Market Outlook
Third Quarter 2023

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MARKET SNAPSHOT

Interest rates rose materially during the quarter, as the yield on the 10-year Treasury bond increased by almost 0.8%.

While higher interest rates have a negative impact on bond prices, they create a more attractive long-term total return profile for bonds.

Equity markets fell during the quarter, as the market feared the impact of higher interest rates for longer.

Inflation has been steadily declining, and a number of macroeconomic datapoints suggest the risk of recession in 2024 is elevated.

There is a path for the Fed to navigate a soft landing if they can lower inflation back to their 2% target without creating a broader economic slowdown and significantly higher unemployment.

Market Recap

The S&P 500 reached a 2023 high at the end of July, before selling off 7.5% through August and September to finish the quarter down 3.3%. Year to date the index remains up a solid 13%. Smaller-cap stocks (Russell 2000) also had momentum early in the quarter but changed course and ended the quarter down 5.1%, though are still positive 2.5% year to date.

Within foreign markets, developed international stocks (MSCI EAFE) declined 4.1% in the quarter yet remain up just over 7% year to date. Emerging-market stocks (MSCI EM) fell 2.9%, bringing down their year-to-date return to just under 2%. The U.S. dollar (DXY Index) climbed over 3% during the quarter, resulting in a headwind for foreign stock returns.

In bond markets, the 10-year Treasury yield climbed nearly 80 bps in the quarter, ending the period at 4.59%, the highest point since before the financial crisis in 2008. As a result, core bonds (Bloomberg U.S. Aggregate Bond Index) fell sharply, declining 3.2% over the quarter. High-yield bonds (ICE BofA US High Yield) managed to eke out a small quarterly gain and are up 6% year to date.

The 'Magnificent Seven' Continue to Power U.S. Equity Returns

With virtually all segments of the stock market posting gains this year through September, one might think that we're in the midst of a broad-based rally. However, stock gains have remained unusually narrow, with the largest stocks in the index leading the way. The standout performers are those sectors with the largest stocks, while most other sectors have been relatively flat. Collectively, the "Magnificent Seven" stocks—Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla—have increased more than 80% this year, while the remaining 493 stocks in the S&P 500 are basically flat.

As a result of their massive outperformance, the Magnificent Seven have a combined \$10.7 trillion market cap and constitute more than 30% of the S&P 500 index. This level of concentration at the top of the U.S. market exceeds what was witnessed in 2021 and the tech bubble of the late 1990s and early 2000s. We have to travel all the way back to the early 1970s (remember the "Nifty Fifty?") to see a market as concentrated as it is today.

Investment Outlook and Portfolio Positioning

From a macroeconomic perspective, the big question remains whether the U.S. economy can avoid recession or not, and the timing if a recession does occur. It goes without saying that the answer will likely lead to meaningfully different market outcomes. If the Fed can manage to slow the economy while avoiding recession, we would expect to see the market's gains broaden out beyond the large-cap technology-related sectors. Conversely, if the Fed's monetary tightening cycle leads to recession, it would likely lead to broader-based declines.

There are reasons to be cautious—we still believe the odds of a recession in 2024 are heightened. We have seen one of the quickest and sharpest tightening cycles in history, and lending standards have tightened considerably. Both factors create recessionary conditions, particularly as the Fed has a history of raising rates too far, tipping the economy into recession. Since 1931, there have been 19 hiking cycles and in only three instances did the economy avoid a recession (below).

Rate Cycles & Recessions

Beginning of tightening cycle	End of tightening cycle	Duration of tightening cycle (months)	Total Fed rate increase over tightening cycle	Following recession begins in	Months between end of tightening and start of recession
Feb 1928	Jul 1928	5	1.50%	Aug 1929	13
Jan 1948	Jan 1953	60	1.00%	Nov 1948	—
Apr 1955	Aug 1957	28	2.00%	Aug 1957	0
Sep 1958	Sep 1959	12	2.25%	Apr 1960	7
Jul 1963	Dec 1965	29	1.50%	—	—
Nov 1967	Apr 1969	17	2.00%	Dec 1969	8
Jan 1973	Apr 1974	15	3.50%	Nov 1973	—
Aug 1977	Feb 1980	30	7.75%	Jan 1980	—
Sep 1980	May 1981	8	4.00%	Jul 1981	2
Sep 1987	Feb 1989	17	1.50%	Jul 1990	17
May 1994	Feb 1995	9	2.25%	—	—
Aug 1999	May 2000	9	1.50%	Mar 2001	10
Jun 2004	Jun 2006	24	4.25%	Dec 2007	18
Dec 2015	Dec 2018	36	2.25%	Feb 2020	14
Mar 2022	Jul 2023	16	5.25%	?	?
Average		***21***	***2.83%***		***9.89***
Median		***17***	***2.25%***		***10***

Source: iM Global Partner and Board of Governors of the Federal Reserve System, IMF, National Bureau of Economic Research (NBER).

However, on the positive side, if the economy falls into recession, it could be relatively mild.

Inflation has declined meaningfully from its June 2022 high of 9.1%, thanks in part to the Federal Reserve's rapid rate hikes. The year-over-year number recently declined to 3.7%, suggesting the Fed's policy has been working and that with time inflation could continue to fall.

At this point, it is clear the rate-hike regime is close to an end and we believe the Fed has gotten the upper hand on inflation. Since March 2022, the Federal Reserve has increased rates from zero to a target level of 5.25%-5.5%. The aggressive hiking cycle that started roughly 18 months ago was finally put on pause in late July, although the Fed has said they expect another 25 bps hike this year.

The rise in interest rates has taken a bite out of bond returns, which have suffered steep losses over the past couple years. The silver lining is that looking forward, interest rates and bond yields ended the third quarter at levels not seen in nearly 20 years. Higher starting yields, all else equal, should lead to higher expected returns. We remain positive on core bonds given their combination of healthy fundamentals, attractive current yields, and the downside protection they provide portfolios in the event of a recession.

Historically, stock market returns over the next six to 12 months following a pause in a tightening cycle are mixed depending on the inflation environment. Most of the negative outcomes occur during bouts of higher inflation, when the Fed typically maintains a more restrictive policy (e.g., pre-1980s). When inflation is not elevated, the Fed can move to a more accommodative stance much sooner, leading to better equity market outcomes (e.g., post-1980s).

S&P 500 Returns After Rate Hiking Cycles

Final rate hike	S&P 500 return three months later	S&P 500 return six months later	S&P 500 return nine months later	S&P 500 return one year later
Jan 1953	-5.4%	-6.4%	-7.2%	-2.3%
Aug 1957	-8.2%	-8.7%	-1.4%	7.2%
Sep 1959	2.6%	-5.5%	1.0%	-2.9%
Dec 1965	-2.8%	-6.4%	-15.7%	-9.8%
Apr 1969	-1.1%	-7.4%	-7.2%	-11.2%
Apr 1974	-8.0%	-21.7%	-18.5%	-3.3%
Feb 1980	-7.0%	8.9%	18.8%	10.0%
May 1981	1.8%	-5.9%	-10.0%	-8.9%
Feb 1989	11.2%	22.1%	19.8%	12.9%
Feb 1995	9.5%	18.8%	25.4%	35.2%
May 2000	2.0%	-6.7%	-11.2%	-12.1%
Jun 2006	4.9%	11.4%	11.6%	18.1%
Dec 2018	12.7%	17.8%	19.4%	28.5%
Jul 2023	?	?	?	?
Average	***0.9%***	***0.8%***	***1.9%***	***4.7%***
Median	***1.8%***	***-5.9%***	***-1.4%***	***-2.3%***

Source: iM Global Partner and Board of Governors of the Federal Reserve System. Data as of 9/3/2023. S&P 500 Index price returns shown.

Today, inflation remains elevated but on a clear path downward. Of note, however, since the day of what might be the Fed's last rate hike, the S&P 500 began its current 7.5% drawdown. This may be a signal that the market expects inflation to persist and for the Fed to maintain interest rates "higher for longer."

Closing Thoughts

As we look ahead, we continue to see a number of recessionary indicators in the data we are observing and believe the risk of recession in 2024 is heightened. The timing and magnitude of the Fed's response to economic data will be critical to the outcome. We can't rule out the possibility that the Fed threads the economic needle and successfully guides us to the rare soft landing of lower inflation and slower economic growth without recession. Given the uncertainty, we expect volatility and think it more critical than ever to be ready to take advantage of market dislocations. This is not to suggest that we are changing our stripes as long-term investors. We continue to believe that taking a disciplined long-term view is the path to successful investing. We will maintain a balance of offense and defense, seeking attractive risk-reward opportunities supported by thorough analysis.

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

Best regards,

Retirement Plan Advisors

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Market Indicators
3rd Quarter 2023

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S&P Sectors

	QTR	YTD	1Y	5Y
S&P Technology Select Sector TR USD	-5.55	32.64	39.46	18.24
S&P Financial Select Sector TR USD	-1.13	-1.65	11.73	6.05
S&P Consumer Disc Select Sector TR USD	-5.06	25.58	14.16	7.73
S&P Health Care Select Sector TR USD	-2.65	-4.09	8.18	8.22
S&P Industrial Select Sector TR USD	-5.16	4.50	24.58	7.29
S&P Cons Staples Select Sector TR USD	-6.60	-5.94	5.94	7.96
S&P Energy Select Sector TR USD	12.27	6.15	30.41	9.02
S&P Utilities Select Sector TR USD	-9.25	-14.41	-7.02	5.66
S&P Real Estate Select Sector TR USD	-8.90	-5.45	-1.84	4.40
S&P Materials Select Sector TR USD	-4.76	2.61	18.05	8.57
S&P Telecom Select Industry TR USD	-8.27	-12.19	-6.70	-0.20

Market Returns

	QTR	YTD	1Y	5Y	10Y
S&P 500	-3.27	13.07	21.62	9.92	11.92
Russell Mid Cap	-4.68	3.91	13.45	6.38	8.99
Russell 2000	-5.13	2.54	8.93	2.40	6.65
MSCI EAFE	-4.11	7.08	25.65	3.24	3.83
MSCI Emerging Markets	-2.93	1.82	11.70	0.55	2.07
BBgBarc U.S. Agg Bond	-3.23	-1.21	0.64	0.10	1.13
High Yield	0.46	5.86	10.28	2.96	4.24

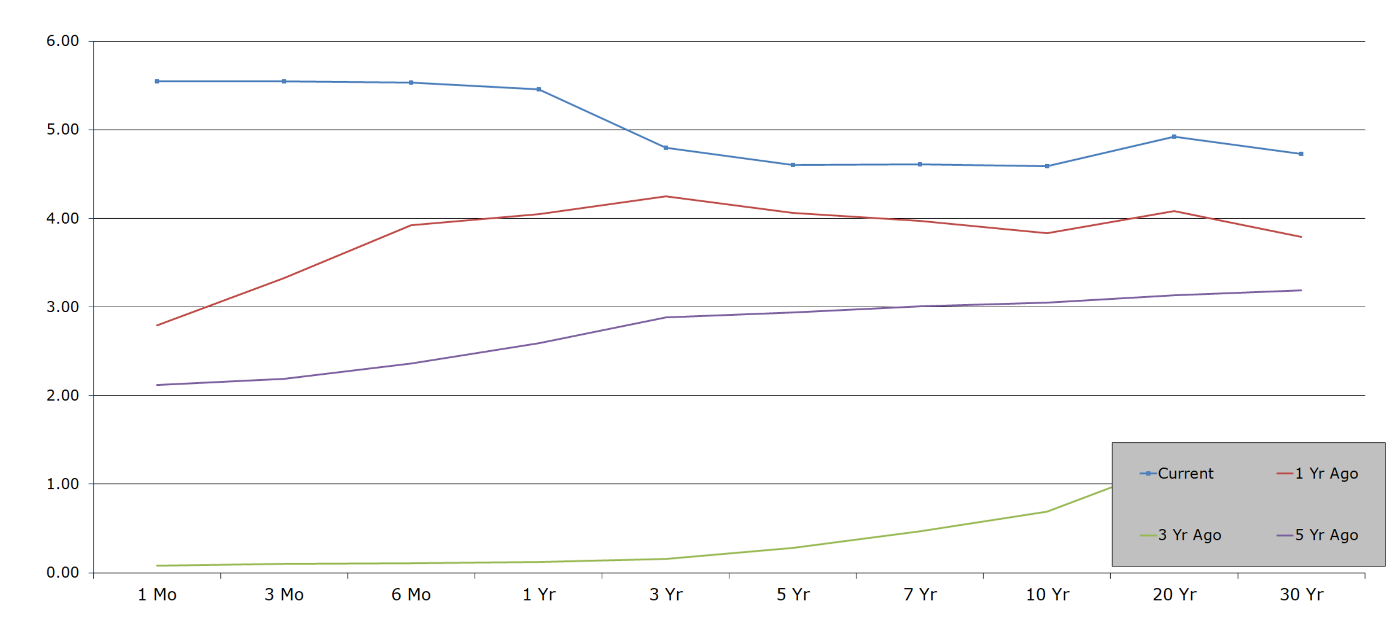
Value / Growth Returns

	YTD			Previous Calendar Year		
	Large	Mid	Small	Large	Mid	Small
Value	7.56	1.56	-2.42	-5.22	-6.93	-12.73
Growth	18.11	6.86	2.47	-29.41	-18.96	-21.08

Index Characteristics

	LTM P/E	NTM P/E	Div Yld	Earn Yld
S&P 500	21.48	17.84	1.52	5.60%
Russell Mid Cap	16.78	16.66	1.59	6.00%
Russell 2000	12.02	13.25	1.58	7.55%
MSCI EAFE	13.17	13.00	2.29	7.69%
MSCI Emerging Markets	12.33	12.96	2.34	7.71%

Long-Term Outlook on Treasury Yield Curve



Source: Morningstar

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