Review & *Outlook*

THIRD QUARTER 2023

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Review and Outlook

Throughout this spring and early summer, stock prices rose significantly, and we found ourselves asking, "Based on what?" Despite the fact that corporate earnings were not increasing, and the overall economic outlook wasn't entirely positive, prices were going up. And when interest rates rise, stock prices typically fall, since the present value of future earnings declines. So, it seemed a bit odd to have stock prices going up in the spring when interest rates were also rising. By early summer, stocks were very expensive by historical standards, without a clear explanation backed by underlying fundamentals.

In the third quarter of 2023, the market declined by 3.3%. We had expected that decline, or at least a long period of little change while earnings caught up and provided a justification for the higher stock prices. Given our concerns, when we have sold stocks or bonds this year, we have held that cash in money market funds or very short term U.S. Treasuries. With the Federal Reserve pushing up short term interest rates, money market funds have provided an annualized yield of roughly five percent in recent months.

Index Performance Data
Total Return as of 9/30/2023

Indices[1]	Q3 2023	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	-3.30%	-20.37%
MSCI ACWI Ex-U.S. Total Return	-3.68%	21.02%
Bloomberg U.S. Aggregate Bond Index	-3.23%	0.64%

During the third quarter, we sold the remaining small amount we held in the Alternatives category, as real estate investment trusts (REITs) have struggled with rising interest rates. We have also been below target to global (non-U.S.) stocks due to concerns about the Chinese economy and weakness in Europe (for example, the German economy slipping into recession this past summer). Fortunately, our conservative approach let our accounts outperform the market overall in the third quarter. You may notice from your quarterly report that the return with money market funds exceeded the performance of the major stock indexes and was even better than the yield from many bond holdings.

Looking ahead, we do not anticipate a severe recession, but we do expect continued volatility. That volatility is likely with uncertainty around inflation, but also with geopolitical unrest and the political theater in Washington DC. Consumer spending has been stronger than expected all year, carrying the economy. From travel to Taylor Swift concerts, consumers have been active, generating a certain optimism about the economy. The labor market has also held up nicely, despite the Fed taking steps to slow the economy. The general view now is that the economy can withstand the steps the Fed is taking to lower inflation, without falling into a recession.

One reason higher interest rates have not resulted in noticeably less spending is that households have managed their finances much better in recent years than in the mid-2000s. Debt levels have been relatively low in recent years, and home owners have locked into low-rate mortgages, which means higher interest rates have not changed behavior as much as would have happened in the past, and as many expected when the Fed started raising rates in 2022.

Businesses also took advantage of record low financing costs, extending out debt at low fixed rates, which allowed for more stability than many anticipated. Having said that, some data on consumer savings gives us pause. A decline in savings in 2022 shows that consumers may not have been doing as well as previously thought.

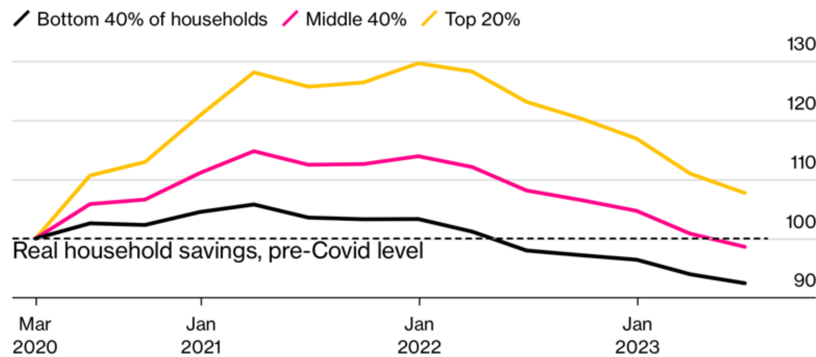
In addition to the downward revisions, we also note that many consumers have now spent their COVID-fueled savings while millions have student loan payments restarting. This trend is shown in Figure 1. As such, we may see consumer spending decline, in part due to a depleted well of savings, just as retailers look for the holiday boost. However, consumers have

responded to surveys saying that they expect to continue traveling, and to spend strongly this holiday season.

In Focus

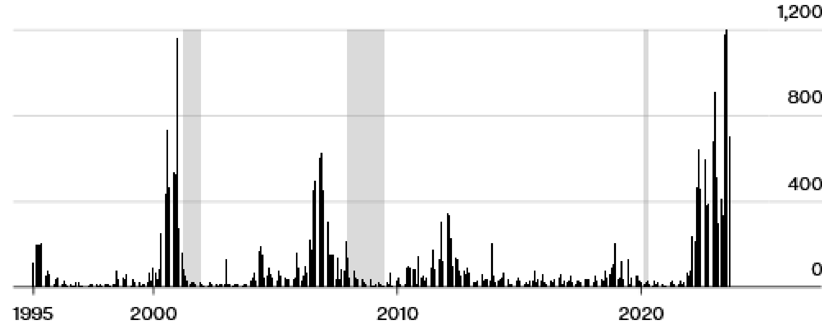
A key question for the economy and the financial markets is, "Where are interest rates going?" Interest rates are a bit upside down at the moment, with short-term bonds giving a higher yield than long-term bonds. We've written before about how an inverted yield curve often precedes a recession. That isn't to say that an inverted yield curve causes a recession, but rather that the curve becomes inverted when the Federal Reserve raises rates to try to slow the economy. Their goal is to slow the economy to reduce inflation, without causing inflation. This is the so called "soft landing" scenario. And there is a lot of optimism that the Fed is succeeding. But we have our concerns.

Figure 1[2]



We worry about energy prices and the re-sorting of supply chains, and how those things could force the Fed to keep interest rates high for an extended period, which would prolong the pressure on real estate markets. We are also apprehensive that with low unemployment and relative labor strength, including strikes for higher wages, upward pressure on product prices may persist, and inflation could turn out to be stickier than expected. As such, we think that the optimism about a soft landing may be somewhat premature, as shown in Figure 2.

Figure 2[2]



The impact of higher interest rates on real estate is more muted than in past decades, because lenders wisely switched to fixed rate loans when interest rates were low. But the impacts of those changes have not yet been fully realized.

Altogether, it seems we may have inflation at or above the Fed's target of two percent for a while. If so, the yield curve can return to normal in terms of its shape and slope, but rates will be higher than we got used to from 2008-2022. And higher, more volatile, inflation means more uncertainty, which will be something we watch closely.

We may be returning to a more normal inflation and interest rate environment, keeping in mind that the lower rates we saw from 2008-2022 were historically unusual. The silver lining for higher interest rates, especially if rates are higher than inflation, is that the bond portion of our portfolios can generate a modest real return. And a higher return in that portion of a portfolio will help mitigate the potentially more modest gains in the stock portion.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Figures 1 & 2: Wong, A., & Orlik, T. (2023, October 1). 6 reasons why a US recession is likely - and coming soon. Bloomberg.com. https://www.bloomberg.com/news/articles/2023-10-01/6-reasons-why-a-us-recession-is-likely-and-coming-soon?sref=IxvJQkZu

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