Market Review & Outlook

October 2023

The bulls were riding high at the end of last quarter as technology stocks had just powered the Nasdaq Composite to its best first half performance since 1983. If we flash back to the 4th quarter of last year, slowing corporate earnings and economic data, not to mention the most rapid Fed tightening cycle in 40+ years, had many economists predicting a recession starting during the 2nd or 3rd quarter of 2023. These fears waned over the first seven months of the year, as a historically tight labor market and resilient consumer spending led many investors to believe the Fed will successfully engineer a soft landing for the economy. A soft landing means no recession. Recently, markets seem to finally believe the Fed's "higher for longer" narrative on interest rates, as rates have climbed steadily since early April, resulting in steep losses for the bond market, with Treasury Bonds falling almost 15% in just the past 3 months. Predictably, this has begun to weigh on stocks. For a more detailed look at how various asset classes performed recently, please refer to the table.

Index	Sept. 2023	3rd Qtr. Perfo-mance	Year to Date	One Year Perfor-mance	Description (what the index is comprised of)
S&P 500	-4.77%	-3.27%	13.07%	21.62%	Large Cap US Stocks
DJ Industrial Average	-3.42%	-2.10%	2.73%	19.18%	Large Cap US Stocks
Nasdaq Composite	-5.77%	-3.94%	27.11%	26.11%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	-5.44%	-3.13%	24.98%	27.72%	Large Cap US Growth Stocks
Russell 1000 Value	-3.86%	-3.16%	1.79%	14.44%	Large Cap US Value Stocks
Russell 2000 Growth	-6.60%	-7.32%	5.24%	9.59%	Small Cap US Growth Stocks
Russell 2000 Value	-5.21%	-2.96%	-0.53%	7.84%	Small Cap US Value Stocks
MSCI EAFE	-3.42%	-4.11%	7.08%	25.65%	Foreign Developed Market Stocks
MSCI EM	-2.62%	-2.93%	1.82%	11.70%	Emerging Markets Stocks
Credit Suisse High Yield	-1.19%	0.46%	5.63%	9.87%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	-2.54%	-3.23%	-1.21%	0.64%	US Treasuries, mortgage-backed, investment grade corporate bonds

From last year's market low on October 14, the S&P 500 rose 28% through July 31 of this year, regaining much of the ground lost during last year's bear market. The strong recovery in share prices has investors debating whether this a new bull market, or simply one of the stronger bear market rallies in market history. While the market has met the technical definition of a bull market with its 20%+ gain from the previous low, the S&P 500 still sits ~12% below its all-time high. With some exceptions, Wall Street strategists have mostly discarded their dour predictions of a recession and another leg down in stocks.

This has happened against a backdrop of declining corporate earnings. After earnings per share for the S&P 500 fell 4.1% in the second quarter of 2023, earnings are expected to drop 0.2% in the third quarter when compared to the same period last year, as per data from FactSet. If that drop is realized, it would mark the fourth straight quarter of year-over-year earnings declines reported by the index. In other words, the fundamental case for stocks has been worsening while momentum and improving sentiment have inflated valuations. Even though earnings have declined slightly, the S&P 500 is trading at around 18 times forward earnings compared to under 16 times earnings a year ago.

As of today (10/3), stocks as measured by the S&P 500 are down 7.8% since the recent high on July 31, and the Nasdaq is down 9%, not yet meeting the 10% definition of a correction. Corrections are rather common, and on average, the S&P 500 has experienced a correction of 10% or more every 1.85 years since the beginning of 1950. Given that, it would be completely normal to see stocks decline a bit further from here. Not only that, but October has proven to be the most volatile month for stocks. We are skeptical about seasonal explanations for market phenomena, but it is true that on average, September has been the worst month for stock market performance, closely followed by October. For various reasons, including some of the most famous stock market crashes in history, October has been more volatile than September, even though its average performance is slightly better.

Still, even with this recent drawdown, the S&P 500 is up more than 10% year to date, and the tech-heavy Nasdaq is still up almost 25%. While those are solid gains by any measure, it would be incorrect to characterize this year's market advance as a broad-based, healthy one. Legendary

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Merrill Lynch strategist, the late Bob Farrell, wrote in his famous 10 Rules of Investing, "Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names." Only three out of eleven industry sectors in the S&P 500 – communication services, information technology, and consumer discretionary – have experienced meaningful gains this year. While industrials and energy stocks have eked out YTD gains of 1.4% and 1.3%, respectively, materials, financial, health care, consumer staples, real estate, and utility stocks are all in the red YTD.

The truth is, the so-called "Magnificent Seven," – Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla, and Meta (the seven most valuable S&P 500 companies ranked in order of market capitalization) – are responsible for all the year-to-date S&P 500 gains once you net out the performance of the remaining 493 stocks. In contrast to the market cap-weighted S&P 500, the S&P 500 Equal Weight Index is down 0.66% YTD as of October 3, while the small cap Russell 2000 is down 1.94%. Even the market-leading Magnificent Seven have experienced corrections in the recent sell-off. Retail giant Amazon, the 3rd most valuable S&P 500 company, has gained 56% this year but is still down 33% from its mid-2021 high and is perhaps a better barometer of the broad economy than 2023's hottest stock, Nvidia. Stepping back and looking more broadly at breadth, as of October 2, just 12% of S&P 500 stocks were trading above their 50-day moving average, a low for the year and a level last visited during the October 2022 market low. Also, with the S&P 500 closing at 4229.5 today (10/3), the senior index now sits just 0.3% above its 200-day moving average.

With stocks weakening and sitting just above key support levels, the upcoming earnings season (unofficially starting on October 13) could take on added significance as financial conditions continue to tighten. Even with the 2022 bear market and recent mini-correction, stocks continue to sport valuations in the richest historical decile. However, if the overall tenor of earnings season is positive, i.e., better than expected, positive sentiment could certainly carry stocks higher into year-end, even with the Fed remaining hawkish on interest rates. Conversely, if the overall tenor is negative and/or if some bellwether stocks report negative earnings surprises, sentiment could weigh on stocks, especially if interest rates keep going higher.

The Fed has signaled it will likely raise rates once more before year-end, and FOMC members continue to repeat their higher for longer mantra in public comments. If the year ended today, it would be the third consecutive calendar year of declines for bonds. As of yesterday, the Bloomberg US Aggregate Bond Index was down 2.67% YTD, after losing 13% last year and 1.54% in 2021. Since its August 2020 all-time high, the iShares 20+ Year Treasury Bond ETF (TLT) is down almost 47%. These are historic losses in the bond market and likely have many investors, both foreign and domestic, re-assessing the risk and volatility characteristics of US Treasuries. At the same time, with 3- and 6-month Treasury bills currently yielding 5.5-5.6%, they at least provide a viable option for short-term cash (e.g., money market funds) compared to a decade plus of the Fed's zero interest rate policy.

The interest rate outlook becomes increasingly important with government, corporate, and private debt all standing at record levels. This debt was mostly financed at the recent, historically low levels of rates and when that debt matures and is refinanced, will have to be financed at much higher rates. Recent stories in the financial press have highlighted that higher rates have not yet impaired the corporate sector's ability to service debt. Maybe so, but if rates remain high, it's just a matter of time before that happens. Many folks are already paying 20% interest or more on outstanding credit card balances, and with total outstanding credit card debt recently surpassing $1 trillion, payment delinquencies are on the rise. The more rates keep going up, the more potential for real damage as they deeply effect the opportunity cost calculus of holding various other assets like gold and tech stocks, not to mention real world economic decisions.

Officially, the Fed says it still believes there's a possibility for a soft landing. For economists still forecasting recession, those forecasts have mostly been pushed out to the first half of 2024. Weighing the economic evidence, we still believe there's a higher than average chance for downside risk over the coming quarters. The lagged effects of all the Fed rate hikes have still not fully reverberated throughout the economy and the index of leading economic indicators has now fallen for 17 consecutive months through August. While long-term investors can ignore most of this market noise, those with shorter term objectives may want to assess your investment plan.