MARKET LETTER

October 2023

Looking Beyond the Challenges

After an exceptionally strong first half, the US stock market gave back some gains during the third quarter of 2023. The S&P 500 declined 3.7% and is currently 7% off its July peak, but still posting a healthy year-to-date return of +11.7%. The US economy has proved stronger than expected as have company earnings. Even though inflation has steadily come down throughout the year, the Federal Reserve continues to communicate a hawkish stance, that rates will stay higher for longer. September in particular is a seasonally weak period in the market, and this September was no exception. The market has grappled with a rising 10-year treasury bond rate, with that rate now near 4.7%, reflecting uncertainty surrounding monetary policy. Stock and by inference market value is based on interest rates, and all things equal, the higher the interest rates, the lower the value of a future stream of cash flow. Financial conditions have tightened significantly, both as a result of rising rates but also due to continued quantitative tightening action by the Fed. Oil prices are closing in on $100 per barrel, keeping inflation worries at the forefront of consumers' and investors' minds. In the meantime, many continue to expect a recession that, to date, has not materialized. The economy has softened to be sure, but has proven to be much more resilient than many expected. Recent economic gains seem precarious with talk of strikes, shutdowns, and student loans repayments looming.

At the same time, with everyone positioned for a recession, that in and of itself could be good news for the market. It is the opposite of a stock bubble. With a lot of cash on the sidelines, an asymmetric bearish stance in the market (only 28% of survey respondents described themselves as bullish), and historically good performance in October, the market could be poised for a fourth quarter rally from technical factors alone. What else could propel this market higher into year end and into 2024? Inflation, particularly core inflation, ex food and energy prices, continues to be on a steady glide path lower, giving the Fed room to pause, if not stop, raising rates. Money supply and money velocity have plummeted, a reliable leading indicator for inflation. In other words, the mountain of money supply that was created in 2020 and 2021 has largely been eliminated. On the earnings front, there is no indication that things are on the cusp of blowing up. Since everyone has been expecting a recession for over a year now, consumers and businesses have adjusted their behavior accordingly. A measure of consumer health, the household debt to asset ratio, is the best it has been in generations and cash on hand has skyrocketed to over $4 trillion. Recent data also show that excess personal savings of $350 billion still provide households a meaningful cash cushion. As long as the job market stays strong and thanks to inflation easing, real wages can continue to grow. While credit card delinquencies have gotten a lot of attention and have ticked up, when all household debt is considered, the overall household debt burden has trended down since the Great Recession. The impact of consumer health on the US economy cannot be understated, given that the US consumer accounts for 70% of the US economy, equivalent to an economy that is the same size as China's and equal to the combination of Japan's, Germany's, India's, the UK's and France's.

Growth levels have slowly normalized from generational highs to pre-crisis levels. The economy is slowing but not falling off a cliff, credit quality is good, wage growth is moderating. Consensus earnings estimates for the S&P500 are forecast at +2% for the third quarter and +12% for 2024. Yes, rates have been higher than expected and will probably be higher for longer than expected. Even if inflation falls, a stronger than expected economy allows the Fed to keep rates higher for longer. Having said that, higher yields don't necessarily preclude stock performance: in the mid-80s to 2008, real rates were higher than now and over that period, stocks returned 15% per annum.

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