INVESTMENT PERSPECTIVE

Quarterly Report

30 September 2023

During the third quarter, the S&P 500 fell 3.27% while the Russell 2000 Value declined 2.96%. International equity markets declined with the MSCI EAFE falling 4.04%.

Inflation peaked in the fourth quarter of 2022 and economic growth bottomed, which set the stage for the move higher in U.S. equity markets during the first seven months of 2023. The reacceleration in growth coupled with declining inflation allowed the market to begin pricing in a "soft landing" for the U.S. economy despite aggressive monetary policy tightening, the emergence of a banking crisis, and rising U.S. Treasury yields as the U.S. Treasury struggled to fund rising deficit spending. The Federal Reserve added fuel to the rally by aggressively pumping liquidity into the banking system to offset the material losses on bank balance sheets. For the quarter ending September 30, 2023, the equity rally has failed to broaden out and quickly corrected as rising oil prices, firming inflationary conditions, and a further slowing in economic growth challenged the "soft landing" thesis.

The reacceleration in economic growth that began in the fourth quarter of 2022 was driven by a surge in Federal spending that offset the developing industrial recession and continuing decline in real consumer spending. With the expiration of Covid stimulus in the third quarter of 2023, Federal spending has peaked and will begin slowing as industrial and consumer spending continue to slow, setting the stage for a potentially recessionary condition in the fourth quarter of 2023 through the first half of 2024. Fortunately, there are signs that disinflationary pressures are building which may provide the Federal Reserve sufficient policy flexibility to ease financial conditions should the economic fundamentals deteriorate materially.

The Bloomberg Aggregate Index returned -3.23% for the quarter and the ICE BofA/ML 1-10 Year AAA-A Municipal Index returned -1.88%. During the quarter, the Federal Reserve raised the Fed Funds rate by 25 basis points in July but elected to pause raising rates at the September meeting. The target rate is now 5.50% and the market is not pricing in any further interest rate increases; instead, the market is forecasting interest rate cuts beginning in the second quarter next year despite the Fed's most recent narrative around rates staying "higher for longer."

During the quarter, investment grade credit spreads tightened approximately 2 basis points to +112 basis points over Treasuries. Credit spreads remained resilient as higher rates have supported demand for credit but weighed on new issuance (supply). Stronger U.S. growth and sticky inflationary readings led to a big jump in Treasury yields with the 10-year U.S. Treasury yield increasing 73 basis points to 4.57%. Also, foreign demand for U.S. Treasuries has declined adding additional pressure to new bond auctions at a time when the U.S. government has simultaneously increased the supply of its monthly Treasury issuance.

We maintained a shorter average duration relative to the benchmarks across our fixed income strategies during this tightening cycle to reduce the impact on returns from rising interest rates. Now that inflation has peaked and with the Fed near the end of its tightening cycle, we are actively increasing duration to take advantage of the more favorable interest rate environment.

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