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Market Overview

All major stock indices experienced a third quarter decline as the 10-year bond yield continued to break out higher and seasonality took effect. Crude oil continued to rise putting upward pressure on the monthly CPI. The Russel 2000[1] led third quarter stock declines finishing down -5.13%, with the Nasdaq[2] and the S&P 500[3] index trailing by -3.94% and -3.27%, respectively.

During the third quarter of 2023, utilities were the worst performing sector declining -9.22% followed by real estate at -8.88%, and consumer staples by -6.60%. These sectors are currently the worst performing sectors for 2023. In terms of performance, U.S. large cap stocks led the way, continuing to find relative strength in the mega caps with the Communication Services sector finishing the quarter ahead by 1%.

The Federal Reserve ("the Fed") continued to hike interest rates in the third quarter with a 25-basis point increase in July. This move brought the Federal funds rate range to 5.25% to 5.50%. The Fed has now changed the trajectory of their rate hiking cycle, as it did not raise its Federal funds target rate in September. Bond market participants give a 11% chance for another increase in the Federal funds rate in November.[4] Further, the Fed pushed out the timing of a decline in the Federal funds rate to later in 2024 than was generally expected.

The U.S. fixed income market struggled as yields climbed, as the ten-year Treasury bond yield rose 73 basis points (.73%) during the third quarter to its highest level since 2007. This was due to continued hawkishness from the Fed on the back of strong economic data and heavy bond supply coming to market. However, resilient earnings and a slight moderation in default rates helped spare global high yield bonds from the broader market price sell-off.

During the quarter, high volatility, competitive yields on cash and negative seasonal pressure contributed to equity and fixed income weakness.

In international markets, a stronger U.S. dollar and weakening growth in Europe and China weighed on returns, with developed and emerging market equities declining by 4.0% and 2.8%, respectively.[5] However, India and Japan were bright spots, with both countries outperforming their respective indices.

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U.S. Equity Returns Table (Source: Tamarac)

Index	Q3 2023 Returns	2023 Returns
Dow Jones	-2.10%	2.73%
S&P 500	-3.27%	13.07%
NASDAQ	-3.94%	27.11%
Russell 2000	-5.13%	2.54%
MSCI World	-3.68%	5.82%

U.S. Treasury Yield Table (Source: Treasury)

	09/2023	09/2022	09/2021
3 month	5.03%	3.22%	0.04%
2 year	4.87%	4.22%	0.28%
5 year	4.60%	4.06%	0.98%
10 year	4.59%	3.83%	1.52%
30 year	4.73%	3.79%	2.08%

Other Indices Table (Source: Morningstar)

	Q3 2023 Returns	2023 Returns
Gold (GLD)	-3.830%	1.09%
Brent Oil (BNO)	25.91%	-13.4%
U.S. Dollar Index (UUP)	4.76%	6.90%
Int'l Equity Markets (EFA)	-4.94%	6.49%
Emerging Equity Markets (EEM)	-4.07%	0.92%

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The Third Quarter Malaise and the Silver Lining of a Soft Landing

The first half of this year was outstanding for most of the major market averages, but not so much during the third quarter, and the picture has the bears growling. Interest rates rose sharply along the yield curve as investors feared that the Fed would continue to raise interest rates and keep them higher than previously expected through 2024. The U.S. dollar rose 7% since mid-July, and oil prices rose 35% during the quarter. The better news on retail sales, auto sales, industrial production, and consumer income was taken as bad news as investors figured that inflation would stay high, and the Fed could raise the Federal funds rate to 5½% to reduce demand and employment growth. As a consequence of all of this, the S&P 500 fell 3.3% and the Dow Jones Industrial Average[6] fell 2.3%, while the Aggregate Bond Index[7] lost 3.2% for the third quarter.

An important bright spot was inflation. The most current August reading of the core PCE price index (the personal Consumption Expenditure Price Index), which is a preferred inflation index tracked by the Fed, rose 3.9% on an annual basis vs. 4.3% the month before.[8] Importantly, this measure fell below the gain in wages over the same period, enhancing consumer purchasing power. Further, despite the substantial advance in oil prices during the quarter, the national average cost of gasoline was only 12 cents higher.[9]

Our view has been that consumer spending has been enhanced by excess savings accumulated from the fiscal largesse disbursed during and after the pandemic, and the sheltering of demand along the way. But the conventional wisdom is that surplus is about to run out, forcing consumers to use credit cards to maintain spending. And that has resulted in over $1 trillion in additional debt that inevitably will cause a downturn in household spending and recession.

But a recent revision of government data ("revision" has become a habit) concluded that the updated numbers reveal a consumer with some $400 billion more in earnings since 2019 along with more prudent spending than previously reported[10]*. Crucially, the revisions confirm that the massive savings buffer households built up during the pandemic remains largely intact.* In terms of the numbers, they are saving $100 billion a year less than they did before the pandemic, which is worrisome but not as apocalyptic *as the $830 billion less that was first reported.*

It's not as if there weren't signs that something was fishy about the data. Although the Fed estimated that savings had been depleted by $2.3 trillion by the second quarter of 2022, total checking account deposits were at an all-time high. Those deposits have declined by $300 billion since then (through June 30), though they are still $3 trillion higher than before the pandemic. The Fed had forecast that excess savings would have been depleted by August! This was touted by mainstream analysts at every turn, reinforcing the recession narrative.

The fact that excess saving has barely declined means that spending was never as out of whack as we were led to believe. It casts the recent strength in retail sales and increases in credit card balances in a more positive light. If you believed that excess savings were nearly gone but that consumers just couldn't stop spending, then record credit card debt looks like a looming disaster. But once it is clearer that households still have trillions of dollars in cash, spending and borrowing are more in balance, contrary to the mainstream recession paradigm that consumers have been spending beyond their means and turning to credit cards in desperation. But the revised data suggests there is no looming disaster on the horizon and no reason to expect a consumer led recession any time soon.

This can have a profound effect on investor expectations going forward. In my opinion, the soft landing scenario is likely to become more dominant in consensus thinking. And the Fed may finally acquiesce to the reality that it is fruitless to force high or higher interest rates on a growing economy that is already well along in the disinflation cycle, responding to actions they have already taken. This awareness could enhance the durability and longevity of the ongoing long-term bull market cycle.

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Disclosures

Sources:

1. The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.
2. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
3. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
4. Source: CME FedWatch Tool using 30-Day Fed Funds futures pricing data.
5. The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the U.S.) and 24 Emerging Markets countries.
6. The Dow Jones Industrial Average (DJIA) is a stock market index of 30 prominent companies listed on stock exchanges in the U.S. The DJIA is one of the oldest and most commonly followed equity indexes.
7. The Bloomberg U.S. Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market.
8. Source: U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/pdf/cpi.pdf
9. Source: AAA. https://gasprices.aaa.com/
10. Source: Bloomberg. https://www.bea.gov/information-updates-national-economic-accounts

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