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Market Review and Outlook

3Q23

Highlights

Equities posted negative returns during the third quarter, as the S&P 500 recorded a third-quarter loss of -3.3%, but the index still remains solidly positive for the year (+13.1% YTD).

Overextended conditions in July made the stock market vulnerable to a pullback in August and September. While valuation metrics are now back to more reasonable levels after the recent selloff, it's possible that continued P/E multiple compression and/or downward earnings revisions could push equity prices lower in the near term.

A strong labor market continues to provide a sturdy footing for the U.S. economy, but a sustained downward trend in payroll growth (albeit from elevated levels) may be an indication of early cracks in that foundation.

Given the uncertainty surrounding central bank activity, bond yields, and earnings growth, capital markets may remain choppy during the fourth quarter, but we remain constructive on equities longer term.

The U.S. Aggregate Bond Index posted a third-quarter loss of -3.2% (-1.2% YTD), as another spike in Treasury rates during the quarter put additional downward pressure on bond prices.

With today's elevated yields producing attractive income, coupled with the capital gain potential if/when interest rates decline, the total-return outlook for fixed income looks compelling moving ahead.

Market Review and Outlook

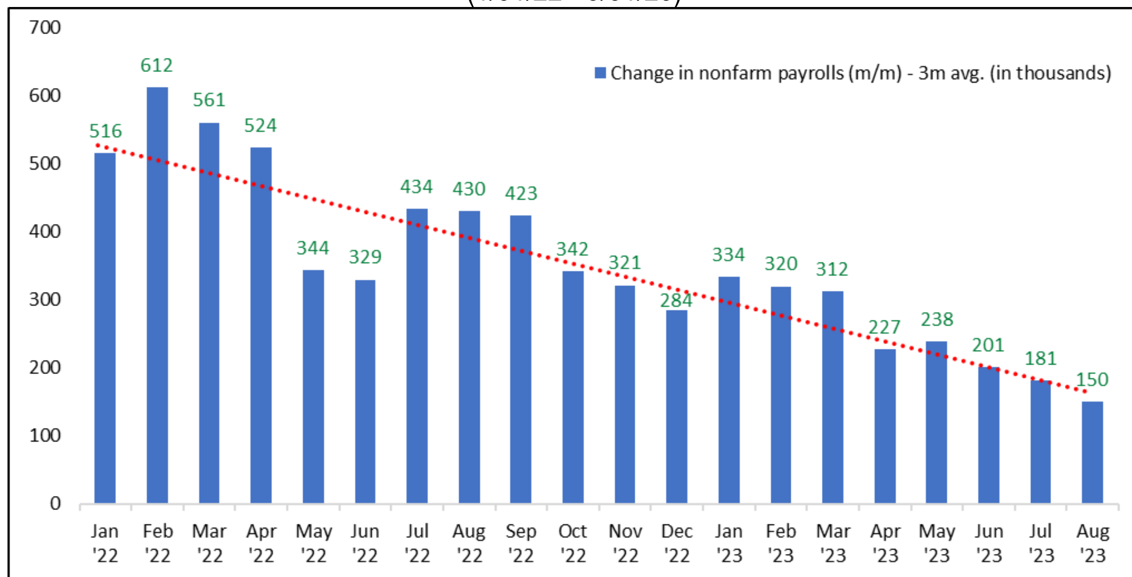
Global equities posted negative returns for the third quarter, as the market rally that started in October of 2022 and crested in July 2023, cooled in August and September. The S&P 500 Index, which had been up more than 20% this year at the end of July, reported a third-quarter loss of -3.3% (+13.1% YTD) as price-to-earnings (P/E) multiples compressed from speculation that the Fed may keep interest rates elevated longer than initially forecasted. The index remains solidly positive for the year, however, as U.S. stocks have been able to climb several walls of worry over inflation, earnings growth, and economic data—all of which have surprised to the upside in 2023. The performance story overseas was similar, as developed markets (EAFE) reported a third-quarter decline of -4.1% (+7.1% YTD) and emerging markets (EM) posted a quarterly loss of -2.9% (+1.8% YTD).

Through the first three quarters of 2023, the economy has proven remarkably resilient to still persistent inflation pressures and restrictive monetary policy aimed at taming further price increases. While the manufacturing sector has been in contraction since late last year, that has been more than offset by a robust services sector (which remains in expansion) and a stout job market (with unemployment under 4%). This surprising economic durability has pushed an increasing number of investors to embrace the expectation for a "soft landing" scenario, in which inflation cools to the Fed's 2% target while the economy continues to expand, providing a path for equities to move higher.

Soft landings are rare, however, as trying to restrain inflation without affecting economic growth is challenging. During eleven episodes of monetary policy tightening over the last 60 years, the Federal Reserve has managed to achieve only one soft landing—in 1995. At that time, inflation was around 2% and Fed officials were raising rates to prevent prices from rising further. Today, with inflation close to 4% and the Fed trying to push it back down to 2%, it will be much more difficult for the Fed to achieve its goal without negatively impacting economic growth.

Continued labor market strength will be a key factor in the Fed's ability to circumvent a recession and land the plane softly. Encouragingly, the economy continues to add a healthy number of jobs each month. That said, the pace of growth in payrolls has slowed considerably and consistently over the last 18 months.

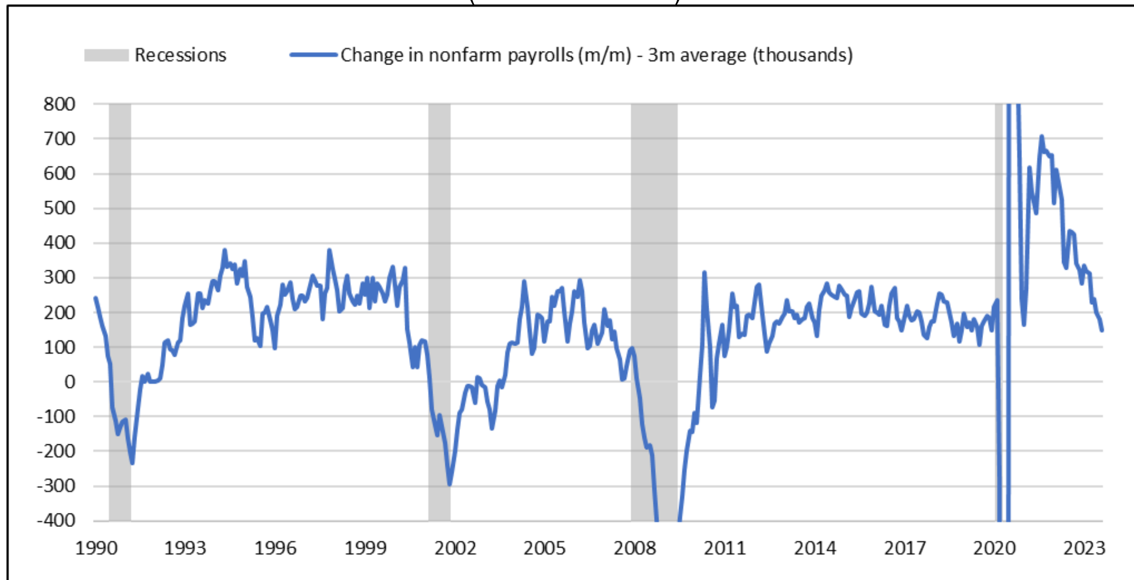
Job gains are slowing
(1/31/22 - 8/31/23)



Source: U.S. Bureau of Labor Statistics, St. Louis Federal Reserve, as of 8/31/2023

A gradual cooling of the labor market (assuming no deep or prolonged downturn) could create a favorable environment for financial markets, particularly if it leads to slower wage gains that enable the Fed to quit raising (before eventually cutting) interest rates. And as illustrated in the chart below, absolute payroll growth figures are currently roughly in line with the averages observed during historical economic expansion periods. The downward trend in payroll growth (albeit from elevated levels) raises concern, however, as similarly sharp drops in job growth have historically coincided with recession. And most recessions (nine of the last 11) have started as the economy was still adding jobs.

Significant deceleration in job gains often coincides with recession
(1/31/90 - 8/31/23)



Source: U.S. Bureau of Labor Statistics, St. Louis Federal Reserve, as of 8/31/2023

It would still be premature to speculate that an economic downturn is imminent based on decelerating payroll growth trends. Other recession indicators—such as the bond market's inverted yield curve (which has been inverted for 11 months) and the Conference Board's leading economic index (which has been in decline for 17 consecutive months)—have been at levels that have historically signaled recessions, yet the economy has continued to expand. Nonetheless, with the "soft landing" scenario seemingly gaining traction as the dominant market narrative, an increasing number of investors appear to be dismissing important cautionary signals and underestimating recession risk—especially if interest rates remain elevated.

The fact that the U.S. economy has not slipped into a recession after a combined 5.25% hike in the federal funds rate over the past 18 months is certainly reassuring. Higher interest rates have negatively affected parts of the economy, such as real estate, but the aggregate impact has been minimal thus far. It seems overly optimistic to believe broader implications won't be felt in the coming quarters, however, as the effects of monetary policy on the economy tend to operate with long and variable lags. On average, it takes nearly two years for a recession to appear after the first Fed rate increase. Thus, the delayed economic impact of this tightening cycle is not unusual, as a recession starting in early 2024 would put it right on schedule with the average historical lag.

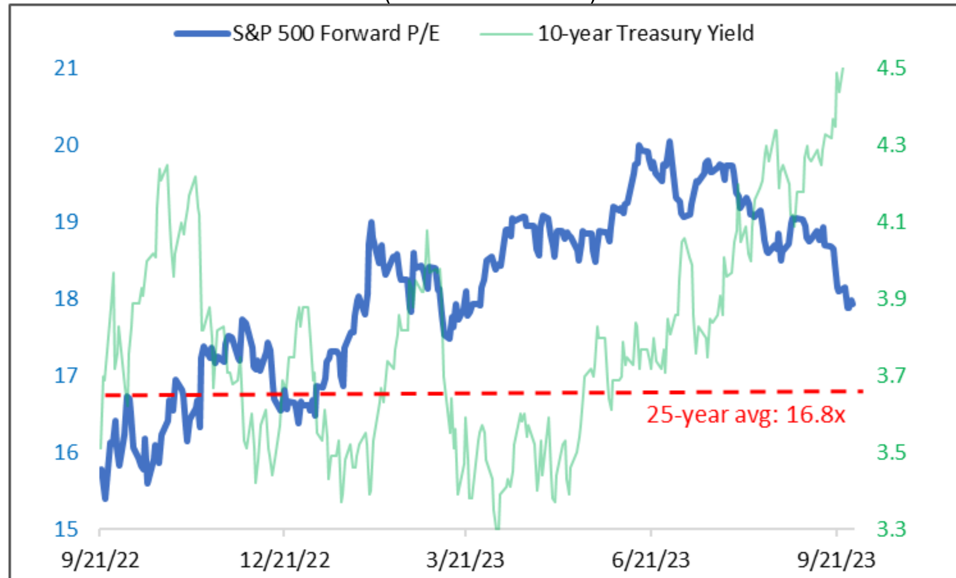
Lag from start of rate hiking cycle to start of recession
(10/31/68 - 9/30/23)

Start of Hiking Cycle	Start of Recession	Recession Lag (Months)
Nov 1968	Dec 1969	13
Feb 1972	Nov 1973	22
Feb 1978	Jan 1980	24
Aug 1980	Jul 1981	12
Mar 1988	Jul 1990	30
Jun 1999	Mar 2001	22
Jun 2004	Dec 2007	31
Average		***22***
Mar 2022	?	18

Source: National Bureau of Economic Research (NBER)

With the prospect of a recession during 2024 still firmly on the table, a certain level of caution towards equities is warranted. Overextended valuations and overbought conditions in July made the stock market vulnerable to a pullback in August and September. Equity valuation multiples, which had been expanding since last October (as prices increased despite flat/declining earnings forecasts), came under pressure from the recent upside breakout in Treasury yields and now sit at more prudent levels.

P/E multiples have corrected with the spike in Treasury rates
(9/30/22 - 9/30/23)



Source: U.S. Dept. of Treasury and FactSet

While that has established a better footing for stocks from here, the S&P 500 forward P/E multiple of 17.9x remains modestly above the long-term average of 16.8x. Moreover, the consensus 2024 EPS growth estimate of 12% may prove aggressive given the current economic crosswinds. Thus, it's possible that continued valuation multiple compression and/or downward earnings revisions could push equity prices lower in the near term.

Against the above backdrop, the outlook for equities remains difficult to handicap. Economic conditions remain supportive for now and valuations are rational, but several historically reliable barometers suggest economic headwinds could intensify in the coming months. Given the uncertainty surrounding central bank activity, bond yields, and earnings growth, capital markets may remain choppy during the fourth quarter—which is historically the most volatile quarter of the year. While a cautious posture is therefore prudent near term, we remain constructive on equities longer term and would view temporary pockets of weakness as potential opportunities to put excess capital to work.

Core Portfolio

From a transaction perspective, the core portfolio had a quiet quarter. We did not initiate any new positions in the core portfolio during the third quarter, though we continue to comb the landscape for attractively priced, cash-flow producing entities capable of generating solid results through all phases of the business cycle. We did not exit any prior core holdings in the quarter either, as we believe our current portfolio mix appropriately balances long-term growth potential with near-term stability.

Tactical Portfolio

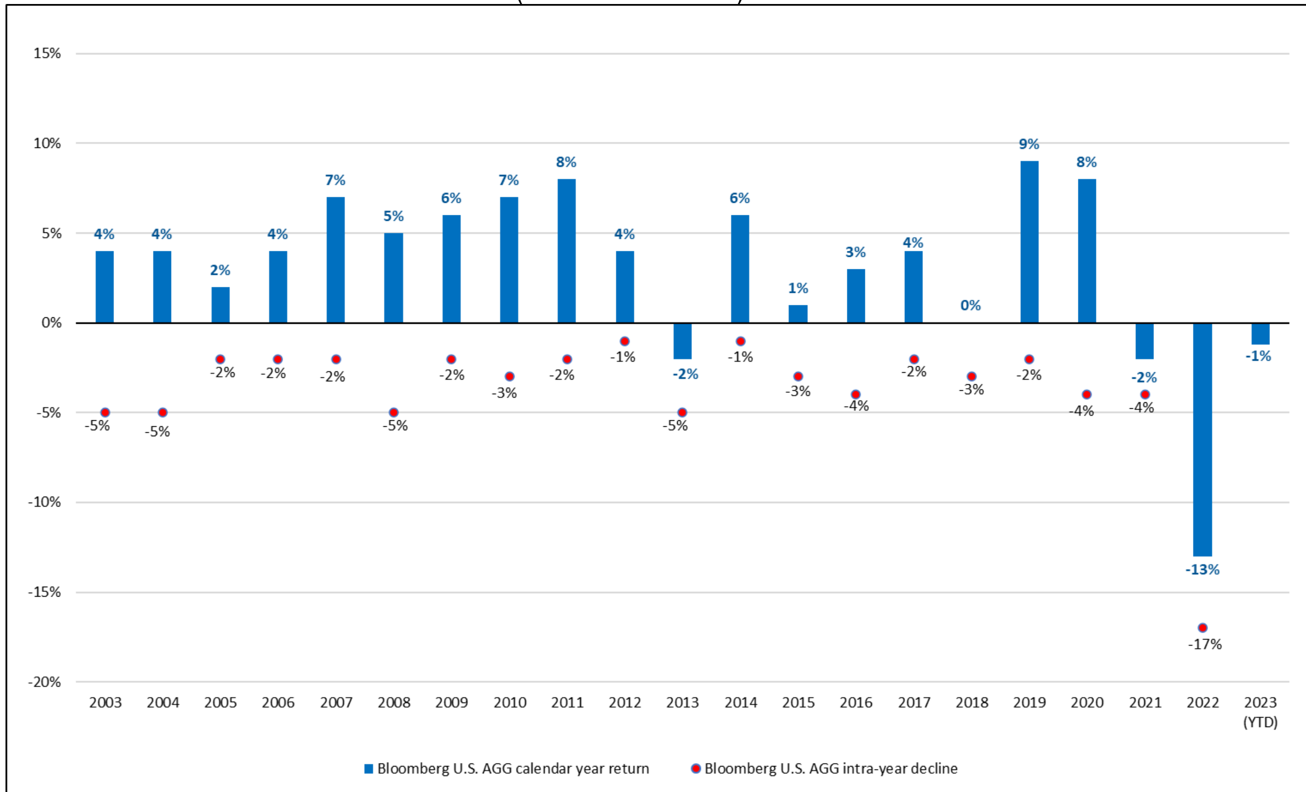
In the tactical portfolio, we maintain concentrated exposure to energy, uranium, gold, and short/medium-duration bonds. Our energy and uranium holdings benefited from strong double-digit rallies in the quarter, more than buffering the modest decline in gold prices and the portfolio's mixed/negative bond holding returns. We remain bullish on each of these tactical categories longer term and we like their ability to enhance asset diversification.

Fixed Income

A sustainable rally continues to elude the fixed income market. Short-term yields remain near the top end of the rate-hike-cycle highs (with the 3-month Treasury yield closing the quarter at 5.6%), suggesting that the Federal Reserve could stay active over the near term as it works to fine-tune the appropriate interest rate level, before moving to a sustained pause (and eventual cut). Meanwhile, the long end of the Treasury curve spiked to multi-year highs (with the 10-year yield of 4.6% touching its highest level since 2007) as economic growth is trending above expectations. Concerns around rising fiscal budget deficits, which require the Treasury to sharply increase T-bond issuance at a time when the Fed is reducing its balance sheet and yields are rising in other countries, has also been putting upward pressure on long-term bond yields.

With interest rates moving higher, bond prices fell again in the third quarter. While elevated yields helped to partially offset the price declines, the benchmark Bloomberg US Aggregate Bond Index posted a third-quarter loss of -3.2%. The index is now down -1.2% for the year—adding to the rare back-to-back losses for the index in 2021 (-2%) and 2022 (-13%).

Bloomberg U.S. Aggregate Bond Index Returns
(12/31/03 - 9/30/23)



Source: Bloomberg, FactSet, J.P Morgan Asset Management
Returns based on total return. Intra-year drop refers to largest market drop from a peak to trough during the year.

The fact that bonds are on track to produce an unprecedented third straight year of losses is jarring for an asset class that is supposed to provide stable returns. Nonetheless, we see reason for optimism moving forward. The Fed is seemingly at or near the end of its rate-hiking cycle, so bond yields are likely biased toward the downside (meaning prices are poised to move higher) over the medium term. With today's elevated yields producing attractive income, coupled with the capital gain potential if/when interest rates decline, the total-return outlook for fixed income looks compelling. However, there is a risk that inflation stabilizes well above the Fed's 2% target and long-term government yields continue to move higher as terminal interest rate forecasts increase. As a result, we continue to view shorter duration securities as offering the best risk-adjusted return profile near term.

Final Thoughts

While the uptick in market turbulence in recent weeks can be unsettling, it's neither surprising nor unhealthy. Investor complacency had been building in the market as equity prices soared this summer, and this latest pullback is a fresh reminder that numerous near-term risks remain. Caution is warranted until the path ahead for both monetary policy and the economy becomes clearer, but bouts of uncertainty often create the best long-term investment opportunities.

Thank you for your continued confidence and trust. As always, please reach out to us at any time.

Have a great close to the year!

Parkside Investments, LLC

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