

Trumbower Financial Advisors, LLC

3rd Quarter 2023

Investment Market Commentary

The Godot Recession?

After a sizzling first half, equities took an intermission in Q3. The S&P 500 fell -3.3% for the quarter but is still up 13.1% YTD. Bit players Mid and Small Cap US stocks lagged again this quarter and are now upstaged by the headline index 8.8% and 10.5% year-to-date, respectively.

The best-in-show for Q3 was Energy, ahead 12.2%. Former diva, Technology, took on the understudy role slumping -5.6%. Interest-rate sensitive sectors Real Estate and Utilities continued to swoon under the

weight of rising yields. Along with Consumer Staples these typically defensive stocks failed to support the cast. As the curtain fell on the quarter, Growth held up better than Value – except among Small Cap US stocks and overseas.

Developed International markets, down -4.1% in Q3, fared slightly worse than their fellow US actors. A 2.8% advance in the dollar index explains some of the weakness. The MSCI EAFE Index ended up 7.1% for the year, worthy of applause, but a far cry

from the S&P 500. They have come back stronger than US Large Caps over the past 12 months.

Challenging economic conditions in Germany and the UK and ongoing concerns about the war in Ukraine heading into winter stifled investors' enthusiasm. The plethora of woes plaguing China's economy that has restrained consumer spending triggered a sell-off of European luxury goods manufacturers that are well represented in the EAFE.

(Continued on page 2)

Selected Benchmark and Category Average Returns

Large Cap Equity

	(Total Return)	
Benchmark Indx & Category Average*	3 rd Q 2023	12 Mos.
S&P 500 Growth	-2.59	19.82
Large Cap Gr Avg	-3.65	24.07
S&P 500 Value	-4.09	22.19
Large Cap Val Avg	-2.51	14.42
S&P 500 Index	-3.27	21.62
Large Cap Blnd Avg	-2.99	19.22

Mid Cap Equity

	(Total Return)	
Benchmark Indx & Category Average*	3 rd Q 2023	12 Mos.
S&P MC 400 Growth	-3.24	16.21
Mid Cap Gr Avg	-5.54	13.26
S&P MC 400 Value	-5.23	14.50
Mid Cap Val Avg	-3.35	14.79
S&P 400 Index	-4.20	15.51
Mid Cap Blnd Avg	-3.86	14.56

Small Cap Equity

	(Total Return)	
Benchmark Indx & Category Average*	3 rd Q 2023	12 Mos.
Russell 2000 Growth	-7.32	9.59
Small Cap Gr Avg	-6.72	8.93
Russell 2000 Value	-2.96	7.84
Small Cap Val Avg	-1.75	14.89
Russell 2000	-5.13	8.93
Small Cap Blnd Avg	-3.99	13.25

International Equity

	(Total Return)	
Benchmark Indx & Category Average*	3 rd Q 2023	12 Mos.
MSCI EAFE	-4.71	22.26
Intl Equity Avg	-4.98	24.43

* **Category average** calculated using Morningstar Direct. Fund universe screened to include funds that meet the following criteria:

- M-Star Category consistent with designated asset class and management style.
- M-Star Style Box consistent with designated management style.
- Fund's Objective consistent with asset class.
- Excludes Index Funds.

We have not independently verified Morningstar data.

3rd Quarter Equity Market Results

	3 rd Qtr. % Chg.	12-mo. % Chg.
S&P 500	-3.27	21.62
S&P 400	-4.20	15.51
Nasdaq	-3.94	26.11
Russ 2000	-5.13	8.93
MSCI EAFE	-4.71	22.26
MSCI Emg	-2.93	11.70
Mkt		

The Godot Recession?

(Continued from page 1)

Emerging Markets, down -2.9%, outperformed the rest of the equities ensemble but the index is only up 1.8% so far this year. Over built, over sold and laden with debt, China's big real estate developers haven't gotten their houses in order after a devastating property bubble deflation. The ripple effect on consumers has snuffed out most of the bright spots in the economy. Youth unemployment has risen to the point where they have stopped sharing statistics, and President Xi warned his young people to learn to "eat bitterness" like generations before. Foreign investors are understandably reducing exposure to China, some in favor of India. Its population is huge and young and, unlike China, it is a democracy that has made progress toward improving governance. India, however, is a much smaller and relatively immature market with its own pitfalls and getting pricey as capital flows in.

Q3 reviews for bonds with any duration were tough. The Aggregate Bond Index declined -3.2% trampled by a 0.7% rise in the 10-year yield. The surge in longer-term interest rates was caused by a combination of factors including expectations that persistent economic growth might keep the Fed from loosening the screws and concerns over financing the enormous US deficit. Investors are demanding a higher premium for absorbing the massive amounts of debt the government must issue to pay its bills and cover progressively higher interest. While we like parking cash at close to 5%, there are negative trade-offs. 30-year mortgage rates above 7.5% have hit a 23-year high. The average new car loan comes with a 9.5% price tag. Despite their ability to jack up rents, apartment building owners are in for a shock when they are faced with refinancing over \$980 billion in mortgages maturing over the next 4 years, while their property values fell -14% during the first half of 2023.

Creditworthy corporations, on the other hand, have largely insulated profits from the Fed's tightening campaign because they locked in low rates for longer terms before the onslaught began.

The scene is not so rosy for lower rated borrowers with floating rate debt. Enticing investors with dramatic yields, Morningstar's US Leveraged Loan index is up over 10% YTD, but there are early signs of concern over credit quality. Bankruptcy filings have jumped. In addition to the big names seen in the news, 400 companies that we have never heard of filed this year. Automobile loan pools are reporting default/missed payments at levels comparable to 2008 – highly unusual given the low unemployment rate.

The quarter's grim outcome underscores the fact that wishful thinking cannot evade reality. Investors' wishfully thought interest rates had peaked earlier this year and that the Fed might start to trim back before year-end. High hopes continued unabated through July, but as August rolled around and the economy refused to succumb to mounting rate pressure, investors acknowledged that hikes are not off the table and near-term cuts are a figment of their imagination.

Interest rates work like gravity on corporate valuations. The higher they go the harder they squeeze price expectations, especially for companies anticipating earnings well out into the future. Higher yields also make bonds more attractive relative to stocks. This accounted for much of the distaste for Utilities and Real Estate, sectors that should have remained appealing in an equity market retreat but bowed to the competition from high-yield, risk-free bonds. TINA "there is no alternative" (to stocks) is a thing of the past.

Early in 2023, the appearance of Fed missteps in combatting inflation with tardy, oversized rate hikes and an inverted yield curve foreshadowed a recession to many. The big questions were whether it would be a "normal" or a "deep" one and would it arrive in the 2nd or 3rd quarter. Ironically, the

The Godot Recession?

(Continued from page 2)

force that drove Q3 rates sharply higher was that the recession, seemingly inevitable at the start of the year, now appears farther down the road if not dodged. Diminished recession risk should be good for stocks but the plot twists when inflation remains the key protagonist.

As fall approached, inflation seemed to be subsiding while the jobs market and consumer spending both stubbornly defied the gravity of higher rates. The pundits pushed their recession forecast out, first to Q4 and later well into 2024. By now, the recession looks like the character Godot in Samuel Beckett's famous play; never quite there but always just around the corner. Some even speculate Godot may not show up at all, allowing the Fed to fearlessly continue its attack on inflation – recently stoked by a spike in oil prices – with interest rates higher for longer.

The US economy has never exited the late stage of an economic cycle without a recession. There are several catalysts waiting in the wings. We mentioned the stress on multi-family apartment building owners, but there is also another commercial real estate disaster looming. Demand for office space has been killed by “work-from-home” and operating costs inflated like everything else. Banks are threatened by a whopping \$3.6 trillion of commercial real estate mortgage exposure. Tightened lending standards coupled with free falling valuations could turn into a horror show for both industries.

A prolonged government shutdown could rattle

confidence and set the dominoes falling. We narrowly avoided a default in June and just got a 45-day extension, but we are not out of the woods yet. So far, the economy has been energized by vigorous consumer spending, but stamina may be waning. There are clear signs excess savings from COVID stimulus are running out and more people are heating up their credit cards. The situation will be exacerbated when the hiatus on student loan payments expires. A spending slowdown is, after all, the Fed's goal as it is the only way to impede inflation. Sending it to a screeching halt rather than a gradual decline, however, could be the showstopper that tips the US into a recession.

Another incongruous side effect of sky-high interest rates is the deleterious effect a strong dollar can have on global economies. Brawny dollars chip away at US inflation by lowering the cost of imports, but they can soften demand for the dollar-denominated goods and services we sell abroad. Multinational companies take a hit when translating revenues from local currencies back into musclebound dollars. Countries that import oil priced in dollars and borrow dollars are especially vulnerable. Sharply escalating dollar values have been known to incite international financial crises that can dim the lights on Broadway as well.

As advisors to investors, we are acutely aware of the risks but the play must go on. We never drastically reallocate in anticipation of economic distress because the customized portfolios we design and strategies we recommend are prepared for Godot, when and if he finally appears.

