3Q23 Market Overview: A Riot of Red

After a strong start to the third quarter, global equity markets wilted in the summer heat, eliciting sour memories of the "nowhere to hide" investment environment of 2022 in the process.

Rising interest rates weighed on a wide range of asset classes, geographic regions and economic sectors; with oil prices bolstered by tightening stockpiles amid OPEC+ production cuts, energy was among the very few areas of the market able to escape the downdraft. The S&P 500 Index and MSCI World Index returned -3.3% and -3.5%, respectively, for the quarter.[1] The style pendulum swung back in favor of value names during the period, though growth has outperformed significantly year to date.

KEY TAKEAWAYS

- A broad swath of asset classes posted declines for the third quarter, as a selloff in long bonds weighed on risk assets globally.
- Combined with generally supportive macroeconomic reports, the latest Federal Reserve dot plot suggested the "higher for longer" narrative espoused by policymakers is closer to becoming a reality.
- Troubling fiscal circumstances in the US may be impacting supply/demand dynamics in the Treasury market while also providing a source of support for the price of gold.
- While the economy has been resilient, persistence is not guaranteed, and conditions likely could become more challenging as the accumulated impacts of policy tightening continue to reverberate. It may be a bumpy ride from here to the Fed's terminal rate.

1. Source: FactSet; data as of September 30, 2023.

Convincing the Unconvinced

Ongoing monetary policy normalization in the US continued to be a source of consternation for markets seemingly reluctant to accept the Federal Reserve's insistence that policy rates are likely to be "higher for longer." The Fed hiked its federal funds target rate by 25 basis points in July, bringing it to a range of 5.25–5.5%. While it held fire at its September meeting, the release of fresh economic projections appeared to throw markets for a loop. The latest Fed dot plot suggests another 25-basis point hike is likely before the end of 2023, but it was the central bank's updated 2024 forecast that likely had a greater impact on sentiment. The median end-2024 projection for the fed funds rate now stands at 5.1%, up from 4.6% in June—a hawkish shift from four rate cuts to two next year.[2]

Recent economic data have supported the "higher for longer" narrative and likely tempered the Fed's enthusiasm for 2024 rate cuts. The Atlanta Fed's GDPNow forecasting model estimates that third quarter US GDP growth will come in at 4.9%, which would be the highest quarterly output in nearly a decade if you disregard the Covid-related distortions of 2020 and 2021.[3] Despite this strength, inflation expectations remain anchored and inflation prints generally have continued to improve. The August core PCE report—which excludes volatile food and energy prices—of 3.9% was the first sub-4% reading since June 2021.[4] A separate "supercore" index—a favorite indicator of Fed Chair Powell that measures the price of services excluding energy and housing costs—also has drifted lower from its peak but at a slower pace than other metrics, as persistent wage inflation has served as a headwind.[5]

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With the terminal point of the current rate-hike cycle seemingly in sight, two-year Treasuries traded in a tight range during the quarter. In contrast, 10-year Treasuries climbed about 80 basis points, with nearly two-thirds of that move occurring in September.[6] Though there are numerous potential drivers for the selloff in long-dated paper during the quarter, we're paying close attention to the country's fiscal condition and the impact that may be having on supply/demand dynamics in the Treasury market. The Congressional Budget Office forecasts persistent federal deficits and mounting debt over the next several decades, suggesting to us Treasury issuance is likely to grow; in fact, the Treasury in late July increased its debt-issuance projections for both fiscal 2023 and 2024.[7] And since the Fed is no longer buying Treasury securities, but is instead letting a large portion of maturing paper roll off its balance sheet, public markets alone are responsible for both absorbing new deficit spending and refinancing maturing paper. Rising rates at the long end of the curve during the third quarter suggest they may be demanding higher term premia to do so after several years in which it was mostly negative.[8]

These circumstances have not gone unnoticed. Citing "expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance," Fitch Ratings on August 1 cut its long-term credit rating on US sovereign issuance from AAA to AA+.[9] This is well-aligned with our own concerns about both the level of the country's debt and its likely trajectory given the apparent lack of political will to enact the spectrum of measures necessary—including tax hikes, entitlement reform and cuts to discretionary spending, as well as supply-side reforms to promote productivity growth—to rein it in. Continued dysfunction in a US political system marked by an abhorrence of compromise—as ably demonstrated by the end-September battle over funding the federal government—suggests repeated party-line standoffs may be far more prevalent than concrete progress toward fiscal consolidation.

2. Source: Bloomberg; data as of October 3, 2023.
3. Source: Federal Reserve Bank of Atlanta; data as of October 5, 2023.
4. Source: Reuters; data as of September 29, 2023.
5. Source: Federal Reserve Bank of Atlanta; data as of September 13, 2023.
6. Source: Federal Reserve Bank of St. Louis; data as of September 30, 2023.
7. Source: US Department of the Treasury; July 31, 2023.
8. Source: Federal Reserve Bank of New York (based on the Adrian, Crump and Moench (ACM) model); data as of September 30, 2023.
9. Source: Fitch Ratings; data as of August 1, 2023.

It's possible that these troubling debt dynamics, which are not limited to the US, also may be among the factors that have provided support for the price of gold amid sharply rising real interest rates. Gold's inverse relationship with real interest rates—i.e., the difference between the nominal interest rate and the expected rate of inflation—historically has been the most important driver of its price movements. Since the Fed began hiking its policy rate in March 2022, however, the gold price has declined by less than $50 per ounce even as the real interest rate (based on the yield of 10-year Treasury inflation-protected securities) spiked more than 300 basis points.[10] Gold's resilience in the face of such a large move in real rates suggests the presence of other influences. The debt issues cited above, for example, may have prompted increased interest in exposure to an asset like gold with an historical track record as a potential hedge against currency debasement. Strong demand from global central banks may be an additional contributor; central bank gold purchases in 2022 were the highest on record, and year-to-date 2023 trends imply another robust year.[11] Geopolitical frailties—highlighted by the protracted war between Ukraine and Russia and the more recent outbreak of violence in the Middle East—also may have buoyed the gold price, as investors seek perceived "safe havens" in uncertain times.

The Last Mile Is the Hardest Mile

Now about 18 months into the policy-normalization process, we find markets' collective resistance to it somewhat perplexing. While we understand it may have been easy to become accustomed to the very low policy rates that prevailed since the global financial crisis, even a touch of historical context reveals this as an aberrance, not the norm. Further, this isn't 1980; the fed funds rate has gone from an all-time low of zero to a still-pretty-low 5.5% on the upper bound. This also isn't the late-2010s when the financial system nearly seized up after a few rate hikes and a bit of quantitative tightening.

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Though many financial assets have suffered losses during the current tightening campaign, we've yet to see the emergence of many indicators typically associated with looming recession, other than the inverted yield curve. Credit spreads remain contained, as do credit-default swap prices, and measures of implied market volatility like the CBOE Volatility Index and ICE BofA MOVE Index confirm the lack of acute anxiety.[12] Meanwhile, the real economy has absorbed the impacts of tightening fairly well thus far. Corporate balance sheets entered 2022 in generally good shape, as many companies took advantage of historically low rates to lock in cheap financing, and we've seen these measures bear fruit in the form of fairly stable fundamentals.

While the economy has been resilient, persistence is not guaranteed, and conditions likely could become more challenging as the accumulated impacts of policy tightening continue to reverberate. And though Fed rhetoric suggests the central bank is still hopeful for a "soft landing," the prospects of such an outcome do not necessarily appear more certain now than they have at any other point in the tightening cycle. Inflation has eased considerably, but it remains above the central bank's target—and the last mile is the hardest mile. Energy costs, housing prices and tight labor markets are all fighting against the Fed, and it's unclear what it will take to tame them. It may be a bumpy ride from here to the terminal rate.

10. Source: Federal Reserve Bank of St. Louis, World Gold Council; data as of September 30, 2023.
11. Source: World Gold Council; data as of October 4, 2023.
12. Source: FactSet; data as of September 30, 2023.

Paying for Time

In his book *The Price of Time: The Real Story of Interest*, financial journalist Edward Chancellor surveys the history of interest rates over millennia, arguing that "influencing the level of inflation is just one of several functions of interest, and possibly the least important." Rather, he contends, a market-determined rate of interest (i.e., one that is not artificially suppressed by policymakers) serves numerous purposes that in aggregate support the proper functioning of a capitalist economy, from rewarding saving to discouraging excessive risk-taking and mal-investment to promoting more equitable distribution of income and wealth.[13]

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While we're hopeful that the move toward a more normal policy environment in which money again has a cost may promote the effective allocation of capital across the economy, we remain cognizant of the many vulnerabilities in global financial and diplomatic structures that appear likely to persist regardless.

13. Source: Edward Chancellor, *The Price of Time: The Real Story of Interest*, Grove Atlantic (August 2022).

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Risk Disclosures

All investments involve the risk of loss of principal.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

Investment in gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals, like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances, and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold and, accordingly, the value of investments in such securities may also be affected. Gold-related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold-related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Implied volatility is the market forecast of future fluctuations and movements in a security's price.

GDPNow is a running estimate of real GDP growth based on available economic data for the current measured quarter. It is maintained by the Federal Reserve Bank of Atlanta but is not an official forecast of the Atlanta Fed.

The **personal consumption expenditures price index (PCE)** measures changes in the prices of goods and services purchased by consumers in the US. Core PCE excludes food and energy.

Supercore inflation measures the price change of a basket of goods and services less food, energy and housing.

Fitch Ratings is a nationally recognized statistical rating organization (NRSRO) registered with the SEC and provides credit rating as an assessment of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

The **yield curve** measures the spread between yields on short- and long-term maturity bonds; an inverted yield curve occurs when longer-dated bond yields are lower than short-dated bond yields.

A **credit-default swap**, most commonly, is a derivative contract that transfers the default risk of a particular fixed income security from the swap buyer to the seller in exchange for a fee.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

CBOE Volatility Index (VIX) measures the 30-day expected volatility of the US stock market. It is based on the prices of options on the S&P 500 Index and is calculated by aggregated weighted prices of the index's call and put options over a wide range of strike prices.

ICE BofA MOVE Index measures US interest rate volatility. It is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.

MSCI World Index measures the performance of large and midcap securities across 23 developed markets countries around the world.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

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