# Market & Economic Commentary

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## Market Performance Recap

Three quarters of the year is the books. Lending contracted, rates increased, and capital became scarcer all while energy prices increased, raising the specter of higher inflation again. This backdrop put pressure on equities, especially in the final month of the quarter. Interestingly, many economists changed their forecasts for the US economy from a "hard landing" to a "soft landing," meaning no imminent recession. Corporate earnings declined for many companies, though most were also not as bad as expected (~70% beating estimates).

Each quarter of this year has had its own personality, and this one is reminiscent of 2022 as energy stocks led the S&P 500 Index and the Goldman Sachs Commodity Index was the best performing index we track. This is a sharp contrast from the Technology-led rally of the first two quarters. The only other positive sector of the S&P 500 Index outside of Energy (+12.2%) was Communication Services, which returned just 3.1%. All other sectors were negative with Real Estate and Utilities both down more than 9% for the quarter. Value and growth fell together for the quarter.

### Chart 1: US Equity Index Returns

| | 3rd Quarter | Year to Date |
|---|---|---|
| S&P 500 | -3.3% | 13.1% |
| Russell 1000 Growth | -3.1% | 25.0% |
| Russell 1000 Value | -3.2% | 1.8% |
| Russell 2000 | -5.1% | 2.5% |

*Source: OIS, FactSet*

International developed market returns moved in step with the US, as they struggled due to a strengthening US dollar. In local currency terms, returns were flat, but when translated back to US dollars, the returns lagged. The pressure from economic growth concerns, declining earnings and an uncertain inflation picture were felt by global investors. Geopolitical tensions surrounding expansionary policies from Russia and China have not helped developed markets as most governments employ some type of trade restrictions or sanctions making goods scarce and more expensive.

The challenges faced by developed markets around trade can be opportunities for emerging markets like India. India employs no sanctions on Russia and has been buying oil at a discount to the global price, reducing inflationary pressures felt elsewhere and benefiting economic growth. The stronger dollar impacted emerging markets, but overall, they fared better than their developed market counterparts. Emerging economies and the corporations within them have less access to debt, which may constrain growth in debt fueled expansions like the last decade but may also result in higher interest rates having less of an impact, as shown in Chart 2.

### Chart 2: Non-US Equity Index Returns

| | 3rd Quarter | Year to Date |
|---|---|---|
| MSCI Emerging Markets | -2.9% | 1.8% |
| MSCI EAFE (Developed) | -4.1% | 7.1% |
| MSCI ACWI-Ex US | -3.8% | 5.3% |

*Source: OIS, FactSet*

The Federal Reserve increased the Fed Funds Rate by a modest 25 bps (0.25%) during the quarter. However, yields across the Treasury curve rose, especially on the longer end. The 10-year Treasury yield finished the quarter at 4.68%, an increase of 79 bps (0.79%) from the beginning of the quarter. While that makes the current yield more attractive to buyers, it puts pressure on existing bonds as their prices fall to offset the higher yield. The 10-year Treasury is the basis for many lending rates, especially mortgages. The 30-year fixed rate mortgage, the most common kind in the US, is now approaching 8%, the highest level it's been at since 2002. Higher rates have pressured fixed income yields making it more expensive to borrow at banks and credit card companies, which have also reduced lending. Higher yields often beget even higher yields as investors avoid the asset class in the short-term, pushing prices down and yields higher. You are seeing this vicious cycle as market leaders such as Larry Fink (BlackRock) and Jamie Dimon (JP Morgan) call for even higher yields.

Municipals bond prices fell this quarter alongside their taxable peers as state and local tax revenues came under pressure and COVID relief funds dried up. The boon to state budgets came from capital gains taxes harvested last year from the equity rally coming out of the COVID crisis as well as from money transferred from the federal government to states to soften the pandemic's blow. Both have disappeared, and many states have spent their way through their surplus. In states like California, the largest weight in the Bloomberg Municipal Index, the surplus has now become a deficit and California is borrowing to balance its budget again.

Around the world, the story is really about the stronger US dollar pressuring returns more than it is about any underlying issues with credit quality or markedly higher rates. European rates have increased, but at a much slower pace than in the US. Like stocks, the strong dollar turned returns negative for the quarter.

### Chart 3: Fixed Income Returns

| | 3rd Quarter | Year to Date |
|---|---|---|
| **FTSE WGBI (USD)** | -4.3% | -2.7% |
| **Bloomberg US Aggregate** | -3.2% | -1.2% |
| **Bloomberg Municipal Bond** | -3.9% | -1.4% |
| **ICE BofA US High Yield** | 0.5% | 6.0% |

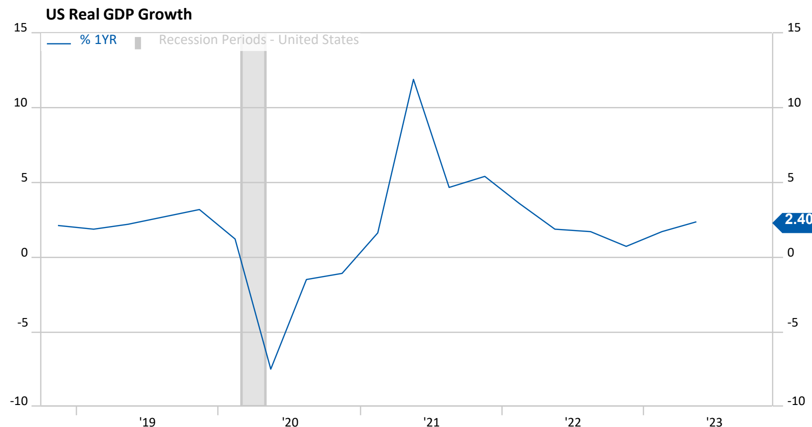
*Source: OIS, FactSet*

### Economy

The US economy has been the growth engine among the developed world this year and has outperformed even the loftiest expectations of economists. Entering the year, economists were almost unanimously calling for a recession which, despite the Federal Reserve's best efforts in raising rates, never materialized. Stimulative economic policies such as the Inflation Reduction Act and the CHIPS and Science Act have pumped and continue to pump hundreds of billions of dollars into the US economy, partially contributing to the upside economic growth. Economists have increased their base case expectations to 1.5% - 2.5% real GDP growth (total GDP growth minus inflation) for the year, lower than the strong growth the US economy is actually experiencing (see Chart 4). While economist's expectations may be below the current growth rate, the Atlanta Fed, which publishes a real

time estimate of GDP growth, is still is forecasting 4.9% real GDP growth in the third quarter.

### Chart 4: Real US GDP Growth

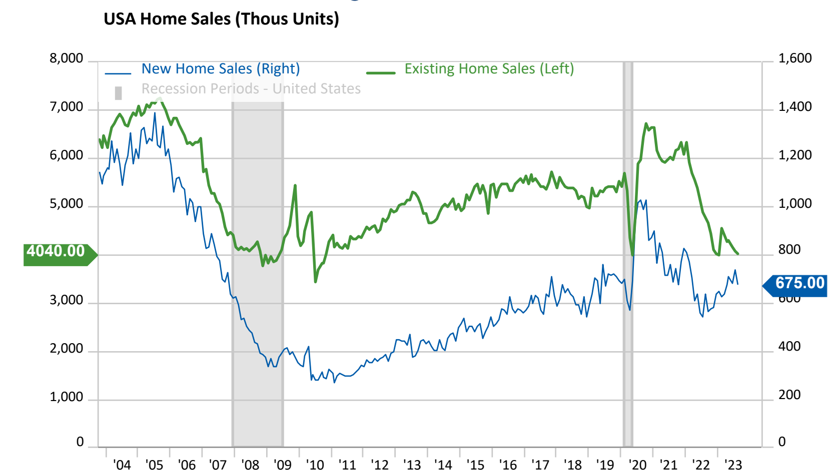



*Source: OIS, FactSet (December 2018 – September 2023)*

Despite the strong growth and stimulative economic policy, headwinds are increasing as the Federal Reserve has increased its Fed Funds rate by over 5% in the last 18 months in an attempt to slow the economy and thus slow inflation. The consumer is the engine of the US economy and recent interest rate hikes are hampering their ability to finance debt. In many cases, banks are pulling back lending and consumers can't take on additional debt even if they could afford the higher rates. This is all before student loan repayments begin this month, which could reduce consumer spending by upwards of $70 billion a year! Additionally, the childcare credit is slated to roll off this quarter, which will take another bite out of consumption.

Higher rates are responsible for existing home sales slowing back to pandemic and Great Financial Crisis lows, while new home sales are down but not back to lows yet (Chart 5). The reason for this diversion in new versus existing home sales is homebuilders re-introducing incentives to sell homes. A popular incentive offered is buying down a purchaser's mortgage rate for a period on a new home. This results in a home buyer paying a lower rate for a period before it moves back to current market rates.

### Chart 5: New and Existing Home Sales

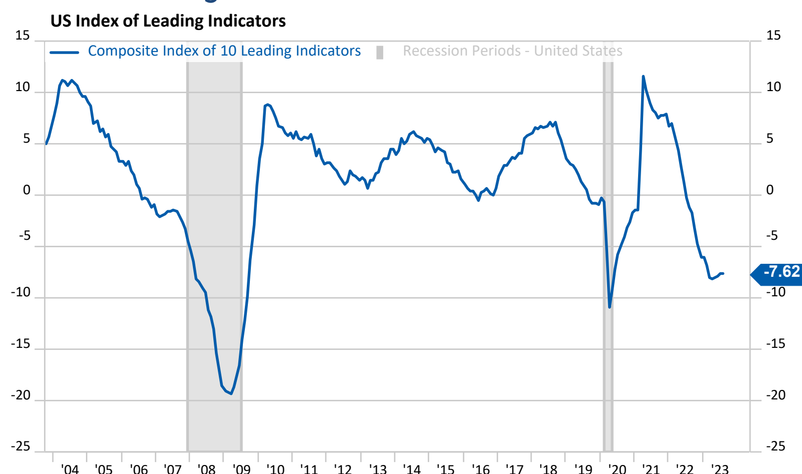



*Source: OIS, FactSet (April 2004 – September 2023)*

Home prices have not caught up to weakening demand. If demand does not pick up, which would likely happen with lower interest rates, prices should eventually drop. Declining prices have a negative wealth effect on consumers causing them to pull back spending, which stunts economic growth.

Another concern for the US economy is that leading economic indicators are pointing to a contraction (Chart 6). This economic statistic is comprised of things like average weekly hours in manufacturing, average weekly unemployment claims and new orders for consumer goods, among several others. This signal may be "crying wolf" though, because it has been negative since July 2022 and not only has the economy not contracted, it has expanded at a robust pace.

### Chart 6: Leading Economic Indicators




*Source: OIS, FactSet (October 2003 – September 2023)*

How the consumer fares over the next few months will be critical to determining the path forward for the US economy. Employment is still holding and there are plenty of jobs available. The automakers union strike will result in higher wages, which will drive greater spending from those workers. Even the US government avoided a shutdown in the final hours of the standoff avoiding a disruption in government employee wages. These developments benefit labor and spending, a positive for the US economy.

The Eurozone is facing similar challenges to slowing inflation while trying to maintain some semblance of economic growth. Economic sentiment is showing a modest weakness in Italy and Germany while France continues to muddle along. The European Central Bank has stated that its rate increases are done, which has taken some pressure off borrowers and the fixed income markets.

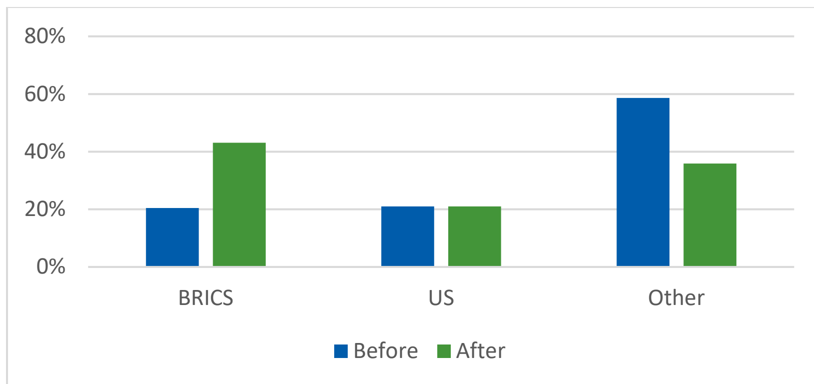
Emerging market GDP growth in the third quarter is strong with India leading the way near 8%, China at 5%, Brazil and Mexico at 3.5% each. Growth across EM is high relative to the rest of the world, and it has proven resilient in the face of stressors like inflation and pandemics. While economic growth does not necessarily drive short-term moves in the equity markets, over time a growing economy should translate into greater consumption and higher earnings, which benefit a country's equity markets.

### Multi-Polar World

As tensions continue to increase between China and the United States over a variety of issues, China has continued its push to weaken US influence across the world. In what may be viewed as the biggest development of the summer, the BRICS (a term given to a group comprised of Brazil, Russia, India, China, and South Africa) met in August and made two substantive announcements. First, they voted to expand the bloc to include Saudi Arabia, Iran, Argentina, Ethiopia, Egypt, and the United Arab Emirates (UAE). This is the first expansion of the bloc since its inception, and it indicates a desire to expand the alliance (of which there are another 40 applicant countries waiting for approval). The new entrants

will enjoy enhanced economic cooperation among the bloc members, including reduced tariffs for increased trade, investment, technology sharing and military cooperation. The expansion adds $3.2 trillion of GDP, increasing the total GDP represented by the bloc to $30.8 trillion or about 29.3% of the global share. BRICS also added 5.3% of the world's population through this expansion bringing the total population represented close to half of the world. The biggest jump is in how much of the world's oil production the bloc represents, which jumps from 20.4% to 43.1% thanks to the inclusion of Saudi Arabia, the UAE and Iran. This meaningful increase makes membership more attractive for other entrants who are oil dependent (Chart 7).

**Chart 7: BRICS Share of Global Oil Production**




*Source: OIS, US Energy Information Administration (data from Dec 2022)*

The second big BRICS development is the desire to create a unified currency. The initial calls for a unified currency came from Brazil, and other countries quickly agreed to pursue the idea. The practical reason is that it would allow for easier trade among the member countries as they avoid having to exchange their own currency (often to US dollars) to do business with each other. From the perspective of Russia, a unified currency would help it to continue to evade US sanctions which are largely facilitated by locking Russia out of the SWIFT payment system and seizing US dollar and euro assets held in banks on the SWIFT network. China sees this as an opportunity to weaken US influence, which stems largely from the use of the US dollar as a reserve currency while also insulating itself from potential sanctions if China were to advance its agenda on Taiwan. The development of this currency will take some effort as there are competing visions among the members of what it may look like. However, if it were to proceed, it would offer a meaningful alternative to the US dollar and the European Union's euro for international payments and pricing.

If you have questions or would like to discuss any of these topics in greater detail, please reach out to us.

Best regards,

**Dennis Santos**
**Chief Investment Officer**

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