



## Quarterly Investment Commentary

October 20, 2023

### Overview

It's not often that bond indexes have the most noteworthy numbers on our return charts, so let's dive right into the fixed income market.

**Bonds:** The U.S. Aggregate Bond Index ("the Agg") lost 3.23% in the third quarter, wiping out gains for the year-to-date period. A quarterly loss of over 3% has only occurred 8 other times since 1976. Four of them were between 1979 and 1981, and the rest occurred after 2021.

But there is good news. The decline in bond prices results in higher yields. At the end of June, 10-year treasury bonds were priced to earn 3.81%, but they ended the third quarter with a yield of 4.59%. Yields have continued higher through the start of this month.

Short-term bonds are much less sensitive to rate changes than long-term bonds. The 1 to 3-year portion of the Agg gained 0.74%, over the quarter. Although short-term yields increased, it was not enough to cause returns on those bonds to be negative. On the other hand, the 10+ year portion of the curve lost 8.66%. Not only are these bonds more sensitive to yield changes, but their yields also increased the most.

Even with rising rates, riskier corporate bonds continued to post gains. The Bloomberg High Yield Index gained 0.46%. The higher starting yields of these bonds protected them from losses.

**Stocks:** Stocks had losses across a number of asset classes this quarter. Smaller companies lost the most; the Russell 2000 lost 5.13%. International developed stocks also struggled, as the MSCI EAFE lost 4.11%. Emerging markets held up a little better with a loss of 2.93%. Utilities and Real Estate were the worst performing sectors, because they tend to be more sensitive to interest rates. On the other hand, Energy stocks performed very well, as oil prices jumped higher. Ultimately, the broad market, which is measured by the MSCI ACWI, lost 3.40%.

With almost all segments of the stock market posting gains this year through September, one might think that we're in the midst of a broad-based rally. However, stock gains have remained unusually narrow, with seven of the largest stocks in the index leading the way. These have been dubbed the "Magnificent Seven," and have accounted for the majority of year-to-date returns of the S&P 500.

Benchmark Returns - 9/30/2023		
<u>Fixed Income Benchmarks</u>	3-Month	YTD
Bloomberg U.S. Aggregate	-3.23%	-1.21%
Bloomberg Global Agg	-3.59%	-2.21%
Bloomberg Municipal	-3.95%	-1.38%
Bloomberg TIPS	-2.60%	-0.78%
Bloomberg High Yield	0.46%	5.86%
<u>Equity Benchmarks</u>		
MSCI ACWI	-3.40%	10.06%
S&P 500	-3.27%	13.07%
Russell Mid-Cap Index	-4.68%	3.91%
Russell 2000 Index	-5.13%	2.54%
Russell 1000 Growth	-3.13%	24.98%
Russell 1000 Value	-3.16%	1.79%
MSCI EAFE	-4.11%	7.08%
MSCI Emerging Markets	-2.93%	1.82%
<u>Other Benchmarks</u>		
Bloomberg Commodity	4.71%	-3.44%
FTSE NAREIT Equity REIT	-7.13%	-2.14%

## **Economic Recap**

There have been some notable improvements to the economic picture over the quarter. GDP forecasts are very robust, with the Atlanta Fed's "GDPNow" registering 5.4% as of October 18<sup>th</sup>. Many economists consider the estimate to be too high, but they still expect strong growth for the quarter.

Inflation has come down meaningfully from its June 2022 high of 9.1%. Headline CPI rose 3.7% over the past 12 months, and it has only increased 3.1% annualized over the past 6 months. This is still above the Fed's target, but shows a clear downward trend.

At the same time, the labor market has cooled from extremely tight to very tight. The unemployment rate increased from its multi-decade low of 3.4% to 3.8% in September. That moderate increase in unemployment should be tolerable for the economy and could support a sustained decline in inflation. Investors' hopes for a soft landing have increased as a result.

Despite the improving landscape, we still see reasons for caution. The U.S. Leading Economic Indicator (LEI) is still flashing a recessionary signal. The index is designed to incorporate credit conditions, stock prices, bond yields, sentiment, business activity, housing activity and labor conditions. It specifically focuses on forward-looking indicators of economic activity and continues to signal an impending recession.

## **Why are Rates Higher?**

**Higher for Longer:** At this point, it seems the rate-hike regime is close to an end. In late September, the Federal Reserve maintained the target range for the federal funds rate at a 22-year high of 5.25%-5.50%, following a 25bps hike in July. However, persistent inflation and the resilient labor market prompted the Fed to be more hawkish in their outlook. The Fed's projection for the level of interest rates going forward was higher than previous projections, suggesting that rate cuts may be further in the future than investors had previously thought. That validated the "Higher for Longer" predictions, which had become more prevalent throughout the quarter.

The impact on the bond market was palpable, as long-term treasury yields rose roughly half a percent throughout September. Investors reasoned that if short-term rates are going to be elevated for an extended period, it justifies earning more on longer-term bonds.

**Treasury Supply and Demand:** While the Fed gets much attention for setting short-term interest rates, their balance sheet operations often go quietly unnoticed. Throughout previous economic crises and disinflationary regimes, the Fed had purchased a material amount of the outstanding treasury supply. However, they are currently letting \$60 billion worth of treasuries "roll off" their balance sheet each month. As those bonds mature, the Treasury will issue new bonds, which will have to be purchased by the public. Meanwhile, the treasury continues to borrow more each year. According to data from the Dallas Fed, the "par value" (what is owed at the end of each bond's life) of Marketable Treasury Debt outstanding has increased by 7.6% over the 12 months ending in August. However, the amount held by private investors (excluding the Fed) has increased 13.5%. That's quite a bit of extra supply for investors to absorb.

In addition, demand from foreign governments and central banks has been waning. According to data from the Federal Reserve, \$3.7 trillion worth of treasuries were held by "Foreign Official Institutions" in the second quarter. However, they held \$3.9 trillion a year earlier.

The bottom line is that investors can pay lower prices and receive higher interest rates due to high treasury issuance and a lack of central bank interest.

**Ratings Downgrade:** At the start of August, Fitch, one of the three main credit rating agencies, downgraded U.S. debt from AAA to AA+. Fitch supported its decision by saying it “reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance.” Standard & Poor’s made a similar decision back in 2011 following a similar fight over the debt-ceiling.

U.S. debt levels did surge higher in the wake of the pandemic. Prior to the pandemic, the federal debt to GDP ratio averaged closer to 100%. That figure is now 120%. Fitch notes that this debt ratio is more than 2.5x higher than the median AAA-rated country.

Interest rates did move higher when the downgrade was announced; however, it was relatively muted. The 10-year U.S. Treasury started the month at 3.97% and moved up to 4.34% by August 21<sup>st</sup>. The yield briefly retreated to 4.09% by August 31<sup>st</sup>. The stock market impact was also limited. The S&P 500 had a 4.7% intra-month drawdown during August. In contrast, the index suffered a decline of close to 20% in the summer of 2011.

## **Outlook**

The “Higher for Longer” narrative comes along with an expectation that a recession will be postponed, but not necessarily avoided. As high interest rates persist, they are likely to become more burdensome for corporations and consumers. That’s especially true now that longer-term rates have moved higher. We believe that a mild recession is still likely, but the start has been delayed. We also have not written off the possibility of a soft landing. If inflation continues to drift lower, as unemployment remains low, calls for a soft landing will become more plausible. However, we won’t let wishful thinking skew our expectations. Soft landings are historically rare.

If the Fed has paused (or peaks soon), what comes next for stocks? Over the last 70 years, stocks have had mixed results during the 6 to 12 months following a pause in a tightening cycle. On average, the market has been relatively flat over the subsequent 6 months and up mid-single digits over the next year. However, to be fair, “on average” does not happen in markets and there is a variation of outcomes depending on a multitude of factors. In the 6 months following a pause in April of 1974, the S&P 500 lost 21.7%. However, the index gained 22.1% in the 6 months following the final hike in February of 1989. Negative outcomes have been more likely when the Fed maintains a more restrictive policy for longer before they cut rates. We believe this is a reasonable expectation for the current tightening cycle.

Although we have outlined many risks to the economic picture, we are also seeing a lot of areas of opportunity for investors. Bond yields have risen to levels not seen in the past 15 years, increasing the return potential for fixed income investors. Higher yields also provide investors with a higher margin of safety because the yield can cover some of the loss if interest rates rise further. To see this effect in action, look back to the performance of high yield bonds this quarter.

## **Portfolio Positioning**

**Stocks:** In equity portfolios we have a tilt toward stocks trading at lower valuations. Relative to the broad market, we are holding less of the seven mega caps that make up over a quarter of the S&P 500. Valuations of foreign equities remain attractive relative to U.S. valuations. The S&P 500 trades at roughly 19 times forward earnings compared to just over 12x for emerging markets and 13.5x for European stocks. We've positioned the portfolios to have a well-diversified exposure across geographic regions.

**Bonds:** The fixed income portfolios currently have shorter durations than the benchmark. In other words, our portfolios have been less sensitive to changes in interest rates, which has protected us from some of the shock to bond markets over the past two years. Now that rates have risen considerably, longer-term bonds are starting to look more attractive. Our investment committee is currently considering steps we can take to extend duration, as we bide time until an appropriate entry point presents itself. Right now, we find the level of yields compelling, but we are happy to wait until yields stabilize.

Currently our portfolios have an allocation to high yield bonds, which raises the overall yield of the portfolio, and adds additional diversification within the fixed income sleeve. We saw that play out well this quarter.

## **Final Thoughts**

Despite elevated uncertainty about the economic outlook, we have confidence that investors in financial markets will achieve positive returns over the long term. Historically, stocks and bonds tend to deliver positive returns over time, although they may experience fluctuations and losses in the short term. This is largely driven by the pricing mechanisms that markets and investors use to value assets. Bonds have imbedded interest rates, which tell us the yield that each bond is likely to earn through its maturity date. Stocks have expected cash flows that can be "discounted" in a similar way. Despite the many assumptions needed in the valuation processes, we believe that markets generally create a statistical advantage for prudent investors.

Bonds typically provide more safety for investors over shorter time periods, while stocks tend to provide superior returns over the long run because of the equity risk premium. By selecting an appropriate mix of assets, investors can greatly improve the likelihood that they will meet their long-term financial goals.

As always, we appreciate your confidence in Seneca and welcome questions about your individual situation.



Denver, Co

Rochester, NY

Washington, DC

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