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2023 Third Quarter Review
The Fed Tightens the Screws

After advancing in the first half of the year, the equity markets generally declined during the 3rd quarter, reversing some of the earlier gains in the indexes and leaving the Dow Jones Industrial Average with a loss for the year so far. During the quarter, the S&P 500 declined 3.7%, the Nasdaq fell 4.1%, and the Dow Jones Industrials were down 2.6%. Long-term bonds were particularly hard hit as interest rates rose, with the iShares 20+ Year Treasury Bond ETF losing over 12% of its value in the quarter alone.

The Federal Reserve Board (the Fed) has now raised short term interest rates to the highest levels since the beginning of the Great Recession in 2007. Because of those increases in short-term rates, investors can secure a "riskless" 5+% return for the next year by simply buying Treasury Bills or certificates of deposit. In a normal world, the competition with higher rates would put stocks at a disadvantage. If a stock pays a 1.65% dividend (the average for the S&P 500), it also has to increase by about 3.5% during the year in order to just match a sure thing. However, the stock price might also go down and provide a negative return. Not so with the Treasury Bill. Money market funds are currently paying over 5%, but they "float" and move with interest rate changes both up and down. We have opted to maintain a mix of assets in order to take advantage of the riskless and floating yields, while keeping some exposure to equities in case the economy actually experiences a "soft landing" and continues on up to new highs.

There is an old saying on Wall Street that "the Fed tightens until something breaks." The first things to break appear to have been the three large banks that failed this past spring. Those banks failed largely due to the knock-on effects of the Fed's rapid increase in rates, which included depositors fleeing (to money market funds) and large losses developing in bonds which were bought when interest rates were much lower. There is reason to believe that another shoe might drop in the banking sector as commercial real estate properties face massive refinancing at much higher rates in the quarters ahead. Regional banks hold a majority of these loans, and the problems with them have already started to come home to roost. A damaging combination of lower occupancy rates, higher operating expenses, dramatically increased interest expenses, and lower values (due to higher capitalization rates) has forced a number of high-profile property owners to "turn over the keys" to the banks and simply abandon the properties in some dire cases. If those examples proliferate, there may be a second wave of banking troubles.

The frenzy over all things related to artificial intelligence appears to have cooled at least for the moment. Many of the related stocks peaked in late July and have trended downward since then. AI may very well change things profoundly, but the same was true of the advent of the internet in year 2000. That didn't keep investors from losing massive amounts of money as the overly-hyped stocks came back to more reasonable valuations. Microsoft's CEO is reported to have recently suggested he may have been overly enthusiastic in his earlier comments about ChatGPT's potential. The stock has declined about 8% from its July peak. We will probably have opportunities to participate at better prices when the frenzy has died down further.

Several factors will influence the market's direction in the near term. Until recently, expectations were that the Fed might hike rates one more time this year. The Fed may signal that it will pause and stop increasing rates sooner since long-term rates have risen so much recently. If this happens, there would likely be a spirited rally in stocks with the hopes that the worst is over. However, a recession may already be on its way, produced with a lag from the previous rate hikes. There are many indicators flashing caution on this issue, but the prospect of a "soft landing' will likely provide optimism until such time as a recession actually sets in.

Unfortunately, we now have three geo-political conflicts in areas with increased risk for escalation: Ukraine, Taiwan, and now the war in the Middle East following the attack on Israel by Hamas. In all three cases, the opposition is led (or sponsored) by autocrats with few internal checks on their aggressive aims. So far, the stock market has shrugged off the dangers represented by these conflicts. We remain mindful of their human toll and the potential for further turmoil.

We remain cautious in our outlook. This is partly due to the factors above and also due to our measures of stock valuation which indicate that the market in general is still quite expensive based on historic norms. These times of inflated valuations are usually resolved by lower stock prices eventually. The market, it is often said, will move in such a way as to prove the most people wrong.

One of many scenarios that we should be prepared for is one where the market has a short-term rally based on a pause in the Fed's rate hikes, but then runs into trouble as the economy feels the effects of the rate increases already instituted. That would draw investors into the market with an apparent "all clear" signal, only to create losses during a subsequent decline. With all of the potential scenarios, we always strive to protect your capital and search for the best opportunities. Sometimes they are more numerous than others. As unpleasant as market declines may be, they can produce increased opportunities for those who have played defense appropriately.

Please review your reports at your leisure and contact us with any questions or suggestions that you may have. Also, give us a call if you'd like to review your capital gains status to help with tax planning before year end.

Best regards,

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