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Wealth Management, LLC

Market Review - Third Quarter 2023

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Volatility Makes a Comeback

Third quarter started out well enough. The stock market continued its solid momentum from Q2 and the S&P 500 hit its 2023 peak in late July—19% higher than where it started the year and 28% higher from the October 2022 low.

Investor sentiment then turned sour in August and September, causing every major asset class to finish the quarter in the red. What happened? As was the case in 2022, rising interest rates were the main culprit. Interest rates up, asset prices down—it has become a semi-regular pattern since early 2022 and unfortunately it popped up again this quarter. To illustrate, the yield on the 10-year US Government bond (a key benchmark), entered Q3 at 3.81%. But in the past two months it has skyrocketed to 4.8%, the highest level since mid-2007. As a result, the S&P 500, the NASDAQ, and the Bloomberg Bond Aggregate all lost more than 3% in the quarter.

There is somewhat of a silver lining here. US Treasury bond yields can be viewed as an investor "fear gauge". When the economy is on the brink of something scary, like in 2008 or early-2020, interest rates fall. When the economy appears to be healthy and investors expect economic expansion, interest rates rise.

And that's where we are right now. Despite widespread gloomy forecasts of recession in 2023 and 2024, our economy continues to perform better than expected. Many economists (and the Federal Reserve) now think we will be able to avoid a recession entirely. It can seem counterintuitive, but we are in an interesting period where the economy doing well is actually negative for markets as it influences interest rates. "Good news is bad news" as the saying goes. Eventually though, good news will just be good news. The combination of low unemployment, declining inflation, and an expanding economy—conditions we are currently experiencing—is typically good for asset prices longer-term. We are hopeful these conditions continue despite how markets may react in the short-term.

Key Q3 Events:

- **Stocks declined, breaking their three quarter winning streak.**
- **Inflation remained near multi-year lows in Q3.**
- **After a brief pause, the Federal Reserve resumed rate hikes in July. The total number of interest rate increases since March 2022 is now 11.**

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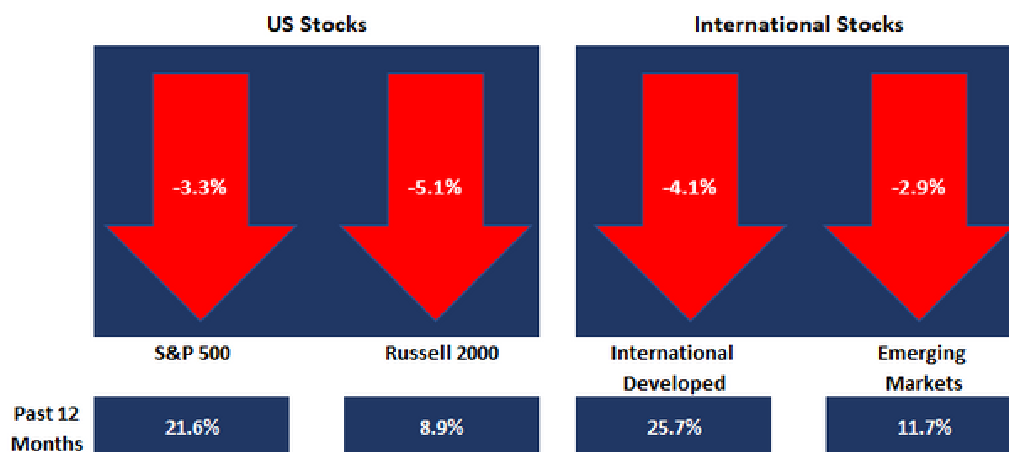
Stocks Decline in August and September

Domestic large cap stock's Q2 momentum carried into Q3, with the S&P 500 gaining over 3% in the month of July. Momentum faded as the calendar flipped to August and investors realized the economy was too strong to feel certain the Federal Reserve was done raising rates. The S&P 500 lost 1.6% in August and another 4.8% in September, bringing its quarterly loss to -3.3%. Smaller US companies and international stocks were not immune from the sentiment shift either. Small cap stocks lost 5%, international developed stocks lost 4%, and emerging markets stocks lost 3% in the quarter.



Source: Morningstar. International Developed measured by the MSCI EAFE NR USD. Emerging Markets measured by the MSCI EM NR USD.

Fixed Income Continues to Struggle

Better-than-expected economic data and a "hawkish" stance from the Federal Reserve continues to lift interest rates across the board. The Federal Reserve raised the Fed Funds rate once again in the quarter, bringing the total number of rate hikes in the past 18 months to 11. Longer term rates rose more dramatically. The 10-year US Treasury yield entered Q3 at 3.81% but rose to 4.59% by the end of the quarter, causing the US bond market to decline 3.2%. A bright spot was less interest rate sensitive High Yield bonds which gained 0.5% in the quarter—a testament to investors' view that the US economy remains on solid footing.

Source: Morningstar. US Bond Index measured by Bloomberg US Aggregate Bond TR USD, Corporate Bonds measured by Bloomberg US Corp Bond TR US, High Yield Bonds measured by Bloomberg US Corp High Yield TR USD, Municipal Bonds measured by Bloomberg Municipal TR USD

The Impact of Rising Interest Rates

"Higher interest rates hurt asset prices”. This is something we’ve mentioned a number of times and you’ve probably heard it elsewhere, too. But why is this so? In this section we’ll expand on the idea as it has been one of the most disruptive investing variables since market volatility began almost 2 years ago.

Most of our clients have been investors for a long time and have lived through many market cycles. That said, the past 7 quarters is probably the first time they have experienced such a dramatic increase in interest rates. Until recently interest rates had been on a multi-decade downward trend. In 1981, the yield on the 10-year US Government bond peaked at 16%. Over the subsequent 4 decades, that yield consistently trended lower and hit the all-time low of 0.54% in March of 2020. Since then, it has risen 9-fold back to ~4.8%, a 16-year high.

The majority of this yield increase has happened since January 2022. It’s no coincidence that in that same time frame the S&P 500 is down ~8%, the NASDAQ is down ~14%, and the Bloomberg Bond Agg is down ~15%. But back to the original question—why do assets react like this? It all comes down to how investors assign a price to stocks and bonds. Any investment, typically a stock or a bond, can be viewed as a stream of cashflows. Investors look at those expected cash flows and decide what price they want to pay for them. But they don’t pay a simple sum of the cashflows, because they’d be waiting for years for them to materialize (in most cases). To compensate them for waiting, they apply a “discount rate” which tends to mirror the overall interest rate environment. So, in a low-interest rate environment like 2008-2021, the discount rate applied to stock and bonds was low. This meant investors were willing to “pay up” for any given cashflow stream. Unfortunately for investors, the reverse is also true. When interest rates go up, so does the discount rate applied to asset prices, and we experience the “yields up, prices down” dynamic.

What does this mean for investors going forward? As painful as it was to live through the shift from low to high interest rates, investors can now generate very attractive yields in low risk investments. It can also be argued that it’s healthy for stocks to have a little competition for investors’ investment dollars. Previously when rates were low, stocks benefitted from the idea of “TINA”—There Is No Alternative. As an example, in late-2021 money market funds, the 3-month US Treasury, and the 6-month US Treasury all paid close to 0% interest. As of October 6, 2023, that figure is above 5% for all three. The ability to generate a 5%+ return in a short-term, low-risk investment has been a gamechanger.

For this reason, it is conceivable that stock investors will now be a little more calculating about a company’s future prospects. Hopefully this will keep them more disciplined and anchored to fundamentals—back to basics, if you will.

Key Things to Watch for in Q4

- Inflation – Large declines in inflation are likely behind us, but will we see sustained progress towards the Federal Reserve’s goal of 2%?
- The Fed - Will they raise rates just one more time in Q4 as the market expects? Or will they continue to surprise investors with additional rate hikes?
- GDP - A recession in 2023 was widely predicted but now appears less likely. Strong economic readings will provide confidence that we may avoid an economic downturn entirely. Q3/Q4 GDP reports, labor market data, and consumer spending trends will be critical.
- Rising geopolitical risk - The recent violence in the Middle East has been shocking. There are now 2 major land wars that America is at least tangentially involved—how will this change the investing landscape?

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