PENOBSCOT

FINANCIAL ADVISORS

MARKET COMMENTARY

Q3 2023

MARKET REVIEW

The positive momentum of the first two quarters of the year did not carry over to the third quarter. Inflation continued to prove stubborn throughout the third quarter, moderating somewhat, but not enough to curb the Federal Reserve's hawkish monetary policy. Crude oil and gasoline prices soared during the summer. Job gains, while steady, declined throughout the third quarter. The housing sector slowed on rising mortgage rates and dwindling inventory. The third quarter saw most of the market sectors decline from the second quarter. Utilities, real estate, information technology, consumer staples, and consumer discretionary fell the furthest. Driven by the increase in oil prices, energy stocks rose nearly 16 percent.

Smaller companies, which tend to be more immediately impacted by a slowing economy, felt the economic pain. These companies make up the Russell 2000, which fell furthest of the major indices during the third quarter. The more tech-heavy NASDAQ was next, with the Dow Jones Industrial average declining the least. Bond yields rose steadily during the quarter, as investors priced in expectations of interest rates remaining higher for longer. Higher yields generally result in lower bond prices and a stronger dollar, and these dynamics played out this quarter. The yield on the 10-year U.S. treasury bill rose to the highest level since 2007. The U.S. dollar also rose in the third quarter, hitting its highest level since last November. The increase in the Federal Funds rate pushed mortgage rates to 7.31% on the benchmark 30-year home loan, the highest rate in 23 years. However, unlike 2000, house prices are generally rising alongside mortgage rates, as demand has outpaced available inventory. Oil prices rose nearly 30.0% since June, ending the quarter near $91.00 per barrel, limiting the reduction in the core inflation numbers.

The quarter started well enough, with signs of moderating inflation pushing stocks markets up notably. The S&P 500 notched its fifth consecutive monthly gain as all 11 market sectors finished the month higher. Overall, small caps outperformed large caps, with the Russell 2000 (6.1%) leading the major benchmark indexes. Energy stocks jumped higher on the heels of rising crude oil prices, which hit a three-month high. Ten-year Treasury yields rose above 4.00% during the month, only to retreat somewhat to 3.95% by the end of July. According to data released in July, both the Consumer Price Index (CPI) and the personal consumption expenditures (PCE) price index rose 0.2% in June compared to a 0.3% advance in May. Despite slowing inflation, the Federal Reserve opted to hike interest rate 0.25% at the end of July.

From there, equity markets got roughed up in both August and September, with the NASDAQ 100 falling into 'correction', indicated by a 10% retreat from its prior level. This market action occurred amidst continued robust indications of industrial production, consumer spending and retail sales, coupled with continued moderation in inflation. Much of the pain felt in both the stock and bond markets could be attributed to investors pricing in a longer period of restrictive Fed rate policy (higher rates for a longer time) as well as indications that the consumer may be running out of the means to continue boosting of the economy. Credit card balances and defaults showed increases over this period, student loan payments are set to resume in October and some of the pandemic era child tax credits will soon be sunsetting, putting pressure on capital markets across the board.

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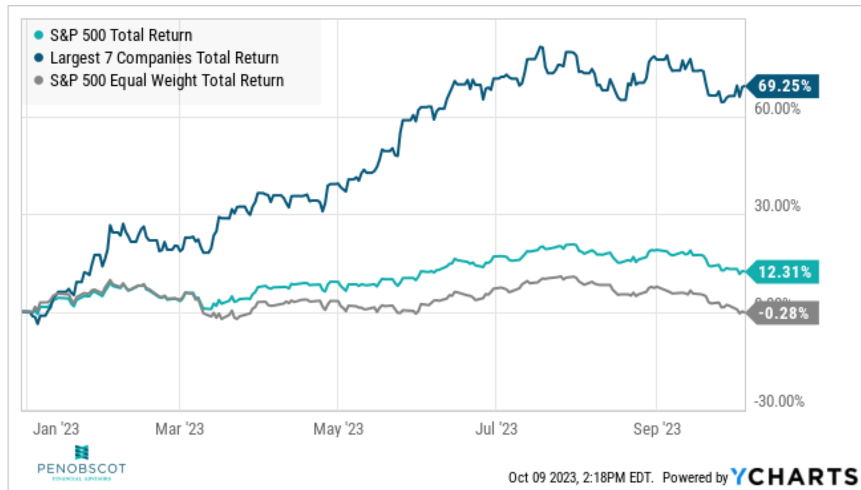
LOOKING FORWARD

MARKETS OUTSIDE THE 'BIG SEVEN'?

Thus far in 2023, the S&P 500 has delivered double digit returns. That fact has been thin gruel for many stock investors because, while the index is solidly up, the average stock in the index is slightly down. How can this be?

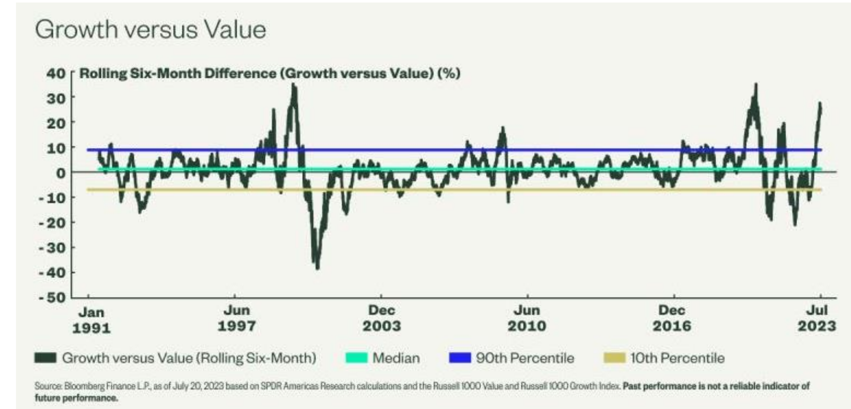
The simple answer is that the S&P 500 is a 'market cap-weighted' index. Companies with larger market values impact the index more significantly when their price changes than companies with smaller values. This isn't an insignificant consideration. Apple, which is the largest company in the index at nearly $3 Trillion has more than 3,500 times the impact on the index as WK Kellogg, the smallest component.

The performance of just 7 companies makes up nearly 28% of the index's performance, with the remaining 72% being attributed to the other 493 companies. Those top seven, Apple, Meta (Facebook), Amazon, Nvidia, Alphabet (Google), Tesla and Microsoft, have posted significant returns, with a weighted average of nearly 70%. Meanwhile, if we simply averaged the total 500 companies returns in the S&P 500, that average is a slight loss.

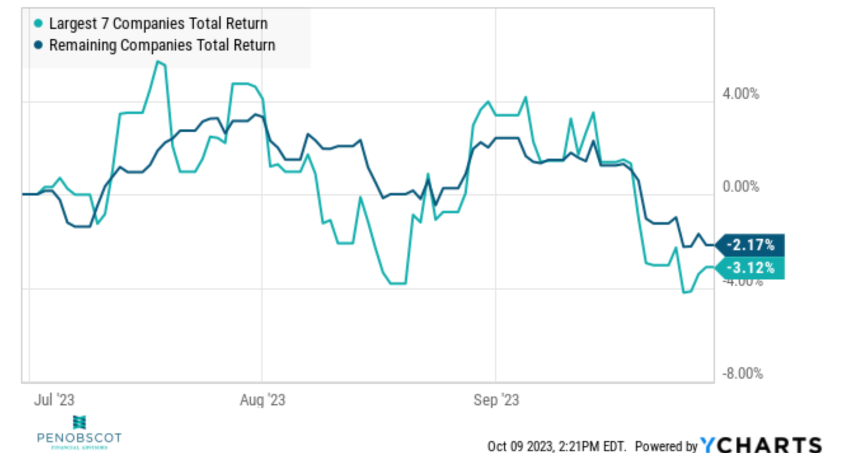


While it may be tempting to chase such eye-popping returns, driven largely by speculation that these companies will benefit from the surge in artificial intelligence (AI), caution is warranted for a few reasons. First, investors are paying nearly twice the amount per dollars' worth of earnings for these stocks as they are for the average stock. This could be justified if those earnings end up growing at twice the rate of other companies, but some consider current valuations to be speculative.

History is another reason to approach this surge in growth stocks with caution. The degree of difference between 'Growth' and 'Value' stock performance has risen to a point only seen twice in the past 35 years: the pandemic recovery surge and the 'dot com bubble' of 1999 and 2000. On both these occasions, there was a significant reversal where value stocks outperformed growth stocks by 20 to 40 percent.



The third quarter of 2023 might even be showing a reversal in this trend, with the average stock in the S&P 500 outperforming the 'big seven' stocks during this period. While having exposure to some of the major potential growth areas in the economy is warranted, a cautious approach like focusing on earnings yields and steady dividends on the heels of growth stock outperformance has proven a prudent strategy over the decades.



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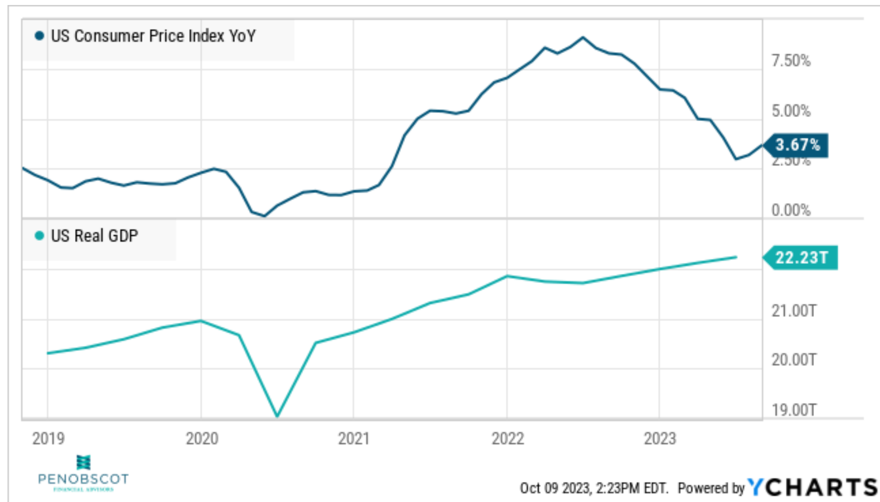
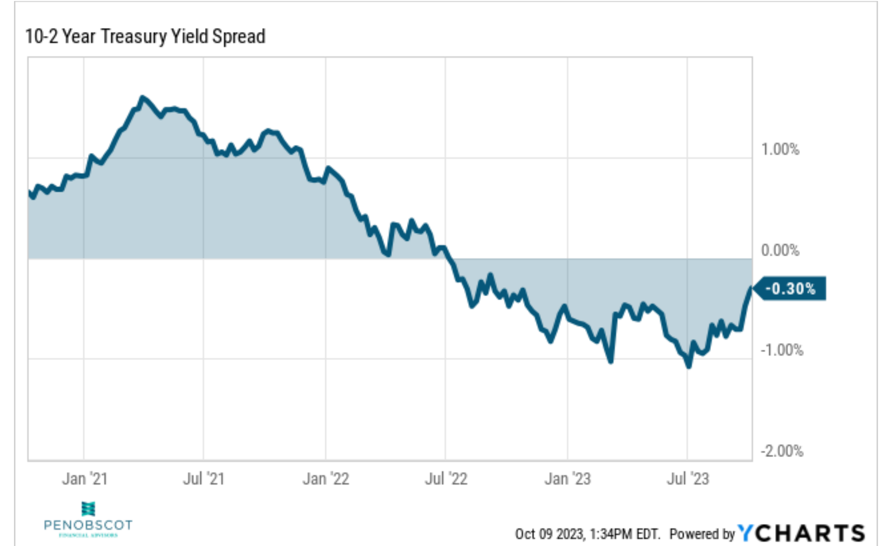
IS A 'SOFT LANDING' STILL POSSIBLE?

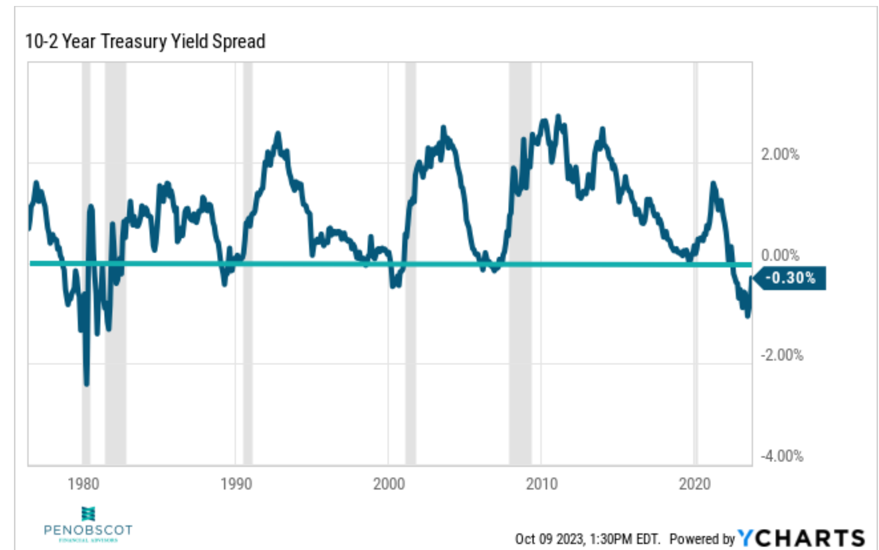
Over the course of 2023, economists and analysts have become much more sanguine about the possibility of the Fed being able to reduce inflation to their target level of 2%, while not slowing the economy so much that it falls into recession. Indeed, the chorus of analysts predicting a 2023 recession have been muted somewhat with inflation (measured below by the Consumer Price Index) having made steady downward progress while real Gross Domestic Product (GDP) has steadily produced higher numbers. More consensus has developed about this 'soft landing' being a real possibility.



While the very aggressive Fed rate increase campaign has yet to drive the economy into recession, the 'soft landing' scenario isn't a sure bet. Historically, an inverted yield curve, where shorter term yields are higher than longer term yields, has been seen as a harbinger for upcoming recession. In fact, the prior six recessions have followed such an inversion. Given that uncanny correlation, it may be heartening to know that the yield curve inversion has narrowed to its lowest level in 12 months.



However, the following chart shows that the yield curve typically dis-inverts just prior to the economy entering a recession. Dismissing the possibility of an upcoming recession might be premature.



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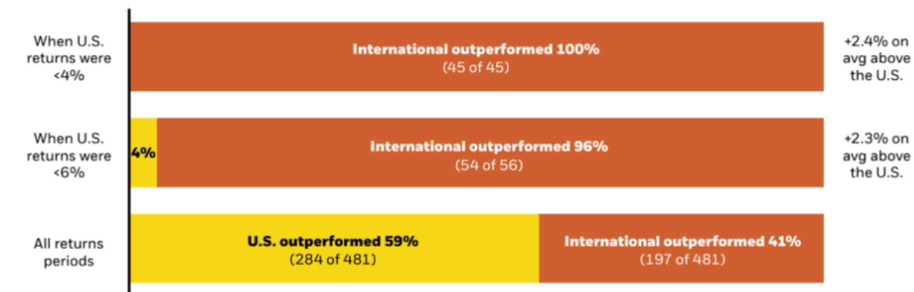
FOCUS: OVERSEAS

With US stocks priced relatively high relative to historical norms and interest rates now looking like they may stay elevated for longer, the case for a surging US stock market on the horizon is a challenging one to make. Certainly, a cessation in rate increases and a resilient consumer could continue the push forward in US stock prices, but headwinds exist.

With valuations of stocks in developed economies outside of the United States at decades-long lows relative to US stocks, the 4th quarter of 2023 could be a very good time to check on your international stock allocation. While the Russo-Ukrainian conflict will likely continue to blur the European market outlook, there is a compelling argument to be made for diversifying overseas.

While U.S. stocks have outperformed international stocks in 10-year rolling periods over the past 50 years, periods of low-returning US stock performance have typically benefited from the inclusion of international stocks to help prop up returns.

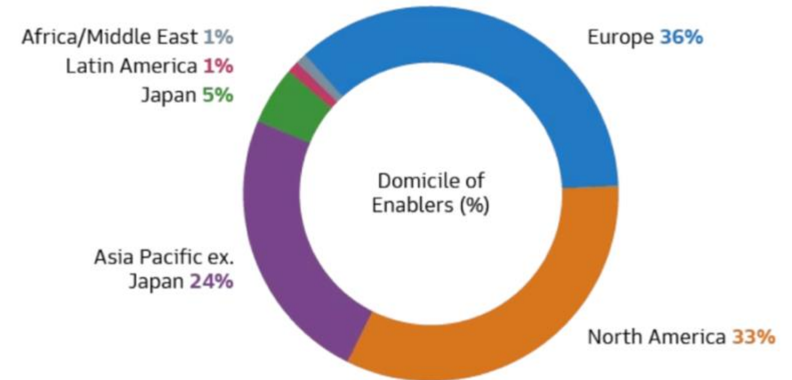
International stocks have historically outperformed in periods of lower U.S. stock returns
(10-year rolling periods, U.S. return levels vs. international, 1973 - 2022)



Source: Morningstar as of 12/31/22. U.S. stocks represented by the S&P 500 Index and International stocks represented by the MSCI EAFE Index. **Past performance does not guarantee or indicate future results.** Index performance is for illustrative purposes only. You cannot invest directly in the index.

The search for gold during the gold rush of the mid-19th century in the US drove a need for sturdier garments for the prospectors. A Jewish immigrant by the name of Levi Strauss developed his iconic, riveted denim jeans to respond to this need, enabling the gold rush and enriching Strauss and his investors.

The big movers in today's information economy will also require enabling companies and industries to reach their growth potential. Decarbonization, changing demographics and educational access are the supports demanded by the big movers in today's AI-centered revolution. Companies that provide these enabling products and services could be some of the most attractive opportunities we've seen in some time. Goldman Sachs' investment research team took the time to determine the domicile of what they call the 'enablers' of this coming wave. The majority of these companies are domiciled outside of the US, and the highest concentration is in Europe.



Source: GS GIR and GS Asset Management.

OUR TAKE

We feel that continuing to use the fundamentals of diversification, both geographically and stylistically, in stock selection is going to become more important as 2023 draws to a close and we enter 2024. A focus on quality companies with demonstrably good free cash flow and earnings will likely become crucial in navigating some of the crosscurrents in the economy. With yields arguably approaching highs, this could be a good time to shore up fixed income allocations, and to take advantage of a bond market which may very well be 'on sale' currently. And comparative valuations, coupled with factors unique to the major areas of growth in today's economy, push us to feel that a good representation of international stocks will provide increased stability and opportunity for our portfolios over the upcoming quarters and years.

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