Insights: October 2023

Market Overview and Performance

With the S&P 500 hovering around a +10% return thus far in 2023, a simple reading of headline data would suggest that this has been an above average year of performance for risk assets. And through July of this year, that was largely true. Even with the banking issues which developed in March, the S&P 500 has never gone negative for the year and has more or less traded steadily higher for 6 of the first 7 months of 2023, hitting a peak of about +20% on July 31st. However, since that time, the S&P 500 has declined for 3 straight months, falling by roughly -8% and fixed income as measured by the Bloomberg US Aggregate Bond Index, has fallen almost -6% over the same period. Without question, there are a myriad of valid reasons why investors have become wary, and recent events have certainly heightened the level of cautiousness. As Jamie Dimon, CEO of JP Morgan Chase, summarized, “The war in Ukraine compounded by last week’s attacks on Israel may have far-reaching impacts on energy and food markets, global trade and geopolitical relationships. This may be the most dangerous time the world has seen in decades." Given that environment, one would expect investors to seek the safe haven of US treasuries, pushing prices up and yields down. But yields have moved relentlessly higher this year confounding even the Chairman of the Federal Reserve. When questioned, Powell pointed to several factors, “Markets and analysts are seeing the resilience of the economy to high interest rates and they’re revising their view about the overall strength of the economy and thinking even longer-term, this may require higher rates. That could be part of it. There may be heightened focus on fiscal deficits, that could be part of it. QT could be part of it. Another one you hear very often is the changing correlation between bonds and equities.” Despite the ambiguity behind their inertia, elevated yields are clearly dominating market behavior. Resolution in the fixed income markets will therefore determine the path forward. Thank you for taking time to read our market Insights.

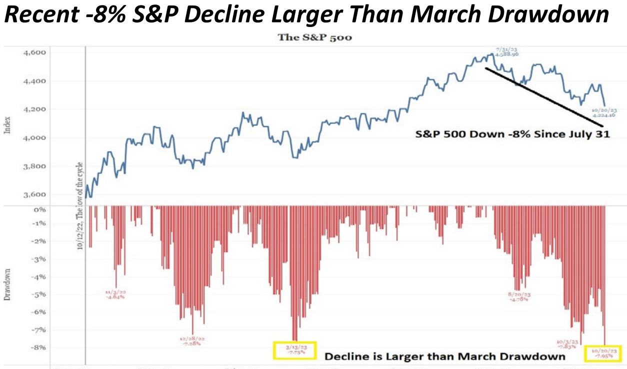
	Quarter to Date September 29	***Year to Date September 29***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**-3.27**	**13.07**
Russell 2000 Index	**-5.13**	2.54
MSCI EAFE Index	**-4.11**	7.08
MSCI Emerging Markets Index	-2.93	1.82
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-3.23**	**-1.21**
Barclay's U.S. Aggregate Credit Index	**-7.23**	-2.62
Barclay's U.S. Aggregate Corporate High Yield Index	0.46	**5.86**
Barclay's Municipal Bond Index	**-3.95**	-1.38
Macro Measures		
Gold	**-3.28**	2.18
Crude Oil	**28.52**	**13.12**
CBOE Volatility Index	**28.92**	**-19.15**
USD Dollar Index	**3.22**	2.61

Current Theme – Stocks and Bonds Have Both Declined Since Market Peaks at the End of July as Sentiment Turns Increasingly Cautious

Elevated Yields and Geopolitical Turmoil Weigh Against a Resilient US Economy and a Likely End to Interest Rate Increases by The US Federal Reserve

As we alluded to, when told that the S&P 500 is up around +10% for the year and the NASDAQ 100 Index, comprised mostly of large cap technology, is up by an astounding +33%, it would be hard to conclude that 2023 has been anything other than a huge success for risk investors. However, those aggregate numbers camouflage some of the underlying dynamics occurring within the US equity market at the moment.

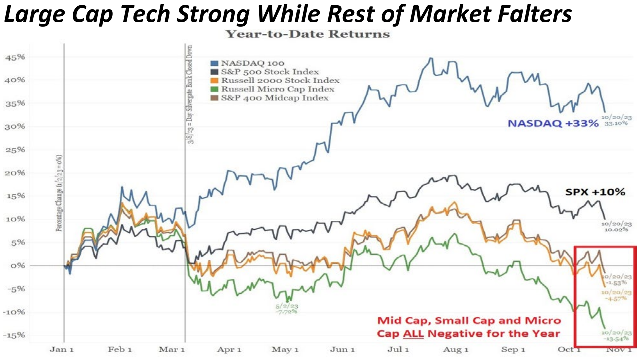
Recent -8% S&P Decline Larger Than March Drawdown



Source: Bianco Research; Bloomberg

As the above chart demonstrates, since July 31st, the S&P 500 has suffered an -8% decline due to a combination of challenging factors. While certainly not unexpected given that this is traditionally a seasonally weak period, it is surprising that this represents the largest intra-year decline experienced in 2023, eclipsing the -7% retraction in March which was fueled by concerns around banking liquidity and solvency.

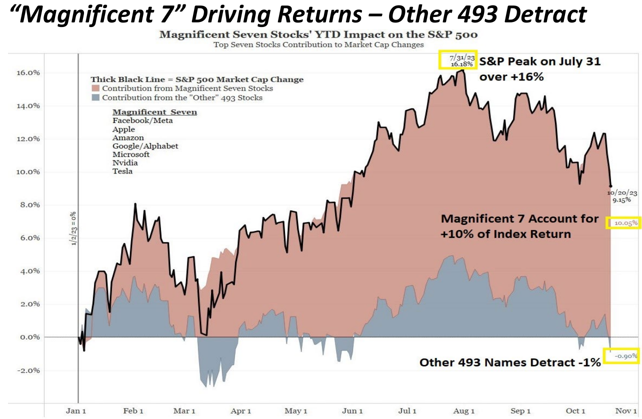
Large Cap Tech Strong While Rest of Market Falters



Source: Bianco Research; Bloomberg

The real surprise to many perhaps is the fact that headline market returns are being almost entirely driven by a very select segment of the market. As the previous chart highlights, while the S&P 500 is solidly positive for the year, most of the remaining equity market is not. Mid-Cap, Small-Cap and Micro-Cap Indexes are all *negative* for the year. In fact, Carter Worth of Worth Charting, examined the Russell 3000 Index which represents 96% of the US equity market, and found that 60% are down for the year, 46% are down by over -10% and 33% are down by over -20%.

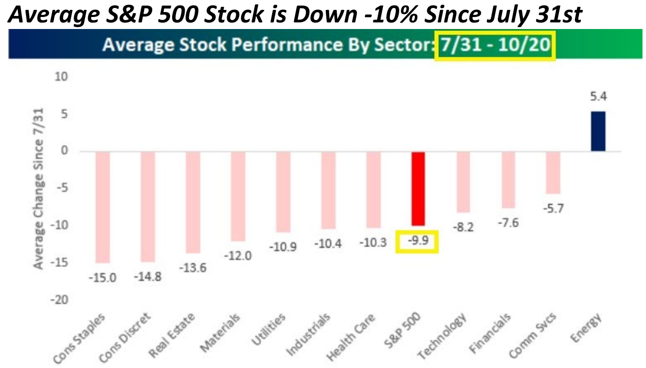
"Magnificent 7" Driving Returns – Other 493 Detract



Source: Bianco Research; Bloomberg

Even strictly within the largest companies of the market represented by the S&P 500, the "Magnificent 7" stocks have accounted for over +10% of the Index level return while the remaining 493 stocks have *detracted* from performance.

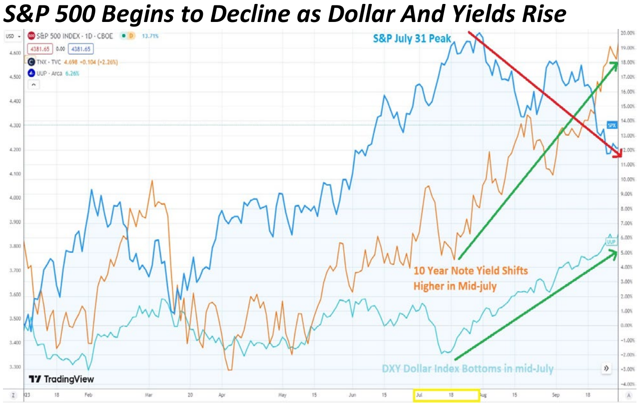
Average S&P 500 Stock is Down -10% Since July 31st



Source: Bespoke Investment Group

Furthermore, the summer sell-off has not been kind to the majority of the market. As seen above, since the end of July, the average S&P 500 stock has fallen by -10% and 7 of the 11 sectors have suffered even more severe declines. Taking these dynamics into account as whole, it becomes clear that rather than a broadly constructive year where almost everything in the market produces gains, the equity environment has actually proven to be a very challenging one for risk conscious, diversified investors in 2023.

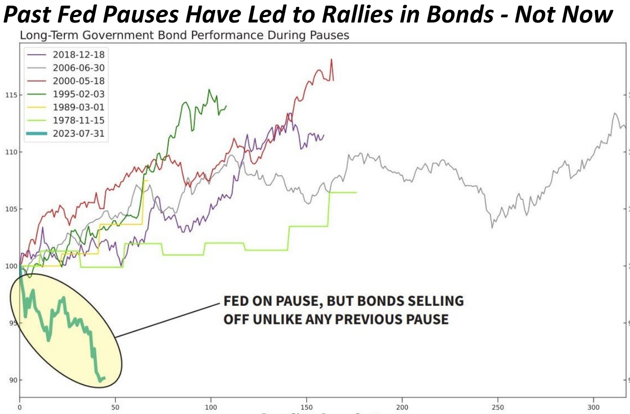
S&P 500 Begins to Decline as Dollar And Yields Rise



Source: TradingView

So, what happened at the end of July to cause the shift in the market? While there is never one single answer behind trend changes, two important components of the market pivoted notably in July. As one can see above, both the yield on the US 10 Year Treasury and the US Dollar began to move higher. Each of these serve as a headwind for US equities, and the combination of both moving in tandem proved to be enough for investors to take some risk off of the table.

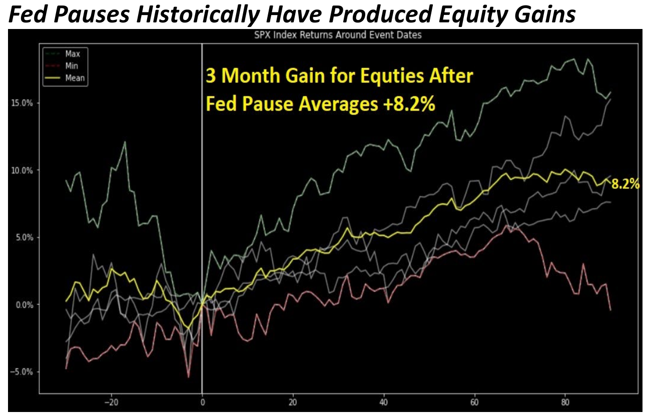
Past Fed Pauses Have Led to Rallies in Bonds - Not Now



Source: 3Fourteen Research

It's also important to note that the US Ferdal Reserve instituted their last interest rate increase on July 26th. The consensus market view has coalesced around the idea that this will be the last rate hike until at least December and perhaps more optimistically, that the Fed is done with raising rates entirely. If that were indeed the case, one would have expected bonds to rally and yields to fall. Obviously, that hasn't happened, and as the preceding chart from 3Fourteen Research highlights, this is in direct contrast to the behavior seen in the 6 previous "Fed Pause" episodes. Despite this anomalous activity there is reason for optimism, particularly for equity investors.

Fed Pauses Historically Have Produced Equity Gains



Source: Gina Martin Adams; Bloomberg

In the chart above, Bloomberg Chief Equity Strategist, Gina Martin Adams, illustrates that during these same 6 "Fed Pause" periods, the S&P 500 has climbed higher over the subsequent six months every time by an average of +8.2%. Additionally, other tailwinds for equites are in place when one looks past the notoriously volatile October period.

Seasonality Traditionally Favors a Year End Rally

Source: Zero Hedge; Bloomberg

While there are quite a few ways to look at the seasonal characteristics of stocks, generally speaking, the August through October window is choppy before a year-end rally typically takes the reins sometime in October. The 30-year trend is charted above, and as one can see, the path traveled by the S&P 500 thus far in 2023 closely matches the patterns that many have become accustomed to. It goes without saying that this is no guarantee that the S&P 500 will move in the same manner throughout the balance of 2023, but there is further evidence to suggest that this might be the case as we near the end of the calendar year.

+10% Through July + Weak Aug and Sept = 4Q Gains

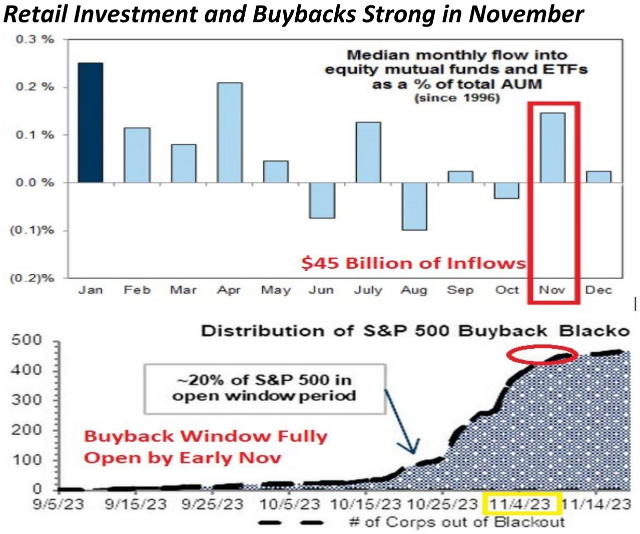
Undefeated
If S&P 500 is up at least 10% through July, but down in August & September, Q4 has never been lower

Year	Return at end of July	August & September	Q4 Return
1961	14.2495	-0.0064	7.0896
1975	27.2426	-5.5716	7.4843
1985	13.6587	-4.6718	15.2631
1986	11.8158	-1.4246	4.7918
1997	26.3189	-0.4292	2.584
1998	14.8618	-8.3401	19.5796
2013	17.0788	-0.1549	9.6208
2019	18.1932	-0.0911	8.3069
2021	16.0267	-1.8578	10.4423
2023	18.3683	-6.6436	?
		Average	9.46
		Higher	9
		Lower	0

Source: Brown Technical Insights; Optuma

The table above from Brown Technical Insights demonstrates that the 9 previous years when the S&P 500 was up by more than +10% through July before experiencing declines in August and September, all finished the year with fourth quarter gains that averaged +9.5% (low +2.6%, high +19.6%).

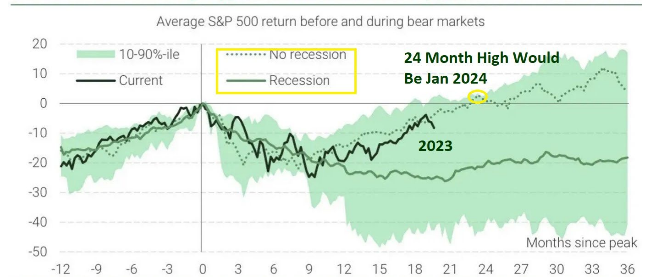
Retail Investment and Buybacks Strong in November



Source: Goldman Sachs Global Investment Research

Equity prices don't just move higher without a catalyst however, so it's important look at fundamental drivers as well. Fortunately, earnings growth is widely believed to have troughed in the second quarter of 2023 with acceleration now anticipated for growth in Q3 and Q4. Additionally, as the chart above from Goldman Sachs highlights, asset flows appear to be poised to enter the market in November. They estimate roughly $45 billion of retail investment flows dedicated to ETF's and mutual funds and perhaps more importantly, the window for S&P 500 companies to re-purchase their own shares being fully open by early in the month.

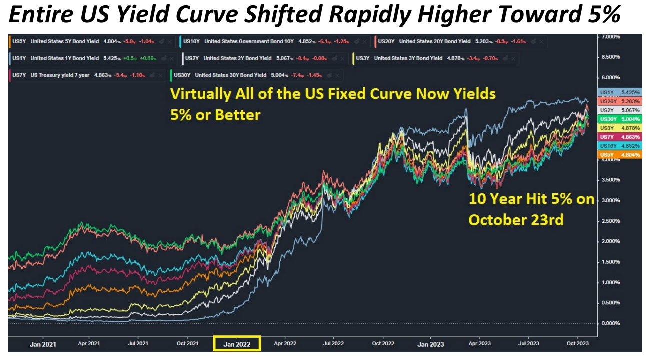
S&P 500 Follwing "No Recesion" Path Toward 24M High



Source: Maverick Equity Research; Bloomberg; GlobalData; TS Lombard

And if US economic data continues to remain resilient, there is reason to believe that the S&P 500 will proceed further along the "No recession" path and revisit its previous high. As the chart above illustrates, following a Bear market decline, it takes about 24 months to revisit the old highs. 2023 has closely followed this trend which would suggest a revisit of the old peak sometime in January of 2024 .

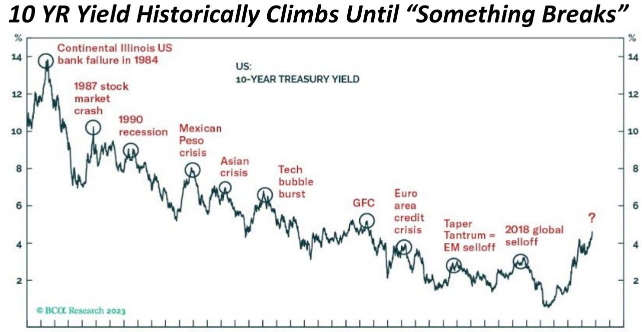
Entire US Yield Curve Shifted Rapidly Higher Toward 5%



Source: Koyfin

While the prospect of new highs in a few months is appealing, the main impediment to this would be the continued rapid ascent of yields as seen above.

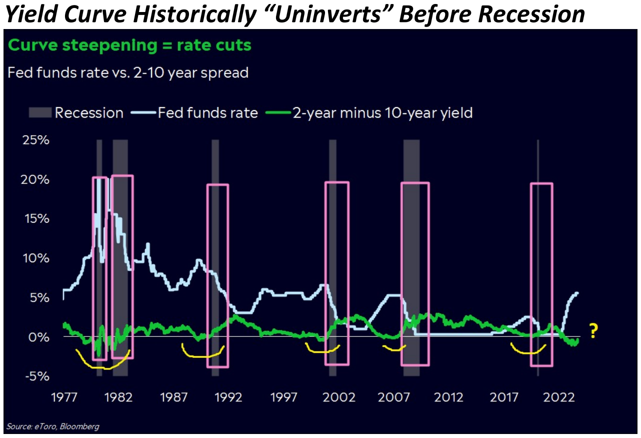
10 YR Yield Historically Climbs Until "Something Breaks"



Source: BCA Research

The velocity of the increase in interest rates from early 2022 was unexpected as is the fact that rates remain around 5% despite overwhelmingly evidence that the inflation spike of the past few years has abated. In fact, the 10 Year Treasury, the standard benchmark for the fixed income market, shot above 5% on October 23rd for the first time since 2007.

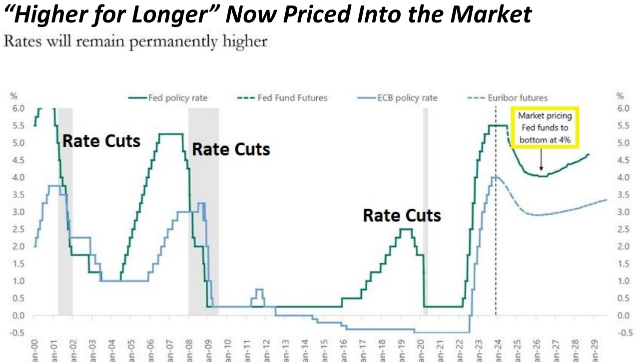
Yield Curve Historically "Uninverts" Before Recession



Source: Callie Cox; eToro; Bloomberg

Interest rates reaching those levels has wide ranging implications for the broader credit markets in general, but one of the primary concerns at the moment is the fact that the yield curve is "uninverting", meaning that the gap between yields of the near-term treasuries and longer-term ones is narrowing. While the inversion of the yield curve typically portends a coming recession by about 24 months, it is actually the "uninversion" that has served as a signal for the start of a recession as illustrated above. Importantly however, this usually happens because the Fed is already cutting short term rates due to weakness in the economy. That is not what's happening now – the long end is increasing.

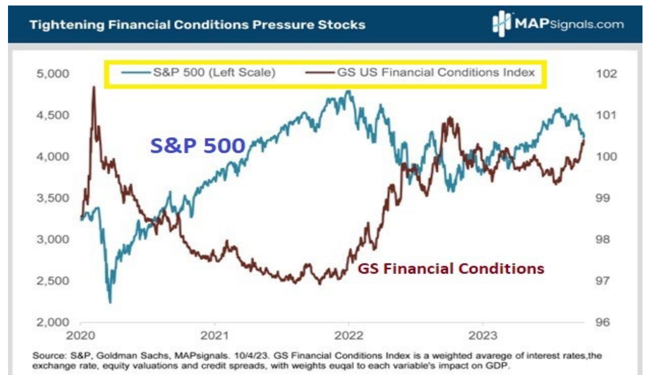
"Higher for Longer" Now Priced Into the Market



Source: Michael Arouet; Apollo Global Management

And in fact, in another departure from past episodes, the market doesn't believe that the fed will be cutting interest rates in a meaningful way anytime soon. As the previous chart highlights, when rates have reached "break something" levels in the recent past, The Federal Reserve has been forced to cut rates in effort to stimulate the economy. Right now however, the economy has yet to display signs of weakness, and with high fiscal deficits and large treasury issuance scheduled for the foreseeable future, the market believes that rates will be "higher for longer".

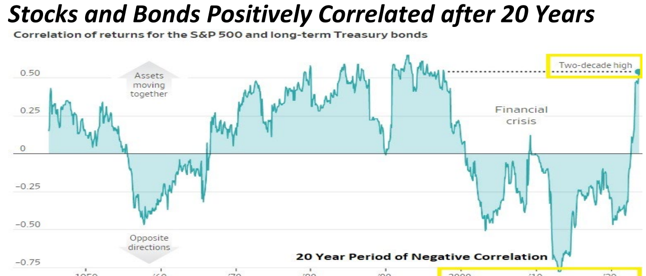
Elevated Financial Conditions Continue as Headwind



Source: S&P; Goldman Sachs; MAPsignals

High interest rates are good for savers, but they don't tend to be friendly to equities. In fact, it's not hard to see why many think the Fed is on an extended pause when considering the above. The Goldman Sachs Financial Conditions Index, which measures things like rates, valuations and credit spreads, has moved sharply higher since July, essentially doing the Fed's job for them. As one can see, when financial conditions climb, equities tend to suffer losses. This has implications for asset allocators, but also for everyday investors. For the past 20 years stocks and bonds have been negatively correlated which allowed for beneficial risk adjusted returns in a typical 60/40 portfolio. That has now reversed which places further importance on the ability to be flexible within asset allocation and the need for dynamic portfolio management.

Stocks and Bonds Positively Correlated after 20 Years



Source: Wall Street Journal

Going Forward

In our experience, no years are easy to invest, but 2023 has presented some unique challenges as several traditional asset relationships and behavior have not adhered to what would be expected given past history. Investors tend to easily forget that the S&P 500 is actually down about -12% from its January 2022 high and in fact, 2022 as whole was the was the worst year on record for diversified investors as both bonds and stocks declined by double digits. While +30% returns for large cap technology names certainly garners attention, most of the market is still in recovery mode which presents opportunity.

As always, we prefer to not take an entrenched view on the market, but rather, adjust allocations and risk as the environment evolves. As such, we have benefitted from our decision to increase exposure to the market leading elements which have produced strong returns since the positive pivot experienced by markets in October of 2022. However, we have certainly been focused on taking profits along the way as merited. This left us with what we considered to be a prudent allocation over the late summer and allowed for liquidity to be available when needed. With the traditional volatility of October largely behind us, we have begun to reallocate capital to areas of the market that have lagged behind the large cap tech rally and now trade at compelling valuation levels as we look toward the historically strong November through January period for equities.

As we discussed in the past, many of the reluctant investors who have not fully participated in some of the stronger performing areas of the market may now be forced into the market in an attempt to chase profits into the end of the year. While this could be beneficial to flows overall, we will remain vigilant regarding individual companies or sectors that reach levels beyond their reasonable valuation expectations.

With the strong outperformance of large cap tech to start the year, some names have provided areas to harvest gains toward the end of summer, however, we still retain a sizable exposure to the large cap technology space and will continue to do so as many of those companies consistently deliver exceptional profitability well above the broader market.

With input prices down and the US Dollar stronger, domestically oriented small and mid-cap companies are in a better position than they were at this time last year. However, due to underperformance through 2023, valuations for both small and mid-cap stocks are now extremely attractive when compared to their large-cap counterparts. With negative returns for small and mid-cap companies experienced in 2023 and the valuation discount to the S&P 500 near levels not seen since the Dot Com bubble in 2002, there may be an opportunity for meaningful returns in the smaller segment of equities as we look forward to 2024.

Regions outside of the US have proven to be volatile this year. Until the shift in the US Dollar occurred in July, the MSCI All Country World Index was up over +22%, outperforming the US indices. However, since that time, the stronger Dollar has brought performance in-line with the US. Valuations outside of the US are compelling on a historical basis after a difficult 2022. If the Dollar strength abates somewhat, and improving fundamental data on inflation and growth continues globally, non-US markets could potentially prove to be another area of opportunity in 2024.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. More recently however, we have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios. As rate increases by the Federal Reserve are projected to end, we would anticipate taking advantage of slightly longer duration exposure that stand to benefit from a more stabilized rate environment combined with falling inflation.

We believe that commodity exposure, primarily via gold, but also including agriculture and energy, will continue to be additive in an uncertain macro-economic environment. Although gold has relinquished some of it's year to date gains as a result of the strengthening Dollar, gold has served its purpose as a diversifying asset quite well thus far in 2023 while other assets have become more correlated.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.