Third Quarter 2023 Letter

Figure 1 – S&P 500

Figure 2 – U.S. 10-Year Treasury Yield

Market Recap

Stocks fell in the third quarter of 2023 as rising interest rates weighed on investor sentiment. The S&P 500 index (**Figure** 1) dropped 3.3% and is now up 13.1% for the year. Selling was broad-based as most other major indices also lost ground, including the Russell 2000 Small Cap (-5.1%) and S&P MidCap 400 (-4.2%). Foreign stocks logged similar losses. Developed economies including Europe and Japan fell 4.1%% and emerging markets gave up 2.9%. Growth stocks in the U.S. once again had stronger relative performance, falling 2.6%, while value stocks declined 4.1%. The increase in the 10-Year Treasury yield (**Figure 2**) weighed heavily on many bond sectors. The Bloomberg U.S. Aggregate Bond index fell 3.1%, giving up gains earned in the first half of the year.

Earnings season in July started well, with enough positive news to move stocks higher. Interest rates initially dipped on hopes that the Federal Reserve would signal an end to rate increases and future rate cuts. However, the Federal Reserve did the opposite, suggesting that another rate hike might be needed, and that they were comfortable keeping short-term rates higher for longer. Consequently, intermediate and long-term bond yields, which have remained well below short-term rates, rose in August and September, pushing both stocks and bonds lower. Headlines in the quarter also brought concerns. Congress struggled to avoid a government shutdown, requiring a last minute bi-partisan agreement in the House. In addition, the impending resumption of student loan payments has reduced consumer spending forecasts. Finally, the auto industry strike has idled plants and workers and will affect the earnings of the Big 3 and their suppliers.

We wrote last quarter about the narrow market leadership, in which relatively few stocks accounted for most of the S&P 500's gains. The so-called Magnificent Seven (Apple, Microsoft, Amazon, NVIDIA, Alphabet (Google), Tesla, and Meta Platforms) comprise about 28% of the index's value. In one measure of the market's concentration, the equal-weighted S&P 500 is only up 1.8%, while the top-heavy market-weighted S&P 500 is +13.1%. In the third quarter, that dominance paused, as the index posted slightly lower losses when those 7 huge stocks were excluded. By some measures, the Magnificent Seven are expensive stocks. They will need strong earnings growth in the coming quarters to justify their valuations and continue as market leaders. However, we would not bet against these long-term winners and generally maintain significant weightings in our portfolios.

S&P 500 earnings in the second quarter fell 7.1%, slightly better than the 9.4% drop expected, while revenue rose 1.1%. This was the third straight quarter of declines. 79.7% of S&P 500 companies topped earnings expectations, as companies managed costs effectively in a challenging environment. However, revenue growth of just 1.1% was a sign of tepid demand across much of the economy. The current earnings picture contrasts somewhat with recent stock declines. Estimates for the 3rd quarter have improved slightly, with strength in technology, construction and industrials offsetting downward revisions in energy and basic materials. Investors will be looking for improvement over last quarter, which would provide confidence that earnings have bottomed.

Economic Perspective
The economy expanded again in the 2nd quarter, growing at the same rate (+2.1%) as the 1st quarter, in line with economists' forecasts. Personal income grew 6.1%, supportive of consumer spending, while corporate profits fell slightly. Gross domestic product (GDP) is now expected to expand 1.9% in the third quarter, a boost from earlier surveys which had predicted less than 1% growth. Purchasing manager surveys in the quarter were consistent: the services sector continued to expand, while manufacturing remained in contraction. Manufacturing surveys did improve in September, a surprising result given the automotive strikes.

Employers continued to add jobs in the quarter, although July and August adds were lower than in the first half of the year. September's jobs report, however, was much stronger than expected, with 336,000 new positions filled. Wages rose 4.2% on an annual basis, slightly less than expected, providing another reason for the Federal Reserve to pause interest rate hikes. In addition, hopes were raised that the economy might escape recession. This appeared to boost investor spirits, and markets rallied sharply on the news. Consumer spending, which comprises about 2/3 of the U.S. economy, has been a source of strength since the bear market began in 2022, although there have been some signs of slowing here. If the employment picture remains solid, spending may sustain near current levels, and recession forecasts may once again be pushed out.

Inflation moderated further in the third quarter. In August, consumer price index (CPI) rose 3.7%, while core CPI rose 4.3%, the lowest reading since September 2021 when inflation was spiking higher. Crude oil prices rose through much of the quarter adding to fears of future inflation and interest rate hikes, but dropped sharply at the end of September and beginning of this quarter when Russia announced a resumption of diesel fuel shipments. Lower fuel costs should help maintain consumer spending in other areas of the economy while alleviating pressure on the Fed to raise interest rates again.

Looking Ahead
The pullback in stocks this past quarter has been painful, given the recent losses in 2022. There may be further volatility in the coming months as uncertainty about long-term interest rates persists. Traditional higher yielding stocks such as utilities and real estate investment trusts may underperform in the near term. Industrials, especially those with strong domestic businesses, are poised to take advantage of infrastructure business and the trend towards deglobalization, in which many companies are move manufacturing and supply chains back to the U.S. In addition, growth stocks, including technology companies, which tend to have little debt and steady cash flows, may be attractive after the quarter's declines.

Figure 3 – Industrials Sector SPDR Fund

Figure 4 – Technology Sector SPDR Fund

The 30-year Treasury index has fallen almost 42% in the past three years, a shocking return almost comparable to the decline of the S&P 500 in the 2000-2002 bear market. But we are still cautious about long-term bonds, which may remain volatile as longer term interest rates fluctuate. In contrast, short-term bonds continue to offer yields above 5%, allowing savers and investors to stay ahead of inflation while taking little risk. We have added short-term investment grade bonds to our fixed income portfolios to take advantage of this.

Index returns taken from Morningstar.com

Recent market weakness and worrisome headlines have given investors many reasons to sell. Recession fears will not go away soon and an economic downturn is still a possibility. The war in Israel adds to the uncertainty. Most investors are best served staying invested, because of the difficulty of timing economic, stock market and interest rate moves. Historically, markets generally shake off the bad news and continue to climb the wall of worry.

In other news from the 3rd quarter, Bernard Wealth Management is happy to announce that Scott Palazzolo has joined our firm as a Client Service Manager. With over 20 years of experience in the financial services industry, Scott brings further depth and expertise to our team. He can be reached at scott@bernard-wealth.com or by calling (248) 556-2900 x4.

Our thoughts are with the people of Israel after the tragic events unfolding this week. We hope that you and your loved ones are safe and well. We encourage you to call us any time with your questions and concerns, and we look forward to speaking to you soon.

Best regards,

Kenneth M. Bernard

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