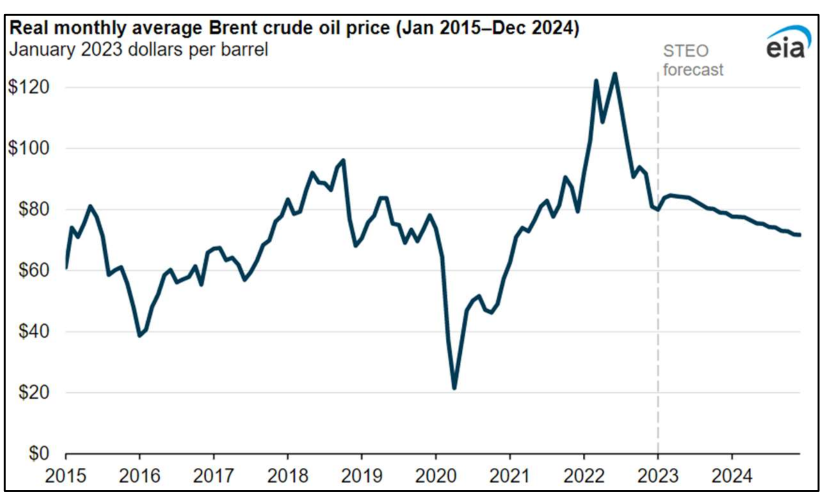
Financial Markets Perspective

October 2023

Is It Darker Just Before Dawn?

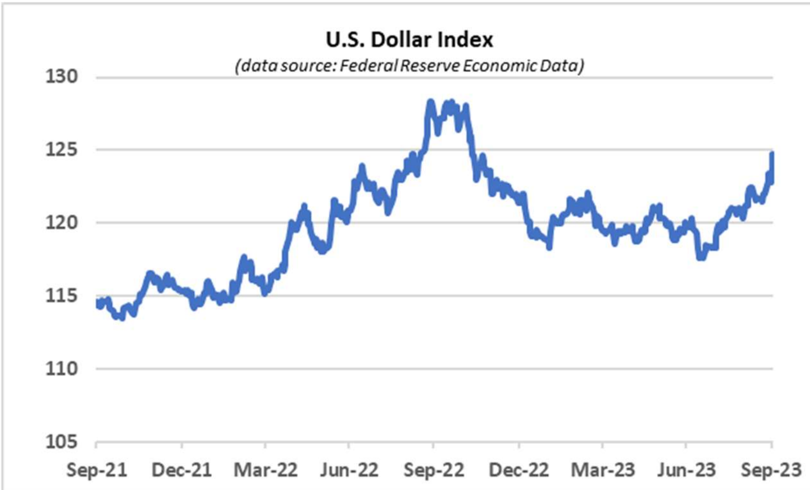
At the turn of the year, the outlook for the economy and financial markets seemed to be brightening. The prospect of a recession had faded, inflation was declining, and monitors of Fed policy were suggesting that the era of rising interest rates was almost over with one or two ¼ point increases in the Fed funds rate. Even though the Fed was committed to slowing the economy by raising the cost of money, there seemed to be a big-picture effect of this policy. For example, economic growth continued to expand, and unemployment remained surprisingly low at 3.8%. If employment continues to expand, there is little chance that an economic downturn is around the corner. Offsetting tight monetary policy was a fiscal policy of record government spending and a rising federal deficit. Such spending keeps the economy on a growth path. While the costs of borrowing were rising, the elderly benefited from an outsized increase in Social Security payments of 8.7% as well as sharply higher interest rates on many forms of savings accounts and money market funds. In essence, the Fed's policy was transferring wealth from borrowers to savers. State governments were still flush with tax revenues derived from the pandemic spending and federal distributions to states were not fully spent and being considered for other uses since the pandemic's effects were diminishing. In essence, the U.S. economy continued to recover from the epidemic.

After a strong July in both domestic and foreign equities, August saw equity declines across the globe. September was not any kinder, with declines in domestic equities of all market capitalizations. Foreign stocks also experienced declines in September, bringing third-quarter returns into negative territory. One culprit contributing to negative returns for the past two months is the surging price of oil from $67.90 at the end of June to $93.58 by the end of September -- a 38% increase! This sudden change is reflected in the chart below. A shortage in supply coupled with a reduction in output by OPEC were responsible for the sudden surge. Since oil affects all output, history tells us that the rise will add to costs across the board and push inflation higher.



The Value of the Dollar

Since the U.S. dollar is the world's reserve currency, changes in its value relative to other currencies can have consequences. Our recent experience is that a strong dollar negatively affects the equity markets, and a weak dollar makes U.S. financial markets better. When the dollar strengthens, multinational companies suffer as they must adjust their foreign earnings lower due to currency translation from a weaker currency. On the other hand, when the dollar weakens, foreign earnings are marked up and contribute to better corporate earnings reports. The problem is when the dollar becomes volatile, financial markets react negatively to such gyrations. Since the dollar began to rally in July, as reflected in the following exhibit, the stock market has been weaker.



Interest Rates

A third concern is the unexpected rise in interest rates during the third quarter as reflected in the chart below.

In September, even though the Fed appeared to be taking a wait-and-see approach, long-term yields began to rise—probably due to the expectation that the economy will be stronger, not weaker as we move toward the end of the year. Investors who parked some money on the sidelines are looking for the opportunity to extend maturities in their bond holdings as yields have continued to move higher. Higher yields mean that bonds become more attractive relative to stocks and money is likely to migrate to bonds from stocks at some point over the next few months. The conservative investor is likely to keep his investments in short-term securities such as money market funds where yields have eclipsed 5%. Short-term CDs sport a yield of above 6%!

The problem is that the Federal Reserve is committed to raising interest rates to slow the economy because it believes that inflation can be brought down by slowing the economy. If the economy continues to grow faster than anticipated and the runup in oil prices pushes inflation higher, then the Fed will keep raising interest rates.

Corporate Profits

The S&P 500 earnings are a good proxy for overall corporate profitability. Over the past year, those earnings have been in the doldrums with two out of four quarters showing profit declines. However, the good news is that forecasts are indicating good times ahead. Third-quarter corporate profits are expected to rise by 1.3% and are expected to be followed by a surge to 10.8% in the fourth quarter, 9.1% in the first quarter of 2024 followed by two quarters of 12.4% and 13.3% gains, respectively. These strong fundamental factors suggest that recession fears can be relegated to the distant future and stocks should begin to reflect this rosy outlook well into 2024.

Domestic Financial Markets

While the stock market is a market of stocks, never in our opinion has there been such divergence among different stock indices as has occurred this year. The bull market that some market observers say has been concentrated in the technology and energy sectors has lifted overall indices higher. However, many other sectors are barely positive, and some have declined so far this year such as consumer staples and healthcare. Below is an example of the disparate returns among stock indices through the end of September. An important characteristic of these returns is that the wide disparity among these indices for the year-to-date is almost offset by the annual performance that occurred over the past five years.

Index	Q3	5 Year
Dow Jones Industrial Average	-2.10%	7.14%
S&P 500	-3.27%	9.92%
NASDAQ Composite	-3.94%	11.41%
Russell 2000	-5.13%	2.40%
Russell 3000	-3.25%	9.14%

Fixed-income markets did not fare well during the quarter and have not recovered from their historic decline last year as you can see in the exhibit below.

Index	Q3	5 Year
Bloomberg U.S. Aggregate	-3.23%	0.10%
Bloomberg U.S. Corporate Investment Grade	-3.09%	0.93%
Bloomberg U.S. Municipal	-3.95%	1.05%
Bloomberg U.S. Corporate High Yield	0.46%	2.96%

The bond market weakness has positive implications for investors who have maintained short-term (low yield to maturities) as they will experience rising income as interest rates rise. From close to zero rates two years ago, those short-term rates have risen well above 5%, a major contributor to increasing income.

Foreign Financial Markets

Foreign equity markets were mostly in the red for the third quarter with a couple of exceptions such as India and Japan. For the first nine months of the year, many foreign stocks are in the green with Japan, South Korea & Taiwan leading the way in Asia. Denmark, Italy, Norway, and Spain are the winners in Europe while Chile and Brazil are supplying Latin America with positive returns. Unfortunately, fixed-income markets across the globe have also been battered by a cocktail of higher interest rates, deficit angst, and hawkish central bankers leaving rates higher and prices lower. Investors hunting for yield can purchase Mexican government bonds that yield 10.5% -- but buyer beware! Inflows have flowed into domestic bond mutual and exchange-traded funds so far this year, a trend that is likely to continue as interest rates remain elevated.

Conclusions

Equity markets are being held hostage to three major economic indicators: oil prices, the value of the dollar, and interest rates. After the attack on Israel, we experienced weakness in oil prices, a downturn in interest rates, and a weaker dollar accompanied by a stock market rally. This coincident performance gives us greater confidence in the impact of these gauges on stock prices and the outlook for these statistics can help in developing investment strategy.

Rising interest rates will continue to provide investors with an alternative to equity investments. But trying to seek out yields in stocks to compete with rising bond yields can require investors to sacrifice principal for income, at least in the short term. For example, year-to-date losses of the utility index, which has long been a source of higher dividend yields, has declined by more than 16%! Making up that difference in yield will take a long time.

The expanding wars in Ukraine and Israel are a factor that can upset any fundamental outlook for financial markets. The involvement of the U.S. may trigger additional uncertainty as to where financial markets will be over the near term. However, as we demonstrated in our analysis of year-to-date vs. five-year index returns, short-term volatility tends to dissipate over time. If we exclude these circumstances from our short-term outlook, the fundamental outlook continues to improve.