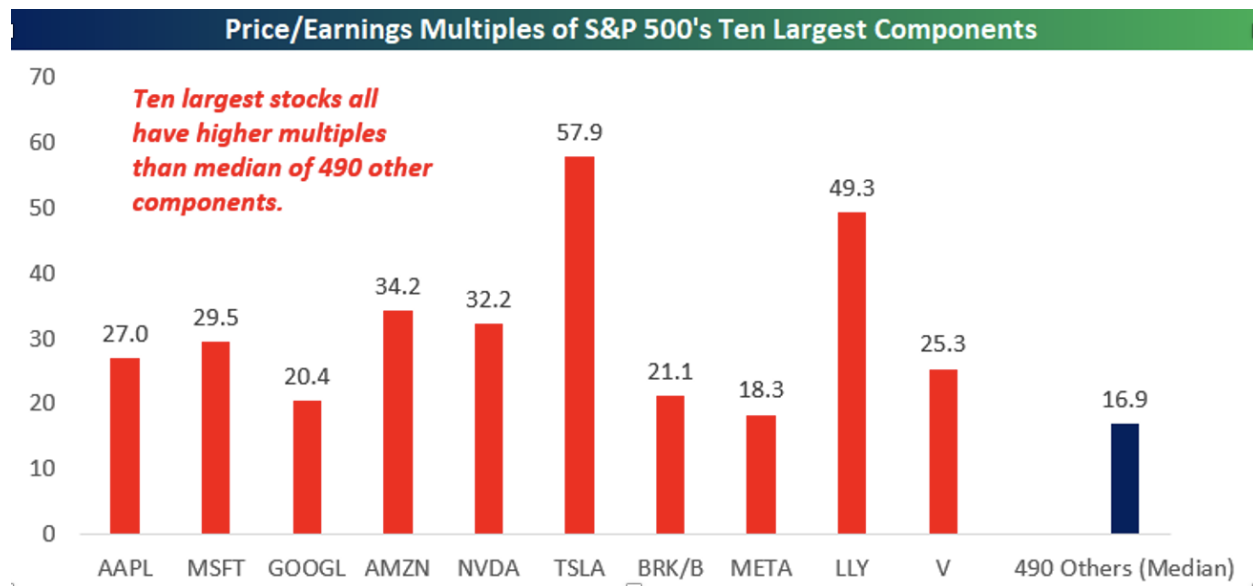
## **A Look Ahead**

Markets are optimistic that the Fed orchestrated a soft landing for the economy and that the era of policy tightening rates will end. That enthusiasm withered over August and September as the prospect of a sustained period of higher rates sank in.



This year's stock market reveals gains did not reflect earnings growth. Investors drove prices higher relative to earnings (aka "multiple expansion"). The sizzling performance of the Magnificent Seven produced a distortion in the S&P 500 Index return this year. Whereas this index returned 13.1% through Q3, the even-weighted index returned a mere 1.8%.

The chart below, courtesy of Bespoke Investment Group, illustrates the disparity:



This provides one of the best illustrations for maintaining a diversified portfolio. ***To date, 60% of companies in the Russell 3000 index (which represents 98% of U.S. stocks) have negative returns for the year.*** Two things are certain: Strong markets have a much better breadth of rising companies, and second, no one knows the future.

My portfolio recommendations for your asset allocation have a few important changes from last quarter.

Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities, and be ready (with cash) to invest when larger short-term declines occur – and as declines are occurring, as distress situations are likely on the horizon.

Consider:

- Maintain prior adjustments to asset allocation targets.
- Assets aren't cheap enough (yet heading that way), cash inside your portfolio remains a great idea, with Treasury bills and money markets able to earn a risk-free 5% until risk assets get cheaper;
- Focus on high-quality, fixed-income holdings with short duration (1- to 3-year), paired with proven opportunistic private credit strategies for yield; avoid high-yield bonds;



- Reduce overall U.S. equity allocation to the lower range of portfolio targets; tilt towards Value over Growth and Small over Large; International vs. U.S.;
- Increase cash by reducing U.S. Large Cap growth stocks and keep private equity distributions on hand;
- Invest in cashflow-generating real estate and real asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities/natural resources, multi-family and farmland);
- Patiently seek to increase allocations to Small Cap Value, Mid Cap Value, and emerging and international stocks within your portfolio target ranges; and
- Wait for well-priced alternatives, including venture capital, growth equity and co-investments, opportunistic strategies, and secondary private investments (don't pay premium prices).

Maintain a disciplined focus on your investment strategies, especially during volatile periods. Many investors' interests in the "E" for the environment (as well as in "S" for social and "G" for governance) of ESG continue to grow. Please know that this has been and always will be a deeply embedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

A handwritten signature in dark ink that reads 'Walid L. Petiri'.

*Walid L. Petiri*

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, JPMorgan Asset Management, Bespoke Investment Group.