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Wealth Advisory Market Update

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Market Update

Equities:

The month of September was the market's worst month of the year. The S&P 500 was down 4.8% and finished the third quarter down 3.3%. After the soft quarter, the year-to-date performance now stands at 13.07%. Equities continue to face headwinds from deteriorating economic conditions, the Federal Open Market Committee's (FOMC) messaging on interest rates, and rising bond yields.

Macroeconomic data are pointing to slower economic growth. At the same time, interest rates have continued to move higher due to sticky service sector inflation, which puts the US in a stagflationary scenario. Historically, high interest rates are not beneficial for growth companies such as the "Magnificent Seven." As we have mentioned before, these stocks have such a large impact on the overall market that it is not surprising to see the index follow their decline over the last month.

Growth companies remain expensive relative to history. Because of this, we have underweighted them in favor of more value-oriented names that we feel offer a better risk/return profile. Energy remains one of our largest overweight's relative to the market. In our opinion, the supply/demand imbalance remains favorable and until that changes, these companies remain undervalued. This worked well in the month of September, as energy was the only positive sector for the month. Utilities are another area where we have shifted monies. We believe a flight to safety is coming in the market, and the utility sector benefits from a risk-off sentiment shift. We expect volatility to continue for the rest of the year.

US Economy and Geopolitics:

The US economy is weakening at a rapid rate, and we still expect a recession in the coming quarters. The consumer remained resilient in the first half of 2023, but we are now seeing major cracks. Auto loan and credit card delinquencies are at decade highs. With consumer spending making up 70% of Gross Domestic Product (GDP), headwinds to this segment of the economy put a strain on growth. The personal savings rate has dropped to 3.5%, well below the average annual rate of 8.9%. Of the $2.1 trillion in excess savings created by the stimulus during the pandemic, $1.9 trillion of that has been spent. Much of the consumer spending has been from credit cards, and that is starting to show some troubling signs with revolving credit reaching an all-time high of $1.27 trillion. Couple this with student loan payments resuming in October as well as the price of oil increasing by nearly 30% in the third quarter, and it will be difficult for the consumer to continue to keep the economy afloat.

Recent economic indicators have displayed signs of stagflation. The latest US Manufacturing data showed higher prices with slower orders and production. We believe this will continue through the rest of the year. The United Auto Workers' strike has now stretched out for a few weeks. The longer this goes on, the more of a drag it will have on the economy, particularly in the Midwest

Congress was able to prevent a Government Shutdown with a last-ditch effort to provide spending for an additional 45 days. However, instead of working on the budget, the house will now be in the midst of electing a new Speaker of the House, as Speaker McCarthy was ousted last night. This was the first time in history a Speaker of the House has been removed. It will be something to watch as Congress appears to be more divided than ever.

Geopolitical risks have continued throughout the year. Tensions with Russia and China persist as they have over the last few years and we do not believe a resolution to these issues will come anytime soon.

Monetary Policy:

The Federal Open Market Committee (FOMC) met in September and decided to pause, leaving the fed funds rate unchanged in a move that was widely expected. This meeting contained the Fed's forecast for economic growth, inflation measures, and, more importantly, longer-run rate expectations. Even though the Fed did not hike rates at this meeting, they left a hawkish tone in their forecasts.

The Fed's dot plot provided some insight into where the committee believes rates are going and how long they will be at that level. In June, the Fed had expected to have the federal funds rate at 4.6% at the end of 2024; that has now been raised to 5.1%. This means instead of multiple rate cuts; we may only see one. For this year, the Fed is expecting to have at least one more rate hike. A large part of the selloff at the end of the month was the reaction to this "higher for longer" mantra that the markets were not pricing in.

During the press conference, Chairman Powell stated that the Fed has reached a data-dependent mode where they will assess the incoming inflation reports to decide on the best course of action. The FOMC will proceed carefully to determine additional tightening and stay data-dependent. The Chairman did state that they are prepared to raise rates further if appropriate, and to hold them there until they are confident that inflation is going down. The Q&A part of the conference also played out in a similar fashion with Mr. Powell not giving definitive answers. When asked if the Fed has a "soft landing" as their baseline expectation, he said "no." but went on to say that a soft landing is possible but factors outside their control can change that. He believes that the worst thing that the Fed can do is to under-tighten.

In our opinion, the Fed seems lost. They waited too long to raise rates while spending was out of control, and then they tried to correct by hiking rates at the fastest pace in history. This had a detrimental impact on banks who were invested in low-yielding securities during 2020-2021 because of fiscal spending by Congress. The US is now facing stagflation, and the FOMC seems set on keeping rates higher until something breaks. Banks already cracked in March and the Fed had to intervene. We are now seeing the consumer crack, and as goes the consumer so goes the US economy. We do not see anything other than a hard landing from this tightening cycle.

Strategy:

As uncertainty rises, we remain steadfast in our discipline. We still believe a recession is likely in the near future. We have positioned equity portfolios in a more defensive manner, focusing on companies with inelastic demand for their goods and services. With inflation continuing to be an issue, we want to own companies that have pricing power and have a dominant market presence. Currently, most defensive stocks are trading at a discount to their intrinsic value, which gives us an opportunity to shift capital to them while they have a favorable risk/return profile.

We continue to be active in fixed income with rates rising to decade highs. During the year, we have been putting monies to work in the belly of the yield curve and extending duration. We believe this is still the best strategy. We will continue to invest in higher-quality debt. High yield is not a place we want to invest as the economy deteriorates.

As always, we strive to navigate this challenging environment to the best of our ability. The team at AMB expresses gratitude for your support and the opportunity to collaborate with you in achieving your financial goals.

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