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Quarterly Market Insights

Late Summer Doldrums

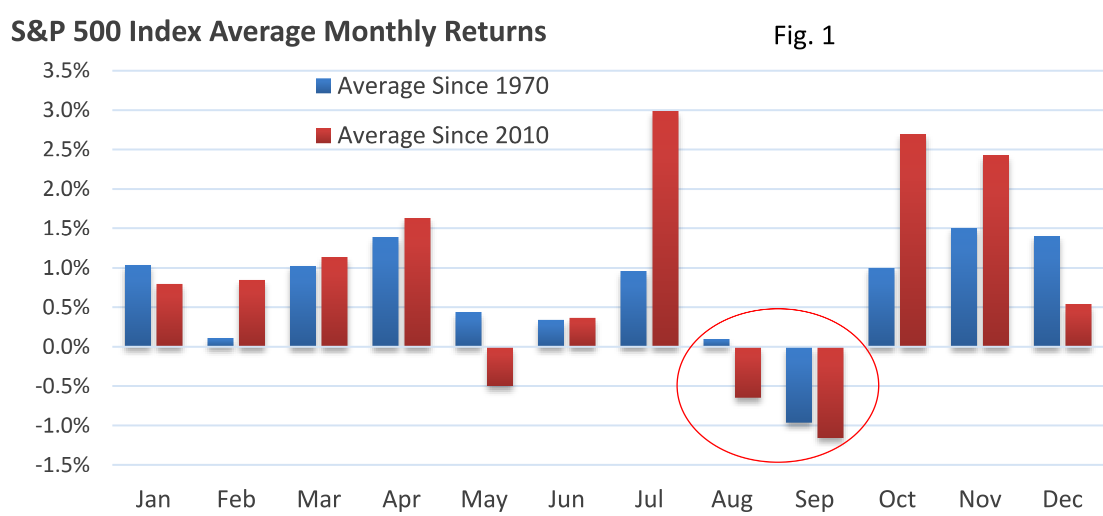
Stocks have had a strong run this year despite a loss in the 3rd quarter. A much slower pace of rate hikes (as illustrated in Table 1), a belief (or hope) that the Federal Reserve would stop hiking interest rates (and eventually start cutting them), and the absence of a much-forecasted recession helped to contribute to this positive result for the year.

Table 1: Comparisons

	Mar 2022 – Sep 2022	Jan 2023 – Sep 2023
Cumulative Fed Rate Hikes	3 percentage points	1 percentage point

The rally that began last October for the S&P 500 continued in July, with the S&P 500 Index peaking at the end of July. It has since fallen, however, by 6.6% through the end of September.

From a historical perspective, August and September have typically been difficult months (see Figure 1) for the stock market. The same two months of 2023 were no exception.



Data Source: St. Louis Federal Reserve; 2023 thru Sep; Oct - Dec thru 2022
Returns do not include reinvested dividends.
Past performance is no guarantee of future results.

While July closed on a high note, the losses incurred in August and September more than wiped out the early gains made in the 3rd quarter and, in fact, showed a loss (see Table 2: Key Returns).

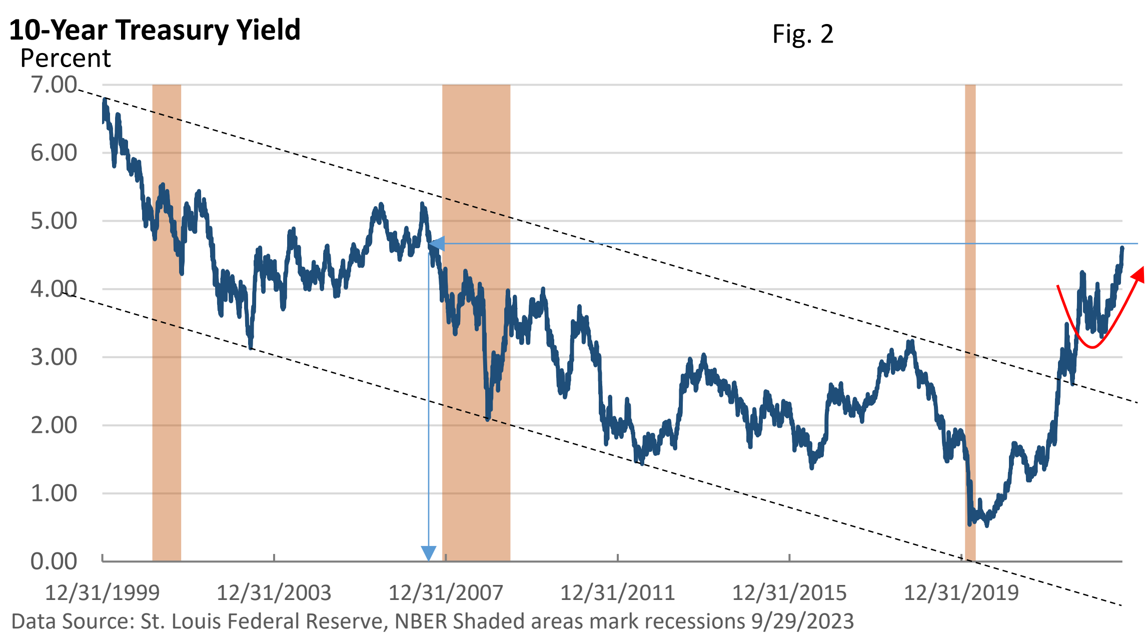
Table 2: Key Returns

Stock Indices	Q3 2023 Return %*	Year-to-Date Return %
S&P 500 (large)	-3.27%	+13.07%
S&P 400 (midsize)	-4.20%	+4.27%
Russell 2000 (small)	-5.13%	+2.54%
MSCI EAFE (intl.)	-4.11%	+7.08%
Bond Yields	**9/30/2023 Yld. & Qtr. Change**	**December 31, 2022 Yield**
3-month T-bill	5.55% (+0.12%)	4.42%
2-year Treasury	5.03% (+0.16%)	4.41%
10-year Treasury	4.59% (+0.78%)	3.88%
30-year Treasury	4.73% (+0.88%)	3.97%
Commodities	**9/30/2023 Price & Qtr. Change**	**Dec. 31, 2022 Price**
Oil per barrel	$90.79 (+$20.15)	$80.26
Gold per ounce	$1,866.10 (-$63.30)	$1,826.20

*Stock indices include reinvested dividends and are not annualized.

Much of the setback in the stock market was caused by the increase in yields across the maturity spectrum in bonds (especially intermediate to longer term maturities). Investors are attempting to price in what analysts call "higher for longer." Higher refers to interest rates. Longer refers to how long rates might stay elevated before a rate cut or cuts. As you can see in Table 2, 10-year and 30-year U.S. Treasury bond yields increased by over 0.75% in the quarter which is a very large move in such a short period of time.

All else being equal, higher interest rates create stiffer headwinds for equities because higher rates compete for investor dollars (why take greater risk in equities when one can get a reasonable and relatively safe return in bonds). The magnitude of interest rate changes over time can be seen in Figure 2. This also shows the sharp increase recently.



Throughout the remainder of the year, the U.S. Treasury will be required to borrow a significant amount of money thanks to low issuance during the debt ceiling debate and the large deficits we are running as a country. As a result of this increase in the supply of bonds, yields may have to rise further to attract buyers of the new bonds that will be issued.

Moreover, the Federal Reserve surprised many by adopting a more aggressive tone than anticipated at its September meeting (less accommodative than expected).

Why Own Bonds and In What Form?

Another area of concern is how investors react when they start reviewing their investment accounts and notice that most of their bond funds are down for the year. This is on top of the negative performance last year in the bond market.

Will people start selling their funds since many bought bond funds hoping to diversify and reduce the volatility of the equities in their portfolio when in fact, they did neither? Such is the quandary when interest rates go up as rapidly as they have over the last 18 months.

Without going into a full dissertation on the math of bonds, let us try and explain the situation in general terms.

The price of a bond moves inversely to interest rates. When interest rates go up, the price goes down and vice versa (when rates decline, the price of an existing bond goes up). This is not an issue if you hold your bond to maturity (assuming it does not default). The problem with bond funds (both bond mutual funds and bond ETFs), however, is that while the bonds in a fund have a maturity, the fund generally never matures. In addition, the longer the maturity of a bond, the more the price changes. For example, many long-term bond funds are down over 10% in 2023 after losing over 20% in 2022. So much for the safe part of a portfolio!!

That is why, at Hopwood Financial, we attempt to put most of the bond component of a portfolio in individual bonds whenever possible. In addition, we keep the maturities in the short to intermediate range.

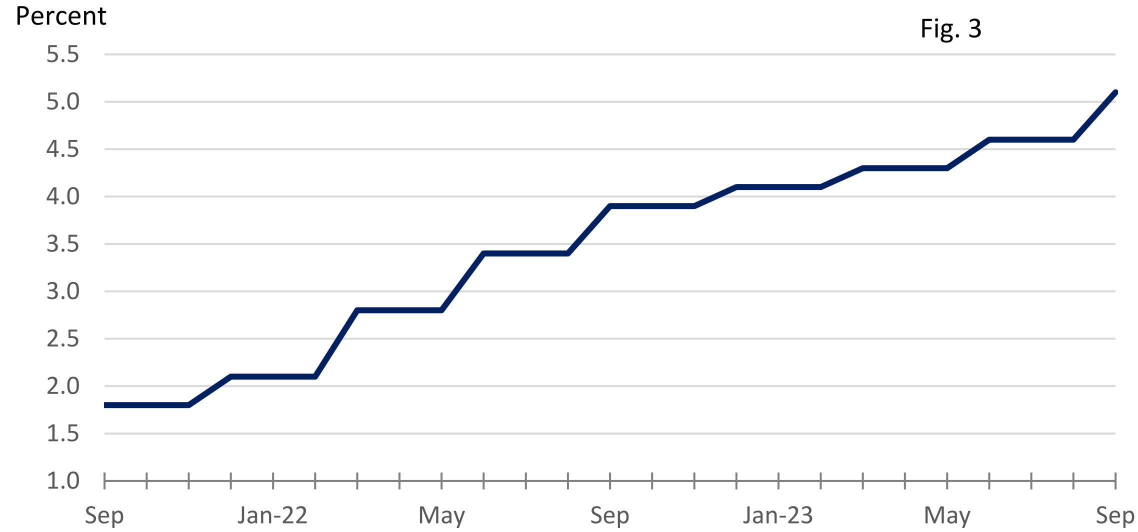
We also utilize a strategy called bond laddering which simply means we have maturities occurring regularly which enables us to take advantage of where rates are at any one time, in addition to providing funds for client cash needs. By utilizing this approach, we believe that the bond component of our clients' portfolios is in fact the lower risk part and acts as a good diversifier.

It's Hard to Forecast the Future

The Federal Reserve releases its forecasts for GDP, inflation, and unemployment every quarter: December, March, June, and September.

The Fed maintained the fed funds rate (the rate that they can control) at 5.25 – 5.50% in September, but it hinted at another rate increase this year and raised its year-end 2024 estimate of the fed funds rate from 4.6% to 5.1% (Figure 3).

Federal Reserve Fed Funds Rate *Forecast* for the End of *2024*



Data Source: Federal Reserve Sep 2023.Projections are subject to change.

Note that the Fed's projections in Figure 3 have almost tripled over the last two years as it hopes to rein in stubbornly high inflation. In fact, it has raised its forecast every quarter since September 2021, when it first issued a forecast for year-end 2024.

Two years ago, the Fed expected a 2024 year-end fed funds rate of about **1.8%**. At the time, it was calling the burst in inflation "transitory." Today, its forecast for December 2024 is **5.1%**.

The best and brightest minds struggle with accurately forecasting future events because projections rely on developing patterns based on historical data. Patterns, however, may change over time, reducing the effectiveness of these models.

In addition, the influence of different variables on the economy can fluctuate from one economic cycle to another, as each cycle has its own unique characteristics.

For example, rising interest rates raise borrowing costs and usually slow consumer and business spending. This has not been the case so far this year as economic growth has been surprisingly resilient. As Fed officials are fond of saying, there are "long and variable lags" regarding the impact from changing interest rates. Thus, things may eventually change with a resultant slower economy but there are no guarantees.

Final Thoughts

As we have emphasized in the past, **focus on what you can control**. You can't control the economy or stock market returns, but you can control your investment strategy. Most importantly, have a strategy that is appropriate for your risk tolerance and the time horizon for the eventual need. **Have a strategy that fits you and stick to it**.

In these uncertain times, the temptation to make drastic changes is very tempting. Please fight this temptation. In our several decade-long careers in investments and planning, we have not found anyone who is able to successfully time getting in and out of the markets over the long term.

Having a written financial plan is the roadmap to your financial goals. It allows you to track your progress, and it reduces uncertainty. Research shows that a solid plan also supports sound money habits and the likelihood of achieving your financial goals.

Please feel free to contact us if you have any questions. We are always here to help you.

Your Hopwood Financial Team