Quarterly Market Commentary

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The Gordian Knot

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"Remember: upon the conduct of each, depends the fate of all."

- Alexander the Great

While conquering Asia Minor (modern day Turkey), Alexander the Great entered a city where a knot of immense complexity had been tied in front of a temple. The prophecy, of course, was that whoever untied the knot would rule the world. The knot was so convoluted, so dense, so self-reinforcing that it was impossible to untie on its own terms. So, Alexander created new terms, external to the game that he was told to play – he cut the knot with his sword.

Our modern-day Gordian Knot has been the confounding persistence of inflation. Despite the most rapid rate hiking cycle in over 40 years, whereby the Federal Reserve raised rates by 550 basis points over 18 months, inflation has begun to reaccelerate. Energy has been the primary culprit with oil prices jumping nearly 30% and natural gas prices 13% since June. With the promise of price stability beginning to fade, the Federal Reserve is creating new terms to address the tightly wound knot – ushering in a higher-for-longer interest rate regime. With current policy rates at 22-year highs, it remains to be seen whether the Fed will be able to loosen the knot without severing the string.

The Great Unwind

The ultra-low rates that consumers had grown accustomed to since the 2008 Great Financial Crisis have come to an end. Over the last year and a half, the Federal Open Market Committee (FOMC) has lifted interest rates 11 times, bringing the key federal funds rate to 5.25-5.50%. The benchmark rate matters because it has ripple effects on every aspect of finance – from consumers' ability to purchase homes and cars, to a business' ability to finance growth projects, and importantly, to the pricing of financial assets. Effectively, the goal of the Fed's campaign is to cool demand and the inherent pricing pressures within the economy.

Throughout the past year, longer-term interest rates fell alongside growth and inflation. This provided the Fed confidence that they were making progress toward returning inflation back to the 2% target. However, that progress ended abruptly in July, and a steady rise in the term premium (longer-term yields vs. short-term yields) began.

The reasons for the increase are varied. The first reason is that the disinflation narrative has stalled, and alongside it, the Fed's consistent drumbeat of higher policy rates has finally sunk in with market participants. With core PCE (Personal Consumption Expenditures) price growth—the Fed's preferred inflation gauge—sitting at 3.9%, we remain a long way from the target of 2%. The Fed cannot risk a resurgence in inflation like we saw in 2022, and famously in 1981.

There are technical factors at play as well. Another tool of the Fed to tighten financial conditions, beyond raising rates, is reducing their balance sheet. At its peak, the Fed's balance sheet held over $9 trillion of fixed income securities. Over the past year, the Fed has reduced their balance sheet by 9%. The Quantitative Easing (QE) program that provided liquidity to the economy and demand for U.S. government securities over the previous 15 years has flipped. Quantitative Tightening (QT), and the reversal of QE has effectively reduced liquidity from the financial system and removed a key buyer of from the market.

External forces have also impacted rates. The Chinese economy, which had only recently emerged from the pandemic induced shutdowns, has yet to recover its pre-pandemic strength. Slowing export growth and an unstable real estate sector have prevented the once formidable global economic power from realizing a much-anticipated recovery. As exports have slowed, China has fewer dollars to recycle into U.S. Treasuries. This has removed another major demand source for the securities.

Taken together, these factors have reduced demand for Treasuries and raised interest rates to yield levels demanded by more price sensitive investors. In turn, the pressure on rates has further tightened financial conditions and tested asset prices.

Market Impact

The stock market is not the economy, and vice versa. Eventually, however, basic economics forces them to come into closer alignment. The rebound in the S&P 500 index to start the year, while welcome, did not fully reflect broader economic conditions. Some reversion to the mean was to be expected given the dramatic selloff in 2022. Also, the emergence of secular growth in artificial intelligence technology promised revenue opportunities, productivity gains, and cost reductions for the largest technology companies. And yet, as growth moderated and interest rates climbed, reducing corporate cash flows and the discounted value of those cash flows, it was challenging to confirm the index's 20% rise by the end of July.[1]

The risks that were evident at the beginning of the year, while less severe than many anticipated, never fully departed. The Federal Reserve kept a hawkish monetary stance, there was, as we all remember, a banking crisis in March, loan officers further restricted lending to levels not seen since the Great Financial Crisis, and the Leading Economic Indicators (LEI) Index continued its downward decent since May 2022 – marking 16 consecutive monthly declines.[2] The divergence between the broad large-cap index and the fundamentals of the economy surprised many investors.

When looking under the market's hood, however, it is clear the S&P 500 return did not completely reflect the market as a whole. Returns through the first three quarters were extraordinarily narrow. Seven technology-focused companies collectively named "The Magnificent Seven" have been responsible for almost 100% of the S&P 500 return in 2023. Through September 12th, if one were to strip out those 7 largest companies (Apple, Amazon, Google, Meta, Microsoft, Nvidia and Tesla), the return of the index would have lost more than -8% on the year.[3]

Collectively, participants in the global marketplace came to terms with the higher-for-longer reality in August. And from the year-to-date peak set at the end of July, risk assets fell in unison.

Quarter To Date as of September 30, 2023[4]	
S&P 500 Total Return Index	-3.27%
Dow Jones Industrial Average	-2.10%
Nasdaq Composite Index	-4.12%
Russell 2000 Index	-5.13%
MSCI EAFE Index	-4.05%
MSCI Emerging Markets Index	-2.93%
Bloomberg Aggregate Bond Index	-3.23%

Loosening the Knot

Alongside the fall in asset prices, investor sentiment became more subdued. Weaker sentiment is not unwarranted. In addition to tight monetary policy, we have been inundated with headlines that include labor strikes, government dysfunction, oil price spikes, and the prospect of recession.

Despite the headlines, however, the declines experienced in August and September have provided reasons to be optimistic. First, "higher-for-longer" does not necessarily mean "higher-for-ever." The Federal

[1] Black Diamond
[2] Hedgeye
[3] www.benzinga.com
[4] Black Diamond

Reserve, despite all the criticism, is doing an effective job at removing the excesses that were prevalent in the markets through 2020 and 2021. Though painful for asset prices in the short term, we are returning to a sounder money environment where there is a real cost of capital and, importantly, a return for investors.

Growth and Inflation are moderating from the very high levels that were present as we emerged from the pandemic. With that moderation, the outlook for forward-looking returns has brightened for many assets. With money market funds and CD's offering 5% yields, and Investment Grade Bonds providing a yield over 6%, investors are being offered an opportunity to receive higher returns on historically low volatility asset classes.

Even within equities, a contrarian can look at the companies within the index that have not participated in the market run-up and recognize that opportunities are presenting themselves. Equity valuations have moved in-line with their historical averages while cash flow growth is beginning to reaccelerate. Furthermore, the equal weight index (which smooths out the impact of the Magnificent Seven's weighting within the S&P 500), looks cheap against historical averages, offering an attractive opportunity to own some of the world's other preeminent businesses.

To be clear, risks remain. We are monitoring the potential for cracks to emerge as the long and variable lag of restrictive monetary policy continues to play out. However, portfolio diversification, maintaining ownership of great assets, and a steady resolve in the face of the current challenges can help investors achieve their long-term financial goals and avoid the pitfalls of emotionally driven and poorly timed mistakes. This is the ultimate goal of any investor. As always, we thank you for your partnership as we face these times together.

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.