Market Newsletter September 30, 2023

EXECUTIVE SUMMARY

- Stocks and bonds fell in the third quarter. For the year to date, the positive performance of large US stocks (S&P 500 Index) was helped considerably by stocks of technology companies. The median stock in the index is flat for the year.

- Despite a rapid increase in interest rates engineered by the Federal Reserve, the US economy remains relatively strong. The rise in interest rates is being partially offset by easier fiscal policy and strong balance sheets of households and corporations.

- An index of leading economic indicators is still signaling a recession in the next year. It is possible that the recession will be a mild one since the cyclical sectors of the economy are not elevated.

- US stocks are trading at a level marginally more expensive than their 25-year average. Non-US stocks are relatively cheaper.

- Diversification reduces risk without a commensurate reduction in returns. Historically, asset classes in a diversified portfolio have gone through periods of underperformance but have bounced back and helped over time.

Table 1: Market indices

(*Returns include dividends reinvested*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	-3.27%	13.07%	21.62%	10.15%	9.92%
S&P Mid Cap 400	-4.20%	4.27%	15.51%	12.05%	6.06%
S&P Small Cap 600	-4.93%	0.81%	10.08%	12.10%	3.21%
MSCI Emerging Markets	-2.79%	2.16%	12.17%	-1.34%	0.94%
MSCI EAFE	-4.05%	7.59%	26.31%	6.28%	4.03%
Vanguard Total Bond Market Index	-3.13%	-1.03%	0.59%	-5.32%	0.03%
Investment Grade Credit	-2.71%	0.44%	3.98%	-4.67%	1.07%
Non-Investment Grade Credit	0.53%	5.97%	10.19%	1.82%	2.80%
Bloomberg Commodity Index	4.71%	-3.44%	-1.30%	16.23%	6.13%
Dollar Index	3.17%	2.56%	-5.30%	4.18%	2.22%
10 Yr. Rate	4.57% 09/30/2023	3.88%% 12/31/2022	3.80% 09/30/2022	0.68% 09/30/2020	3.06% 09/30/2018

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 10/06/2023			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	336,000	Positive	The latest jobs number blew past estimates reflecting a very healthy employment situation. Prior numbers were revised significantly higher. Wage growth was lower than expected at 4.2% year over year, which eased fears of inflation. Unemployment rate held steady at 3.8%.
Weekly Claims for Unemployment Insurance	207,000	Positive	Initial claims for unemployment benefits increased marginally last month but it is still at a historically low level.
ISM Manufacturing Index (over 50 indicates growth)	49	Negative	The manufacturing index improved for the third straight month and is inching towards 50, raising hopes of a 'soft landing' of the economy.
ISM Non Manufacturing Index (Over 50 indicates growth)	53.6	Negative	The services sector continues to grow, although at a slower pace, as new orders fell to a nine month low. The continuing expansion of the services sector, which is a majority of the GDP, augurs well for economic growth.
Consumer Prices (Month over month change)	0.6%	Positive	In August, consumer prices rose at the fastest rate of the year. Year over year, prices increased 3.7%. However, excluding energy and food, consumer prices increased 4.3% from a year ago, a slower rate than before.

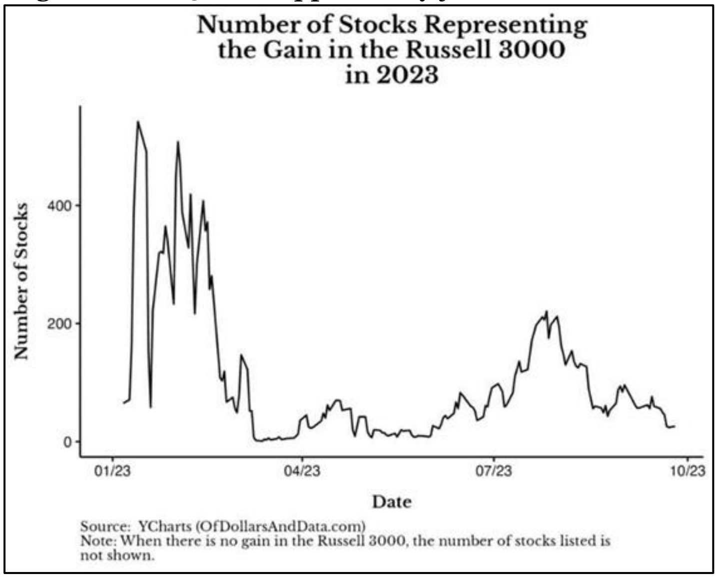
	Latest Release	Recent Trend	Notes
Producer Prices (Month over month change)	0.7%	Positive	Producer prices increased at the fastest rate in a year because of energy and transportation costs. However, the annual increase at 1.6% has decreased significantly from a year ago.
Retail Sales (Month over month change)	0.6%	Positive	Retail sales remained strong helped by gasoline prices. Excluding gasoline sales, retail spending increased 0.2%. Year over year, retail sales increased 2.5%. Consumer spending remains strong because of a healthy jobs market.
Consumer Confidence (Conference Board)	103	Negative	Consumer confidence fell for the second consecutive month in September. Consumers are expecting a recession in the near future.
Durable Goods Orders (Month over month change)	0.2%	Positive	Durable good orders surprised to the upside in August. Business investment increased by 0.9% indicating that companies are investing for the future which augurs well for the economy.
Industrial Production (Month over month change)	0.4%	Positive	Helped by oil drilling, industrial production rose better than expected in August. A surprising increase in manufacturing activity helped.
Capacity Utilization	79.7%	Positive	Capacity utilization was higher than expected and is close to its long term average.
Housing Starts	1.233 Million	Negative	Housing starts plunged to a three year low hurt by high mortgage rates.
Home Prices (Case-Shiller Home Price Index- Year over Year)	0.1%	Positive	Although home prices set a record in July, the annual increase has been falling throughout the year. Low supply and inventory are countering high mortgage rates.
GDP (Real, Annualized)	2.1%	Positive	GDP growth has proven surprisingly resilient in the face of increasing interest rates.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Global stocks gave up their early lead to end the quarter down. A rapid increase in interest rates was the reason for the decline in stocks as the 10-year US Treasury reached a level last seen in 2007. For the year to date, stocks are still in positive territory but there is a significant difference in their performance depending on size and geography. Large US stocks have outpaced smaller stocks and foreign stocks. The performance of large US stocks was helped considerably by stocks of technology companies such as Apple, Microsoft and Google. For example, while the S&P 500 index is up for the year, the median stock in the index is essentially flat for the year. Similarly, the Russell 3000, which is an index of the largest 3000 stocks has gained over 12% for the year, but the median stock in the index is down for the year. Fig 1 shows that a relatively small number of stocks has contributed to the index's performance.

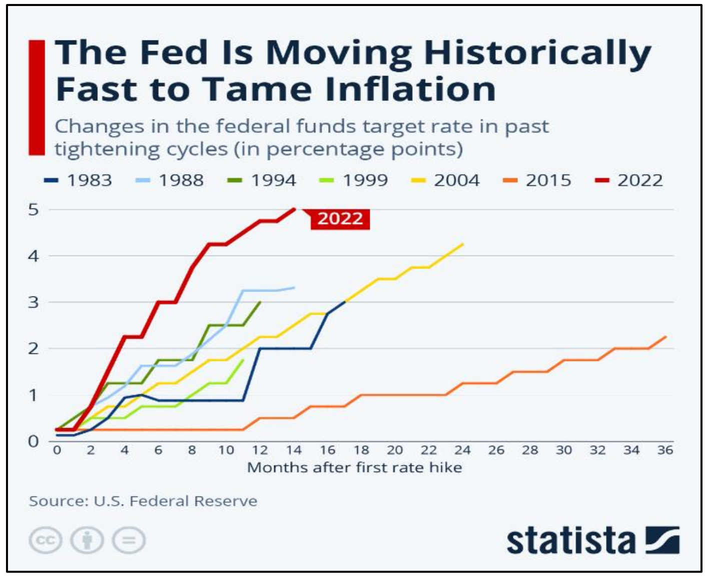
International stocks got off to a great start at the beginning of the year but have since moderated along with a rise of the US dollar against foreign currencies (As the dollar strengthens, the value of international stocks measured in US dollars decreases). While they are underperforming year to date, stocks of companies in developed markets as measured by the MSCI EAFE index are outperforming US stocks over the last 1 year.

Fig 1: Russell 3000 supported by just a few stocks.



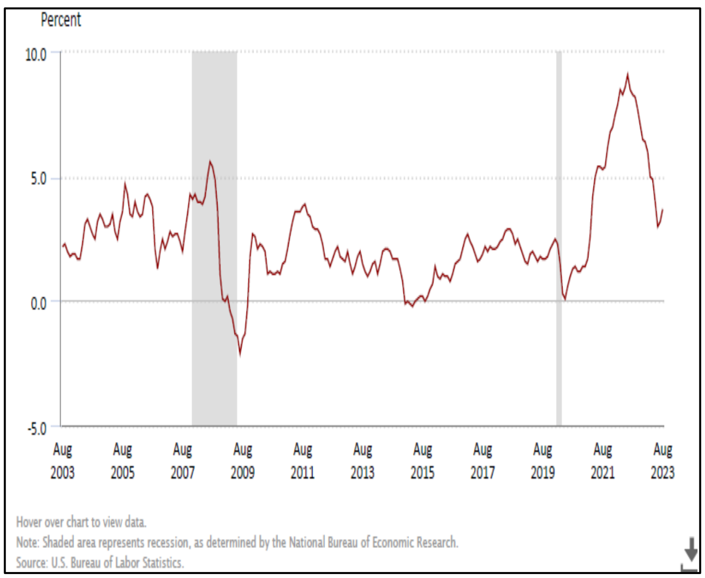
Source: OfDollarandData.com

Fig 2: The Fed has hiked interest rates at the fastest rate.



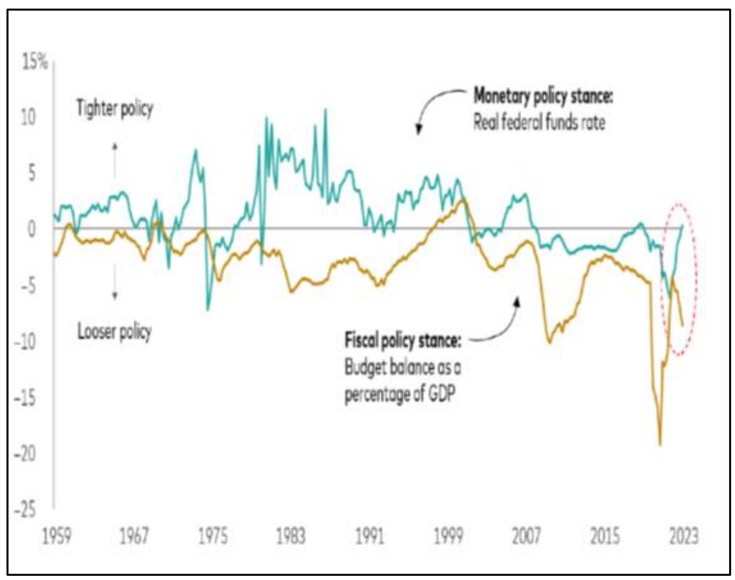
Source: Statista

Fig 3: Consumer Price Index has declined.



Source: Bureau of Labor Statistics

Fig 4: Fiscal policy has partially offset monetary policy.

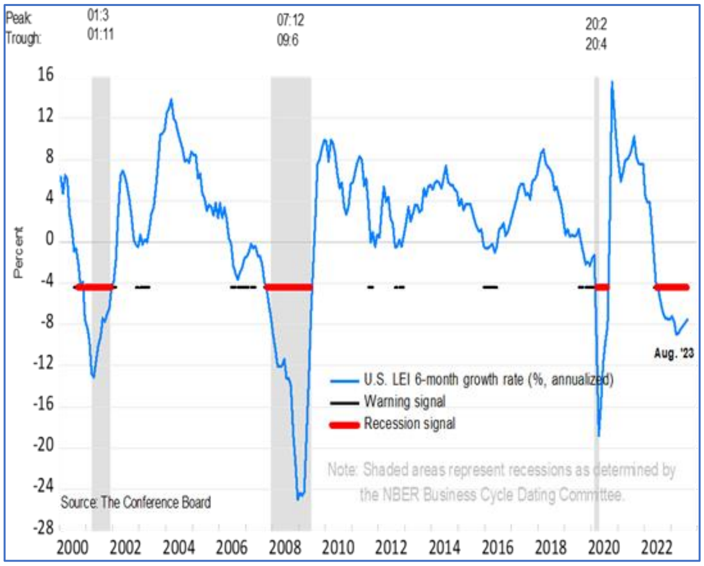


Source: JP Morgan

The US economy continues to surprise to the upside, baffling economists who had earlier predicted a recession by now but have since revised down their expectation for a recession and postponed its timing. The US Federal Reserve (The Fed) has raised interest rates at the fastest pace ever (Fig 2). Historically, a rapid increase in interest rates has led to a crisis, leading to a recession. When a few Silicon Valley banks failed earlier in the year, economist expected that a recession would follow. However, apart from a rapid response by the US Treasury and the Fed to stave off any contagion from the bank failures, an increase in rates has been partially offset by a loser fiscal policy (Such as spending on infrastructure, energy, and semiconductors. See Fig 4).

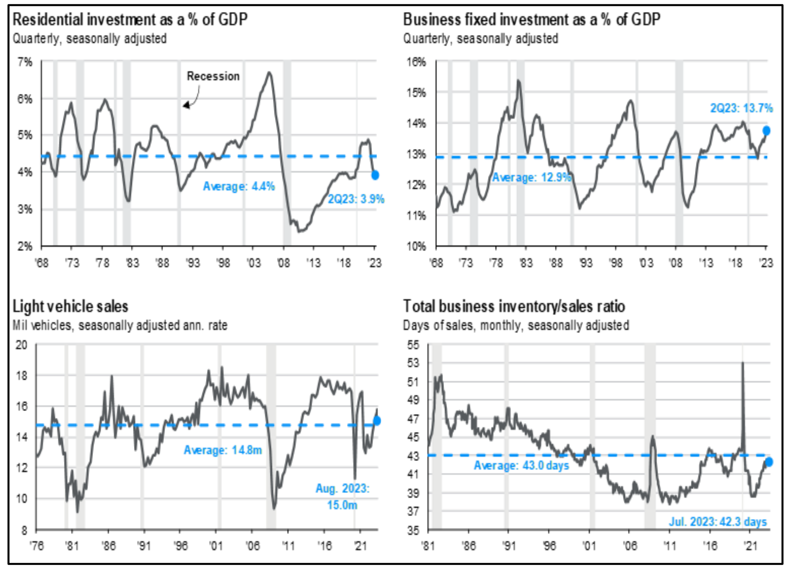
Other factors helping offset any harm from the rise in interest rates: Strong corporate and household balance sheets helped by low interest rates on loans that were locked in recently and a resilient/strong labor market.

Fig 5: Leading economic indicator



Source: Conference Board

Fig 6: Cyclical sectors of the economy are not elevated.



Source: JP Morgan

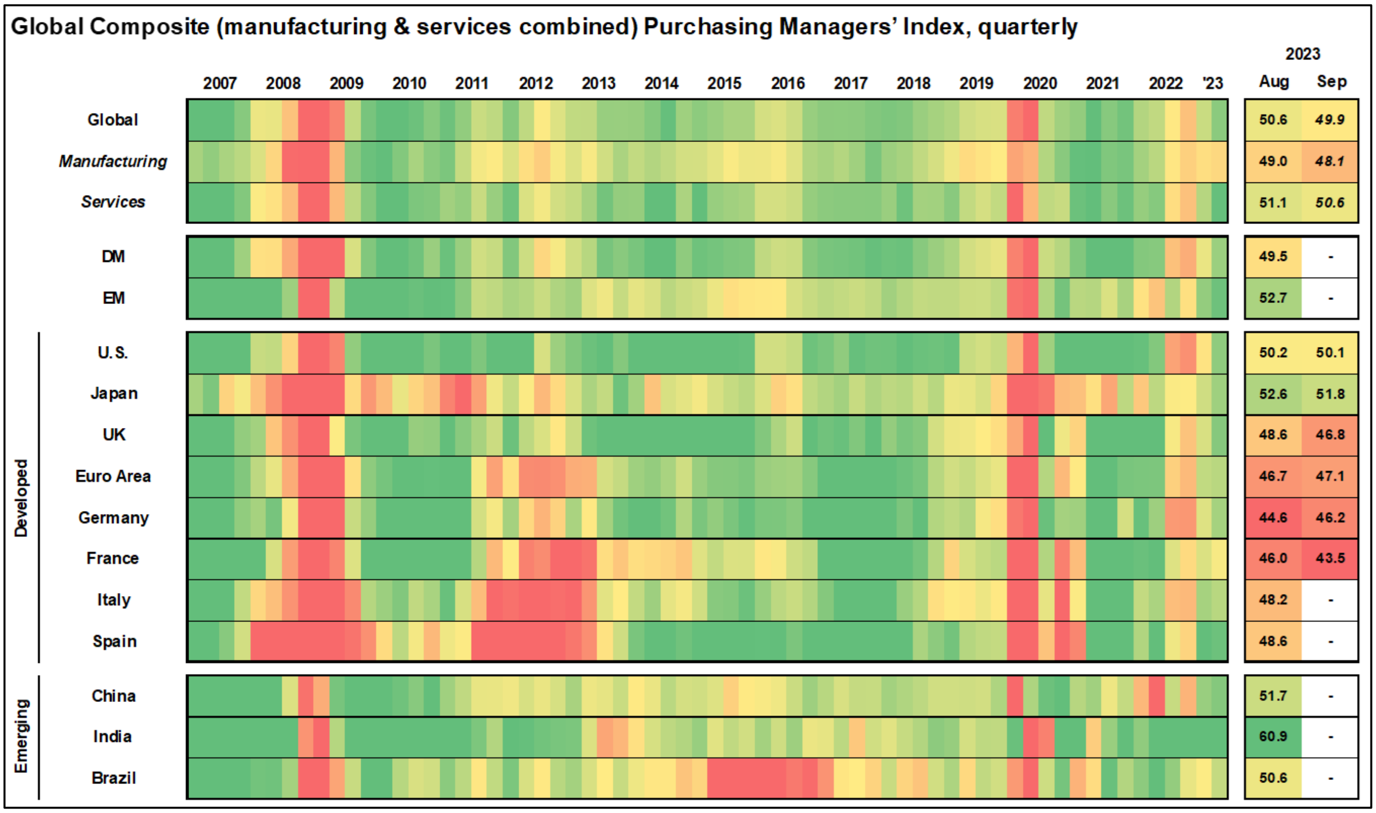
Inflationary pressures have continued to fall as seen in figure 3. The latest year-over-year increase in the CPI (Consumer Price Index) was 3.7%, a steep drop from the 9.1% reached last year. Another measure of inflation that the Fed prefers because it includes a comprehensive range of goods and services, the PCE Index, fell to 3%. The Fed would like to see the PCE index drop to 2% and said that it expects to keep interest rates higher for longer. However, it will be challenging for inflation to further decline from current levels, making the Fed's job difficult.

An index of leading economic indicators (By the conference board) has perked up recently reflecting the economic conditions, however, it is still flashing a warning of a recession in the next year (Fig 5). It is possible that if a recession were to follow in the next year, it would be a shallow one, since the cyclical sectors of the economy such as business fixed investments and residential investment are not at a historically high level as they usually are before a deep recession. (Fig 6)

Economies outside the United States are similarly facing recessionary fears caused by high inflation and interest rates. The ISM manufacturing and non-manufacturing indices are indicating contraction in most countries with a few exceptions like India and Japan as seen in Fig 7

US companies will start reporting third quarter earnings shortly. Analysts expected the operating earnings of the companies in the S&P 500 to collectively earn $55.27 in the third quarter and $220.6 for the full year 2023 according to S&P Capital IQ. Based on the expected earnings estimate for the next 12 months, the S&P 500 is currently trading at a Price Earnings multiple of 18, which is marginally higher than its 25-year average. In comparison, foreign stocks are trading at valuations below their 25-year average and a steeper discount to US stocks than usual.

Fig 7: Purchasing Manager's Index in various countries around the world.



Source: JP Morgan

Diversification takes time to benefit.

Diversification is primarily a risk management tool and is often called the only free lunch in the investment world. This is because it reduces the risk of a portfolio of investments without a commensurate reduction in expected returns. A diversified portfolio gives investors the confidence to tolerate the volatility of the portfolio so that they can benefit by staying invested over time, even if it comes at a cost of lower returns as compared to any specific market index. However, when the performance of the market is driven by a small number of stocks, as we are seeing now, a diversified portfolio tends to underperform the market more than usual and investors may lose faith in it. Historically, when this has happened, the performance gap has been narrowed after the markets normalized. One extreme example of this is what happened at the end of the 1990's and early 2000's during the so called "internet bubble" (Please note past performance is in no way indicative of future returns and history may illustrate what can happen but in no way tells you what will happen)

As seen in Fig 8, between 1995 and 1999, technology stocks (represented by the Nasdaq index) significantly outperformed every other asset class and took the S&P 500 to lofty heights. A diversified portfolio of various asset classes would have significantly underperformed the S&P 500 during this period. Subsequently, technology stocks experienced a painful drop and brought down the US stock markets with it. Between 2000 and 2007, other asset classes such as small cap stocks, foreign stocks and even bonds significantly outperformed US stocks. An investor who held various asset classes for the entire period 1995 to 2007 would have experienced short term underperformance but have done well the entire period. You can also see that holding cash may seem like a safe choice in the short term, but it tends to underperform significantly over the long term.

Fig 8: Asset Class Returns 1995 to 2007

For Newsletter			
	1995-1999	2000-2007	1995-2007
NASDAQ	40.20%	-5.20%	10.20%
S&P	28.60%	1.70%	11.30%
Small Stocks (1)	20.10%	11.70%	14.90%
Foreign Developed Stocks (2)	13.40%	6.10%	8.80%
Foreign Emerging Stocks (3)	2.00%	15.30%	10.00%
Bonds (4)	7.70%	6.50%	7.00%
Cash (5)	5.10%	3.20%	4.00%
1: Dimensional US Small Cap Index			
2: MSCI World Ex USA Index			
3: MSCI Emerging Market Index			
4: Bloomberg US Aggrgate Bond Index			
One Month US Treasury Bill			

Source: Dimensional Fund Advisor