Economic Overview

Steve Scranton, CFA, SVP, Chief Investment Officer and Economist

Consumers remain the "little engine that could" for the economy. Continued jobs creation and the income associated with those new jobs has helped support the continued spending. Consumers are also resorting to increasing their debt level to maintain spending.

As it stands now, the Atlanta Federal Reserve's GDPNow index is forecasting 4.9% annualized growth in the 3rd quarter. That is by far the outlier in optimistic forecasts. The consensus forecast from economists who participate in the Blue-Chip economic forecast is closer to 3%.

Consumers

- Personal spending rose $20.1 billion between 6/30/23 and 8/31/23. That was funded through a combination of increased income and borrowing.
  - The nation has averaged just shy of 156,000 jobs per month in 2023. July and August have maintained that pace. To give some perspective, based on the average weekly earnings for July and August and the number of jobs added, the nation added $1.6 billion in new income from the new jobs created.
  - The consumer also borrowed more. Consumer borrowing with credit cards and other revolving plans rose $21.7 billion from 7/3/23 to 9/30/23.
  - The basic risk for the consumer is that borrowing to fund spending pulls forward spending to now at the expense of future spending, since the borrowing must be paid off.

Businesses

Business spending continues to show the split personality that existed in the second quarter of the year.

- Construction spending
  - Total construction spending is up $4.9 billion between 6/30/23 and 8/31/23. Residential construction spending was up $1.7 billion while non-residential was up $3.2 billion.
- Manufacturing
  - Manufacturing activity continues to show declines as the major manufacturing activity indices still show manufacturing activity in decline.

Summary

The economy continued to put in solid growth in the 3rd quarter. That growth has been fueled by a combination of pay raises, new jobs — and income added — and additional borrowing. The question remains as to how long the consumer can continue its debt-funded borrowing. This is deficit spending but on a smaller scale compared to the US government. For the consumer, debt must be repaid. Many pundits and economists argue that the consumers' financial position is in great shape based on the overall debt to income ratio of the consumer. Unfortunately, that is a macro view that can be distorted by the strength of the upper income brackets who have higher income and may carry less debt compared to the lower and middle-income brackets who may be forced to borrow because their income does not cover their monthly expenses. Now, with student loan payments restarting, the true strength of the consumer's willingness to continue to deficit spend may be tested. Stay tuned.

Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

This was a tough quarter for financial markets. Although inflation has been trending lower and the Fed may be nearly done with rate increases, messaging that it intends to hold rates at these levels for longer finally stuck with investors. The Treasury yield curve flattened, as longer end yields rose much more relative to the shorter end. These moves pressured both equities and fixed income prices. Growing concerns of slowing economic growth has also weighed on investors' minds.

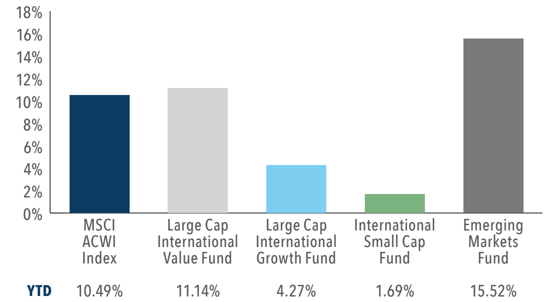
How quickly gains in July evaporated with losses in the next two months. Global equities finished the quarter down a little over 3%, with domestic equities outperforming developed international. Emerging markets performed slightly better down around 2.8% where China underperformed and India aided EM with gains. International equities felt some pain with a strengthening US dollar as it gained a little more than 3% over foreign currencies. Domestically, narrow leadership in tech-heavy names continued to drive most of overall market performance both up and down. Growth outperformed value in the quarter but lagged in the month of September.

Higher rates have been good and bad for fixed income markets. First, there was the negative impact over the course of 2022 (ouch!) as rates rose rapidly from near zero. Now, while volatility remains, these higher levels provide measurable income with a bit more of a cushion for future rate changes and the opportunity to gain from these yields going forward. The flattening yield curve did hurt in the longer maturities. Global aggregate bonds fell 3.59% and US aggregate bonds fared slightly better, down 3.23%. By contrast, the very short end finished the quarter 1.3% higher, and intermediate bonds were down a little less than 1%. High yield bonds were slightly positive, supported by the higher yields they offer as well as still being perceived as fundamentally sound.

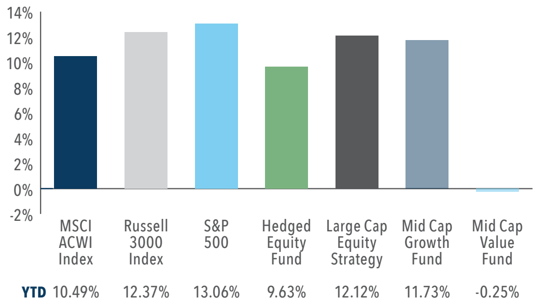
Commodities rose in the quarter, largely due to the roughly 30% increase in oil prices amongst projected tighter market conditions – less supply available to meet demand. Opposite increasing oil prices was falling gold prices, down nearly 4%. Overall, broad basket commodities gained 4.7%. Managed Futures trend-following strategies also gained with strong directional market moves. Global macro struggled with the interest rate and currency volatility over the quarter, closing slightly negative. Real assets in global infrastructure and real estate were both hurt as they are interest rate sensitive. They finished down a little over 7% and 8%, respectively.

Whether the Fed can avoid a recession and simultaneously tame inflation remains to be seen, but in the meantime some volatility should remain. Getting back to diversification basics, bonds should once again be a ballast to equity risk if there is an economic slowdown.

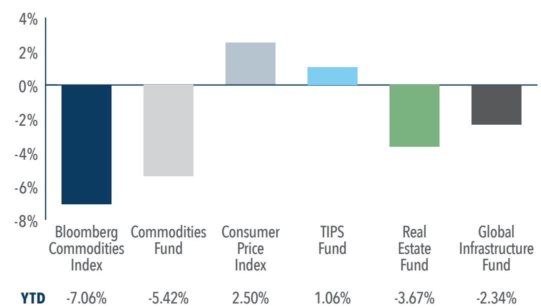
International Diversification
Year-to-Date Performance



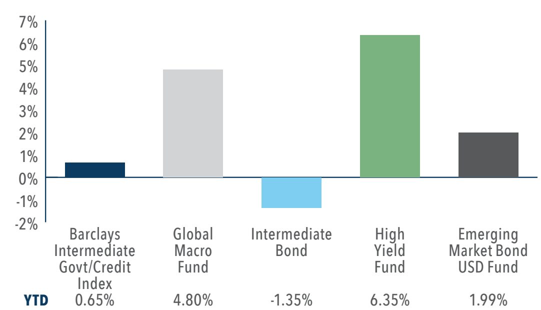
Domestic Diversification
Year-to-Date Performance



Real Return (Inflation Protection) Diversification
Year-to-Date Performance



Income Diversification
Year-to-Date Performance



Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

After the impressive rally in the first half of the year that highlighted a significant rise in valuations and narrow leadership from some mega cap technology companies (i.e., the Magnificent Seven), stock indices gave back performance during the 3rd quarter. The best performance came from the Dow Jones Industrial Average (Dow), down 2.1%, while the small-cap oriented Russell 2000 lost 5.1%. The S&P 500 gave back 3.3% and the NASDAQ Composite fell by 3.9%.

Toward the end of July, investor psychology shifted from enthusiasm toward a "risk off" tone. With inflation remaining elevated and the Federal Reserve (Fed) continually reiterating its "higher for longer" message, the equities market started to question its hopefulness that the Fed was close to ending the rate increase campaign and that the economy could potentially put in a soft landing. Additional headwinds to psychology included: the looming potential for a government shutdown if the debt ceiling was not raised, higher oil prices (up over 30% before peaking at $93/barrel), a continual rise in bond yields, the start of the United Autoworkers (UAW) strike, and the anticipated resumption of student loan payments.

Given the pullback in risk during the quarter, it is not surprising that money flowed out of some big first half gainers. Notably, four of the "Magnificent Seven" stocks (high fliers in the first half) were at the bottom of the performance roster in the 3rd quarter — Apple (AAPL), Microsoft (MSFT), Amazon.com (AMZN), and Tesla (TSLA). The market broadened out and at the sector level, only two sectors provided positive returns: energy, up 12.2% and communication services, up 3.1%. The other nine sectors were in the red, with utilities down 9.2% and real estate down 8.7%, pressured by concern about the relentless rise in bond yields. Interestingly, growth stocks, down 2.6%, maintained their lead over value, down 4.1%.

Going into the final quarter of the year, the equities market will look for catalysts to reignite enthusiasm. Dovish messaging from the Fed would be welcomed, as would stable economic data and consumer spending behavior. Importantly, investors are hoping that corporate America swings to positive earnings after three consecutive quarters of negative earnings growth. Third quarter earnings results and management outlook commentaries will be focal.

Fixed Income

Callen Young, AVP, Portfolio Manager

Continued economic resilience, rising Treasury supply, and persistent hawkishness from the Federal Reserve inspired domestic bond market movement during the 3rd quarter.

The Federal Reserve raised the Fed Funds Rate to 5.25%-5.50% at its July meeting. There was no meeting in August, and at the September meeting they paused on an additional rate hike but delivered a very hawkish message. Fed officials projected, via the quarterly Summary of Economic Projections, one more rate hike in 2023 and fewer rate cuts in 2024 and 2025 than previously expected. The message they were trying to deliver was loud and clear to the bond market: don't expect a rate cut anytime soon, rates will be higher for longer.

The growing view that the central bank would keep rates higher for longer, along with rising Treasury supply and increasing energy prices, pushed US Treasury yields higher across the curve — most notably at the long-end where 30-year Treasury yields were higher by more than 80 basis points during the quarter, its highest level since 2011. Three-, 5-, and 10-year Treasury yields reached their highest levels since 2007 and the 7- and 20-year Treasury notes touched their highest yields since regular issuance of these tenors began in 2009 and 2020, respectively.

After remaining stubbornly anchored (and expensive) for most of the quarter, the municipal bond market cheapened on the back of the late-quarter move in Treasury yields. Bloomberg's 5-year AA-rated General Obligation index yield rose 87 basis points in the third quarter, leading to taxable-equivalent yields (depending on an investors tax bracket) well above 5%. Taxable-equivalent yields of bonds from high-tax states are even higher in some instances.

Market expectations still see the cumulative effects of rising rates leading to economic weakness but perhaps less harmful than previously feared. Futures markets currently expect the Fed to cut rates by about 75 basis points in 2024, down from nearly 150 basis points earlier this year.

The increase in rates has been painful for markets with year-to-date performance ranging from +1% to -5%, based on maturity and credit rating. With inflation trending lower and tighter financial conditions leading some to expect recession in the near term, we think current levels will look attractive by next year.

International

Matt Clarke, CIMA®, VP, Senior Client Portfolio Manager

Global monetary policy is still very much the dominant factor in terms of dictating the direction for the markets. In the 3rd quarter of this year, **developed international stocks continued to lag the US** as the fight against inflation dragged on and the "higher for longer" interest rate mantra began to settle in across the globe.

Both the Federal Reserve (Fed) and the European Central Bank (ECB) hiked rates by 25 basis points (bps) in the month of July. The Fed paused in August and again in September, but not without delivering a **hawkish tone** and setting the stage for further hikes. The ECB paused in August and then hiked rates by 25 bps in September to a 22-year high of 4.50%. Surprisingly, data released late in the quarter showed Eurozone slowing to a two-year low, but it wasn't enough to quell concerns about how higher interest rates would weigh on economic growth. In August, the Bank of England (BoE) raised its main refinancing rate by 25 bps to 5.25% (15-year high) and elected to hold in September.

The notable outliers were the Bank of Japan (BoJ) and the Peoples Bank of China (PBOC). The BoJ held rates in negative territory at -0.1% throughout the duration of the quarter, while the PBOC cut its loan prime rate by 10 bps to 3.45% in August as they continued to struggle with a property crisis, falling exports and weak consumer spending.

The MSCI EAFE (developed international) closed the quarter lower by -4.03%. **Emerging markets fared slightly better** with a few notable winners (see below) as the MSCI Emerging Markets index ended lower by only -2.85%. With a backdrop of rising rates around the world, global bonds continued to lose ground. The Bloomberg Global Aggregate (measure of global investment grade debt) closed the quarter lower by -3.59%.

Even though the international markets continued to lag throughout the 3rd quarter, **there were a few winners**. The UK found some footing as the FTSE 100 closed out the quarter higher by 2.07%. The UK benefited from a weaker sterling and a stronger dollar, which made their exports more competitive and US denominated earnings more attractive. In the emerging markets space, we saw gains in Turkey, Egypt, India, United Arab Emirates, Colombia, Hungary, and the Czech Republic.

As we peer into the final quarter of the year, we see **potential for further volatility** in the international space as global inflation, central bank policy, and rising geopolitical tensions remain in focus.

Additional and expanded information to this newsletter discussion may be obtained by contacting your relationship manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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