



Market Recap

The S&P 500 reached a 2023 high at the end of July before selling off 7.5% through August and September to finish the quarter down 3.3%. Year-to-date the index remains up a solid 13%. Smaller-cap stocks (Russell 2000) also had momentum early in the quarter but changed course and ended the quarter down 5.1%, though are still positive 2.5% year-to-date.

Within foreign markets, developed international stocks (MSCI EAFE) declined 4.1% in the quarter yet remain up just over 7% year-to-date. Emerging market stocks (MSCI EM) fell 2.9% bringing down their year-to-date return to just under 2%. The U.S. dollar (DXY Index) climbed over 3% during the quarter, resulting in a headwind for foreign stock returns.

In bond markets, the 10-year Treasury yield climbed nearly 70 bps in the quarter, ending the period at 4.59% – the highest point since before the financial crisis in 2008. As a result, core bonds (Bloomberg U.S. Aggregate Bond Index) fell sharply, declining 3.2% over the quarter. High-yield bonds (ICE BofA US High Yield) managed to take out a small quarterly gain and are up 6% year-to-date.

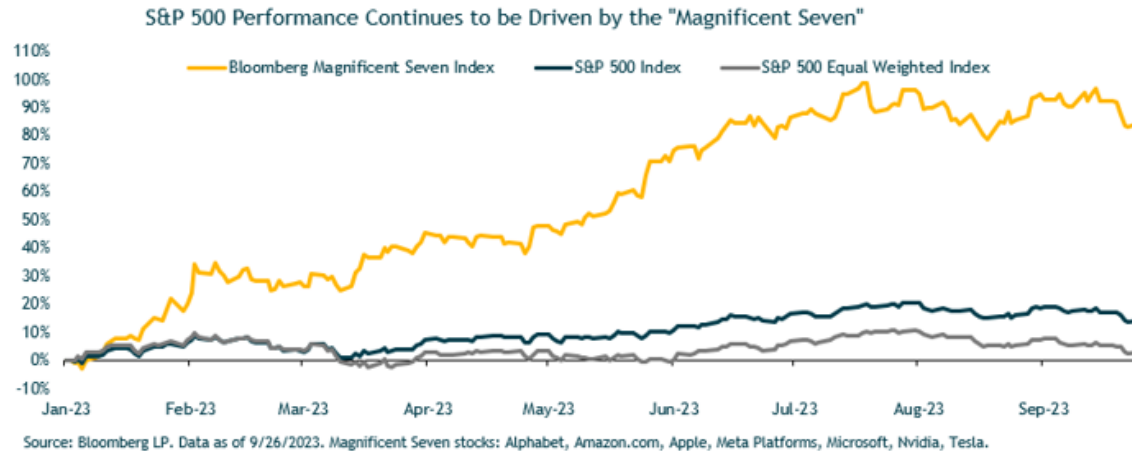
Finally, multi-alternative strategies (Morningstar Multistrategy Category) and managed futures (SG Trend Index) demonstrated their diversification benefits. Multi-alternative strategies returned 0.2% and managed futures gained 1.15% in the quarter.

The “Magnificent Seven” Continue to Power U.S. Equity Returns

With virtually all segments of the stock market posting gains this year through September, one might think that we’re in the midst of a broad-based rally. However, stock gains have remained unusually narrow, with the largest stocks in the index leading the way.

Despite stalling in the latter half of the third quarter, the year-to-date performance of the “Magnificent Seven” stocks (Amazon, Tesla, Apple, Microsoft, Nvidia, Google, and Facebook) continues to explain most of the U.S. stock market’s returns. These seven stocks have collectively increased more than 80% this year, while the remaining 493 stocks in the S&P 500 are basically flat (chart below).

As a result of their massive outperformance, the “Magnificent Seven” have a combined \$10.7 trillion market cap and constitute more than 30% of the S&P 500 index. This level of concentration at the top of the U.S. market exceeds what was witnessed in 2021 and the tech bubble of the late 1990’s / early 2000’s. We must travel all the way back to the early 1970’s (remember the “Nifty Fifty”?) to see a market as concentrated as it is today.



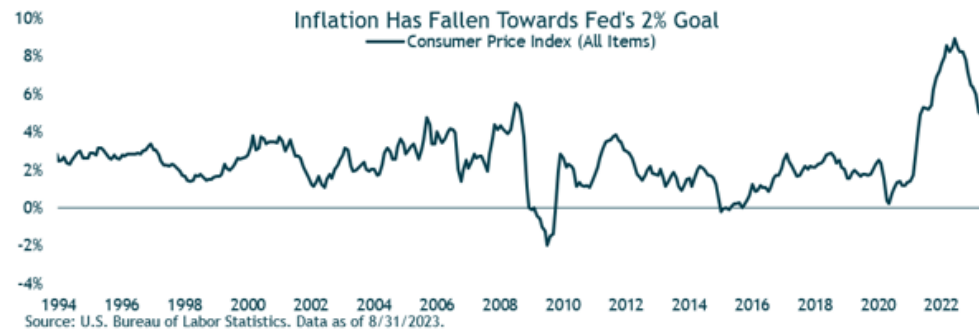
Investment Outlook and Portfolio Positioning *

From a macroeconomic perspective, the big question remains whether the U.S. economy can avoid recession or not, and the timing if it does occur. It goes without saying that the answer will likely lead to meaningfully different market outcomes. If the Fed can manage to slow the economy while avoiding recession, we would expect to see the market's gains broaden out beyond the large-cap technology-related sectors. Conversely, if the Fed's monetary tightening cycle leads to recession, it would likely lead to broader-based declines.

There are reasons to be cautious – our base-case is for a mild recession looking out to 2024. We have seen one of the quickest and sharpest tightening cycles in history, and lending standards have tightened considerably. Both factors create recessionary conditions, particularly as the Fed has a history of raising rates too far, tipping the economy into recession. Since 1931, there have been 19 hiking cycles and in only three instances did the economy avoid a recession.

However, on the positive side, if the economy falls into recession, we believe it will be relatively mild. There are several data points supporting a more positive outlook for the economy (strong consumer spending, healthy household balance sheets, among others), plus this has been one of the most anticipated recessions ever. Amid all this built-up anticipation many companies have already laid off workers and slowed hiring. These corporate moves help loosen the labor markets and potentially ease inflationary pressures.

Speaking of inflation, it has come down meaningfully from its June 2022 high of 9.1%. Recent inflation data show it has declined to 3.7%, suggesting the Fed's policy has been working and that the current interest rate hiking regime may be coming to an end.



The rise in interest rates has taken a bite out of bond returns, which have suffered steep losses over the past couple of years. The silver lining is that looking forward, interest rates (and bond yields) ended the third quarter at levels not seen in nearly 20 years (the Bloomberg Aggregate Bond Index ended the quarter yielding 5.4%). Higher starting yields, all else equal, should lead to higher expected returns. We remain positive on core bonds given their combination of healthy fundamentals, attractive current yields, and the downside protection they provide portfolios in the event of a recession.

In addition to core bonds, we continue to have meaningful exposure to actively managed, flexible bond funds run by experienced teams with broad opportunity sets. There are several fixed-income sectors outside of the traditional parts of the bond market that provide attractive risk-return potential. Some of these funds are currently yielding in the high single digits, while maintaining an eye on capital preservation and interest rate risk.

Within our portfolios, we maintain significant exposure to U.S. stocks overall and hold many of the mega cap tech stocks mentioned in this commentary through our equity mutual funds and ETFs. However, given the strong performance of the “Magnificent Seven,” we believe they are trading at expensive valuations and not adequately reflecting the recession we expect to play out over the next year or so.

That said, other parts of the U.S. stock market are more reasonably valued, so we remain diversified across styles (i.e., growth, value, blend) and market caps (larger and smaller cap stocks) to take advantage of those opportunities. That focus on diversification and valuations led us to reduce our overall exposure in the healthcare sector from 13% to 9% in our moderate-growth portfolios. We remain long-term positive (demographics, earnings visibility) on the healthcare sector although it has grown beyond our overall allocation target %. We reallocated those proceeds to an S&P 500 *equal weight* index which is an alternative to the S&P 500 capitalization-weighted approach dominated by “The Magnificent Seven” mentioned above. As the name suggests, this will allow exposure to all companies in the S&P 500 *equally*.



Overall, we continue to remain relatively equal weight the U.S. market versus foreign stock markets per our strategic target allocations. While it is true foreign stocks will likely decline as much as U.S. stocks in a recessionary scenario, foreign stocks remain far less expensive than the U.S. setting them up for attractive medium-to-longer term expected returns.

Finally, our highest-conviction alternative strategy in terms of diversifying traditional assets remains managed futures, which have historically been able to generate positive returns during periods of losses for stocks and/or bonds. And in the case of standout years like 2022, when managed futures outperformed stocks by 45% and bonds by 40%, the diversification benefits can be meaningful.

**Does not apply to all portfolios*

Closing Thoughts

As we look ahead, a mild recession is still our base-case looking out to 2024. Of course, the timing and magnitude of the Fed's response to economic data will be critical to the outcome. However, we can't rule out the possibility that the Fed threads the economic needle and successfully guides us to the rare soft landing of lower inflation and slower economic growth without recession. Given the uncertainty, we expect volatility, and we think that it will be more critical than ever to keep our pencils sharp and be ready to take advantage of market dislocations. This is not to suggest that we are changing our stripes as long-term investors. We continue to believe that taking a disciplined long-term view is the path to successful investing. We will maintain a balance of offense and defense, seeking attractive risk-reward opportunities that are supported by thorough analysis.

As always, we thank you for your trust and welcome any questions you may have.

Best regards,

The Rainey and Randall Investment Team

Notes: The historical index performance provided in this publication is for illustrative purposes and includes the reinvestment of dividends and income, but does not reflect advisory fees, brokerage commissions, and other expenses associated with managing an actual portfolio. An index is an unmanaged group of securities considered to be representative of different segments of the financial market in general. Index performance does not represent actual portfolio performance. One cannot invest directly in an index.

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