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3Q23 Review - When Good News is Bad News

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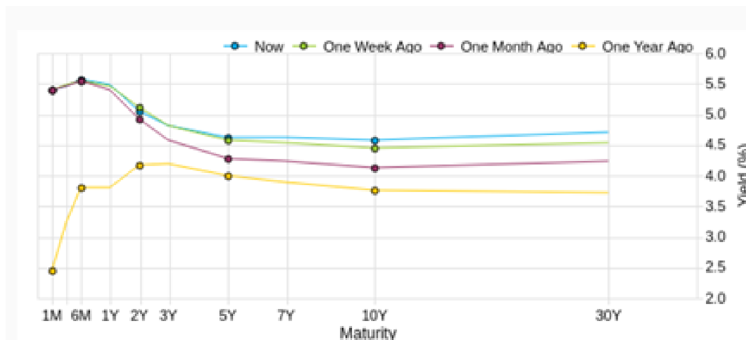
A year ago in August, Federal Reserve Chairman Jerome Powell gave his infamous "some pain might be required" speech that started the aggressive short-term interest rate hikes to help subdue inflation. The third quarter behaved eerily similar to last year's quarter, but now the "pain" might last longer than anticipated by investors. Being up in the month of July, the market then finished down for the quarter as investors digested that the good economic data points would likely help reinforce the Fed's resolve to keep interest rates higher for longer. This is where the good news on the economy became bad news for those that anticipated that a weakening economy would result in the Fed cutting rates sooner than the committee has been consistently communicating for months. In the previous market review, there were three factors listed that could have a negative impact to the current bull market, and the first factor was the investor's need to reconcile the Federal Reserve's message of "higher for longer" on interest rates instead of expecting a pivot by the Fed to reduce interest rates to help strengthen a slowing economy.

With each economic data release tipping the scale in favor of a stronger than expected economy, investors began to realize that the data wasn't supporting their narrative of the Fed cutting interest rates soon, and long-duration bond yields started to rise. (see Exhibit 1) As interest rates rose, bond prices dropped, and the stock market took a "risk off" approach and sold stocks into the end of the quarter. For the general stock market, the Morningstar U.S. market index was down 3.19% for the quarter but still up 12.81% for the year. The S&P 500 index was down 3.27% but up 13.07% for the same time periods. Though the year-to-date performance of the market appears strong, the actual results have been significantly influenced by a handful of large mega-cap technology companies that are big weights in benchmarks. When applying an equal weight to all of the constituents in the S&P 500 index, it is nearly flat year-to-date.

Exhibit 1. U.S. Government Yield Curve



Source: Factset

Exhibit 2. Investment-Style Returns

	Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021	2022	2023 1st Qtr.	2023 2nd Qtr.	2023 3rd Qtr.	2023 ytd
Growth	U.S. Growth	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	14.79%	11.64%	-5.92%	20.56%
Growth	Large Growth	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	17.56%	12.80%	-4.04%	27.25%
Growth	Mid Growth	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	9.71%	6.48%	-6.42%	9.32%
Growth	Small Growth	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	10.20%	7.34%	-6.46%	10.65%
	US Market	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	7.40%	8.49%	-3.19%	12.81%
Value	U.S. Value	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	0.18%	3.86%	-1.91%	2.06%
Value	Large Value	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	0.72%	4.06%	-1.22%	3.53%
Value	Mid Value	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	-1.28%	2.50%	-3.92%	-2.78%
Value	Small Value	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	-1.40%	4.01%	-3.18%	-0.70%

Source: Morningstar

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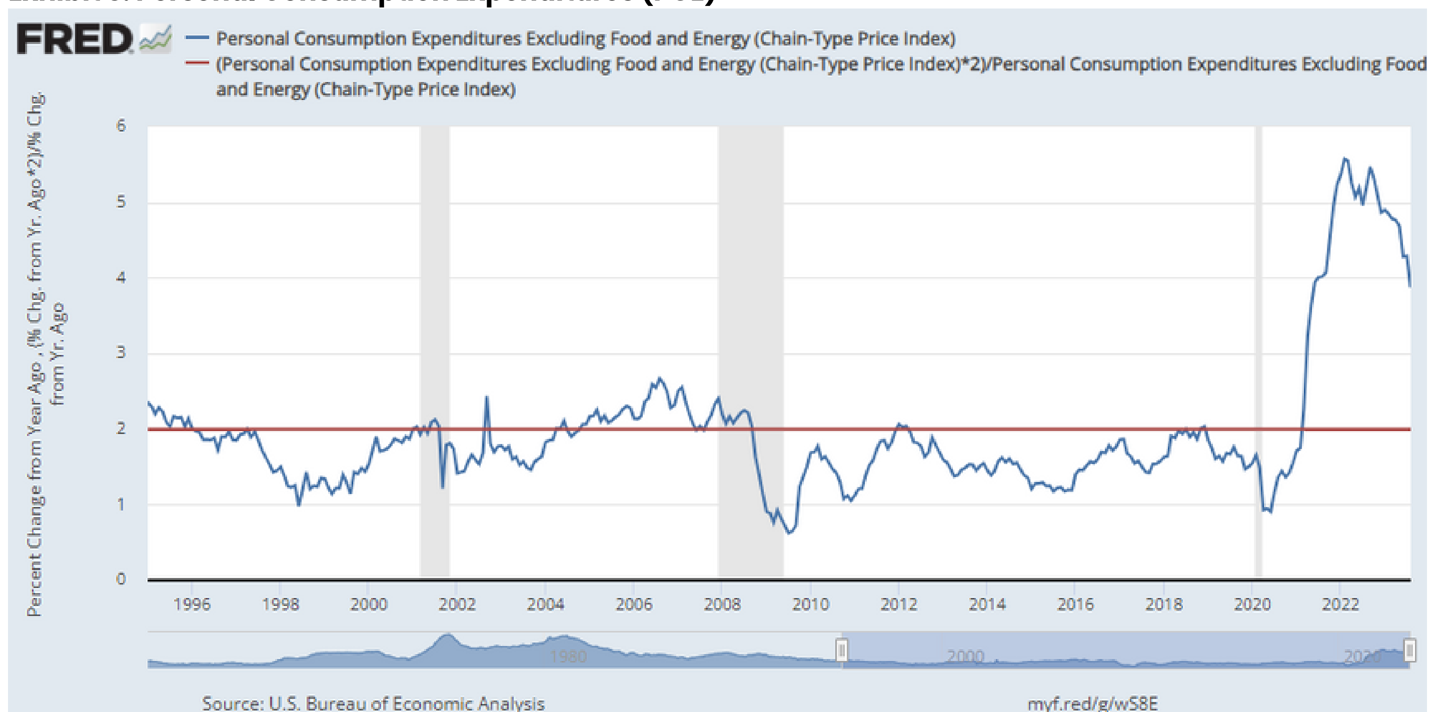
Growth stocks underperformed value stocks during the quarter but continue to outperform value year-to-date. As mentioned above, most of the outperformance year-to-date of growth relative to value has been the overweight of the technology sector in the growth benchmarks. Additionally, as with any data analysis, understanding the context of the starting and ending dates can always influence conclusions, and in this case, growth stocks were starting from a significantly oversold position at the beginning of the year with the group's relative underperformance versus value stocks in 2022.

Market outlook: During this past June, the market reached a level at which a bull market was officially declared. As stated in last quarter's market review, just because the market was now officially in a bull market, it didn't mean that the market returns would be linear in an upward direction. The market will likely continue to experience some volatility for the remainder of this year, particularly in October. Nonetheless, with the acceptance by investors of the Fed's "higher for longer" stance on short-term interest rates, it has priced out some of the risk to the market.

As the market capitulates to what the Federal Reserve has been communicating for months, there is a high likelihood that data forthcoming in the next several months will influence the Federal Reserve to cut short-term rates much faster than currently expected by investors. As of the last Federal Reserve meeting, the members expect to cut the Fed funds rate 50 basis points in 2024. This is only an estimate by the FOMC members; nonetheless, there is a compelling reason to believe that rates will need to be cut at a more aggressive rate, sooner than later.

While this expectation isn't necessarily based on a coming weakness in the economy or labor markets, it is based upon the distinct possibility of inflation which has transitioned to disinflation (a reduction in the rate of inflation) and its potential of evolving into deflation (when prices become negative year-over-year). Deflation is a rare event and isn't considered a great thing for an economy. The chart below is the Fed's preferred benchmark for measuring inflation, the core Personal Consumption Expenditures (PCE) excluding food and energy. The bold horizontal line in the graph is the Federal Reserve's inflation goal of 2%.

Exhibit 3: Personal Consumption Expenditures (PCE)



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For nearly 12 years after the Great Financial Crisis of 2008, the central banks grappled with trying to get inflation back to its preferred level of 2% by embarking on an aggressive monetary policy of quantitative easing and zero interest rates to spur economies and inflation to self-sustaining levels instead of the grossly subsidized efforts of the central banks. The shutdown of the world economy via COVID restrictions wreaked havoc on supply chains, which for the most part have normalized. While labor costs continue to capture the headlines, more companies are discussing on investors' calls that they are seeing minimal impact from inflation on their costs outside of labor. But there is an elephant in the room that will likely help keep driving inflation lower and it isn't higher short-term interest rates; it is what is going on in the second largest economy in the world, China.

For decades, China was the preferred destination to outsource manufacturing because of inexpensive labor. Companies were willing to give away their intellectual property to harness this labor pool and large consumer market. But over the past decade, government officials have utilized food commodities, tariffs, and export bans of high-end technology to China to discourage capital flows. Nonetheless, it was the COVID shutdown that was the final nail in the coffin, as companies throughout the world were held hostage by their supply chain. This accelerated the movement of nearshoring, friendshoring, and onshoring manufacturing to prevent future trade disruptions. This has a powerful impact on the lifeblood of every economy: the flow of capital, crude oil, and copper.

It is well-known that world governments are incentivizing local investment to bring manufacturing back to local markets to best insulate against future disruptions to key supply chains. After decades of building out its manufacturing capacity, China is left with excess capacity that its citizens cannot support through consumerism. While income per capita has increased significantly in China, it isn't to the level that it can offset the decrease in external demand. That external demand will continue to decrease as manufacturing comes online throughout the world and will be a glacier-like change. China won't go quietly, but it will export excess goods and products throughout the world at any price and risk spreading deflation for survival. While most of the economic data coming out of China is often viewed suspiciously, the other two lifebloods (crude oil and copper) of an economy are shedding light as to the health of the world's economy.

Crude oil prices hit a low of $69 a barrel in mid-June and recently traded as high as $94 a barrel by the end of September before retreating to $82 in the first week of October. With the strength of the current U.S. economy, the price of crude isn't indicative that all is well throughout the world, particularly with how low the commercial inventories are currently for crude oil, and Russia and Saudi Arabia voluntarily cut their oil production by 1.3 million barrels of crude output per day. The key with crude oil demand is that the vast majority of the incremental world demand comes from the Chinese economy. Without a strong Chinese economy, crude prices will likely languish, with the exception of a weather-related rally that is typically short-lived. Copper prices are also indicating that something is amiss with the world's economy given the supply of copper above the surface is only 2.5 days' worth of world demand as of June, down from 3.5 to 4.0 days' supply at the end of the first quarter. However, copper prices are down for the year, even with the rampant growth coming from the data center and manufacturing demand in the United States. It would appear that currently the only resilient economy in the world is the United States.

Last year at this time, there was significant uncertainty in whether the economy was heading towards a hard, soft, or not landing. Even the Federal Reserve was projecting only a slight increase for 2023. Now it would appear that the US economy, as measured by the Real GDP (adjusted for inflation), will grow over 2%. The US economy and the consumer have held up much better than any expectations. Some of that can be attributed to the significant amount of cash savings in the economy.

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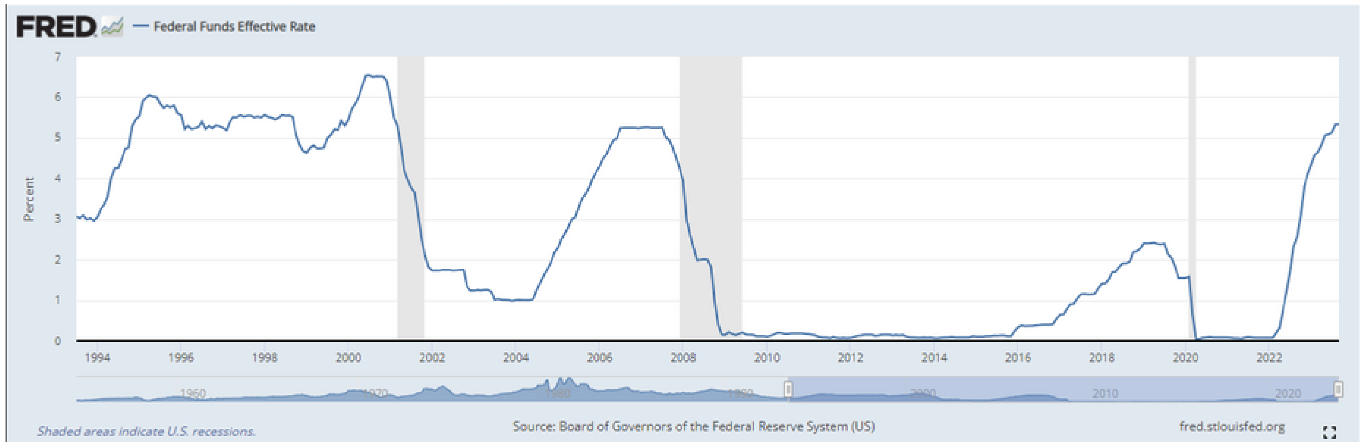
Exhibit 4: U.S. Fed Funds Rate



Nonetheless, Chairman Powell has commented in his press conferences that the Fed will act to cut interest rates before inflation hits the 2% goal. Given the above on how inflation is trending and that the interest rates don't stay long at their peak levels, the Fed will likely cut rates more aggressively than the current 50 basis points expectations in 2024. While it will be unlikely to return to a zero-interest rate policy, it could be plausible to see short-term rates during 2024 be lowered to 2.5% versus the current fed funds target range of 5.25 – 5.50% and a return of a more "normalized" yield curve that has longer duration interest rates staying at the 5% level.

October has a history of being an interesting month for the market, and all eyes will be on the Fed's November and December meetings to see if the Fed will do its last 25 basis points raise before reaching peak levels. After that, the market should broaden out and rally into the end of the year. Having a well-diversified portfolio in companies that have strong balance sheets and solid competitive positioning should benefit investors in this type of market.

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