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Market Commentary Q3 2023

The U.S. economy has proven resilient thus far in the face of significant monetary tightening. However, the latter half of the summer ushered in renewed market and rate volatility as the hawkishness of the Federal Reserve ("Fed") took hold. The third quarter ended on a down note, with the S&P 500 posting a -3.3% decline and a nearly -5% drop in September.[1] Until recently, the perceived benefit of lower inflation outweighed all other macro risks. Inflation progress and healthy labor markets fanned investor optimism and bolstered consensus expectations for a soft landing. As the quarter progressed, however, there was growing acceptance of the Fed's "higher for longer" mantra. That has the bond market flirting with its third straight down year, even as fixed-income markets are offering their highest yields in over 15 years! At the same time, the household names among growth stocks that helped usher in what many called a new bull market in the first half of the year ran out of steam.

September's weakness was nothing out of the ordinary, given the month has historically seen some of the weakest market performance on the calendar. Style was not a differentiator, as the Russell 1000 Growth and Value indexes achieved roughly similar total returns. Despite the down quarter, the Nasdaq has maintained a strong year-to-date ("YTD") return of 27%, surpassing both the S&P 500 and the Russell 1000, both of which have returned about 13%, respectively.[1]

Leading US Indices (Total Return)	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23	3Q'23 (sorted)	TTM
S&P/Citigroup Growth	-8.6%	-20.8%	-3.9%	1.4%	9.6%	10.6%	-2.6%	19.8%
S&P 100 Mega-Cap	-4.6%	-16.9%	-5.4%	5.6%	10.1%	11.1%	-2.8%	25.7%
S&P 500 Total Return	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**8.7%**	**-3.3%**	**21.6%**
Nasdaq	-8.9%	-22.3%	-3.9%	-0.8%	17.0%	13.1%	-3.9%	26.1%
S&P/Citigroup Value	-0.2%	-11.3%	-5.8%	13.6%	5.2%	6.6%	-4.1%	22.2%
S&P 400 Mid-Cap	-4.9%	-15.4%	-2.5%	10.8%	3.8%	4.9%	-4.2%	15.5%
S&P 600 Small-Cap	-5.6%	-14.1%	-5.2%	9.2%	2.6%	3.4%	-4.9%	10.1%
Russell 2000	-7.5%	-17.2%	-2.2%	6.2%	2.7%	5.2%	-5.1%	8.9%

Source – Strategas Securities, LLC – 10/10/2023

A resilient economy, a jump in energy prices, and U.S. deficit concerns all contributed to a surge in Treasury yields in the quarter. The downturn in the market pushed equities of all sizes and styles into negative territory in the third quarter ("Q3") and wiped out YTD gains in some of the most vulnerable areas of the market (i.e., smaller caps and less profitable companies). The higher rate backdrop blunted some of the momentum of the richly valued "Magnificent 7" stocks, as

referenced in the news, but the group's leadership remained firmly intact. Energy was the only positive sector during Q3, benefiting from the rise in crude oil prices.

Turning to market factors, quality performed well amidst the growing uncertainty, as it usually does. Companies with high returns on invested capital and balance sheet strength (i.e., higher interest coverage or low leverage) outperformed, though the positive impact was most pronounced down the market cap spectrum.

S&P 500 Sectors (Total Return)	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23	3Q'23 (sorted)	TTM
Energy	39.0%	-5.2%	2.3%	22.8%	-4.7%	-0.9%	12.2%	30.2%
Communication Services	-11.9%	-20.7%	-12.7%	-1.4%	20.5%	13.1%	3.1%	38.5%
Financials	-1.5%	-17.5%	-3.1%	13.6%	-5.6%	5.3%	-1.1%	11.7%
Health Care	-2.6%	-5.9%	-5.2%	12.8%	-4.3%	3.0%	-2.7%	8.2%
S&P 500 Total Return	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**8.7%**	**-3.3%**	**21.6%**
Materials	-2.4%	-15.9%	-7.1%	15.0%	4.3%	3.3%	-4.8%	18.0%
Discretionary	-9.0%	-26.2%	4.4%	-10.2%	16.1%	14.6%	-4.8%	13.8%
Industrials	-2.4%	-14.8%	-4.7%	19.2%	3.5%	6.5%	-5.2%	24.6%
Technology	-8.4%	-20.2%	-6.2%	4.7%	21.8%	17.2%	-5.6%	41.1%
Staples	-1.0%	-4.6%	-6.6%	12.7%	0.8%	0.5%	-6.0%	7.3%
Real Estate	-6.2%	-14.7%	-11.0%	3.8%	1.9%	1.8%	-8.9%	-1.8%
Utilities	4.8%	-5.1%	-6.0%	8.6%	-3.2%	-2.5%	-9.2%	-7.0%

Source – Strategas Securities, LLC – 10/10/2023

Growth and value performed narrowly in line during Q3, as both were down 3%.[1] Yet, YTD, growth is significantly outperforming value. But given the wide dispersion in performance, it may be surprising to find that over the last three years, value outperformed growth by more than 3% annualized![1]

Description	3Q23	YTD	3 Year
Russell 1000 Growth	-3.13%	24.98%	7.97%
Russell 1000 Value	-3.16%	1.79%	11.05%

Source - FactSet – 10/10/2023

Concurrently, the yield on 10-year U.S. Treasuries jumped 0.46% to 4.57%, the highest yield since 2007![1] Although the Fed opted to pause its aggressive tightening policy in September, Chairman Powell has made it abundantly clear he plans to keep the Fed funds rate "higher for longer." Investors have finally come to the realization that we have entered a

new era of significantly higher interest rates. The Fed continues to thread the needle between reigning in inflation and avoiding a recession, a difficult task. At the same time, a growing list of nagging concerns is plaguing investor confidence. These worries include tightening lending standards, higher energy prices, the resumption of student loan payments, a global economic slowdown, growing U.S. debt and deficits and labor disruptions. As financial conditions tighten, market volatility tends to accelerate, and the probability of a recession mounts. Although the Fed's optimal outcome remains a soft landing, it will be hard to reach the 2% inflation target without a cooling of the labor market and a reduction in consumer demand. With yields reaching new heights, the credit markets may now offer a unique opportunity to capture higher returns with less volatility than the equity markets.

October marks the resumption of student loan payments for millions of Americans who owe over a trillion dollars following a three-year pause.[4] With an average monthly payment obligation of over $400, consumer spending may be squeezed as the Fed showed ~40% of borrowers lacked the needed savings to cover the payment, though a one-year "on ramp" period will provide a buffer against defaults, credit bureau reporting, and debt collections.[4] The renewed financial burden of student loan payments comes just as most Americans have exhausted their pandemic-era savings. A Fed study of household finances showed that only the wealthiest 20% of Americans still have excess savings, while the bottom 80% by income had lower bank deposits and other liquid assets than they did in March 2020 when adjusted for inflation.[3]

Towards the end of the quarter, a government shutdown was barely avoided as U.S. legislators were able to come to a temporary agreement just before the Oct. 1 deadline. The bill agrees to keep the government funded for the next 45 days until mid-November. This is good news in the short term as economic data will continue to be reported, which avoids unneeded challenges for the Fed as it decides whether another rate hike is needed to control inflation.

The S&P 500 has been driven by concentrated and narrow performance in 2023. The first two quarters of 2023 included the widest dispersion of the S&P 500 market-weight above its equal-weighted equivalent in the past decade, with the exception of the first quarter 2020. As referenced in the news, the top seven stocks, aka the "Magnificent 7," have contributed 84% of the index's YTD total return.[1] These top seven stocks have an average 32x fwd P/E multiple, compared to 18x for the broader index. [1] This is heavy concentration risk towards higher duration securities.

We believe this to be unsustainable, favoring active management, especially in a new elevated rate environment. Thus far in 2023, the S&P 500 equal-weight gross return is 1.8%, while the market cap weighted return is 13%.[1] Since 2000, the equal-weighted index has outperformed +9.0% annualized vs. S&P 500 +6.6%.[1]

The U.S. continues to outperform the international markets as domestic equity markets are driving 2023 global equity returns. This strength can be partly attributed to the U.S. consumer, who is supported by a tight labor market and excess savings. This has been a trend throughout the year, with the U.S. being one of two countries to have climbed by 10% YTD. Japan was the other country to have a 0.8% increase. Without Japan, the Pacific was the lowest-performing major region, falling 4.1%.[1] On the emerging market side, all three market

regions showed minor decreases this quarter. EMEA dropped 1.8%, Emerging Asia lost 2.2%, and Latin America lost 2.7%.[1]

International Indices (Price Chg)	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23	3Q'23 (sorted)	TTM
Sensex (India)	0.5%	-9.5%	8.3%	5.9%	-3.0%	9.7%	1.7%	14.6%
FTSE 100 (UK)	1.8%	-4.6%	-3.8%	8.1%	2.4%	-1.3%	1.0%	10.4%
Bovespa (Brazil)	14.5%	-17.9%	11.7%	-0.3%	-7.2%	15.9%	-1.3%	5.9%
IBEX 35 (Spain)	-3.1%	-4.1%	-9.0%	11.7%	12.2%	3.9%	-1.7%	28.0%
MSCI EAFE	**-4.4%**	**-8.8%**	**-4.3%**	**8.4%**	**6.7%**	**3.2%**	**-1.9%**	**17.1%**
All Ordinaries (Australia)	0.1%	-13.4%	-1.0%	8.1%	2.1%	0.4%	-2.1%	8.5%
Swiss Market Index	-5.5%	-11.7%	-4.4%	4.5%	3.5%	1.6%	-2.8%	6.8%
MSCI AC World	**-5.1%**	**-14.1%**	**-5.3%**	**7.0%**	**6.5%**	**6.0%**	**-2.9%**	**17.3%**
S&P/TSX (Canada)	3.1%	-13.8%	-2.2%	5.1%	3.7%	0.3%	-3.0%	5.9%
CAC 40 (France)	-6.9%	-11.1%	-2.7%	12.3%	13.1%	1.1%	-3.6%	23.8%
Bolsa (Mexico)	6.1%	-15.9%	-6.1%	8.6%	11.2%	-0.7%	-3.7%	15.5%
Kospi (South Korea)	-7.4%	-15.4%	-7.6%	3.8%	10.8%	3.5%	-3.9%	14.4%
Nikkei 225 (Japan)	-3.4%	-5.1%	-1.7%	0.6%	7.5%	18.4%	-4.0%	22.8%
DAX (Germany)	-9.5%	-13.8%	-5.3%	14.9%	11.9%	0.3%	-4.7%	22.9%
Hang Seng (Hong Kong)	-6.0%	-0.6%	-21.2%	14.9%	3.1%	-7.3%	-5.9%	3.4%

Source – Strategas Securities, LLC – 10/10/2023

Despite a strong start, the MSCI Emerging Markets Index ended the quarter in negative territory, albeit ahead of the MSCI World. Concerns that strength in the U.S. economy will keep interest rates higher for longer had a negative impact. This was combined with ongoing weakness in the Chinese economy and concerns about the property sector. Limited policy stimulus has been announced to address these issues, but macroeconomic data released towards the end of the quarter was more positive than anticipated.

The fixed income market struggled in the third quarter of 2023 as interest rates rose. With the Bloomberg Aggregate Bond Index dropping 3.2%, the domestic bond market recorded its worst quarter of the year.[1] High-yield credit continues to outperform investment-grade credit YTD, driven by steady credit spread tightening since May. We are paying close attention to this dynamic going forward.

The rise in Treasury yields has pushed up most other corporate and consumer interest rates. Long Treasury bonds led the way down as the yield curve steepened, plunging 12%.[1] High-yield bond volatility increased as investors focused on credit spreads and default risk.

The U.S. Treasury yield curve flattened in the third quarter. The 2yr Treasury increased 0.17% in Q3, while the 10yr Treasury increased 0.76% and 30yr Treasury increased 0.85%.[1] This dynamic indicates we are nearing the end of Fed rate hikes, but credit markets are still adjusting to the “higher for longer” policy, which we expect will remain restrictive.

US Yields	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23	3Q'23	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	1.8	3.3	4.5	5.0	5.3	5.5	25	225
3-Month T-Bill	1.7	3.3	4.4	4.9	5.4	5.6	12	222
2-Year Note	2.9	4.2	4.4	4.1	4.9	5.0	16	82
5-Year Note	3.0	4.1	4.0	3.6	4.1	4.6	48	55
10-Year Note	3.0	3.9	3.9	3.5	3.8	4.6	76	71
30-Year Bond	3.1	3.8	3.9	3.7	3.9	4.7	85	94

Source – Strategas Securities, LLC – 10/10/2023

Maturity	9/30/2023	6/30/2023	12/31/2022
2Y	5.04	4.87	4.42
10Y	4.57	3.81	3.88
30Y	4.70	3.85	3.97

Source - FactSet – 10/10/2023

Since 1977, there have been five prolonged periods of yield curve inversion. In each instance, a recession followed shortly thereafter. The average duration of these prior periods has been approximately 350 days, while the current inversion duration is nearing 330 days. However, some strategists have suggested that the current inversion may be different from past cycles due to the extreme rapidity of the rate rise.

On the municipal bond front, supply remains down this year, but to a lesser extent than in 2022. Municipal yields remain at some of the most attractive levels seen in over a decade. The Bloomberg Municipal Bond Index offers a yield-to-worst of around 4.4%.[1] The taxable equivalent yield for investors in the highest federal tax bracket is approximately 7.5%!

Municipal credit fundamentals remain strong, underscoring the potential attractiveness of municipal bonds as a late-cycle asset class. After-tax yields for investment-grade municipal bonds remain well above historical averages, and high-quality municipal curves remain steep, offering a potential opportunity for relative value-focused investors.

On the currency front, the dollar has taken off relative to other currencies. The EUR/USD strengthened +3.3% in the third quarter, reflecting demand for higher-yielding U.S. bonds and investments, along with strong U.S. consumer spending abroad.

The S&P GSCI index, the commodity index, rose sharply in the third quarter, driven by significantly higher energy prices after Russia and Saudi Arabia cut oil production. Energy was the best-performing component in the quarter. Natural gas was the only segment to record a price fall in the quarter.

The industrial metals component achieved a modest gain in the quarter, with price gains for zinc, lead, and aluminum offsetting weaker

prices for nickel and copper. The agriculture component ended the quarter in negative territory, with lower prices for wheat, corn, soybean, and coffee offsetting substantial price gains for cotton and sugar. Precious metals were the worst performing component of the index in the quarter, with lower prices for both gold and silver.

As we enter the final quarter of 2023, the macro picture hasn't changed much. The conversation continues to revolve around the path of inflation, the Fed's corresponding policy-rate decisions, and the impact of these developments on economic growth that's moderating (though still strong), and the jobs picture.

So, why haven't we seen the "most anticipated recession of all time" yet? The answer could be partially due to the fact that many publicly traded companies wisely refinanced their debt between 2020 and 2022, locking in low, fixed rates and extending their maturities. So even as the Fed aggressively raised rates over the past 18 months, corporate interest payments relative to revenues actually touched their lowest levels in over 50 years! If you're a small business or don't have access to the capital markets, then you've likely had a different experience. Corporate bankruptcies, which include small businesses, have surged in 2023, piling up at the fastest pace since the great financial crisis. Historically, credit spreads on corporate bonds lead bankruptcies, but we're seeing the inverse this cycle. Combined with tighter bank lending standards, the Fed's rate hikes have squeezed Main Street, but the same effect has not caught up to Wall Street. Tight credit spreads are an artifact of the now-expiring stimulus effects. With the era of cheap money over, the interest burden will be going up, which will likely favor higher-quality businesses with healthy balance sheets.

What has changed meaningfully in recent weeks, however, is that there is some sense that the bill for our own fiscal recklessness is coming due. To the extent to which more than 50% of America's outstanding debt matures in the next three years, it is not difficult to imagine continued upward pressure on long-term bond yields.

Despite aggressive monetary tightening over the past 18 months, it would seem as if the balance of power between capital and labor has shifted decidedly toward private sector unions. The settlements achieved by the Airline Pilots Association, the Teamsters, and likely the United Auto Workers are a testament to this trend.

Remarkably, the YTD gain on the S&P 500 was a mere 0.6% on the Friday before Silicon Valley Bank failed.[1] What followed was akin to violently shaking a can of carbonated government-issued alphabet soup and then opening it. The Fed and Treasury Department increased the amount of assets on its balance sheet and injected billions into the economy in the first five months of the year. Meanwhile, the Strategic Petroleum Reserve kept oil prices contained through the summer, and by July 31st, the S&P was up a stunning +19.5% YTD![1]

We try our best to be forward-thinking market participants and truly focus on the long-term economic outlook. We are positioned for "higher for longer" and believe this new environment will favor higher-quality companies that are less impacted by an elevated interest rate environment. The U.S. economy remains strong, as Q3 GDP is projected to be around +5% (anything above 2.1% represents acceleration).[1] Leading indicators like new orders, building permits, and initial claims are all strong for the economy and support the Fed continuing its tight stance.

Without meaningful improvements in productivity, it would seem as if it would be very difficult for the Fed to maintain even a 3% inflation target without continued monetary tightening. Ten-year Treasury yields broke through the 2022 high of 4.2% in mid-August 2023, rising from a low of roughly 3.3% in early April to about 4.6% today.[1] Naturally, a slowdown could herald the end of the central bank's tightening campaign, but it is difficult to see such a development being positive for risk assets.

Waiting to gather more data seems prudent, as the economy can look fine until right before a recession starts (i.e., recessions are often non-linear contagion events). Tightening seems likely to occur through time ("higher for longer" + QT) vs. magnitude (more hikes), in our opinion.

The bottom line is that the U.S. economy has proven resilient but is facing numerous additional shocks as we start the fourth quarter. A key issue is that as long as there's an imbalance (labor demand > supply), the central bank is likely agitated and set to continue restrictive policy (with the goal of slowing the economy down). We've made notable progress, but we're not to mission accomplished yet.

The quickest way for a central bank to know they can cut is to see a recession, which anchors inflation lower by opening up slack. The slower way is for inflation to drift down, but this takes time to be certain about what is happening. As we've noted previously, holding our breath under water (restrictive policy) for a long time is dangerous as well, hence the continued discomfort with the type of U.S. growth we are seeing.

The bottom line is that the U.S. economy has proven resilient, but it is facing numerous additional shocks as we start the fourth quarter. When monetary policy is easy, price surges (e.g., oil) can lead to sustained inflation (both prices and wages rise together). Shocks are accommodated. When policy is tight, overall demand is restrained and shocks can become disinflationary (as they eat up a share of the consumer's wallet, for instance).

As we head into the final months of 2023, the macro outlook remains uncertain. Taking a glass-half-full perspective, notable tailwinds include the tight labor market, rising wage gains, resilient corporate earnings, and continued progress on inflation. Higher rates are eating into household budgets, but the share of household debt that adjusts with market rates still hovers near 40-year lows. These positive dynamics are counterbalanced by growing concerns over weakness in Europe and China, the lagged effect of Fed rate hikes, tight lending standards, and a yield curve that remains inverted. Elevated energy prices, resumption of student loan payments, dwindling of pandemic savings, and rising rates of delinquency are additional headwinds for U.S. consumers. We still have a top-heavy market with narrow leadership in the richly valued "Magnificent 7." Moreover, dysfunction in Washington, D.C. isn't helping the situation. From our vantage point, we believe uncertainty will persist into the foreseeable future as recession risks remain elevated.

Regardless of whether we get a soft or hard landing, we believe rising debt servicing costs will become a growing part of the macro conversation from here. Years of cheap money enabled a lot of cans to be kicked down the road, but now an immense corporate debt maturity wall is beginning to creep into view. Longer term, we remain optimistic about the prospects for the U.S. economy and equity markets, but elevated

debt loads coupled with higher rates present major refinancing risk over the next several years. Servicing that debt may cut into corporate profits, capital spending, hiring, economic growth, and investor returns. As America grapples with its debt burdens, we foresee a multi-year backdrop that favors companies with strong balance sheets and the ability to self-fund their operations. We believe higher-quality companies of all sizes again will assert their structural advantage. Even though the competition for capital is fierce today, we also firmly believe dividends will enjoy a resurgence in the years ahead. The potential for lower returns could mean dividends' contribution to total return could be increasingly important and revert toward historical norms.

We approach the path ahead with humility, simplicity, and discipline. We know from history that a reliance on quality and diversification has proven to be a strategy that can lose battles along the way but tends to win the war over time. We take comfort in the durable profitability, strong free cash flow, and balance sheet flexibility of our investments. These attributes give our portfolios precious breathing room as the squeeze from tighter financial conditions continues.

As always, we appreciate and highly value the trust you have placed in us.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] FactSet – 10/10/2023
[2] Strategas Securities, LLC 10/10/2023
[3] https://www.bloomberg.com/news/articles/2023-09-25/only-richest-20-of-americans-still-have-excess-pandemic-savings - 10/10/2023
[4] https://www.cnbc.com/2023/10/01/how-the-restart-of-student-loan-payments-could-shake-the-economy.html - 10/10/2023

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