LEEWARD
FINANCIAL PARTNERS

Q3

# 2023
## MARKET REVIEW

Policymakers' commitment to bringing inflation back to target contributed to a surge in interest rates which pushed financial asset prices lower over the quarter.

# 3Q 2023 Quarterly Review

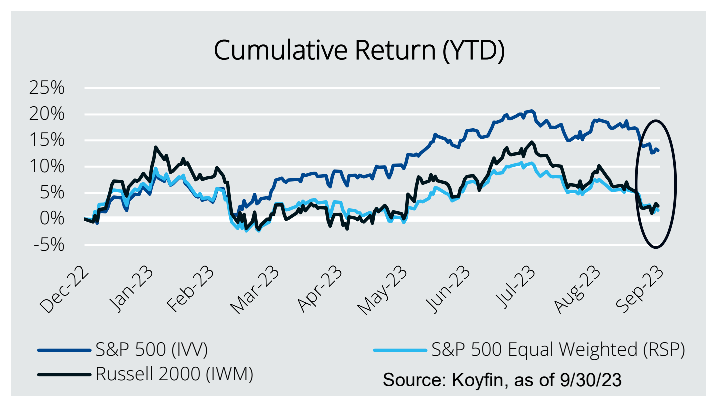
LEEWARD FINANCIAL PARTNERS

## Rate movement dominated markets

The rapid rise in interest rates and the corresponding tightening of financial conditions cast a gloomy shadow over the financial markets in the third quarter. Performance started strong in July, fueled by solid company earnings and optimism that the Federal Reserve had finished hiking interest rates this cycle. Moving into the August doldrums, most market indices hit their peak and trended lower. In September, equity and bond market declines deepened following the release of new projections from the Federal Reserve, indicating interest rates may need to stay higher for longer to suppress inflation. The net result was negative investment returns for the third quarter.

## Index performance is deceptive

In the U.S. equity market, mega-cap leadership remained the theme: the S&P 500 Index (a market-cap weighted index that gives more weight to bigger companies) fell 3.2% in Q3 but is still up 15.4% over the year. However, the S&P 500 Equal-Weighted Index (which gives equal weight to each of the ~500 companies in the index) dropped 4.9% in Q3 and is up just 1.1% year-to-date. The stark year-to-date outperformance of the S&P 500 Index relative to the S&P 500 Equal-Weight Index speaks to the extreme underperformance of small-cap companies, which are generally less equipped to deal with stricter financing conditions.

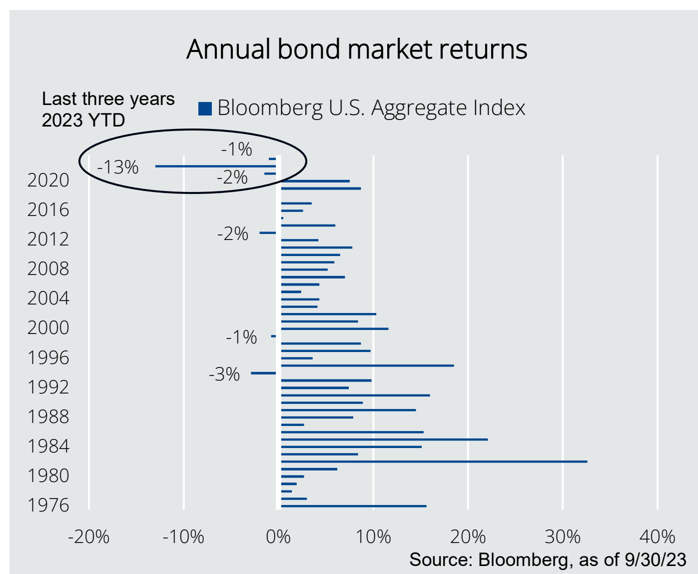



From a sector perspective, energy (+13.0%) was the lone bright spot. All other sectors fell over the quarter. Interest rate movement explained much of the sector behavior. Energy companies, for example, benefit directly from high-interest rate environments. Financial service companies (down -0.5% in the quarter) also tend to fare well, as profits can accelerate in high-interest rate environments. Conversely, technology companies (-6.0%) underperformed, driven lower as high-interest rates compressed valuations.

The best example of a rate-driven equity sell-off was the movement in the utility sector, which declined 9.5%. Utilities are defensive stocks that should outperform in a down market. The fact that this defensive sector failed to provide downside protection over the quarter speaks to the impact of higher rates on the markets in Q3.

In fixed-income assets, concerns that the strong U.S. labor market will incentivize Fed officials to

keep interest rates higher for longer sparked a rout in the bond market. The yield on the 10-year Treasury rose from 3.82% to 4.57% in Q3 (this is a big move in bond land), which resulted in bond owners seeing the value of their bond holdings decrease. We are now on track for an unprecedented third year of negative returns in the broader bond market. The silver lining here is that Treasury and corporate bond assets are near capitulation levels and may present an attractive buying opportunity for long-term investors.




## Economic landscape

Last year, the consensus estimate from economic forecasters was that we would likely be in recession by now. That hasn't happened. Conversely, we now expect real gross domestic product (GDP) growth to be close to 5% for the third quarter. The U.S. economy is much stronger this year than anticipated, especially in the labor market. Job growth has averaged 260,000 per month this year, about 60,000 above the pre-pandemic average. Unemployment has remained below 4% and near 50-year lows.

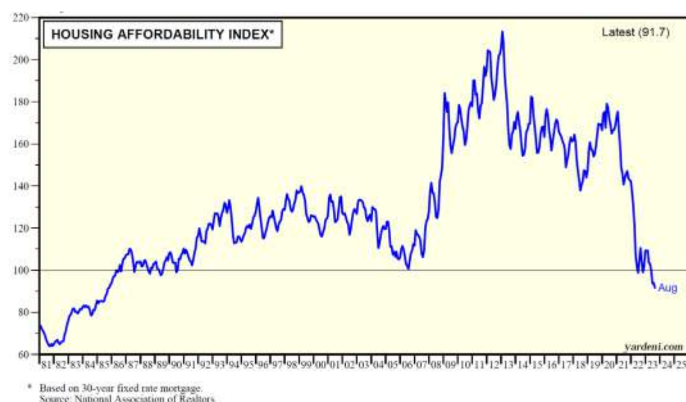
The nationwide inflation rate has cooled from the post-pandemic high of 9.0% to about 3.7% in September. We expect inflation to continue to decrease, albeit slower than earlier this year. The rise in oil and gas prices through the summer driving season added inflationary pressure but should drop into the end of the year. We don't expect the conflict in the Middle East to impact inflation here in the U.S. materially, although we may see higher energy prices temporarily.

If you strip out energy and food prices, which tend to be more volatile, core inflation (CPI) has fallen from a post-pandemic high of 6.6% to about 4.1% today. Core CPI is the measure that Fed officials care the most about, and they would like to see it fall back down to around 2.0%. While we are on our way back to 2.0%, several factors are lengthening the process.

Most notably, shelter price inflation (i.e., rent and home prices) remains high. Mortgage payments have increased due to higher interest rates. Still, home prices are elevated, creating a game of chicken between home buyers waiting for prices to fall and sellers seeking to realize the latest Zestimate. The net result is the worst affordability metrics since the 1980s. The U.S. housing market inventory is currently 500,000 units below buyer demand. We don't see this imbalance correcting anytime soon.

About 42% of single-family home buyers are first-time buyers, far above the 27% historical norm. Many of these buyers are electing to wait for lower mortgage rates. In response to the lower buyer traffic, 32% of builders are cutting prices, the

largest percentage since December. Additionally, shortages in construction workers, buildable lots, and distribution transformers are all squeezing builder margins and weighing down sentiment. Unfortunately, we think the housing market could remain gummed up for some time.




More encouragingly, the services sector (about 70% of our economy) is growing, and the cyclical manufacturing sector has shown signs of life in recent months. In September, the ISM Manufacturing PMI Index rose to 49.0, just one point below the neutral level of 50. Looking around the corner, manufacturing activity should continue to trend upward based on increased factory capacity built up to facilitate manufacturing semiconductors, electric vehicles, and various clean energy apparatus.

Consumer sentiment is tepid. Heading into the holiday season, consumers are worried about high prices, business conditions over the next year, and the impact of lifting student loan payment moratoria. Credit card balances are up, but not egregious. More concerning is the uptick in headcount reduction. Lay-offs never feel good and reduce productivity. Despite these negative factors, consumer sentiment is leveling out near pre-pandemic levels.

## What about the Fed?

The surprising strength of the U.S. economy has put policymakers in a challenging position. The Federal Reserve's mandate is to keep unemployment low and prices stable. Presently, unemployment is low. But inflation is still above where the Fed officials would like to see it. As a result, we believe the Fed's bias will be to keep rates higher for longer to pump the brakes on the economy and bring inflation back within the ballpark of its 2.0% target.

In the most recent Fed Summary of Economic Projections, officials increased their expectations for real GDP growth next year to 1.5% from 1.1% and decreased their 2024 unemployment rate projection to 4.1% from 4.5%. In line with those improved economic expectations, officials increased their median interest rate estimate from 4.6% to 5.1% in 2024 and 3.4% to 3.9% in 2025. In other words, most Fed officials expect interest rates to be higher for longer.

## Portfolio Positioning – the haves and the have-nots

The S&P 500 Index is one standard deviation below its 50-day moving average, and fixed-income markets are at capitulation levels. Despite these negative technical levels, fundamentals appear healthy in many areas.

The Federal Reserve has adopted a more restrictive policy stance to suppress inflation, and interest rates have adjusted higher. Lending

standards have tightened, and access to capital has become more complex. In areas of the economy where financing is required – small businesses, home mortgages, private debt, corporate real estate, etc. – we're seeing restrictive policy dampen growth. Restrictive policy is especially prevalent in small-cap stocks, financial services, consumer discretionary, and some industrials. These areas are challenged; we believe it is too early to make new investments here. Conversely, companies that can self-finance and have strong free cash flow should be more protected in a higher-rate environment. Large-cap companies, especially Technology and Communication Services, will be able to maintain their earnings and continue to grow despite high interest rates.

In September, we reduced our exposure to small-cap and international equities while increasing our exposure to faster-growing large-cap U.S. companies. At the sector level, we continued to fine-tune our exposure to Semiconductor and Software companies to take advantage of an uptick in demand from Artificial Intelligence (A.I.) initiatives. We also adjusted our holdings in industrials to increase our weighting in companies benefiting from increased demand.

We believe we are close to seeing interest rates peak, and fixed-income investments will perform well once rates stop moving higher. And while we want to be patient because interest rates may remain high, bond prices are attractive; bond holdings will provide outsized returns if rates decrease faster than expected. As such, we are slowly increasing our interest rate exposure for clients with heavier fixed-income weightings.

## Outlook and Conclusion

Markets will remain choppy until investors pivot from rate concerns to company-specific fundamentals. We expect this to happen once we get into Q3 earnings reports in late October and early November. On a technical level, almost all sectors are oversold, and many areas are extremely oversold. For these reasons, we are going to view market turbulence as an opportunity to buy rather than a signal to become defensive or raise cash in client accounts. We expect earnings reports to be positive catalysts for the markets and believe the fourth quarter has a good chance of providing positive returns.

We welcome your thoughts, questions, and input. We look forward to speaking with you.

Thank you for your business and partnership.

Sincerely,
**Jim & Mike**

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