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Q3 2023 Update

Inflation Worries and Higher Bond Yields Pressure Stocks in Q3

The S&P 500 rose to the highest level since March 2022 early in the third quarter but 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.

The S&P 500 started the third quarter largely the same way it ended the second quarter – with gains. Stocks rose broadly in July thanks primarily to "Goldilocks" economic data, meaning the data showed solid economic growth but not to the extent that would have implied the Federal Reserve needed to hike rates further than investors expected. That solid economic data combined with a decline in inflation metrics to further boost stock prices, as investors embraced reduced near-term recession risks and steadily declining inflation. The Federal Reserve, meanwhile, increased interest rates in late July but also signaled that could be the last rate hike of the cycle. That tone and commentary further fueled optimism that one of the most aggressive rate hike cycles in history was soon coming to an end. Finally, Q2 earnings season was better-than-feared with mostly favorable corporate guidance which supported expectations for strong earnings growth into 2024. The S&P 500 rose to the highest level since March 2022 and the index finished with a strong monthly gain of more than 3%.

The market dynamic changed on the first day of August, however, when Fitch Ratings, one of the larger U.S. credit rating agencies, downgraded U.S. sovereign debt. Fitch cited long-term risks of the current U.S. fiscal trajectory as the main reason for the downgrade, but while that lacked any near-term specific justification for the downgrade, the action itself put immediate downward pressure on U.S. Treasuries, sending their yields meaningfully higher. The Fitch downgrade kickstarted a rise in Treasury yields that lasted the entire month, as the downgrade combined with a rebound in anecdotal inflation indicators and a large increase in Treasury sales stemming from the debt ceiling drama pushed yields sharply higher. The 10-year Treasury yield rose from 4.05% on August 1st to a high of 4.34% on August 21st, the highest level since mid-2007. That rapid rise in yields weighed on stock prices throughout August and the S&P 500 posted its first negative monthly return since February, as higher rates pressured equity valuations and raised concerns about a future economic slowdown. The S&P 500 finished August down 1.59%.

The August volatility subsided in early September, however, as solid economic data and a pause in the rise in Treasury yields allowed the S&P 500 to stabilize through the first half of the month. But volatility returned following the September Fed decision as the FOMC delivered markets a "hawkish" surprise, despite not increasing interest rates. Specifically, the majority of Fed members reiterated that they anticipated the need for an additional rate hike before the end of the year and forecasted only two rate cuts for all of 2024, down from four rate cuts forecasted at the June meeting. Then, late in the month, two additional developments weighed further on both stocks and bonds. First, the United Auto Workers labor union began a general strike, a move that would disrupt automobile production and temporarily weigh on economic growth. Second, the U.S. careened towards another government shutdown as Republicans and Democrats failed to agree on a "Continuing Resolution" to fund the government. The shutdown was avoided at the last minute, but the funding extension only lasts until November 17th meaning there will likely be another budget battle in the coming months. The S&P 500 declined towards the end of the month to hit a fresh three-month low, ending September down modestly.

In sum, volatility returned to markets during the third quarter, as rising bond yields pressured stock valuations, some inflation indicators pointed to a bounce back in inflation and the Fed reiterated a "higher for longer" interest rate outlook.

Third Quarter Performance Review

Rising bond yields were the main driver of the markets in the third quarter as high Treasury yields caused reversals in performance on a sector and index basis, relative to the first and second quarters.

Starting with market capitalization, large caps once again outperformed small caps, as they did in the first two quarters of 2023, although both posted negative returns. That relative outperformance by large caps is consistent with rising Treasury yields, as smaller companies are typically more reliant on debt financing to sustain operations and rising interest rates create stronger financial headwinds for smaller companies when compared to their larger peers.

From an investment style standpoint, however, we did see a performance reversal from the first two quarters of the year as value relatively outperformed growth in the third quarter, although both investment styles finished with a negative quarterly return. Rising bond yields tend to weigh more heavily on companies with higher valuations and since most growth funds overweight higher P/E tech stocks, those funds lagged last quarter. Value funds that include stocks with lower P/E ratios are less sensitive to higher yields, and as such, they outperformed in the third quarter.

On a sector level, nine of the 11 S&P 500 sectors finished the third quarter with a negative return, which is a stark reversal from the broad gains of the second quarter. Energy was, by far, the best performing S&P 500 sector in the third quarter thanks to a surge in oil prices. Communications Services also finished Q3 with a slightly positive quarterly return on hopes integration of advanced artificial intelligence would boost search and social media companies' future advertising revenues.

Looking at sector laggards, the impact of rising bond yields was again clearly visible as consumer staples, utilities and real estate were the worst performing sectors in the third quarter. Those sectors offer some of the highest dividend yields in the market, but with bond yields quickly rising those dividend yields become less attractive and investors rotated out of the high-dividend sectors and into less-volatile bond funds as a result.

Fourth Quarter Market Outlook

Markets begin the fourth quarter decidedly more anxious than they started the third quarter, but it's important to realize that while the S&P 500 did hit multi-month lows in September and there are legitimate risks to the outlook, underlying fundamentals remain generally strong.

First, while there are reasonable concerns about a future economic slowdown, the latest economic data remains solid. Employment, consumer spending and business investment were all resilient in the third quarter and there simply isn't much actual economic data that points to an imminent economic slowdown. So, while a future economic slowdown is certainly possible given higher interest rates, the resumption of student loan payments and declining U.S. savings, the actual economic data is clear: It isn't happening yet.

Second, fears that inflation may bounce back are also legitimate, given the rally in oil prices in the third quarter. But the Federal Reserve and other central banks typically look past commodity-driven inflation and instead focus on "core" inflation and that metric continued to decline throughout the third quarter. Additionally, declines in housing prices from the recent peak are only now beginning to work into the official inflation statistics, and that should see core inflation continue to move lower in the months and quarters ahead.

Finally, regarding monetary policy, the Federal Reserve's historic rate hike campaign is nearing an end. And while we should expect the Fed to keep rates "higher for longer," high interest rates do not automatically result in an economic slowdown. Interest rates have merely returned to levels that were typical in the 1990s and early 2000s, before the financial crisis, and the economy performed well during those periods. Yes, the risk of higher rates causing an economic slowdown is one that must be monitored closely, but for now, higher rates are not causing a material loss of economic momentum.

Why Are Yields Rising?

This is the big question as we closed out the 3rd Quarter and the opening days of the 4th Quarter. Under "normal" conditions, bond yields usually rise for one of three primary reasons:

1. Rising Inflation Expectations – Are inflation expectations currently rising? According to the 5 Year TIPS/Treasury Breakevens, which were 2.22% as of 9/29/23, no. Inflations expectations have largely remained unchanged throughout the third quarter even though rates have surged on the 10 Year Treasury by ~.60% in the month of September alone.
2. Surging Economic Growth – Although it may not feel like it, the economy is growing at a respectable pace (2.10% in Q2 2023 and estimates for 4.9% in Q3 according to the Federal Reserve) but the growth expectations have not changed enough to justify this kind of move in the 10 Year Treasury.
3. Hawkish Fed Expectations – Has the Federal Reserve indicated it is going to get materially more aggressive in raising rates in 2023 or 2024? No. Yes, the market is telling us it believes the Fed is going to keep rates higher for longer but that doesn't by itself justify the rapid increase in rates as measured by the 10 Year Treasury.

So what can possibly be the causes of the recent move in Treasuries?

1. Sentiment & Speculation – For some of the more experienced (older) investors that are reading this, you may remember the so-called Bond Vigilantes, a popular Wall Street term used to describe bond investors that would sell treasuries (and cause a rise in rates) to voice disapproval over U.S. Fiscal Policy.

2. Oversupply – The US Treasury is issuing TWICE the number of bonds in the second half of 2023 due to the debt ceiling standoff from the first half of the year when they were not able to issue new bonds.
3. Reverse QE – Don't forget the Federal Reserve is still shrinking its balance sheet by the tune of about $100 Billion/Month which is another source of supply for the markets.
4. Global Central Banks – Global Central Banks are diversifying their reserves from being severely overweight U.S. Dollars to other Central Bank Currencies. While there may be a number of reasons why, any currency that is pegged to the U.S. Dollar has been struggling in the fact of a strong dollar and it just makes sense if you need to go in to the market and buy more dollars to keep your currency pegged to the Dollar.
5. Government Dysfunction – Yes, this does matter even if it isn't a primary reason. Not to get political, but we need a government that acts in a fiscally responsible manner. Runaway spending and government shutdowns are not the way to run a functional democracy.

What makes rates stabilize and or decline? Well, the data tells us that nothing has materially changed in Q3 2023 to justify this move in rates which leads us to believe that this Rate Spike is temporary, and any sort of "soft" economic data could cause a correction in yields but until then momentum and general anxiety will be alive and well in the very short-term.

In sum, there are real risks to both the markets and the economy as we begin the final three months of the year. But these are largely the same risks that markets have faced throughout 2023 and over that period the economy and markets have remained impressively resilient. So, while these risks and others must be monitored closely, they don't present any new significant headwinds on stocks that haven't existed for much of the year.

That said, as we begin the final quarter of 2023, we remain vigilant towards economic and market risks and are focused on managing both risk and return potential. We remain firm believers that a well-prepared, long-term-focused, and diversified financial plan can withstand virtually any market surprise and related bout of volatility, including "higher for longer" interest rates, stubbornly high inflation, geopolitical tensions, and recession risks.

At Davis Executive Wealth Management, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical for you to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you accomplish your financial goals.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

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