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Investment Committee Perspective

Third Quarter 2023

Our Investment Committee meets quarterly to evaluate asset class performance, analyze macroeconomic data and trends, and review asset class valuations and risks to refine our market outlook and tactical portfolio positioning. This quarterly investment committee perspective summarizes the topics discussed during those investment committee meetings and provides guidance on our outlook and corresponding tactical investment strategy.

Third Quarter in Review

In the third quarter of 2023, both fixed income and equity markets contracted, with declines of -3.6% and -3.4%, respectively. The S&P 500, which reached a peak in July, fell -6.3% by September, mirroring the pullback faced earlier in the year during the regional banking crises of February and March. As we navigate these fluctuations, the Federal Reserve's continued interest rate hikes through the summer—designed to temper inflation—are contributing to a prevailing sense of economic uncertainty. As noted in our previous letters, the full implications of these rate increases are yet to be fully realized, given their delayed impact on the economy—a factor that remains a key consideration in our economic and tactical market outlook.

During the quarter, the 10-year Treasury yield surged by 80 basis points, from 3.8% to 4.6%, exerting downward pressure on fixed income returns and equity valuations. As interest rates move higher, fixed income yields begin to compete with yields/returns offered by the equity market, prompting a recalibration of investor expectations.

Despite these challenges, September's year-over-year inflation rate decreased to 3.7%, a notable reduction from 9.1% in 2022. During the September FOMC meeting, The Fed paused its rate hikes, indicating confidence in curbing inflation, which had been intensified by pandemic-induced supply chain disruptions, substantial government stimulus, and a notable shift in consumer spending habits. This pause is not just a procedural step but a deliberate expression of belief that the enacted policies are effectively addressing the inflationary pressures.

Nevertheless, with inflation lingering at 3.7%—considerably above the Federal Reserve's target of 2.0%—an imminent reduction in interest rates remains unlikely. The Fed's current stance is informed by historical caution, with a firm resolve to avoid the missteps of the 1970s that precipitated a secondary inflationary spike and led to a severe recession through accelerated rate hikes. Additionally, the robustness of the labor market, evidenced by a still-low unemployment rate of 3.8%, provides the Federal Reserve with the leeway to maintain a 'higher for longer' interest rate policy.

Although earlier projections suggested a recession might loom in 2024, the swift and steep ascent in interest rates has reinforced recessionary concerns. Several indicators underscore this outlook: the pace of the current interest rate tightening cycle is among the most aggressive in history, and lending standards have become significantly stricter. History offers a cautionary tale; out of the 19 interest rate hiking cycles since 1931, only three have managed to sidestep a recession. These conditions, alongside the Federal Reserve's delicate balancing act of rate increments, pose a tangible risk of an economic downturn.

In summary, despite a robust labor market and the continued downward trajectory of inflation, the third quarter saw financial markets retreat from the initial exuberance fueled by AI advancements. However, the slight easing of inflation, although promising, does not signal an immediate shift to calmer seas, keeping the economy on alert. Heading into year-end, both caution and a keen eye over the horizon will serve equally well as resilience and patience will ultimately be rewarded while the undertow of a potential recession continues to weigh on the collective minds of the market. We will discuss our full economic and tactical market outlook later in this letter.

Recent U.S. Equity Market Performance and Concentration

Financial journalists often bestow catchy nicknames upon the largest players in the U.S. stock market, usually doing so in recognition of their recent exceptional success and widespread popularity. In the 1970s, the "Nifty Fifty" referred to the largest blue-chip growth stocks. In the late 1990s, the "Dot-Com Bubble" emerged with the exuberance and eventual crash of internet-related growth stocks. Post-2008, tech companies earned the "FAANG" nickname. Today, we have the "Magnificent Seven," including Apple, Microsoft, Google (Alphabet), Amazon, Facebook, Tesla, and Nvidia.

Investors are drawn to these companies for their disruptive business models and growth. They often represent the vanguard of innovation, driving advancements across various industries and capturing substantial market share. Their rapid growth and impressive financial performance are compelling factors that attract investors seeking opportunities for substantial returns. Despite this belief, the emergence of financial nicknames often signals a point at which stock market enthusiasm may be reaching unsustainable levels, which tends to lead to subsequent long-term underperformance for the recent winners. The pattern includes rising price-to-earnings (P/E) ratios, driven by recency bias, as investors overestimate recent winners.

In our 30+ years of managing money, we've witnessed these nicknamed stocks enter challenging environments and the wild swings of volatility that accompany periods of heightened enthusiasm. The emotional rollercoaster of watching investments soar to new heights only to plummet back down can be gut-wrenching. While the allure of concentrated positions during moments of apparent success can be strong, the risk of capitulation when markets turn is a real and costly danger.

The "Magnificent Seven" stocks recently experienced these extremes, with an +84% gain this year accruing on the back of a -45% drop in 2022. Such extreme volatility is a test of nerves that very few investors, let alone financial professionals, are equipped to handle. Moreover, it highlights the substantial behavioral risks and challenges associated with attempting to capitalize on these extraordinary market episodes.

Driving investor behavior during these periods is Fear (of missing out, "FOMO") and Fear (as a financial impulse). FOMO drives investors to chase overvalued hot stocks (think: GameStop), while fear can lead to panic selling during downturns. One organization that has statistically measured the detrimental impact of these emotions is Dalbar. In the *2023 Dalbar Quantitative Analysis of Investor Behavior (QAIB)* study, they quantify while the S&P 500 has produced a 9.7% annualized total return in the 30-year period through 2022, the *average* equity investor has only managed a 6.8% return over the same period. The reason for this 3% annualized underperformance is what's known as the "behavior gap" and is largely driven by FOMO and fear as a financial impulse. Both have shaped investor sentiment over the past two years and have highlighted the tendency for investors to feel an urge that is contrary to the investment adage: "buy low and sell high". Unfortunately, investors, during periods of exuberance or market panic, tend to do the exact opposite: "buy high and sell low".

In 2021, our Investment Committee lowered exposure to U.S. growth stocks due to high valuations. In 2022, these stocks fell -45%, benefiting the relative performance of client portfolios. This year, P/E expansion sparked a significant rebound, which isn't a sustainable trend. Our client portfolios include value stocks, small-caps, and international stocks trading at discounts, offering long-term growth potential and risk mitigation.

A globally diversified approach naturally differs from the performance of just the U.S. large cap stock market. Despite not being positioned to ride the full crest of a market surge, our client portfolios have shown resilience and growth, appreciating by high-single to low-double digits over the past twelve months, reflective of the varying investment strategies and risk allocations tailored to each client. This growth, achieved within the broader context of economic ebb and flow, underscores the value of a balanced approach to charting a course through the ever-changing financial seas.

The key responsibility of our fiduciary investment committee is to allocate monies toward asset classes in combinations that have historically been proven to deliver targeted rates of return at acceptable levels of risk and drawdown potential. This is accomplished through studying historical returns, analyzing correlations across asset classes, and statistically determining the combinations necessary to achieve each targeted rate of return. In contrast, the job of speculators and traders is to chase the latest trends, make wagers on price action, and attempt to play the stock market casino. We prefer the former. Speculation isn't our focus as stewards of long-term capital.

Economic and Tactical Market Outlook

The key question, like last quarter, is whether we'll experience an economic soft or hard landing, and the timing. We've seen a rapid tightening cycle and stricter lending standards, factors that can lead to recession, especially if the Fed raises rates excessively. In the past 90 years, there were 19 rate hikes, and only three didn't result in a recession. A soft landing would diversify market gains beyond technology sectors, while a hard landing could cause broader market declines.

Economic Considerations:

- With the Fed focused on inflation and high interest rates, a recession in the next year seems likely. Indicators like the steeply inverted yield curve and the declining Leading Economic Index for 18 months suggest challenging growth.
- The Fed may cut rates after seeing labor market slowdown, but overall, labor conditions remain tight with low unemployment, which could extend high interest rates due to wage growth and inflationary pressures.
- While we anticipate a recession, it's likely to be mild. The economy has experienced "rolling recessions" across industries, which dampens the impact compared to simultaneous industry-wide slowdowns.
- Interestingly, because a recession has been long anticipated, it could be less severe. Some companies, especially tech firms in 2022, have already laid off workers and slowed hiring, easing inflationary pressures.

Tactical Asset Allocation Considerations:

- Rising interest rates have challenged fixed income returns. To counter this, we added **Private Debt** to portfolios. These investments, up 9.2% year-to-date, don't suffer when interest rates rise, unlike traditional fixed income.
- Fixed income's outlook is turning positive, with 5%+ yields, not seen in two decades. When the Fed stops raising rates, fixed income returns should stabilize and start delivering 5-7% returns without the offsetting negative impact of rising rates.
- International equities, small-caps, and value stocks offer attractive valuations compared to their U.S., large-cap, and growth counterparts. Shifting away from growth stocks in 2022 was successful, and we're confident in the positioning of client equity exposures and potential for sustainable long-term growth.

Conclusion and Updates

Looking ahead: a mild recession remains our base-case scenario for 2024. The timing and scale of the Fed's response to economic data are pivotal. Currently, the Fed signals 50 basis points of rate cuts in 2024, but more significant cuts are possible. While a successful soft landing is plausible, uncertainty abounds, which invariably leads to bouts of volatility. We emphasize that a well-diversified portfolio remains crucial for resilience, helping navigate market extremes.

To reduce concentration risk in the U.S. stock market, we plan to introduce **Private Equity** to client portfolios in the coming quarters. More details will be shared in upcoming client meetings and Investment Committee Perspective letters.

If you haven't reviewed and signed your updated Investment Policy Statement, we recommend discussing these enhancements with your Investment Adviser to assess their suitability for your financial situation.

We value your trust and welcome your questions and concerns. Regular communication is crucial to meeting your investment and financial planning goals. Thank you for your continued confidence.

Cordially,
Causey Demgen & Moore Investment Committee
Robb Stone, Nathanael Koch, Stephen Warren, Paul Demgen, John Connell