OCTOBER 30, 2023

TUCKER FINANCIAL GROUP®

QUARTERLY MARKET REVIEW

OVERVIEW

The idea of higher interest rates for longer seems to be the new consensus for investors. After an unexpectedly strong 2.1% second quarter GDP reading, the Atlanta Fed projects third quarter GDP to rise 5.1% for the third quarter. According to Bloomberg, the early July consensus forecast for third quarter GDP was a paltry 0.1%. The economy has remained resilient, fueled by excess savings, continued job growth, and investment from both businesses and governmental entities. In response to the above trend growth data, the Fed unanimously decided to raise the Fed Funds rate by 25 bps to a 22-year high at its July FOMC meeting while Chairman Powell remained firm that they would continue to be data-dependent in their analysis of economic conditions. August began with the U.S. government's second ever credit downgrade, when Fitch lowered the rating from AAA to AA+, noting the high U.S. debt to GDP ratio of 113%, over 2.5x the 'AAA' sovereign median of 39.3% of GDP and the 'AA' median of 44.7% of GDP. The U.S. debt to GDP ratio is down from its peak during the Covid pandemic, but is likely to increase from current levels, and is above 2019 levels of 100% of GDP. In mid-September, the Fed left rates at the 5.25% - 5.50% range, opting to skip a hike for only the second time since the first increase of the cycle in March 2022. A new dot plot was released which maintained forecasts for one additional hike in 2023 and reduced the forecast for easing in 2024 to 50 bps from 100 bps in June - a hawkish surprise for the bond market. The new dot plot also showed more participants raising their outlook for the longer-run policy rate; five participants now expect a 3% or higher longer-run rate. Relative to their projections from June, the FOMC revised their growth outlook higher and lowered their unemployment forecasts for 2024 but kept core PCE inflation forecasts unchanged at 2.5%. U.S. labor market data continues to exhibit strength, defying expectations for a hiring slowdown. Nonfarm payrolls increased by 336,000 in September, almost double the consensus estimate for 170,000, and an additional 119,000 jobs were added via revisions to prior months' data. Unemployment currently stands at 3.8%. Average hourly earnings rose by 0.2% in September and by 4.2% from a year ago, down slightly from June but still exceeding the Fed's 3.0% to 3.5% target. The quarter ended with the Fed's preferred inflation metric, core PCE, dropping to 3.9% annually in August, the lowest reading since May of 2021. Long-term bond yields increased during the quarter, with the 10-year U.S. Treasury rising from 3.84% to 4.57% and the 30-year from 3.86% to 4.70%, evidence of a growing acceptance by the market that the Fed plans to keep rates higher for longer, and fear of profligate spending by Washington. A government shutdown was temporarily avoided, with President Biden signing a stopgap bill on the last day of the quarter to temporarily fund the government until November 17th. Further brinksmanship is expected to emerge in 45 days. Disruption in the auto industry occurred in September when the United Auto Workers announced they would strike, following weeks of failed negotiations with the Big Three Automakers.

Constructive Observations

- Inflation is trending lower on a global scale.
- Unemployment remains near generational low levels and real wage growth continues to fuel personal consumption despite the surge in interest rates.
- Central bank hiking cycles are nearing completion around the globe.
- Supply chain pressures have dissipated, with lower shipping costs, greater container ship capacity and shorter delivery times. As a result, profit margins (ex-financials) are stabilizing near pre-pandemic high watermarks.

Cautious Observations

- A broadening of the Israel/Hamas conflict presents geopolitical threats.
- PMI data suggests global economic activity is slowing.
- Central bank policy error could prematurely end the business cycle.
- Resumption of federal student loan payments could disrupt consumer spending habits.
- The job market appears to be softening, albeit in an orderly manner.

MACRO OVERVIEW

Interest rates rose significantly during the quarter, driven by a combination of economic forces, adverse supply/demand conditions in the U.S. Treasury market, and an overhang of potential global central bank actions. The dysfunction displayed in the U.S. House of Representatives, evidenced by the first-ever removal of a sitting House speaker, casts doubt on the government's ability to achieve agreement on fiscal policy and could also pressure yields higher. Surprising strength in U.S. economic data (GDP, ISM services, labor market metrics), has reenforced the narrative that rates will need to remain higher for longer for the Fed to accomplish its goal of returning inflation to its 2% target. Both the Fed and the ECB raised rates by 0.25% in July, with the latter continuing to hike in September, bringing rates to the highest level since the creation of the eurozone. The ECB suggested current rates might be sufficient to guide inflation back to its target. Rapidly expanding U.S. deficits necessitate a material increase in Treasury issuance over the near-term, which could continue to support rising yields. China and Japan have curtailed their purchases of U.S. debt, as they deal with their domestic economic issues, leaving a meaningful gap in absorbing new Treasury bonds.

The housing market has weakened since last quarter with existing home sales down slightly from 4.3 million homes to 4.0 million. Median prices rose 3% in the quarter and 4% year-over-year. The national median home price in August was $407,100, according to the National Association of Realtors, not far off the record high of $413,800 set last year. Home values have held steady, even as mortgage rates have soared toward 8% due to a lack of housing supply. Existing home sales have fallen from pre-pandemic levels of 5.5 million to the 4.0 million level, but new home sales have remained consistent with pre-pandemic levels of around 675,000 homes.

The University of Michigan Consumer Sentiment Index climbed to 68.1 in September from 64.4 in June and is 16% higher than a year ago. Gas prices rose 7% in the quarter, which acts as a tax on the consumer. The risk of an economic slowdown, fueled by high interest rates, suggest that confidence is unlikely to rise meaningfully in months ahead, especially if unemployment were to increase – a distinct possibility considering a possible shutdown of the federal government and labor disputes in the auto industry.

MARKETS OVERVIEW

Equities

As the third quarter began, prevailing sentiment began to embrace the idea that a soft landing for the U.S. economy was possible, despite one of the most aggressive monetary policy tightening cycles in modern history. July's stock market performance was strong, with most major indices up over 3%, marking five consecutive months of positive performance. The Fed ratcheted up their hawkish rhetoric that sent the stock market on a downward trajectory during the seasonally weakest part of the calendar. The S&P 500 declined 3.3% in the third quarter, with growth stocks falling 2.6% and value names falling 4.1%. Of the eleven sectors comprising the S&P 500, only two were positive this quarter: Communication Services +3.1% on hopes integration of advanced artificial intelligence would boost search and social media companies' future ad revenues, and Energy +12.2% due to a 30% surge in oil prices. Utilities and Real Estate were the two worst sectors, both declining around 9% as investors eschewed the higher dividends associated with those sectors for the meaningfully higher yields available in the bond market. The S&P 500 is up 13.1% year-to-date, but most of that performance has been driven by the 55% return attributable to the "Magnificent 7" stocks. Without those seven stocks the S&P 500 would be running even with the Russell 2000 year-to-date at 2.5%. With the September pullback, the S&P 500 now exhibits a forward 12-month P/E ratio of 18.0; very near its 5-year average of 18.7 and 10-year average of 17.5. Small cap stocks fell 5% this quarter.

International equity returns were generally weak this quarter as well. Developed international markets declined 4%, again lagging the S&P 500, as disappointing economic data in Europe bolstered regional recession fears. International value stocks (+0.7%) outperformed growth stocks (-8.6%). Emerging market stocks fell 3% this quarter; India was the exception, up almost 3%, bolstered, in part, by massive infrastructure spending, and it may be an indirect beneficiary of China's downturn. China's manufacturing sector contracted for a fifth straight month in August, while exports continued to decline and consumers cut back on spending. The Chinese property sector remained weak despite government measures to boost home sales.

Fixed Income

Credit markets struggled in the third quarter as interest rates rose. The long end of the Treasury yield curve rose sharply more than the front end, which reduced the severity of the yield curve's inversion. The yield curve has steepened to a level last seen in October 2022. Treasuries with 10-20 year maturities experienced price declines of 10% this quarter; 20+ year maturities declined by 13%. The domestic bond market recorded its worst quarter of the year, with the Bloomberg Aggregate Bond index declining 3.2%, wiping out year-to-date gains in the investment grade space. As rates rose this quarter, credit spreads across a range of sectors traded in tight bands near the low end of their one-year ranges. Strong new issuance in September, up 52% year-over-year for investment grade credit, was met with strong demand. The stability in spreads and the associated carry allowed credit to outperform Treasuries this quarter. Following the September FOMC meeting, however, spreads have widened beyond the narrow ranges where they spent most of the quarter. The combination of tight spreads and higher Treasury yields has brought the proportion of yield compensating investors for credit risk to the lowest level in more than 15 years.

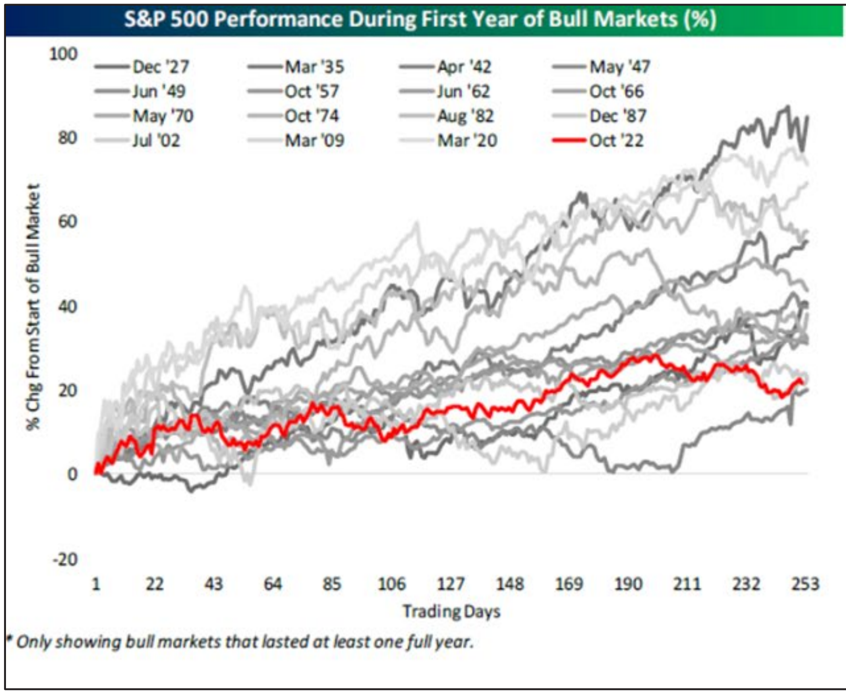
High-yield bonds were the only major bond sector to advance; the Bloomberg U.S. High Yield index returned 0.5% this quarter. Corporate fundamentals generally appear to be in decent shape. Many high yield companies have been shoring up their financial positions over the last few years, leaving them poised to weather a possible downturn. Many companies locked in low borrowing costs during 2020 and 2021 with debt proceeds predominantly used for refinancing purposes. This essentially pushed out the debt maturity profile of the market. With a higher credit quality profile, limited near-term maturities, ample cash cushions and financial discipline, default rates are unlikely to increase dramatically in coming months. The higher-rated parts of the high yield market (BB-rated bonds) are currently yielding around 7.5%, while yields on the rest of the high yield market are above 9%.

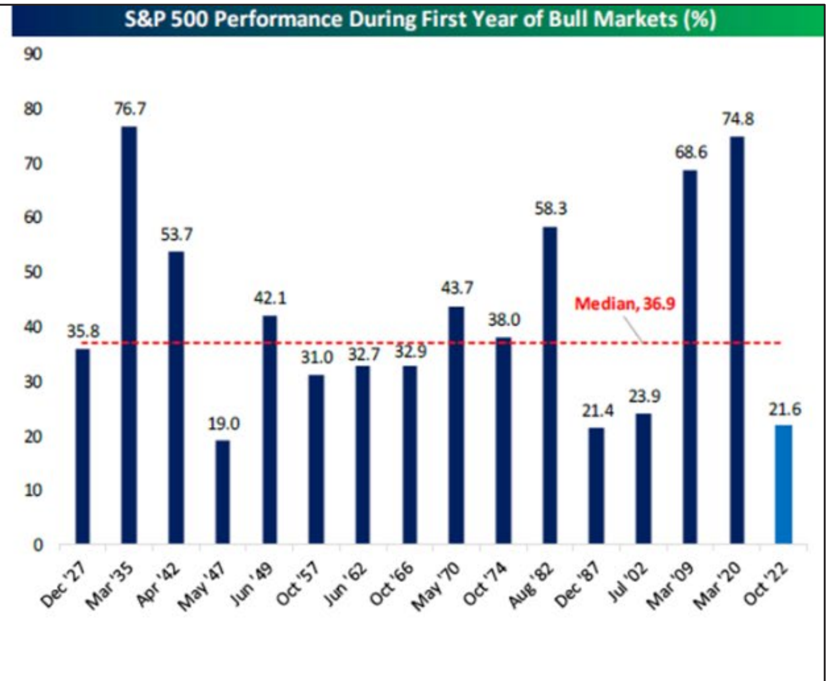
New issuance of leveraged loans jumped to $76 billion this quarter. That's the highest level since the Fed started hiking interest rates. Riskier, profitable M&A and LBO deals are emerging more routinely. Bid prices in the secondary market increased this quarter, with the S&P/LSTA Leveraged Loan index increasing 3.5% in the third quarter; its best showing since the fourth quarter of 2020.

Real Assets

Commodities were a mixed bag in the third quarter, but generally were the best performing major asset class thanks to a significant rally in the energy complex. Crude oil rebounded after being pounded over the prior six months. Oil rose throughout the quarter on continued supply concerns as Saudi Arabia and Russia extended voluntary supply cuts to year-end. Natural gas was the only energy segment that declined in the quarter. Gold declined 4% this quarter, and silver was down about 2.5%, primarily because of the stronger U.S. dollar, which rallied more than 3% over the course of the quarter, hitting a fresh 2023 high in September. The industrial metals achieved modest gains, with price increases for zinc, lead and aluminum offsetting declines for nickel and copper. Agricultural commodities generally declined this quarter, with weaker prices for wheat, corn, soybeans and coffee. Cotton and sugar were the exceptions rising 10% or more in the quarter.

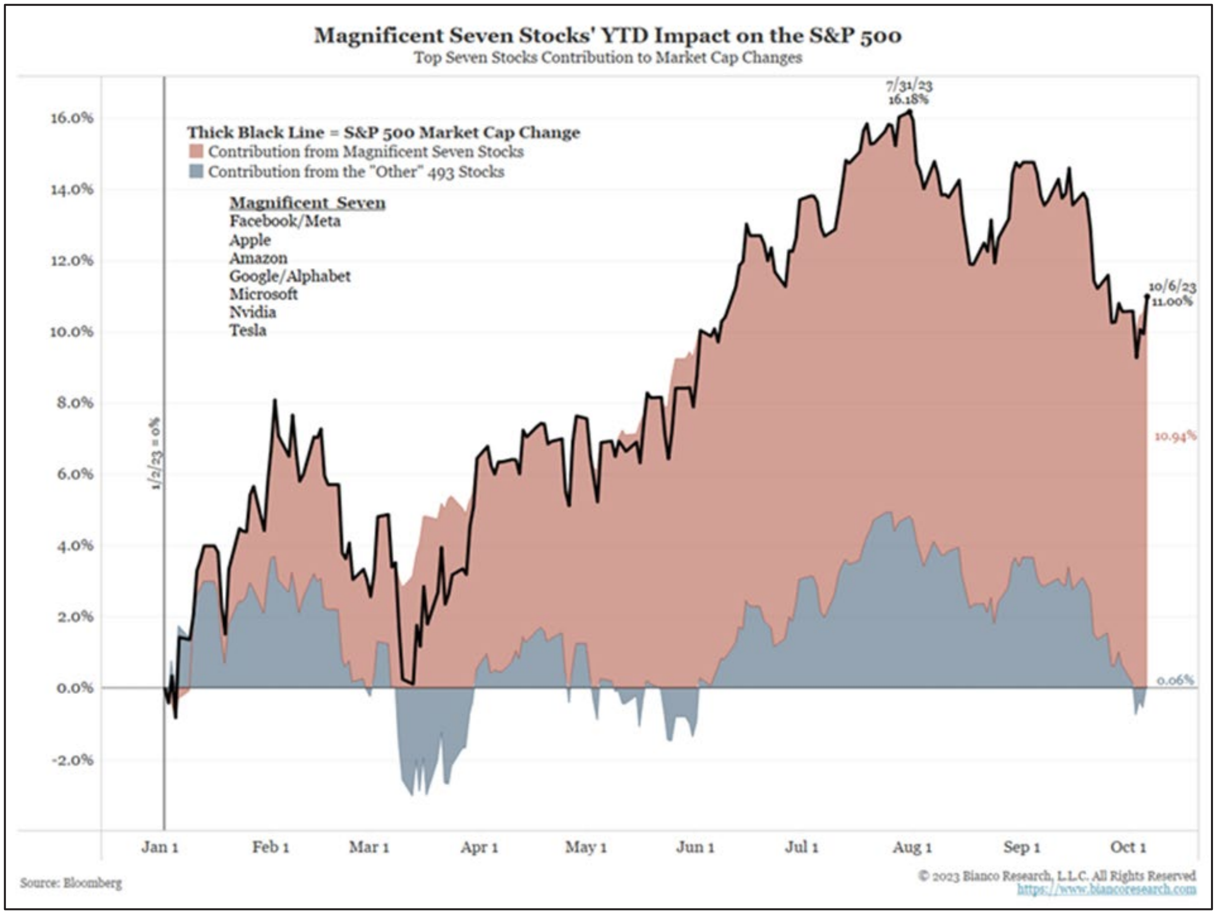
OCTOBER MARKS THE ONE YEAR ANNIVERSARY OF THE NEW BULL MARKET





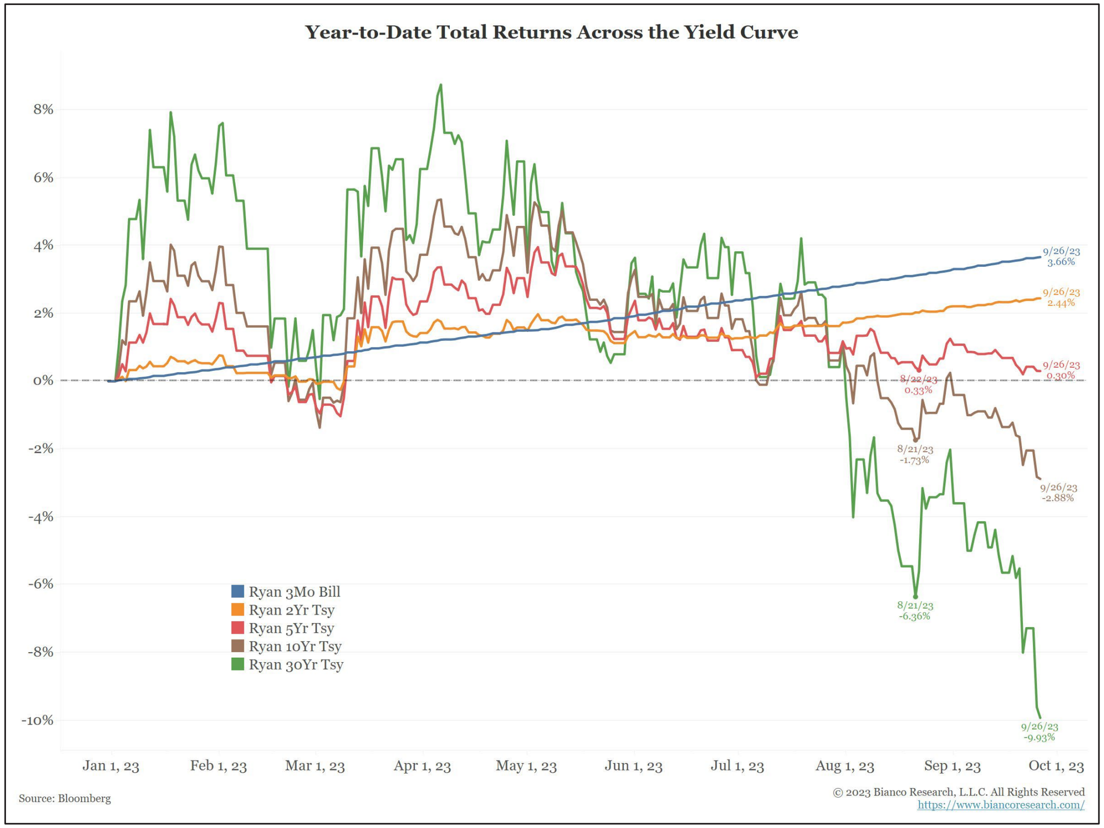
SOURCE: BESPOKE

POST BANKING CRISIS, SEVEN STOCKS HAVE ACCOUNTED FOR ALL THE S&P 500'S RETURN YTD



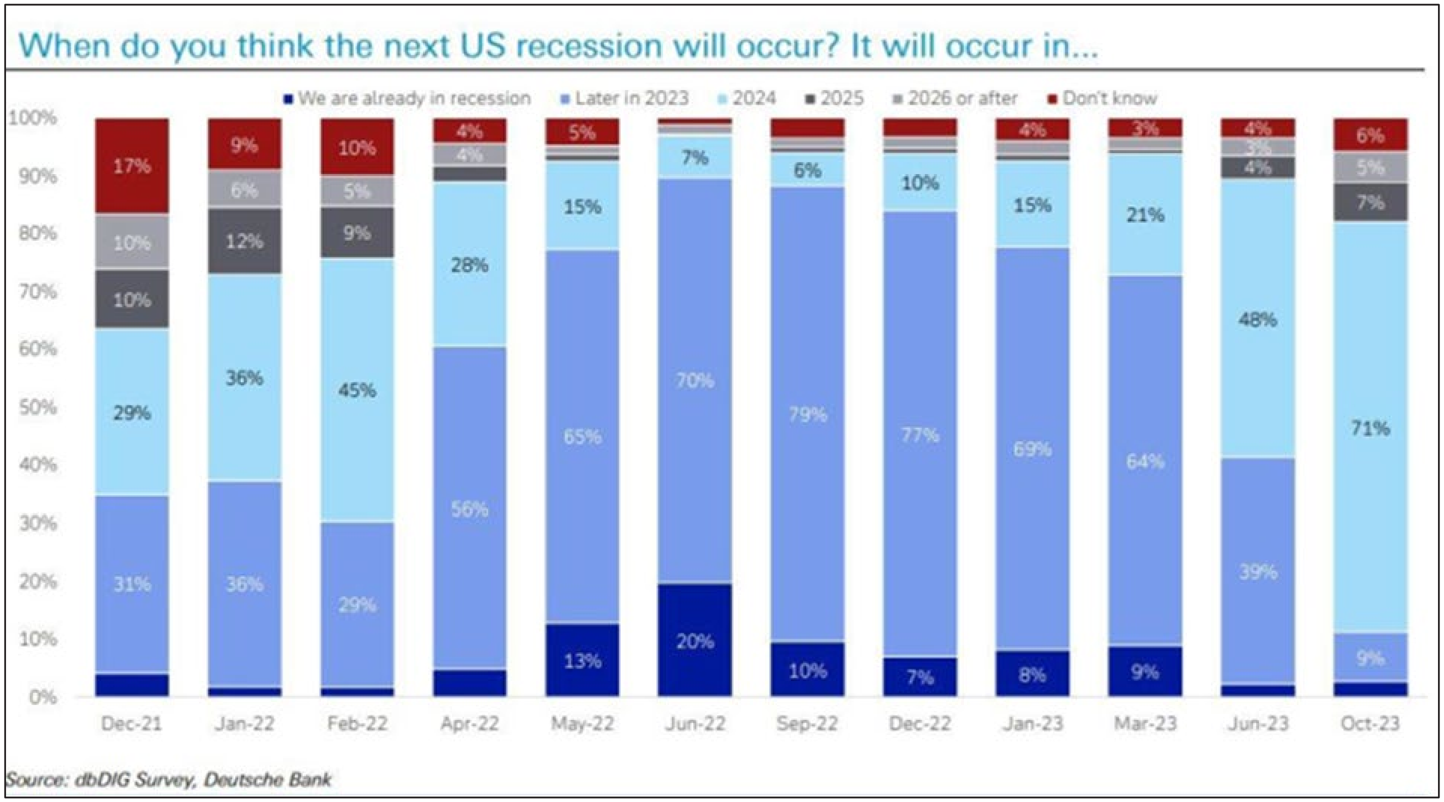
SOURCE: BIANCO RESEARCH

RAPID RISE IN RATES AFTER DEBT CEILING SUSPENSION LEADS TO CONTINUATION OF BOND BEAR MARKET



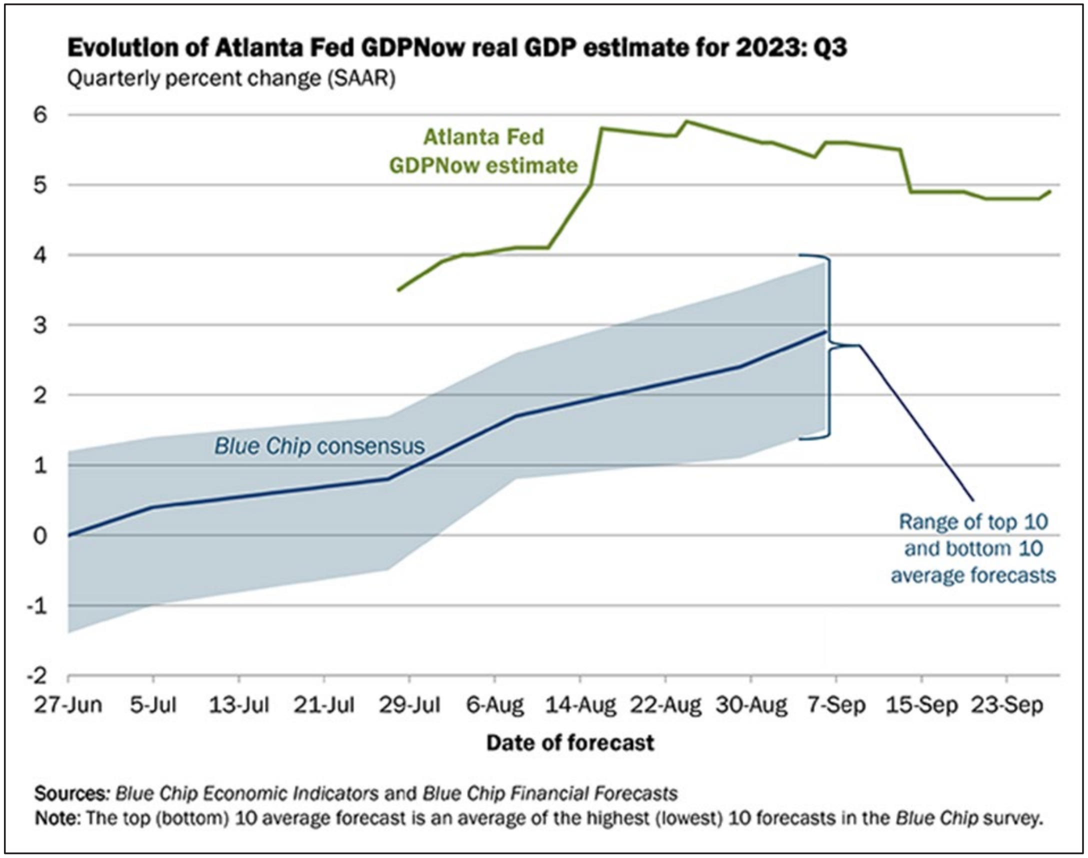
SOURCE: BIANCO RESEARCH

CONSENSUS CALLS ON RECESSION WRONG AGAIN



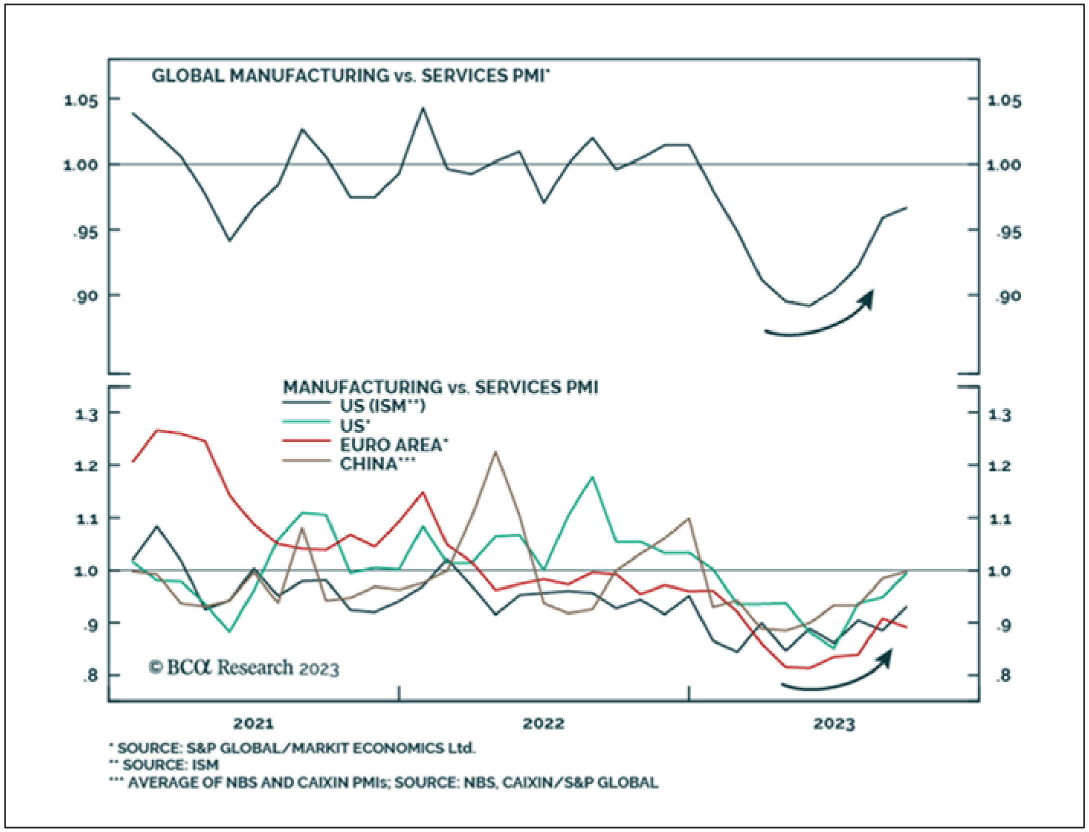
SOURCE: DEUSTCHE BANK

CONSENSUS CALLS ON RECESSION WRONG AGAIN (CONT.)



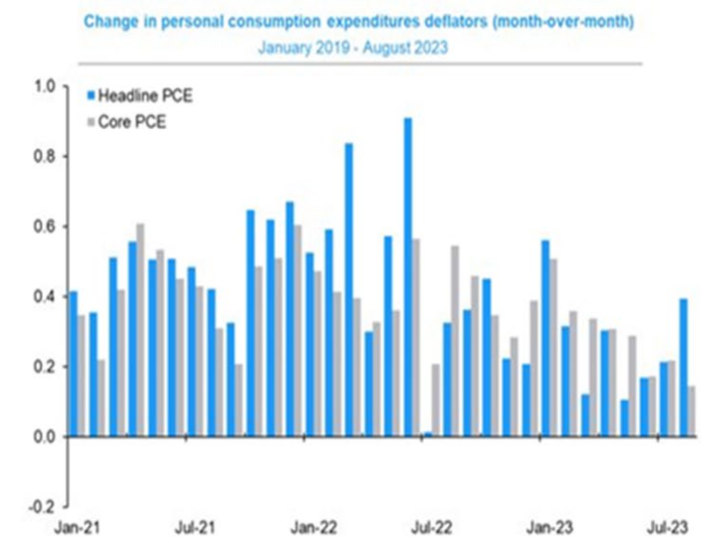
SOURCE: ATLANTA RED

MANUFACTURING SHOWING SIGNS OF LIFE

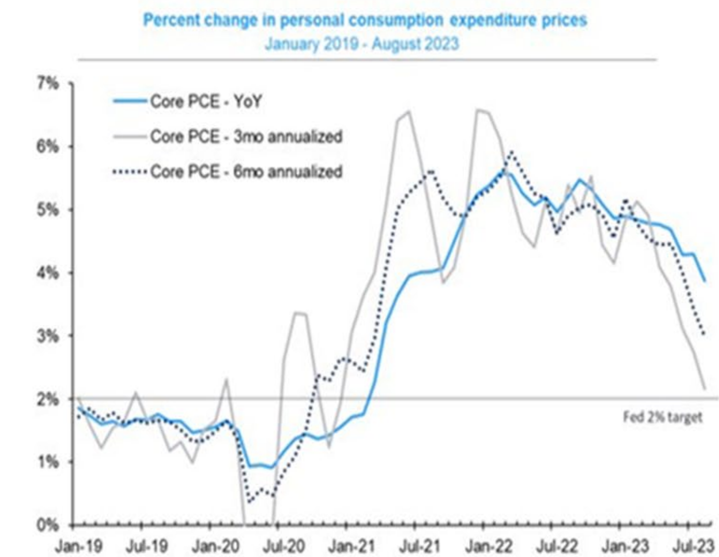


SOURCE: BCA RESEARCH

THE FEDS PREFERED METRIC OF INFLATION TRENDING LOWER



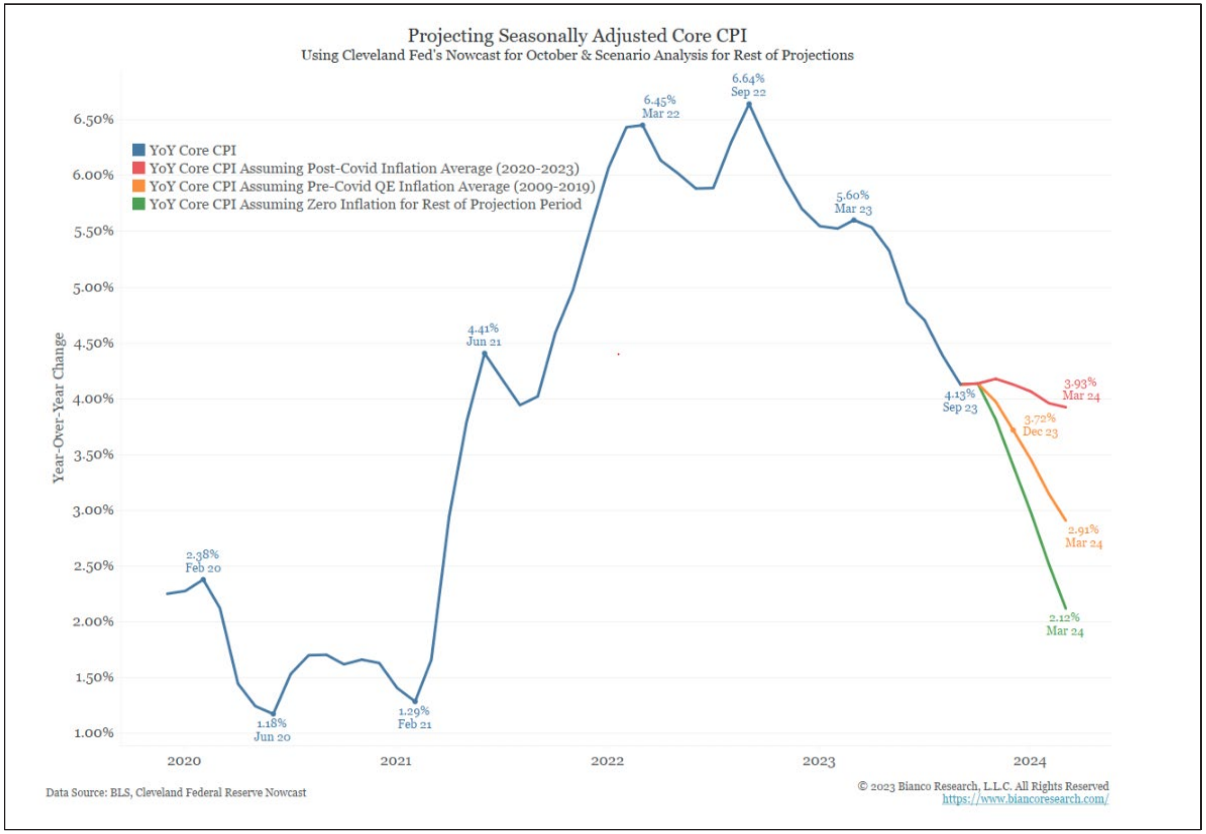
Source: BEA; EY-Parthenon



Source: BEA; EY-Parthenon

SOURCE: EY-PARTHENON

IS THE PACE OF DISINFLATION FAST ENOUGH FOR THE FED?

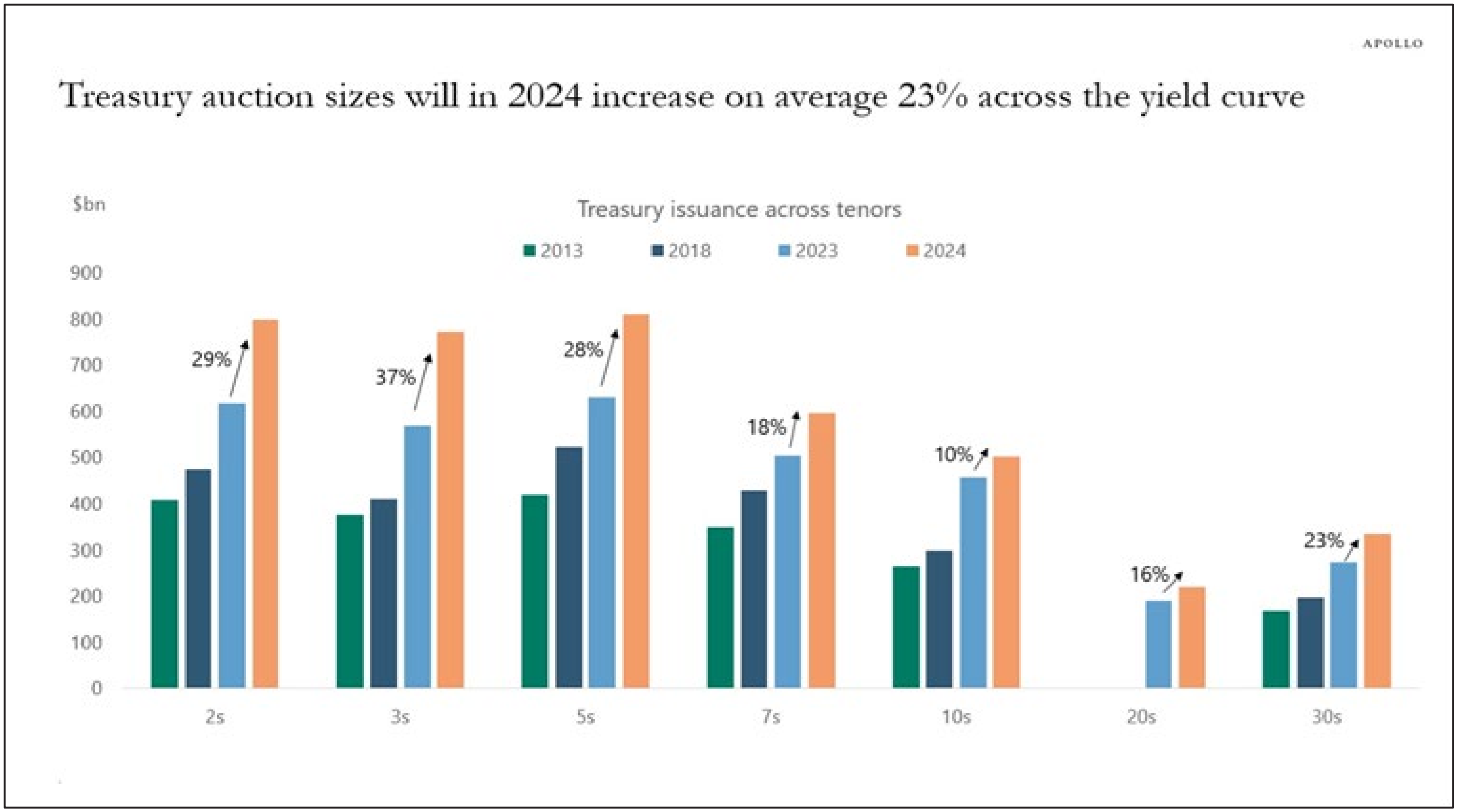


SOURCE: BIANCO RESEARCH

STRONGER ECONOMIC GROWTH AND DEFICIT SPENDING WILL PUT PRESSURE ON THE FED

SOURCE: BCA RESEARCH

STRONGER ECONOMIC GROWTH AND DEFICIT SPENDING WILL PUT PRESSURE ON THE FED (CONT.)



SOURCE: APOLLO GLOBAL

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