Investment Newsletter

Third Quarter 2023

After one of the stronger performances ever recorded in the first half, equity markets cooled off in the third quarter. The S&P 500 index posted a total return of -3.39%, and the MSCI All-Country World ex-U.S. index posted a total return of -3.77%. The key driver of performance was the Federal Reserve's announcement in September that it intended to raise interest rates one more time this year to a range of 5.50-5.75%, and that interest rates would remain higher for longer to fight inflation – dashing expectations for rate cuts next year. Given that the timing of these higher interest rates coincides with the expiration of multiple pandemic-era stimulus programs, investors are also concerned about a slowdown in consumer spending.

The extremely narrow breadth seen in the stock market's first-half performance continued. Of the S&P 500's +12.65% year-to-date total return, 85% of that performance was concentrated among just seven mega-cap technology stocks tied to Artificial Intelligence (A.I.). Those seven companies have posted a year-to-date equal-weighted average total return of +87.8%. That compares to just +1.1% for the rest of the stocks in the S&P 500. Moreover, if the S&P 500 were an equal-weighted index instead of a market cap-weighted index, its year-to-date total return would be +2.41%.

Fixed income markets also experienced declines in the quarter as yields rose across all maturities. The Bloomberg U.S. Intermediate Government/Credit index returned -0.83% and the Bloomberg Municipal Bond Blend 1-5 Year index returned -1.18%. Longer maturity yields are now the highest since 2007. Year to date, all Treasuries with maturities over four years have posted negative total returns. Most of the higher move in yields occurred in September, triggered by the Federal Reserve's interest rate announcement that negatively impacted all sectors, including municipal bonds.

Bond investors have several other concerns that point to a 'higher for longer' interest rate environment. Chief among them is the rising budget deficit, projected at $18.8 trillion over the next 10 years. In addition, rising interest payments on the $33.1 trillion of government debt currently equates to 90% of the defense budget and 54% of the social security budget; 52% of total U.S. debt matures in the next three years; foreign holders of U.S. debt are selling and demanding a higher yield; and the Federal Reserve is selling down its $8 trillion balance sheet. Consequently, Fitch lowered the ratings of U.S. debt from 'AAA' to 'AA+' in August, and Moody's – the last credit agency to rate the U.S. debt 'AAA' – cautioned that a government shutdown would indicate weak governance and cause it to lower its rating too.

Despite negative returns in the quarter, fixed income has become increasingly attractive as new bonds are issued at higher yields and with higher coupons. This is an opportunity to lock in higher yielding, intermediate-maturity bonds with coupons in the 4.0% to 5.0%-plus range that have not been seen in 15 years. The current 1-Year Treasury yield of 5.48% captures a significant portion of the +7.0% long-term average return on equities – risk free. Thus, we will continue our strategy of investing in higher coupon bonds and extending the average bond maturity in client portfolios.

Alongside interest rates remaining higher for longer, there are a number of other concerns with consumer spending, which powers 68% of U.S. gross domestic product and is one of the key driving forces behind the stock market:

- Excess pandemic-era personal savings built up from stimulus programs are now largely depleted. After peaking at $5.9 trillion in April 2020 from $1.2 trillion before the pandemic (January 2020), personal savings have declined -87% to $0.8 trillion in August 2023.
- Federal student loan payments restarted on October 1. An estimated 40.5 million people owe a total of $1.4 trillion. With an average monthly payment of $389, student loan payments are estimated to cut -8% from consumer monthly income and $190 billion annually from the economy.
- Pandemic-era federal stabilization grants to child care centers have ended. This amounts to $24 billion and will keep upward pressure on child care rates, which have already risen twice as fast as overall inflation.

- Gasoline prices have rallied +23% since December 2022 because oil prices have risen by the same amount tied to OPEC production cuts, Russia sanctions, and a depleted U.S. Strategic Petroleum Reserve (SPR).
- Credit card delinquencies are climbing. Since making an all-time low at 1.55% in the third quarter of 2021, delinquencies have rallied to 2.77% in June, the highest level since 2012. U.S. consumers have $1.26 trillion of credit card debt, which has grown +38% since April 2021. The average credit card interest rate is +20.7%, up from 14.5% in early 2022.
- The current national average 30-year fixed mortgage rate is 7.90% – the highest in the last 23 years – versus 3.22% in January 2022. This has dampened home sales, produced a low supply of homes for sale, hurt home affordability, and limited worker mobility as most consumers are currently locked into a lower mortgage rate.
- Inflation remains 'sticky.' The August reading of the Personal Consumption Expenditures Index (PCE) was +3.5%, still well above the Federal Reserve's target of +2.0%. In addition, the PCE will have tougher year-over-year comparisons beginning in November.
- An increase in natural disasters has catalyzed a +21% year-over-year average increase in homeowner insurance premiums as of May 2023 in 44 states. On average, premiums are +35% higher today than two years ago.

The following are some of the supportive factors for the consumer, the economy, and stock market:

- The U.S. labor market is still sturdy. The unemployment rate is 3.8%, there are 8.8 million job openings, and wages are currently increasing +5.3% while inflation continues to moderate.
- The ratio of household debt service payments to disposable personal income is still at a manageable level. As of the second quarter, the ratio was 9.8%. While up from the 8.3% all-time low in the first quarter of 2021, it is well below the all-time high of 13.2% set in the fourth quarter of 2007, right before the Great Recession.
- Continued easing of U.S. inflation. The headline PCE peaked at +6.8% last June and is +3.5% as of August. The full effect of the Federal Reserve's higher interest rates should continue to pressure inflation lower.
- With increased upward pressure on the consumer and downward pressure on inflation, the Federal Reserve is closer to ending its interest rate hikes.
- Winter heating costs this year will be down significantly for Americans. Nearly a majority of U.S. homes are heated with natural gas, the price of which has collapsed -61% year-over-year.
- S&P 500 earnings growth is forecasted to accelerate to +11.9% in 2024 from +1.0% in 2023 based on easing comparisons driven by three things: 1) companies finally lapping the large negative effects of inflation from wages, materials, shipping and freight; 2) lapping the tough sales growth comparisons for technology companies whose products experienced a two-year acceleration in demand during the pandemic; and 3) a significant drop-off in COVID-19 medical and test products this year (e.g., Pfizer's sales and earnings will plummet -34% and -50%, respectively, on lower vaccine and therapy sales).
- Three government infrastructure investment programs worth $2.2 trillion are still in their initial stages.
- The valuation of the S&P 500 largely reflects the current inflationary environment with a forward price-to-earnings ratio of 17.6x, only marginally above the average of 17.4x for all previous time periods when inflation was in the +2-4% range going back to 1950. Furthermore, while the seven mega-cap technology stocks that have powered the S&P 500 sport a market cap-weighted average forward price-to-earnings ratio of 28.9x, the rest of the 496 stocks in the S&P 500 trade at 15.7x.
- Investor sentiment is negative. Recessions and bear markets are usually preceded by consumer and business greed and over-confidence, not by fear. The CEO of one of the largest financial firms in the world recently said that "…what the world is missing today is hope. I see more fear than any time in my business career."

As monetary and fiscal policy continue to become more restrictive, resulting in higher interest rates for longer, sustained upward pressure on bond yields, and increased financial pressure on the consumer, the investment environment is likely to become more challenging in the short term. Despite this, we are well positioned for the long term and continue to find exciting investment opportunities in companies with meaningful innovation, strong balance sheets, solid free cash flow, high barriers to entry, and impressive management teams that can successfully navigate shifting business environments.

Sources: CBO, FDIC, BEA, DHS, Commerce Department, Policygenius, Barclays, Nareit, Federal Reserve Economic Data (FRED) and FactSet

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