Market Monitor: October 2023

Which should we cheer for… good news or bad news? As we enter the homestretch of 2023, investors are in a peculiar place. Inflation has come down significantly from the readings of late last year, but the U.S. Consumer Price Index appears to have leveled off in the 3.5% to 4.0% range. The Federal Reserve would like to see this reading drop toward 2.0%, which likely entails a slowing economy, but growth and employment numbers continue to defy expectations, showing strength and stability. When these positive trends occur, investors are taught to be happy. For this cycle, however, that could mean that the Federal Reserve must keep interest rates "higher for longer", a cause for concern. Two more inflation releases this year may help complete the picture and provide some insight on the path forward for interest rates and the economy in 2024.

3rd Quarter Highlights

- The S&P 500 Index of large U.S. companies ended the quarter up 13.1% for the year, although August and September were both down months for stocks. Non-U.S. developed stocks rose 7.1% for the year, as measured by the MSCI EAFE Index. The CRSP Small Cap U.S. Index and MSCI Emerging Markets Index were up modestly for the year at 4.1% and 1.9%, respectively.
- Growth stocks continue to lead the way. The Vanguard Growth ETF increased 28.3% for the year-to-date period, while the Vanguard Value ETF was nearly flat with a 0.2% return.
- Perhaps the biggest surprise has been the struggle for returns in the bond market during 2023 after a historic decline last year. The yield on the 10-year U.S. Treasury Bond has continued to rise modestly moving from 3.88% to 4.57% for the first nine months. Note that a rise of this magnitude does not have quite the same impact on bond price declines as a 0.7% move when starting from a lower level of yields as we saw last year. The Bloomberg Aggregate Bond Index finished the quarter down 1.2% for the year.
- One silver lining for many investors has been the substantial increase in the yield on money market funds over the last 12 months. High quality government money market funds now yield over 5%. For those investors that need to hold cash, this is a welcome development as this yield currently exceeds inflation. Historically, however, such a configuration does not last very long, and investors will eventually be looking for higher returning opportunities for much of that cash.
- We may be at an attractive entry point for many bond investors with the Federal Reserve winding down rate increases, the economy slowing at the margin, and yields on a high-quality bond portfolio in excess of 5%.

- In a positive sign for the economy, the September payrolls report showed a large upside surprise in new jobs added at 336,000. Employers are feeling confident enough to continue to hire at a rapid pace even with growth in hourly earnings rates above the inflation level.

Three Big Things

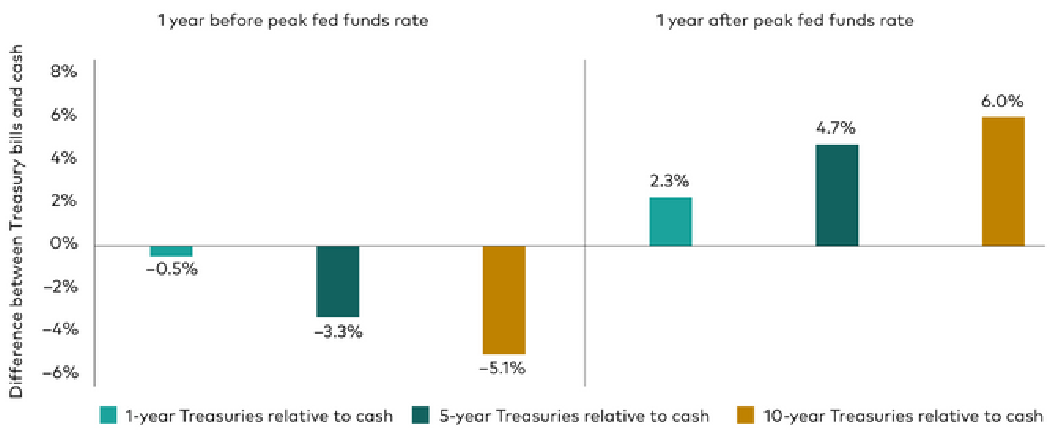
Here we review some emerging trends that may be important for investors and their portfolios. We discuss the potential upside in bonds on the heels of Federal Reserve rate hikes, bond yields vs. stock earnings yields, and the recent trend in oil production.

Before and After Rate Hikes

The Federal Reserve has been aggressively raising short term interest rates in an effort to slow the economy and inflation. Fixed income performance has suffered as most bonds do not offer compensation for rising prices. The chart below shows the 1-year performance of various treasury instruments before and after the peak of the Federal Funds Rate. As rates are increasing, short term instruments that are less interest rate sensitive have performed better. After the peak in the Federal Funds Rate, the opposite is true. Assuming we are at or near the peak, this may be an opportune time to begin looking at longer duration fixed income investments.

Investments in Treasuries generated stronger returns than cash after interest rates peaked

FIGURE 1: Average return differential of various Treasury securities relative to cash (1953 to April 2023)

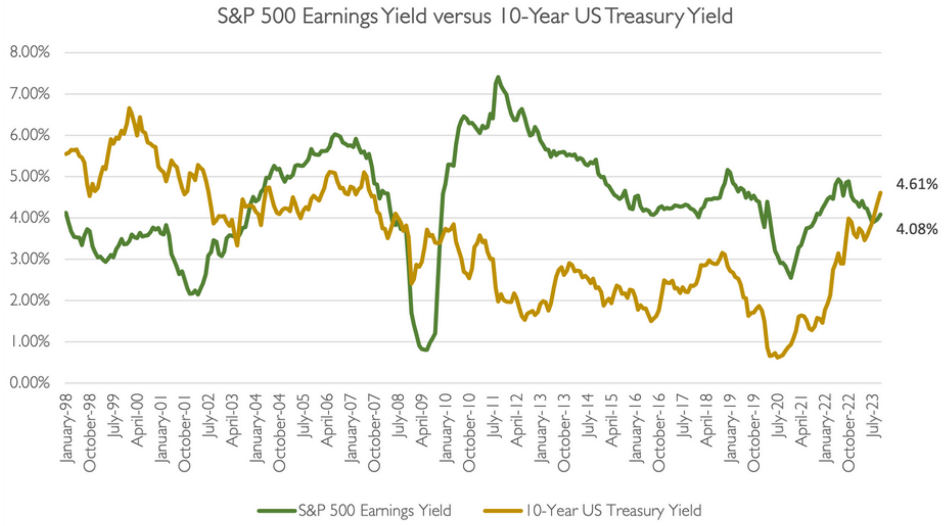


Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Sources: Investment Advisory Research Center analysis using data from Morningstar Direct and Saint Louis FRED database.

Bond Yield vs Earnings Yields

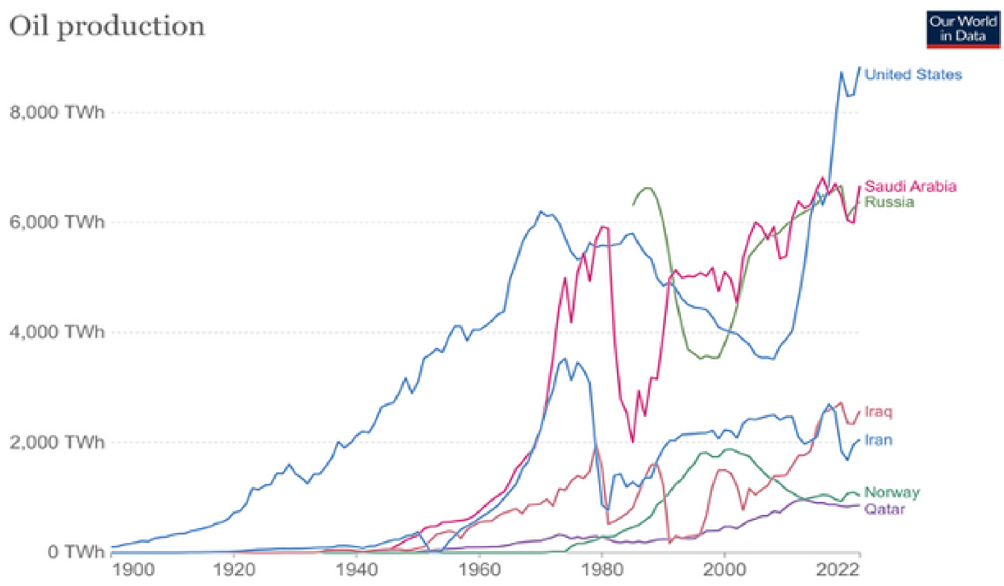
Many use the yield on bonds or the earnings yield on stocks as a valuation metric. Yield on bonds is the annual cash flow divided by the price. Earnings yield is the 12-month trailing earnings of a company (or market) divided by the price. The higher the value of each metric, the more earnings or cash flow we are getting for each dollar invested. In the last decade, as bond yields plummeted, the yield on bonds was far lower than the earnings yield on stocks. This has now shifted. Historically, this crossover has marked an attractive entry point for bond investors.



Source: https://www.multpl.com/s-p-500-earnings-yield/table/by-month, Standard & Poors, St. Louis Fed (FRED) Database, Board of Governors of the Federal Reserve System

Oil Production

As we have watched the price of oil rise in the second half of 2023, it is natural to wonder about the amount of oil being produced. The chart below reveals some interesting observations. First, the United States is now the world's largest oil producer. Second, the amount of oil being produced has seen a dramatic rise in the last several years. Oil consumption, on the other hand, has been relatively stable. With the economy slowing, this data may portend a softening in oil prices in the coming years. Future inflation readings will shed more light on these trends.



Source: Energy Institute Statistical Review of World Energy (2023); The Shift Data Portal
OurWorldInData.org/fossil-fuels/ • CC BY

We look forward to the opportunity to review your wealth management plan in the coming months. As always, please do not hesitate to reach out to us at any time.

Please find this newsletter and others on our website at www.gardecapital.com.