It Continues to Start and End with 'The FED'

"There is no more unhealthy conversation than one that starts with "The Fed'" – **Aswath Damodaran**

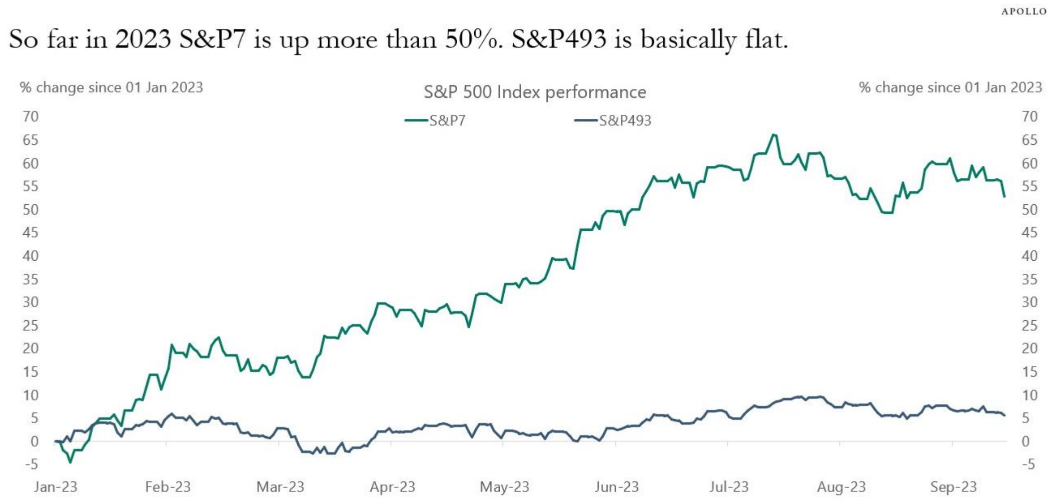
Blue skies turned somewhat turbulent in the third quarter as markets (S&P 500) gave back some of their first half gains (nearly 20%) and are now up 12% as the quarter ended. Most of the volatility was once again the result of the Fed's future direction of interest rates, which now points to higher rates through the end of 2024. As a result, the 10-year Treasury Bond has increased from 3.25% in March to nearly 4.9% as of 10/6/2023. The 10-year helps determine mortgage rates, bond performance and ultimately stock performance, so this advance is not good for any type of risk asset.

As a result of the interest rate moves, bond indices (Barclays Aggregate) lost all of their gains for the year, giving up over 3% in the quarter. On the flip side, Treasury Bills and short-term fixed income instruments performed well and saw overall yields increase during the quarter, rewarding safe investors.

2023 began with a wall of worry and saw some incredible storylines, such as artificial intelligence (AI), advancing markets beyond most investors' expectations. As we close out 2023, most of these issues are still out there and some new ones (ie: Middle East) have come about. Below we discuss the risk and opportunities as we head into year end and 2024.

Risks (Market Concentration)

Year to date, stocks have been driven by 7 names dubbed the "Magnificent Seven" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla & Meta). In aggregate, these stocks are up over 50%. The other 493 stocks in the S&P 500 are essentially flat on the year. Part of this outperformance is a result of the snap back from a poor showing in 2022 along with continued flows into passive indices for which these make up the largest allocation, but the lions share can be attributed to the quality of their balance sheets and exposure to AI. In a market that is searching for growth opportunities, companies with strong balance sheets while also having direct exposure to AI and its potential impacts on the economy, are the lowest hanging



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fruit. Rising rates have not had a material impact on these large tech companies because they really don't have a lot of debt, and what debt they do have is at favorable rates with maturities that are well beyond the Fed's timeline to get back to their target. This gives these companies the dry powder and flexibility to continue to invest in growth/AI. Historically, market concentration is a normal phenomenon, and the top 10 stocks often make up around 20% of the index. Today the market concentration is at an extreme of 30%. It certainly feels like we are at a crossroads, either the rest of the market catches up to the Magnificent Seven or the Magnificent Seven come back to more normal valuations. Rising rates, a slowing economy and a potential recession are not a great backdrop for the catch-up story. Perhaps the bigger risk is that all of the AI hype that has been priced into these stocks doesn't play out as expected. AI is an extraordinary technology and has the potential to make anything and everything more efficient, however it might just take longer to play out than the stock market has priced in today.

Risks (Higher Rates)

Although a lot of progress has been made in the fight against inflation, the continuing strength of the economy is making it challenging to get to the Fed's ultimate goal of 2% inflation. The Fed has increased its rate this year by 1% and the 10-year Treasury has tracked that move pretty closely. Higher rates for longer will be a challenge for many borrowers, but the most impacted are small businesses and commercial real estate owners. After the challenges that small and regional banks encountered in March, they have become even more restrictive in their lending standards. In some cases, they will not even consider new loans and if they do, the rates are pushing double digits. With every passing quarter of higher rates, there will be more defaults, which could translate to more trouble for the banks. The Fed is well aware of these potential defaults, but its first mandate is to tame inflation. There is one silver lining for the higher rates and that relates to residential mortgages. Most homeowners with mortgages refinanced after COVID to the lowest rates in history. Although home prices are still high because people are simply not moving, the cost for homeownership for most is very affordable.

Opportunities (Short Term Momentum)

History doesn't repeat itself in markets, but it does tend to rhyme. Although the news cycle has gotten extremely negative again and stocks have fallen for the last few months, history says that the 4th quarter should be good. When the S&P 500 was up between 10 & 20% through the first three quarters, the 4th quarter has seen returns of almost 6%. This return setup has occurred 22 times in history and the 4th quarter has had positive returns in 86% of those occurrences. So, despite the news, the momentum of the year may just carry markets higher.

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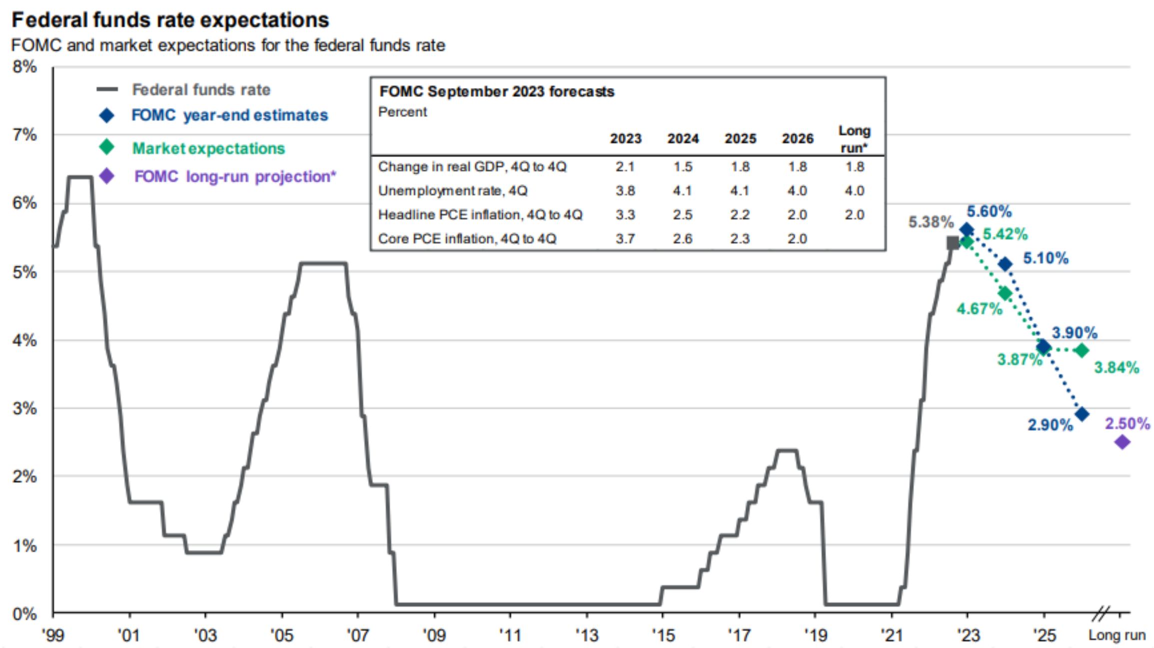
Statistic	4Q returns when up 10-20% YTD through 3Q	4Q returns when not up 10-20% YTD through 3Q	All period 4Q returns
Average	5.8%	1.9%	2.8%
Median	6.7%	4.2%	4.6%
% of time up	86%	70%	74%
Maximum	15.2%	20.9%	20.9%
Minimum	-1.3%	-28.9%	-28.9%
Standard Deviation	0.04	0.10	0.09
Observations	22	73	95

Source: BofA Global Research, Bloomberg

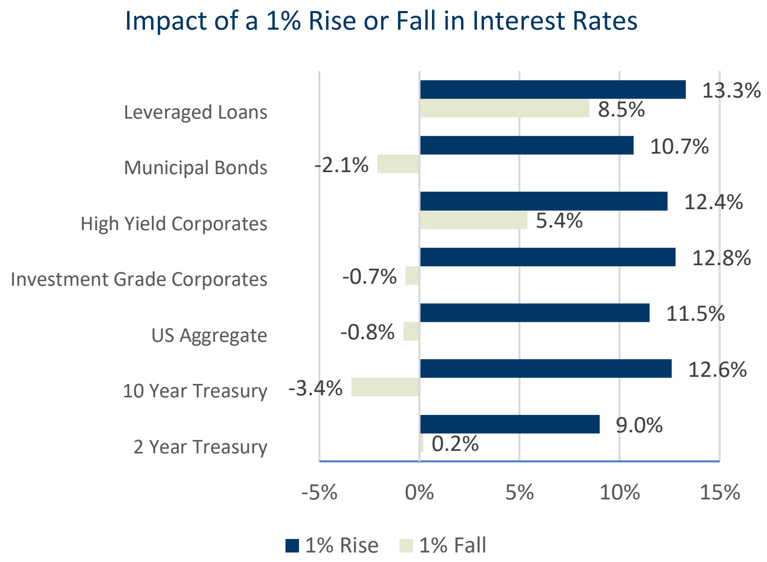
BofA GLOBAL RESEARCH

Opportunities (Bonds)

Bond investors have had a tough time for nearly two years. The safe money was down 14% in 2022 and negative again this year as rates continue to march higher. The diversification benefits of bonds have mostly been nonexistent as they have moved in the same direction as stocks. However, there hasn't been a time since 2005 that bonds were more attractive than they are today. While the rising rates have been a massive headwind to bond prices, future lower rates will be a tail wind. The Fed could potentially raise rates one



more time in November, but even if they do, the rate increases are probably behind us. Above are the Fed's actual expectations of interest rates over the next few years (*blue line*) and futures markets expectations (*green line*). Both sources are pointing to much lower rates with the Fed's terminal value closer to 2.50%, half today's rates.



Bonds are much easier to predict than stocks (in theory!) and are driven by two main variables, default risk and interest rate risk. Default risk essentially relates to the underlying issuer's ability to pay back interest and principal. Interest rate risk now is more of an opportunity than a risk. The accompanying chart shows the impact of a 1% rise or fall in interest rates. As you can see, if rates were to continue higher (*gray line*), there is not much downside, except for very long duration 30-year bonds. However, if rates were to fall, the gains for nearly every type of bond are impressive. Prior to 2022, this chart was inverted, meaning the potential losses from rising rates were far larger than the equivalent move to falling rates. Remember, back then rates couldn't fall unless they went negative. To put future returns into perspective, if rates were to fall by 2%, to 3.38%, well above the Fed's ultimate goal, corporate bonds would increase by over 25% in price. In addition, an investment grade bond pays annual interest of 5.5% - 6.5% today, which is pretty attractive income to wait for the ultimate move in rates.

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time to set up a review meeting.

Finally, Over Labor Day Charles Schwab moved 3.6 million accounts from Registered Investment Advisors utilizing the TD Ameritrade platform to its own platform. This transition was a result of the merger between the two companies that was finalized in October 2020. After the addition of $1.3 trillion in assets from TD Ameritrade, Schwab now custodies over $8 trillion.

Sincerely,

Canal Capital Management

DISCLOSURE:

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