Market Strategy
by STRATEGAS A BAIRD COMPANY

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Private Wealth Management

Quarterly Market Update

Third Quarter, 2023

REFLECTING ON A MORE VOLATILE QUARTER

If markets started Q3 with an airy lightness of aspiration, by the end of September they remembered the solid weight of Earth. The most immediate cause for the shift was the Federal Reserve signaling that it will likely keep interest rates higher for longer. Investors have been slow to heed the Fed's commitment to a 2% inflation target, and who could blame them? Central banks have been slow to give up the shiny new toy of quantitative easing, especially in times of market stress.

The S&P was up just +0.6% YTD before Silicon Valley Bank failed in March (triggering new government stimulus). What followed was akin to shaking a can of carbonated government-issued alphabet soup and opening it. The Fed's BTFP expanded its balance sheet by $300 billion in just 3 weeks, the TGA injected ~$550 billion into the economy through May, and the SPR kept oil prices contained through July. By July 31, the S&P was up +19.5% year to date. *(Soup initialisms: **B**ank **T**erm **F**unding **P**rogram, **T**reasury **G**eneral **A**ccount, **S**trategic **P**etroleum **R**eserve)*

Of course, optimists might point to Artificial Intelligence (not stimulus) to explain the market strength through July. That the dominance of the "Magnificent Seven" (Apple, Alphabet, Meta, Amazon, Microsoft, Nvidia and Tesla) could be attributed to investors merely recognizing the potential economies of scale of generative AI. Ultimately, both analyses of what's behind the gains—government stimulus and technological advancement—can hold true.

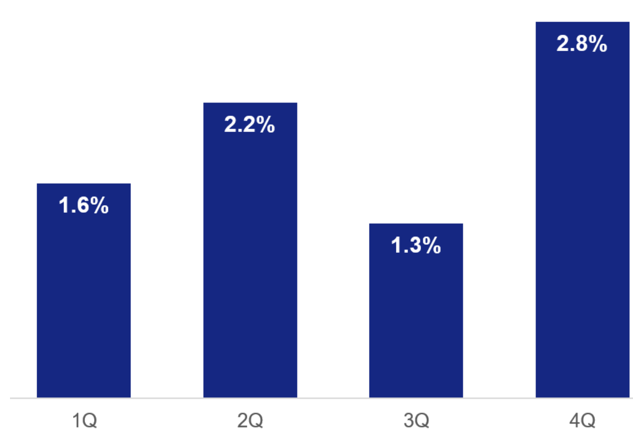
What changed in Q3 is a sense that the bill for unsustainable fiscal policies is coming due. Foreign lenders are demanding higher yields on U.S. Treasuries (and in fact, the 10-year Treasury yield recently hit a new post-2008 high of 4.6%). With over 50% of U.S. debt maturing in the next 3 years, it's not hard to imagine continued upward pressure on long-term bond yields. (Yields have an inverse relationship to price, so rising yields can be an indicator of lower demand.) Of course, a financial crisis could end the Fed's tightening campaign and provide relief on rates, but it is difficult to see that being positive for risk assets, at least near-term.

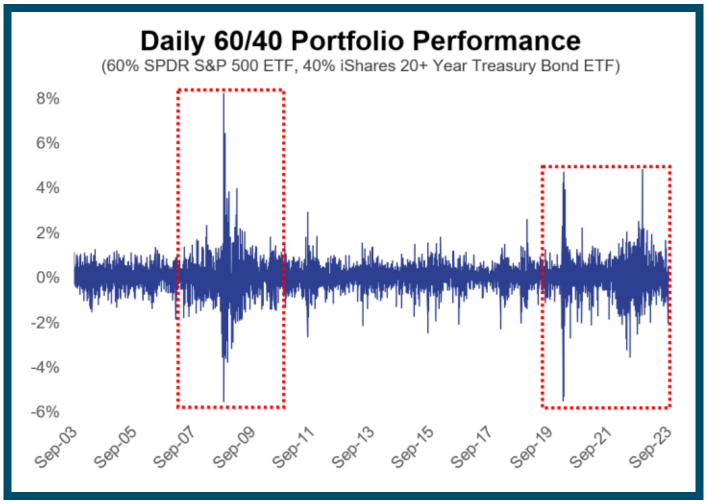
Even a 3% inflation target would be tough to reach without productivity improvement. Despite 18 months of monetary tightening, the balance of power between capital and labor seems to have shifted toward private sector unions. This should keep upward pressure on overall wage growth, prolonging the Fed's fight against inflation.

The drivers of market performance changed in Q3. Stocks with lower valuations and higher returns on invested capital dominated. Of the 30 best performers in the S&P 500, nine were in the Energy sector and only one was in the Consumer Discretionary sector. We continue to favor shorter-duration equities (i.e., companies that are generating cash flow sooner rather than later) during a period when sticky inflation looks poised to keep interest rates higher for longer.

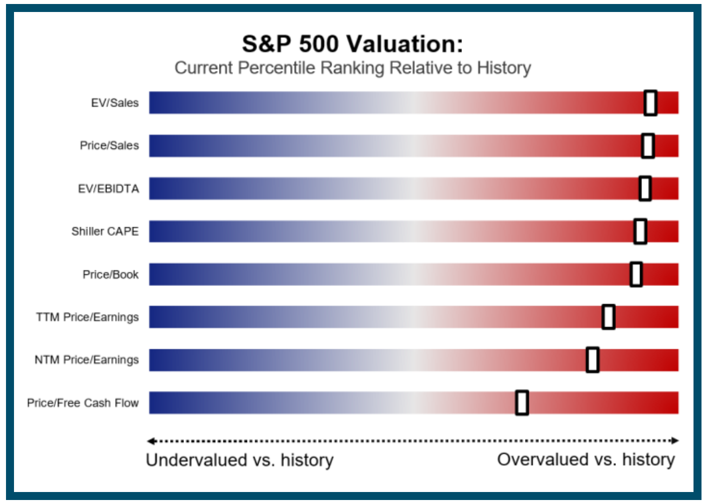
Asset Class	Representative Benchmark	Q3 Return
US Large Cap	S&P 500	-3.3%
US Small Cap	Russell 2000	-5.1%
International	MSCI AC World ex-USA (USD)	-3.7%
Commodities	Bloomberg Commodity	4.7%
Municipal Bonds	Bloomberg Municipal Bond	-4.0%
Taxable Bonds	Bloomberg US Aggregate	-3.2%
Cash	Bloomberg 3-Month T-Bill	1.3%

S&P 500 Average Quarterly Return (since 1928)

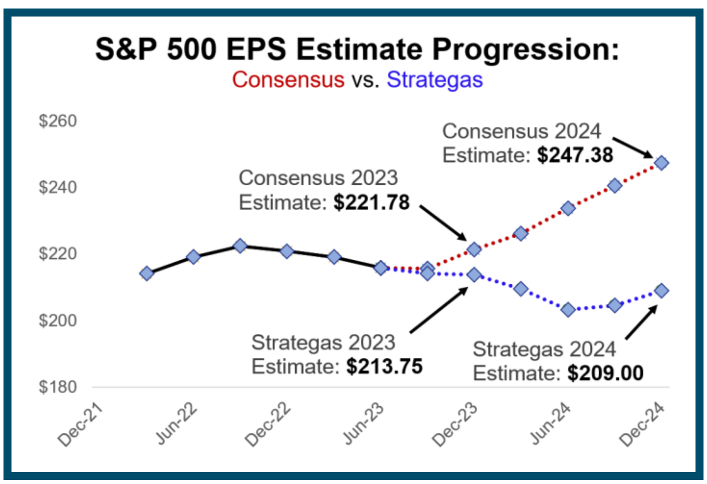




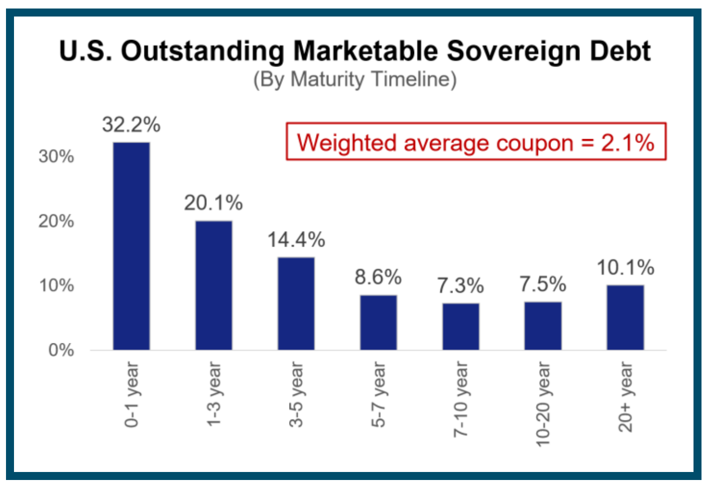
Not since the Great Financial Crisis has the 60/40, stock/bond portfolio seen such consistent volatility. Generationally high inflation (and the Federal Reserve's leisureliness in beginning to fight it) led to one of the more rapid and aggressive interest rate hiking cycles in the last four decades. As a result, both stocks and bonds have seen heightened volatility – particularly since 2021 ended. Further, if sticky inflation keeps interest rates elevated, it wouldn't be surprising if volatility remained elevated from here (especially when compared to last decade). Heightened geopolitical risk and tense domestic politics could contribute, as well. A new regime seems to have arrived.



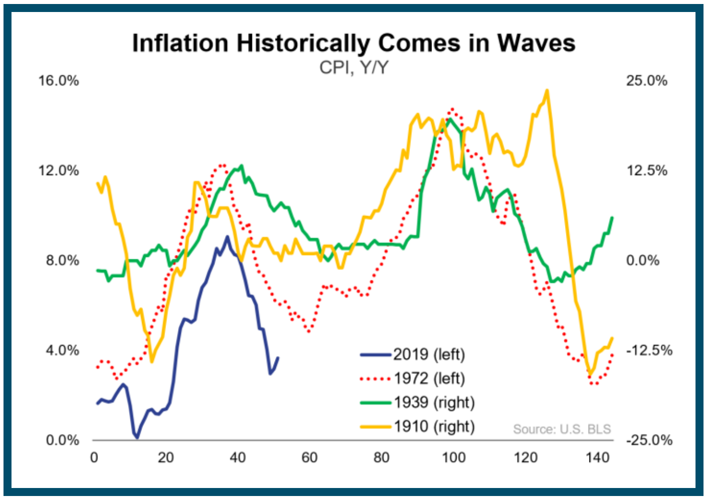
By any metric, it would be hard to describe the stock market as cheap, particularly given the recent upward pressure on interest rates. At these levels, Treasurys are becoming meaningful competition for common stocks in the U.S. (the S&P 500 earnings yield is only ~1pp higher than the 10-year Treasury, the tightest spread in roughly two decades). Even if one attempted to account for the influence of the "Magnificent Seven" (i.e., the expensive mega-cap tech behemoths at the top of the market) by comparing the S&P 500's P/E to the median stock's P/E, you'd find very little difference. Any way you slice it, the market looks pricey.



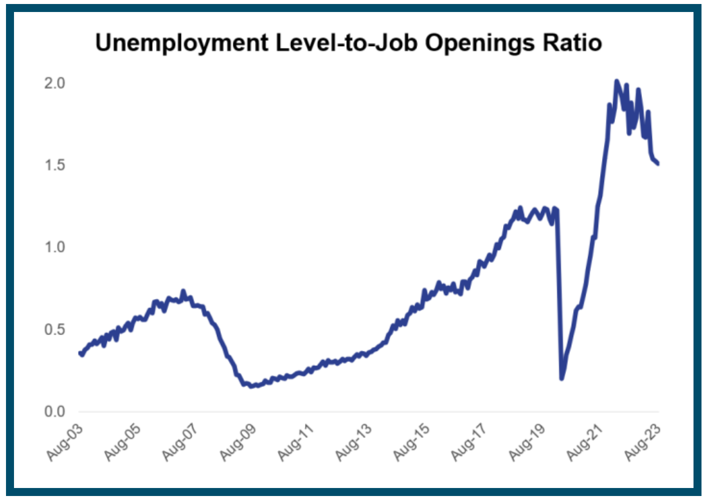
Given the lagged effects of monetary policy and the stickiness of inflation, it's difficult to build the truly exciting bullish narrative for stocks. Even the recent economic "strong patch" has only just curbed the downward trajectory of corporate profits that peaked last fall. On the other hand, the resiliency of the labor market and U.S. consumer have left corporate earnings unlikely to be as weak this year as we'd originally estimated. We therefore increased both our 2023 and 2024 S&P earnings estimates this fall (though we remain well below consensus). Ultimately, we believe the long build back to previous levels of profitability should commence in late-2024 and into 2025.



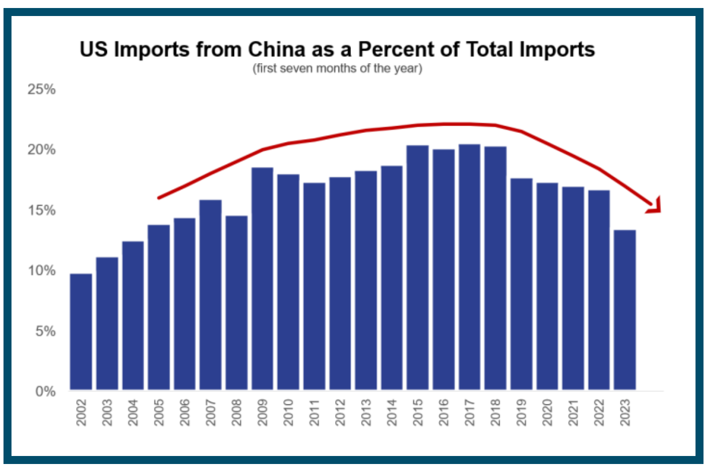
A majority of U.S. government debt is maturing in the next 3 years and will undoubtedly need to be rolled forward. However, as interest rates have risen, this will increasingly be done at higher rates – and will markedly increase the cost of servicing the national debt. This will impact future fiscal policy. In fact, across recent history, when interest costs surpass 14% of tax revenue, U.S. fiscal policy goes into austerity mode. We are now above 14%, and as a result, the 25-year period of stimulus is fading. From here, fiscal hawks will continue to push for spending cuts and other reforms, and structural issues in the country's finances will need to be addressed.



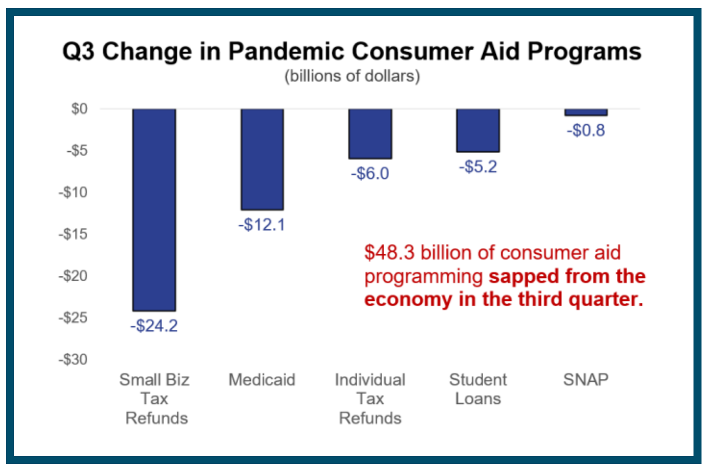
Throughout history, there's been a symmetry to inflation: the faster CPI inflation rises, the faster it tends to fall. This pattern has played out again this cycle, with the CPI peaking at 9% y/y in 2022 and falling to 3.7% most recently. However, just because this wave is passing does not necessarily mean inflation will return to target and stay there. After examining 62 inflation episodes across 24 countries and over 2,100 years of economic history, we found that just 8 of them ended after only one wave of price surges. Inflation returning in multiple waves was the much more common pattern, and this is a key reason that the Federal Reserve will remain vigilant.



We've argued that a key step to achieving an economic soft landing was to destroy job openings rather than jobs. That is to say, if the Fed's rate hikes caused firms to pull back on hiring (destroy job openings) but were not so aggressive as to cause mass layoffs, the economy could decelerate enough to squash inflation without needing a recession. We are on that path today, but time is running out as pressures continue to build amid ever higher interest rates. Today, there are roughly 1.5 job openings for every unemployed person, down from ~2.0 at the cycle peak. Wage growth has moderated, but the labor market is likely still too tight for the Fed's comfort.



One of our primary policy themes of the last few years is de-globalization; that we are shifting to a more multipolar world where national security takes priority over economic efficiency. And to the extent to which China has been at the heart of globalization and outsourcing for the past two decades, it would appear the pandemic has irreparably damaged the country's brand (and the ability of developed nations to import disinflation via cheaper production of goods). For investors, we think this means we're moving to a pre-Berlin Wall coming down framework: slightly higher inflation and interest rates with a lower price to earnings ratio on stocks, all else equal.



After providing a massive economic boost from 2020-2023, the tailwind of Covid-era consumer stimulus is finally nearing an end, and in fact, is likely rolling off much faster than the consensus expects (not to mention the impact of rising gas prices, which were up ~10% in Q3). This will undoubtedly weigh on consumer spending through year-end and into 2024. On the other hand, though fiscal austerity is likely coming for Washington, much of the already-passed investment-focused stimulus – infrastructure, clean energy, and CHIPs funding – is about to be unleashed, with the bulk of spending hitting the economy over the next three years.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization.● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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