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Third Quarter Review & Outlook: Keep Those Seat Belts Fastened

Following a challenging 2022, investors enjoyed a smoother upward rise in markets, despite three bank failures during the first half of 2023. A resilient global economy continued to chug along with moderate levels of inflation, slow but stable growth and low unemployment levels. As we neared the end of July, global equities started to falter as the prospects of a soft landing of the economy began to face challenges from spiking interest rates. Market prognosticators have begun to question whether the Fed has done enough (or too much) to contain inflation, while higher rates suggest increasing pressure on the consumer. Will higher rates slow the economy too much? Have we become too complacent over recessionary concerns? As we begin the fourth quarter, the outlook is slightly less rosy than just a few months ago.

Capital Markets Review

While year-to-date equity market returns look solid, with the S&P 500 up a healthy 13.07%, sentiments changed as the calendar turned to August. After hitting a 20.4% (Source: FactSet - All citations from FactSet as of 09/30/2023) peak on July 26, the S&P 500 dropped 6.14% between July 28 and September 30, posting a decline of -3.27% for the third quarter. US small cap (-5.13%), international (-4.11%) and emerging market stocks (-2.93%) all followed the same pattern.

As longer bond yields continued to rise throughout the quarter, the aggregate bond market declined by 3.23%, causing year-to-date returns to turn negative at -1.21%. High-yield bonds weathered the storm quite well, returning 5.86% year-to-date. Alternative investments helped manage portfolio declines, posting a 1.38% return through September 30.

Asset Class Returns

	Asset Class	Index	September 2023	Q3 2023	YTD 2023
Equity	US Large Cap	S&P 500	-4.77	-3.27	13.07
	US Small Cap	Russell 2000	-5.89	-5.13	2.54
	International Developed	MSCI EAFE	-3.42	-4.11	7.08
	Emerging Markets	MSCI EM	-2.62	-2.93	1.82
Fixed Income	US Investment Grade	Barclays US Agg	-2.54	-3.23	-1.21
	US Inflation-Indexed	Barclays US TIPS	-1.85	-2.60	-0.78
	US High Yield	BBgBarc US Corp High Yield	-1.18	0.46	5.86
	EM US$ Debt	JPM EMBI Global	-2.60	-2.23	1.76
Alternative	Absolute Return	HFRX Global Hedge Fund	-0.10	0.75	1.38

Source: Morningstar
All citations from Morning Star as of 09/30/2023.

Sector Review

Seven of the eight US economic sectors posted negative returns for the third quarter. Communication Services was the only sector showing a positive return, up 3.07% thanks mostly to Meta Platforms (up 4.61%) and Alphabet (up 9.3%) (Source: FactSet). Year-to-date returns remain strong for Communication Services (+40.40%), Technology (+34.72%) and Consumer Discretionary (+26.67%), but Q4 is likely to present challenges, especially in the Consumer Discretionary sector, as consumers face higher interest costs.

Sector Returns: Q3 and 2023

Sector	Index	September 2023	Q3 2023	YTD 2023
Communication Services	S&P 500 Sec/Commun Services	-3.26	3.07	40.43
Technology	S&P 500 Sec/Information Technology	-6.87	-5.64	34.72
Consumer Discretionary	S&P 500 Sec/Cons Disc	-5.98	-4.80	26.67
Industrials	S&P 500 Sec/Industrials	-5.96	-5.16	4.50
Materials	S&P 500 Sec/Materials	-4.78	-4.76	2.61
Financials	S&P 500 Sec/Financials	-3.14	-1.13	-1.65
Consumer Staples	S&P 500 Sec/Cons Staples	-4.53	-5.97	-4.76
Real Estate	S&P 500 Sec/Real Estate	-7.25	-8.90	-5.45

Source: Morningstar

Portfolio Positioning

Big Picture

As global investors, we believe in the principles behind diversification, as asynchronous economic conditions affect markets differently. However, the current economic landscape across the G7 is fairly synchronized, while Europe continues to face headwinds with slower growth and higher inflation. Europe is also on the front lines of the ongoing Ukraine conflict. As such, we remain underweight in European equities. Asia, Japan and Taiwan have been bright spots thus far in 2023, with the Nikkei 225 up 24.5% and the Taiwan TAIEX index up 19.7% for the first three quarters of the year (Source: FactSet), but geopolitical and economic risks in China are a source of concern for the rest of Asia in our view. Real GDP is forecasted to decline to a consensus 4.4% reading due on October 18 (Source: FactSet).

Economic Estimate Comparison — Real GDP Growth

Country/Region	CY 2020	CY 2021	CY 2022	CY 2023	CY 2024	CY 2025
G7						
United States	-2.2	5.8	1.9	**2.0**	0.8	1.8
Japan	-4.3	2.3	1.0	**1.8**	1.0	1.2
Canada	-5.1	5.0	3.4	**1.2**	0.7	2.0
Italy	-9.0	7.0	3.8	**0.9**	0.8	1.0
France	-7.7	6.4	2.5	**0.7**	0.9	1.2
United Kingdom	-10.4	8.7	4.3	**0.4**	0.5	1.3
Germany	-4.2	3.1	1.9	**-0.3**	0.7	1.3

Source: FactSet

Economic Estimate Comparison — CPI Inflation

Country/Region	CY 2020	CY 2021	CY 2022	CY 2023	CY 2024	CY 2025
G7						
Japan	0.0	-0.2	2.5	**3.0**	1.7	1.4
Canada	0.7	3.3	6.8	**3.8**	2.4	1.9
United States	1.3	4.7	8.0	**4.1**	2.6	2.2
France	0.5	2.1	5.9	**5.6**	2.6	2.2
Germany	0.4	3.2	8.7	**6.0**	2.7	2.5
Italy	-0.2	1.9	8.8	**6.3**	2.5	2.1
United Kingdom	0.9	2.6	9.1	**7.5**	2.9	2.0

Source: FactSet

Economic Estimate Comparison — Unemployment Rate %

Country/Region	CY 2020	CY 2021	CY 2022	CY 2023	CY 2024	CY 2025
G7						
Japan	2.8	2.8	2.6	**2.6**	2.4	2.3
United States	8.1	5.4	3.6	**3.7**	4.4	4.4
United Kingdom	4.6	4.5	3.7	**4.2**	4.6	4.8
Canada	9.6	7.4	5.3	**5.4**	6.0	6.2
Germany	5.9	5.7	5.3	**5.7**	6.0	5.6
France	7.9	7.8	7.2	**7.2**	7.3	7.1
Italy	9.3	9.5	8.1	**7.8**	7.9	6.9

Source: FactSet

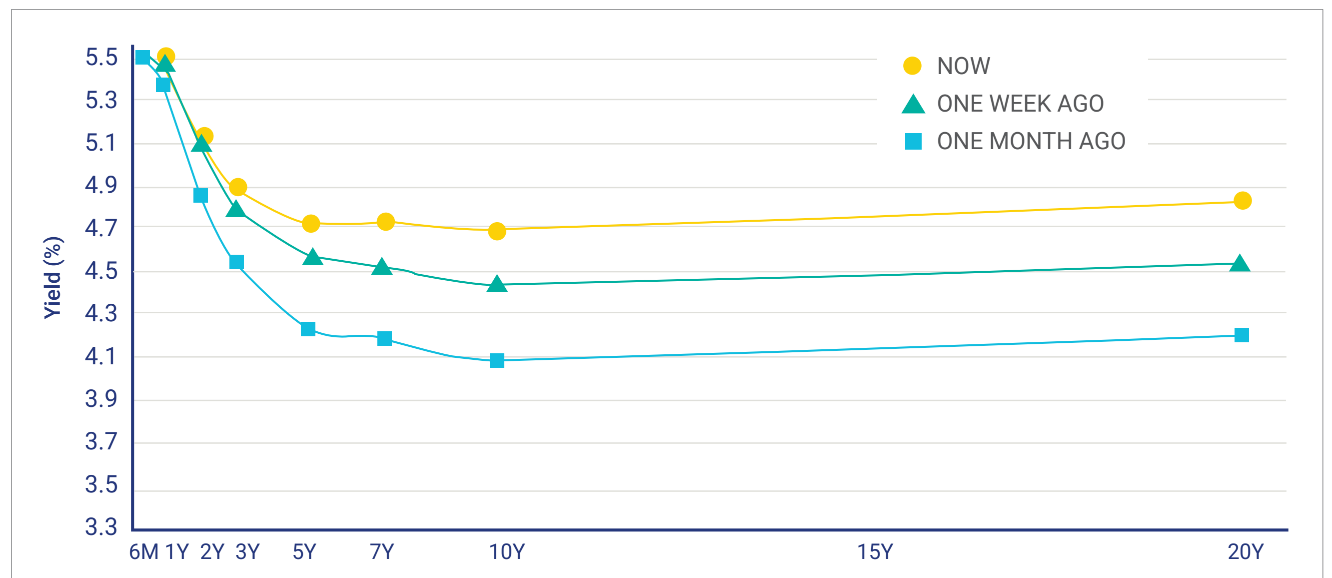
For our US equity allocation, we continue to favor large cap stocks over small caps. Small caps historically perform well coming out of a recessionary period. While we are not forecasting a meaningful recession, we believe that current economic conditions warrant patience. We have slightly reduced our overweight to US large cap, moving portfolios closer to the long-term target weightings. Concerns over recession may be enough to spook markets, causing an increase in volatility. We remain bullish over the long term but prefer to have dry powder through the rest of the year.

Fixed Income Focus

One thing that certainly had the market's attention during the third quarter (and contributed to the market's lackluster returns) was the sharp rise in bond yields. From June 30 to September 30, 2023 the 10-year treasury yield increased by 76 basis points from 3.81% to 4.57%. As such, the 10-year treasury now sits at its highest level in over 16 years (Source: FactSet, 9/30/23). While earning additional income on a risk-free treasury bond is beneficial to income investors, an aggressive rise in yields has important implications for the economy as well as equity and fixed income markets.

It is difficult to understand all the technical dynamics behind the upward move in yields, but there are a few clear fundamental factors at play. First, the Fed has been telling us for months (through its press conferences and now through its economic projections) that rates will be "higher for longer." It seems the markets finally woke up to this fact, and yields went up accordingly. In its most recent "Summary of Economic Projections" following the September 20, 2023 meeting, the Fed adjusted its projection for 2024 rate cuts from 1.0% of cuts to 0.50% of cuts. (Source: FederalReserve.Gov, Summary of Economic Projections)

U.S. Treasury Yield Curve



Source: US Department of the Treasury
As of 9/29/2023

Economic data that continues to surprise to the upside, particularly from the labor market, has also contributed to the rise in bond yields. The labor market has moderated somewhat in recent reports, but at 3.8% the unemployment rate is still hovering at a nearly 50-year low (Source: US Bureau of Labor Statistics). Strong economic data has created a "good news is bad news" dynamic for markets, as it is interpreted through the lens of the Fed needing to keep policy tight (aka rates higher) for longer.

What does all of this mean for portfolio strategy? On the fixed income side, while the additional income that comes from higher yields is nice, remember that bond prices fall as yields rise. A sharp upward move in rates can have a very negative impact on bond prices, particularly longer dated maturities. We have believed for some time that rates would need to move higher and stay higher. As such, our fixed income strategy has been focused on shorter maturities that have not been hurt by these aggressive rate increases.

Equity Focus

An aggressive move higher in bond yields can also negatively impact equities. At the most basic level, there is finally competition again for investment dollars. In a zero (or close to zero) rate environment, equities are truly the "only game in town." But with inflation-adjusted ("real") treasury yields well over 2% as of September 30, 2023 (Source: FederalReserve.gov), there is now a risk-free alternative to stocks. Certain sectors are disproportionately impacted by higher rates. Tech and other "long duration" equities are hurt the most, as conventional wisdom says most of their earnings will come far in the future. Higher rates impact future cash flow projections, which in turn lower earnings estimates and impact multiples. On the other hand, more defensive sectors such as financials, health care and consumer staples generally hold up best in rising rate environments. As always, balance is key. We don't want to completely abandon the long-term potential of growth stocks for what might be a relatively short market disruption. At the same time, we will not ignore tactical opportunities that come our way.

While making specific calls or predictions on the exact future level of interest rates is a fool's errand, one can certainly get a sense of the general direction and momentum. For now, we will take the Fed and the economy at their word that rates will be "higher for longer." Our client portfolios continue to be well positioned for such an environment.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you and we appreciate the trust you have placed in us.

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