Investment and Economic Update
Third Quarter 2023

The Congressional leadership returned to some semblance of sanity and finally passed a bill to keep the U.S. government funded for another few weeks, and the markets breathed a sigh of relief. But the third quarter was filled with drama, moderate losses and a lot of day-to-day volatility. We are experiencing the part of the investment roller-coaster that tests the stomachs of investors and tempts people to jump off at the wrong time.

The market losses in the first three months of the year were spread fairly evenly across all sectors, but due to gains early in the quarter, these were relatively modest, and most sectors are still up by healthy margins so far into the year.

Looking at large cap stocks, the widely quoted S&P 500 index of large company stocks has gained 11.68% since January 1. Meanwhile, the Russell Midcap Index is down 5.80% for the year. As measured by the Russell 2000 Small-Cap Index, investors are clinging to a 1.31% gain over the past three quarters. The technology-heavy Nasdaq Composite Index lost 4.12% in the third quarter but is up 26.30% so far this year.

Foreign markets moved in lockstep with the U.S. but lacked the early-year gains and thus are not as generous when looked at on a year-to-date basis. The broad-based EAFE index of companies in developed foreign economies was down 4.71% in the third quarter, but still shows a 4.49% gain for 2023. Emerging market stocks of less developed countries, as represented by the EAFE EM index, lost 1.29% in dollar terms in the third quarter, and are down 0.51% so far this year.

Bond rates continue their upward trend. 30-year U.S. government bonds are yielding 4.87%; 10-year bonds are yielding 4.74% while, interestingly, 2-year Treasuries are more generous at 5.12%, one-year government bonds are yielding 5.50% and 6-month securities are now yielding 5.58%. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it is called a yield curve inversion. Rarely will you see one as dramatic or long-lasting as this.

Due to the upward pressure on rates across the maturity spectrum, we reduced our exposure to the BlackRock Systematic Multi-Strategy Fund (BIMBX) and the First Trust Low Duration Opportunities fund (LMBS). We used the proceeds from the BIMBX and LMBS trades to increase our exposure to the Guggenheim Total Return Bond Fund (GIBIX). By increasing our exposure to GIBIX, we were able to add additional yield to our fixed income holdings. Overall, we continue to maintain a low weighted duration which should limit interest rate risk if interest rates continue to rise.

Municipal bonds look a bit more orderly at the moment but there is still inversion going on; 30-year and 10-year munis, on average, are yielding 4.47% and 3.49% respectively, but the inversion can be seen in 2-year (3.69 and 1-year (3.77%).

Whenever the markets start to show anything other than steady gains, the financial press rushes in to try to explain it and they usually start with logic and statistics when the obvious dynamic is mass psychology. Many quick-twitch traders think that we are plunging toward a recession, which may happen, but the numbers suggest that they're pulling the trigger too soon. This is actually normal; markets tend to experience downturns before a recession and recover during it.

The traders can point to the yield curve inversion as evidence for an economic decline, but of course we have had that signal flashing for more than a year and every quarter we see roughly average GDP gains. The inflation rate is higher than the Fed economists would prefer, and some predict that the Fed will decree another rate increase. But inflation is clearly moderating as the manufacturing sector finally works through the last of the supply mismatches triggered by the Covid pandemic. Unemployment remains low; more people are working, and their wages are trending up. Those are not signals of a weak or faltering economy. There are undoubtedly signs of weakness in the commercial real estate sector, where many companies have embraced remote work, and are questioning whether they really need to rent or lease office space that is largely no longer occupied. But those leases are gradually unwinding, and nobody expects to see significant unwinding until sometime in the middle of next year.

A recent poll of economists, who are the most sober readers of economic statistics, found that 55% of them expect a mild recession next year and that's the lowest reading in a year. For the moment, the quick-twitch traders seem to have the upper hand in dictating stock prices and returns, but their method of playing the market seldom wins in the end.

Below, we've summarized some of the widely quoted indexes for your reference. As a reminder the challenge is, the DJIA is not the same as the S&P 500, which is not the same as the NASDAQ – and none of these indexes perfectly match your own distinct mix of assets and their expected returns, especially if you own a globally diversified portfolio with exposure to stocks and bonds, large and small companies, value and growth companies, and U.S. and non-U.S. based companies. The following returns are quarter, year-to-date and the rolling 1-year; respectively:

S&P 500: -3.65%, 11.68%, 19.59%
Dow Jones: -2.62%, 1.09%, 16.65%
NASDAQ Composite: -4.12%, 26.30%, 25.00%
Russell 2000 (Small-Cap): -5.53%, 1.31%, 7.18%
MSCI EAFE (International): -4.71%, 4.49%, 22.26%
Barclay's Capital US Aggregate Bond: -3.23%, -1.21%, 0.64%