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2023 Q3 OUTLOOK LETTER & Q2 REVIEW

IT'S THE 10-YEAR STUPID! Most of us who have been around a while (umm … older) remember the phrase from the 1992 presidential election "It's the Economy , Stupid", used by Bill Clinton's campaign when discussion came about what was the most pressing issue in the election. Presently, the stock market is in a similar state where a building wall of worry is being constantly bantered about (more on that in a minute), when in reality, market volatility is basically due to 1 thing – the rising yield on the 10-Year US Treasury … aka… **It's The 10-Year, Stupid!** The 10-Year UST has moved from a yield of about 3.82% at the end of June to 4.8% reached on October 3rd, its highest level since 2007. This 100 basis-point move in bonds in such a short time has rattled investors and is the main cause of stocks falling. It also means the price of the 10-YR bond has declined almost 10% in that time (inverse relationship), leading stocks down a similar amount since then.

The quarter just ended for stocks started positive but ended in volatility. A strong July (+3.1%) move by the S&P 500 was met by rising bond yields and typical seasonal resistance in August (-1.8%), selling in September (-4.7%) and so far, early October. Overall, the S&P 500 returned -3.22% in Q3. As of today, the market has corrected -8% from its August high, closing in on a -10% correction. As mentioned above, the primary cause of this has been a move in yields higher on the longer end of the bond spectrum. The Barclays Bond Aggregate also fell -3.22% in the quarter ended. Here are price returns of several asset classes for Q2.

ASSET	% RTN	ASSET	% RTN
Nymex Crude	28.5%	Muni Bond Agg	-3.5%
Orange Juice	28.7%	Vanguard Total Bond	-4.0%
Tel Aviv 35	5.5%	Nikkei 225	-4.0%
Nymex Nat Gas	4.7%	Nasdaq Composite	-4.1%
FTSE 100	1.0%	S&P Midcap 400	-4.6%
FTSE Italy	.04%	German Dax	-4.7%
Spain IBEX	-1.7%	Ishare 7-10 Yr Treas	-5.2%
Tot Internatl Bond	-2.2%	SP SmallCap 600	-5.4%
STOXX Europe 600	-2.5%	Russell 2000	-5.5%
Dow Jones Industrials	-2.6%	Investment Grade Bond	-5.7%
Shanghai Comp	-2.9%	Hang Seng	-5.9%
CAC France 40	-3.6%	Nymex Gasoline	-7.4%
S&P 500	-3.7%	Ishare 20+ Treasury	-13.8%
Comex Gold	-3.8%	Lean Hogs	-16.2%

A few other highlights – Nymex crude oil jumped 28.5% as the price/barrel jumped to over $90 stoking inflation. Almost all equity indexes ended in the red as did bond indexes. Gold dropped 3.8% and the small cap stock Russell 2000 fell 5.5%. Finally, Lean Hogs gave up gains from last quarter and fell 16%.

CAPITALIZATION AND STYLE

Growth stocks outperformed Value stocks across all capitalizations again, although all indexes were down. Large Growth was the top performing group returning -2.55%. In terms of size performance, Large cap S&P 500 fell -3.22%, the Midcap 400 fell -4.27% and Small Cap 600 declined -4.89%. Below are total returns for the various indexes.

SP 500 Value	-4.05%	SP 400 MC Value	-5.36%	SP 600 Sm Cap Value	-5.63%
SP 500 Growth	-2.55%	SP 400 MG Growth	-3.42%	SP 600 Sm Cap Growth	-4.53%
SP 500	-3.22%	SP MC 400	-4.27%	SP Sm Cap 600	-4.89%

SECTOR ANALYSIS - S&P SECTORS

	Performance (%)		
Cyclical	Q3 2023	Q2 2023	1 Year
Basic Materials	-4.96	3.63	20.05
Consumer Cyclical	-4.69	12.14	16.05
Financial Services	-0.16	5.15	14.16
Real Estate	-8.46	2.30	-0.82
Sensitive			
Communication Services	2.51	12.59	36.44
Energy	12.66	-0.48	28.90
Industrials	-4.85	7.40	24.40
Technology	-4.91	16.48	40.99
Defensive			
Consumer Defensive	-5.22	0.56	8.16
Healthcare	-3.46	2.99	7.04
Utilities	-9.27	-2.75	-6.85

Energy by far outperformed due to the sharp rise in the price of oil. The sector returned 12.66% while communication services rose 2.5%, the only 2 sectors to show positive returns. Financial Services were about flat returning (-.16%). On the downside, interest rate sensitive sectors Utilities (-9.27%) and Real Estate (-8.46%) were the worst performing areas. All other sectors declined between -4% and -5%.

ECONOMY AND KEY TAKEAWAYS LOOKING AHEAD

The Wall of Worry is building – When markets are volatile, usually investors are worried. The volatility index (VIX) which measures stock market volatility started spiking up during September by almost 40% after drifting to lows reached in July. This index is often called the fear index, and the higher the index, the more fear in the marketplace. Weak markets generally need to battle the wall of worry before they can advance. The current wall of worry includes the following:

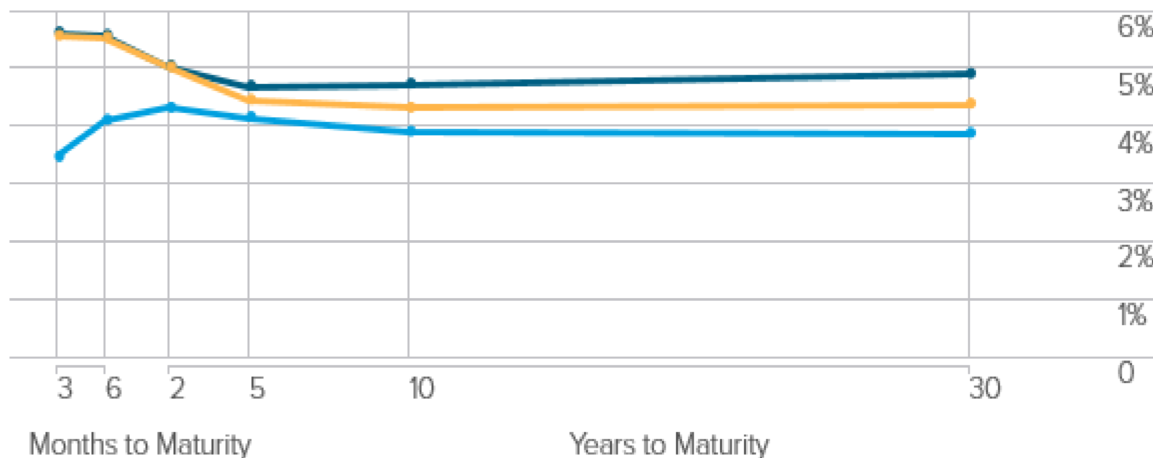
- **Rising bond yields – 10-Year UST rising 1% to near 4.8%**
- **Mortgage rates above 7%**
- **Surging Oil prices stoking inflation fears**
- **Lingering inflation – annual rate declining but still over 4%**
- **UAW Labor strike – may cause higher car prices due to supply issues**
- **Stubbornly strong economy and labor market – more fuel for inflation**
- **Federal Reserve comments about higher rates for longer – no rate cut in sight**
- **Government shutdown fears – shutdown temporarily averted but only 45 days to negotiate**
- **Congressional speaker of house ousted**
- **Questions of a weakening China economy**

As investors digest and adapt to the Wall, stocks will have a better chance to move higher. Meanwhile, the economy has remained resilient with a fairly solid labor market and expanding service sector. There are signs of weakness such as in the

manufacturing sector, but the economy is expanding albeit around a 2% or less growth mode. Not very exciting but perhaps necessary to get inflation under control. Higher mortgage rates could finally start taking a toll on housing but so far has also remained steady. I am still in the camp of either no recession in 2024 or a very mild one. But continued growth in income, spending and prices should keep the Fed on its toes.

BONDS

The Fed announced in September that rates wouldn't be cut anytime soon but would stay higher for longer. The "higher for longer" terminology caught markets by surprise (personally I never believed rates would be cut this year) and the subsequent rise in yields lead to stock weakness. The target range of Fed Funds has stayed at 5.25-5.5% since July. The Fed has raised rates 1% so far in 2023 (4 times) compared to from 0% to 4.25-4.5% in 2022.
The short end of the bond market has remained in a tight range because of the Fed holding steady. The chart below shows the current Treasury yield Curve. The three lines below from top to bottom are as of today, 1-month ago and 1-year ago. The top line shows we remain inverted although the inversion has lessoned as the long end (5 to 30 years) has moved higher while the short end (0 to 2 years) has stayed flattish. I've mentioned that the inversion would eventually end either by short rates declining or long rates rising. More economists are now looking for the long end to move above 5%.



EQUITIES

YTD, a look at the S&P 500 after Q3 one might think it was a pretty good year. The S&P 500 finished the quarter down but still with a return of 13% YTD. However, under the hood the engine is not running so smooth. The small group of Megacap Growth stocks, now dubbed "The Magnificent 7" is driving the returns. These stocks include Apple, Microsoft, Google, Meta, Nvidia, Tesla, and Amazon. The Nasdaq 100, of which these stocks are a big component, is up 35.1% YTD. Since the S&P 500 is a cap-weighted index, these 7 stocks have contributed almost **all** the S&P return. The other 493 stocks in aggregate are about flat to down! The equal-weighted S&P 500 is only up 1.7% YTD in comparison. The Equal Weight 100 is up 6.6%. And the Dow Jones Industrial Average of 30 Blue Chips returned 2.6% YTD. The S&P Small-Cap 600 (+2.47% YTD) and Mid-Cap 400 (+4.34% YTD) stocks held onto gains for the year but again are much lower than the Megacaps.
Last quarter I talked about the fact that the rest of the market needs to catch-up at some point. But I do think that near-term with the volatility high, investors will continue to want to own the Megacap stocks. The positive news regarding the S&P 500 is with the recent sell-down, valuation is getting better. The forward P/E ratio is now 17.7x compared to 18.9x at the end of June. This is below the 5-yr average (18.7x) and slightly above the 10-year average (17.5x). Excluding the magnificent 7, valuation would drop dramatically under the averages. The rest of the market is undervalued IMHO.

Analysts expect EPS to decline .3% in Q3 and grow 7.8% in Q4. For 2024 EPS are expected to grow 12% for the S&P 500. So, for Q3 there is a low bar to beat while Q4 may be a bit too optimistic.

The Q3 earnings season begins this week with the banks and over the next several weeks we will get a look at how companies performed and their outlook for Q4. It's likely that Q3 earnings will end up showing positive growth when all said and done given the low bar mentioned above. Positive surprises and decent guidance will go a long way in helping stocks regain momentum. Alternatively, weakness, especially among the Megacaps, could ruin the Q4 party.

SUMMARY THOUGHTS

Higher bond yields are not necessarily negative for stocks. In the past, stocks have been able to do quite well in higher rate environments. A growing economy and lower inflation are 2 of the keys. We've lived in a low (zero) rate environment for some time now and TINA (there is no alternative) favored stocks. With yields above 5%, there is now another option for investors to earn a decent (not great) return in short bonds. But stocks still hold the greater longer-term rewards, especially regarding inflation.

I believe the market is oversold in many areas, especially the non-Mega Caps. Overall, I am sticking with my recommendation for a diverse portfolio with Large, Mid, Small cap and international stocks represented. Near-term I favor the Large Caps but as we move to November and December small and mid-cap stocks may do better assuming no shocks to the system. International stocks, specifically European equities, are still attractive on relative valuation. **I'm going to go out on a limb and say that Q4 will be a good one for stocks.** First, here is what I said last quarter in my letter -- "*If I were to map out the usual pattern, I'd suggest good earnings could lead to a gain in July followed by some weakness into October. Assuming the economy doesn't falter, the last 2 months could resume the climb*." So far, the first part of that is happening as I forecasted. I believe the 2nd part can follow which means a rally between now and year-end. My caveat is that it will not be a straight line as there are too many unknowns. And the next couple weeks could be dicey. But my prior forecast of the S&P 500 reaching its 2022 high is still possible. That would mean a gain of about 10%+ from current levels by year end. That is my optimistic case scenario and the one I am assigning the highest probability. It also assumes the Fed raises rates in November then stops, inflation continues to decline steadily but slowly, and the government doesn't shutdown in November.

I could paint a more bearish scenario that inflation remains elevated, and the economy stays strong causing the Fed to be more aggressive again in raising rates and tightening monetary policy. This could potentially send the economy to recession in 2024. Stocks would falter through the end of this year and into 2024. This is a low probability in my analysis but still a potential outcome among the uncertainty.

I think bonds will return their coupon in the final quarter on the short end but higher yields on the long end could cause some loss of principal. It seems the 10-year is destined to climb above 5%. I continue to recommend holding equities and bonds for balanced accounts and am moving maturities out to 2 years on bonds and still getting 5%+.

I plan to start sending out short monthly updates again given the uncertainty of the environment rather than just quarterly. I promise not to clutter your inboxes.

Have a great fall and winter and feel free to call or email me with your thoughts.

Bob