Third Quarter Market Review and Comment
October 2023

Updated Market Performance

Returns	3rd Quarter 2023	YTD	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-3.27%**	**13.07%%**	**21.62%**	**10.15%**	**9.92%**	**11.91%**
DJIA	**-2.10%**	**2.73%**	**19.18%**	**8.62%**	**7.14%**	**10.79%**

Performance: July continued June's gains, returning 3.21%. August began a downward trend after July's gains, posting a return of -1.59%. September returns followed August's lead, falling -4.77%. This left us with a 3rd quarter 2023 total return of -3.15%.

After the 2nd quarter 2023 posted a gain of 8.74%, the 3rd quarter 2023 started off positive but had a weak finish. We ended the quarter negative leaving us with a return of -3.15%. The Dow Jones Industrial Average (DJIA) outperformed the SP500, posting a -2.10% gain over the same period. For the previous twelve months the SP500 returned 21.62%, outperforming the DJIA which returned 19.18% over the same period. The annualized three-year returns for the SP500 were 10.15%, the DJIA three-year returns trailed the average increasing 8.62%. Over the last five years the annualized returns are right around historical norms (around 10.15%), with the SP500 returning 9.92% and the DJIA posting 7.14%. The ten-year annualized numbers are running above long-term averages (around 10.15%), with the SP500 returning 11.91% versus the DJIA which turned in 10.79%.

Breaking down the returns for Q3 2023, we note that there were four outperforming sectors and seven underperformers. **The best sectors were Energy (11.33%), Communication Services (2.84%), and Financials (-1.60%). The underperformers during the quarter were Utilities (-10.10%), Real Estate (-9.65%) and Consumer Staples (-6.61).** The best sectors over the last year were Information Technology (39.70%), Communication Services (37.16%), and Energy (25.63%). Following behind were Utilities (-10.02%), Real Estate (-5.36%), and Consumer Staples (4.54%).

Economy: Growth in the economy increased in 2022 by 2.10% compared to an increase of 5.90% in 2021. 2022 began the deceleration in growth leaving us with growth below historical trends (Historical growth is ~3.13%). Expectations are that we will continue to see growth slow even though the advance estimate for 3rd Quarter GDP recently came in at 4.90%. We believe this is anomaly and that 4th Quarter will come in below average. Inflation is still running above historical averages, although it has been continuing to ease. The Fed has eased back on its aggressive tightening of monetary policy to get inflation under control. Normally when the federal reserve tightens monetary policy and raises short term rates, they usually result in hindering growth and causing the economy to go into a recession. Recession risks are currently high. We had a technical recession in the first half of 2022 which is defined as two negative quarters of GDP. We think a more meaningful recession will occur sometime in 2024 or early 2025. At the current moment, the recession looks to be shallow and short.

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The advanced estimate of 3rd quarter 2023 Gross Domestic Product (GDP) is 4.90%; according to the report released at the end of October by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter 2023 increased 2.80% from the 2nd quarter 2023 third estimate of 2.10%. GDP for 2022 came in at 2.10% compared to 5.70% in 2021, -3.50% in 2020, 2.20% in 2019, 2.90% in 2018, and 2.20% in 2017. Currently, Trading Economics estimate (Forecast of U.S. GDP Growth) has forecasted 2023 Q4 GDP growth at 0.80%. By comparison, China says their GDP increased 4.90% in the 3rd quarter of 2023. Decreasing from 2nd quarter 2023 reading of 6.30%. China's 2022 GDP was 2.90%, 8.10% in 2021, 2.30% in 2020, 6.10% in 2019, 6.60% in 2018, and 6.80% in 2017. Growth rates for the European Union (EU) and the Euro Area were 0.40% and 0.50% respectively in the 2nd quarter 2023. For 2022, GDP grew 3.50% for the EU and 3.50% for the Euro Area. For 2021, GDP grew 5.30% for the EU and 5.30% for the Euro Area. For 2020, GDP fell -6.10% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.50% for the EU and 1.20% for the Euro Area. This is down from the 1.90% growth achieved by the EU and the 1.80% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 3rd QTR 2023 are -0.10% for the EU and -0.30% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.73%). According to the Bureau of Labor Statistics, September unemployment remained unchanged at 3.80%. Unemployment for 2022 came in at 3.65% which is 1.71% below 2021's rate of 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019, respectively. The number of unemployed was essentially unchanged at 6.4 million for September. The labor force participation rate held at 62.8% in September. In September, job gains occurred in leisure and hospitality, government, health care, professional, scientific, technical services, and social assistance.

Inflation increased 3.70% in September continuing to run above the average trend. After averaging 3.97% in the 2nd quarter 2023, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 3.53% for the 3rd Quarter 2023. The average rate of inflation for 2022 was 8.01% and was above average by historical standards (~2.59% over last 30 years and 3.27% from 1914-2023). The energy index decreased 0.50% for the 12 months ending in September, and the food index increased 3.70% over the last year.

Consumption is an important driver of the economy as it represented 68.1% of the 2nd quarter 2023 nominal GDP. The U.S. Census Bureau announced in October that retail sales for September 2023 were 0.70% from August and were up 3.8% above September 2022. Non-store retailers were up 8.40% from last year, while the food and beverage industry were up 9.20% from September 2022.

The manufacturing economy contracted in September. Economic activity in the manufacturing sector contracted for the month of September, with the overall economy contracting for the 11th consecutive month. This follows a 28-month period of expansion. The Purchasing Managers Index (PMI®) registered 49.0; an increase of 1.4 from August's reading of 47.6. The five manufacturing industries that reported growth in September were Nonmetallic Mineral Products, Food, Beverage & Tobacco Products, Textile Mills, Primary Metals, and Petroleum & Coal Products. The 11 industries reporting contraction in September are Printing & Related Support Activities, Furniture & Related Products, Plastics & Rubber Products, Paper Products, Fabricated Metal Products, Wood Products, Computer & Electronic Products, Machinery, Electrical Equipment, Appliances & Components, Chemical Products, and Transportation Equipment. This month, none of the 10 subindices were above 50 for the month. A reading above 50 indicates that the manufacturing sector is generally expanding while below 50 indicates that it is generally contracting. Based on historical relationships between PMI and GDP, a PMI of 49.0 corresponds to a 0.10% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to increase in July. According to the S&P Case-Shiller Home Price Indices home prices in July increased 1.00% over the last 12 months, which is up 1.00% from the previous month's 0.00%. Chicago, Clevland, and New York had the largest year-over-year increases with 4.40% for Chicago, followed by 4.00% for Clevland, and 3.80% for New York. According to the National Association of Realtors, the year-over-year change in existing home sales was -17.40% in September for Single family homes between $250,000-$500,000. Housing supply continued to remain tight in September with 3.3 months of supply.

Markets: The markets have continued to trade in a range after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market back in January of 2022. At this time, the market will continue to be driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings, and geopolitical risks.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to decrease -0.40% for the 3rd quarter 2023. For Q3 2023, the estimated earnings decline for the S&P 500 is -0.40%. If -0.40% is the actual decline for the quarter, it will mark the 4th straight quarter year-over-year earnings declines reported by the index.** Looking at future quarters, analysts project earnings growth for the 4th QTR 2023 to be 6.70%. Earning growth for 2023 is projected to be 0.70% and 12.20% for 2024.
- **Valuations: Valuations came down meaningfully last year and have expanded so far this year.** The Price to Earnings at the beginning of 2023 was 16.7. It has increased to 17.8 through the 3rd quarter 2023. The 20 Year average P/E is 15.6, which is 2.2 below our current levels. There is some room for P/E expansion currently, but there is the potential for contraction without meaningful earnings growth.
- **Interest Rates/Monetary Policy: Short Term Interest Rates are continuing to increase and are right above historical averages. The average effective Fed Funds rate since July 1954 is 4.60%. The average over the last 10 years is 1.01%.** The Federal Reserve left rates unchanged at a range between 5.25%-5.50% in its latest meeting in September and is expected to keep rates at their current levels for the remainder of the year. The Fed will continue reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet. The Committee is strongly committed to returning inflation to its 2 percent objective. The spread between the 2-year and 10-year Treasury yields is -0.16% as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve is currently inverted (2-year yield is higher than the 10-year yield) and financial conditions are tightening. **Eight of the last Nine recessions since 1955 have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too far. It is not if, but when.**
- **Inflation: Inflation has continued to remain elevated, however we are continuing to see signs of inflation easing.** Inflation is easing albeit slowly. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to continue to fight inflation. This comes at a time when growth is slowing. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.

- **Russia-Ukraine Conflict and other Geopolitical risks: The current conflict is continuing to weaken the European economy more than the US economy, with some speculation of a recession in some countries (especially Germany) as soon as the 4th quarter 2023.** At this time, it is hard to determine the total impact this conflict will have on the US. US-China relations remain tense.
- **Geopolitical Risks:** The current conflict between Israel and Gaza could have large impacts across many countries. Especially if they get involved.
- **Student loan moratorium lifted:** After a three-year moratorium, Congress recently passed a law preventing further extensions of the payment pause. Student loan interest will resume starting on Sept. 1, 2023, and payments will be due starting in October. The largest impact could be seen in consumer spending since borrowers will have less disposable income. This could potentially have a drag on GDP causing growth to slow and increasing the probability of a recession.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by elevated inflation, the Fed tightening monetary policy, and economic contraction. We think the SP500 will end Q4 2023 between 4300 and 4500. At this juncture, we venture a guess that stocks will end the year somewhere between 8% and 10% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 5.25%-5.50% to 5.50-5.75%. **The 10-year Treasury, which is currently priced at ~4.86% should remain in a range between 4.75%-5.00% through the end of the 4th quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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