3rd Quarter 2023 Review

Markets were lower in the third quarter of 2023 with declines for stocks in the months of August and September overcoming the gains in July along with rising treasury yields.

The quarterly returns for the major averages were: The Dow Jones Industrial Average fell over 2%, the S&P 500 was down over 3%, the Russell 2000 Small Cap Index fell over 5%, the NASDAQ declined 4%. International equities were also lower for the quarter with emerging market stocks falling 4%, while the MSCI EAFE Developed International Index declined by nearly 5%. The broad U.S. bond market gave up even more ground with the Aggregate Bond Index declining 3.2% for the quarter as yields moved higher.

Despite the declines for the quarter, each of the major stock indices managed to post gains for the year-to-date period. On a YTD basis the Dow Jones is up 2.6%, the S&P 500 is up 13% and the Russell 2000 is up 2.5%. Notably, and consistent with what we wrote about last quarter, the market is still being led by a narrow group of the largest capitalization stocks in the index. This can be seen in the divergence in performance between the S&P 500 Equal Weighted Index, which is up 1.69% YTD, and the market-cap weighted S&P 500 index that is up 13%. Without the performance of the 7 largest companies in the index, the S&P 500 would be up by only about 1% for the year. Concentration remains high and market breadth remains low.

Macro news dominated the quarter with the market focused on the Federal Reserve and the trajectory of the economy and interest rates. At the September Federal Reserve meeting, the decision was to leave interest rates unchanged (after 18 months of rate hikes totaling 525 basis points), while leaving open the option to resume hikes based on the incoming data. Markets took this to mean the Fed will keep rates higher for longer with stocks reacting negatively and bond yields rising. The pause in rates acknowledges the potential lags involved in monetary policy's impact on the economy, while the higher estimates for economic growth by some Fed participants provided some

uncertainty in the direction of longer-term rates. Bond markets took this as an opportunity to reprice longer-term yields higher, and with that, stock markets reacted negatively as well.

As the final quarter of the year begins, the U.S. economy is still growing but the growth is slowing. The long and variable lags associated with the increase in interest rates on both consumers and businesses are beginning to take hold. While the impacts of these were likely muted for an extended period due to the distortions coming out of the COVID stimulus, it is likely too much of a stretch to think they will not impact the economy eventually. Add to this the fact that the U.S. just narrowly avoided a government shutdown that just kicked the can down the road for 45 days before it must be dealt with again, and other factors that could weigh on growth (resumption of student loan debt payments, UAW strikes, higher gas prices, to name a few) and the odds of the Fed being able to pull off a perfect "soft-landing" are falling.

The Federal Reserve's own forecasts for real GDP growth are all over the map depending on which region is used. The Atlanta Fed has real GDP annualized growth for Q3 at 4.9%, while the St. Louis Fed sees it at 1.6% and the New York Fed at 2.1%. The point is that not even the best economic minds at the Fed know for sure where the economy is heading in the short run. Goldman Sachs estimates that the tightening of financial conditions that we've seen, if persistent, could impact real GDP growth in the coming year by 1 percentage point.

As long-term investors we must take the opportunity set across the investment landscape as it is and decide where attractive value exists to allocate capital in a risk-managed way to achieve long-term return goals. The relative valuation differentials among various segments of the equity markets should excite long-term investors in these areas given the more attractive starting valuations that can be found. Given the wide dispersion in valuations for stocks, we feel confident in embracing an active management approach in pursuit of valuation discounts and avoidance of overvalued assets. We can't know precisely when a recession will occur, or how deep or shallow it may be; but we can control what valuation we are paying for assets and whether that includes an adequate margin of safety for the inevitable unknowns.

In terms of the bond market, if an investor's investment policy calls for an allocation to fixed income, the present starting yields on bonds should provide some confidence in putting on some duration in fixed income portfolios. The level of starting yield is a major driver of total return for bond investors and while they can certainly go higher from here, they are at levels that can provide return and protection for the first time in over a decade. Here, we also like active managers who can choose when to stay in shorter term fixed income investments earning decent yield now, while having the optionality to deploy that dry powder later at attractive spreads in credit or moving out the treasury curve in rates.

In the alternative space, we continue to like the diversification benefits and lower correlations that come from allocating to alternative investments. The “participate but protect” features of various strategies and investments can be tailored to specific needs in terms of how much upside participation is sought as well as downside protection to be targeted.

As always, we thank you for your trust and confidence.

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