Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 3, 2023

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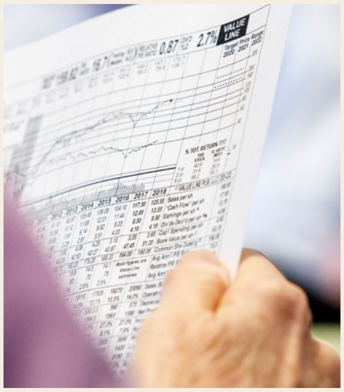

Investors' euphoric outlook over the rapid government stimulus that followed the implosion of Silicon Valley Bank drove markets higher throughout the first seven months of the year. On July 31, the S&P 500 hit a new recovery high of 4,588.96 carried by the impressive performance of mega-cap growth stocks, especially the "Magnificent Seven." A gentle decline through August gained momentum in September as markets were confronted with a host of headwinds from sticky inflation to a looming government shutdown to (perhaps paradoxically) a resilient job market and economy. As stock markets were getting their wings clipped, bond yields were exploding to the upside with the 10-year note ending the quarter at 4.6% and the 30-year at 4.7%, higher than they were at the end of June by 76 and 85 basis points respectively. Value and growth stocks saw a near identical return for the quarter only after value outperformed by nearly 160 basis points in September. In an interesting twist during an otherwise "risk off" quarter, Emerging Markets stocks fared better than US and developed international equities.

Data as of Sept. 30, 2023	Sept. '23	Qtr. 3 '23	YTD '23
S&P 500	-4.77%	-3.27%	13.07%
MSCI AC World Index (incl. US)	-4.10%	-3.30%	10.49%
MSCI EAFE (Europe, Asia, Far East)	-3.37%	-4.05%	7.59%
MSCI EM (Emerging Markets)	-2.57%	-2.79%	2.16%
Russell 1000	-4.70%	-3.14%	13.02%
Russell 1000 Growth	-5.44%	-3.13%	24.98%
Russell 1000 Value	-3.86%	-3.17%	1.80%
Russell Midcap	-5.03%	-4.68%	3.92%
Russell 2000	-5.89%	-5.13%	2.54%
Bitcoin	4.03%	-11.49%	63.16%

Data provided by Tamarac Inc.

Fixed Income Markets

As mentioned above, the quarter was not kind to fixed income markets, with much of the damage seen in September. For the quarter, the Bloomberg U.S. Aggregate index returned a negative -3.23% with the weak performance leaving the index down -1.21% for the year. Tellingly, there was no major bond index or maturity period that saw a positive total return in the final month of the quarter. With longer-dated bonds seeing the highest increase in yields, total return suffered more as one moved farther out in the maturity spectrum. The Bloomberg 1-5 Year U.S. Credit index saw a marginal positive return for the quarter of 0.25% while the Bloomberg U.S. Credit Long Bond index returned a negative -7.23%, resulting in a year-to-date return of -2.62%. In contrast, high yield continued to impress, returning 0.46% for the quarter and 5.86% for the year.

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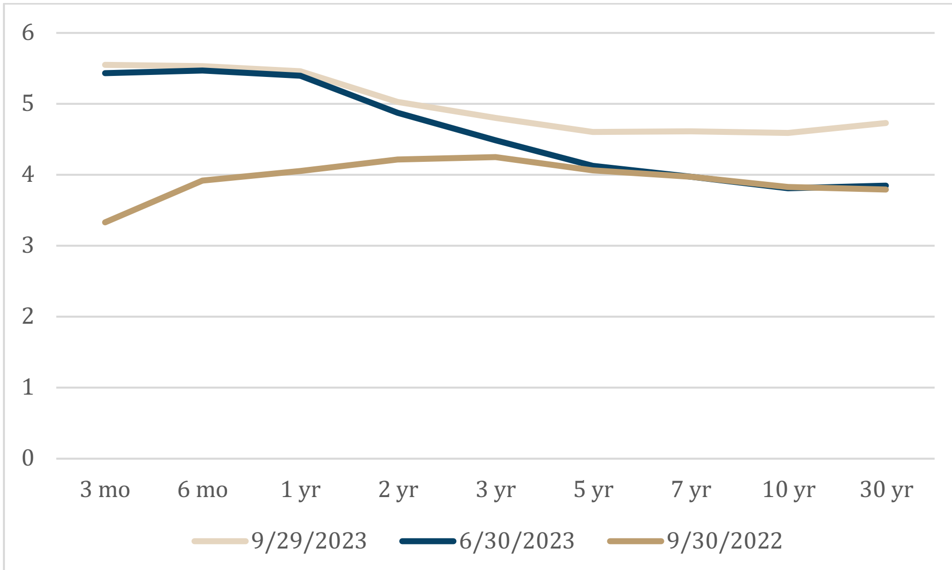
US Treasury Yields

Early signs the tightening cycle has come to an end?...

The yield curve remains inverted, but with the rapid rise in longer rates that inversion is rapidly shrinking. At the end of the second quarter the spread between the yield on 2-year and 10-year Treasuries was -106 basis points. By the end of September that spread had shrunk to only -44 basis points through a pattern referred to as a "bear steepener" where long rates move up at a more rapid clip than short rates. It is notable in that bear steepeners are relatively rare occurrences and often associated with the end of a tightening cycle.

Yield curve un-inverting…



Data from U.S. Treasury

Commodities

Oil drives commodity index higher…

On the surface, the third quarter looked like a strong one for commodities. The price action of the overall CRB Index jumped over 10% to bring the year-to-date performance into positive territory. The headline number is misleading, however, as the strong return was driven primarily by the rally in oil prices.

Away from that category, the commodity landscape was much more a mixed bag. Wheat, rice, corn, gasoline and gold all fell while sugar, cotton and natural gas all joined oil on the positive side of the ledger.

In perhaps an encouraging sign for global growth and trade, the Baltic Dry Index, which measures the price of moving goods via sea, leapt higher by 54%. Copper, another economic indicator but one much less volatile than the Baltic, was flat in the quarter and remained down -2% for the year.

Commodity	Qtr. 3 '23	Year to Date '23
CRB (broad index)	10.07%	6.43%
Oil	28.52%	13.12%
Gold	-4.21%	1.19%

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Economic Overview

Surprising resilience from the domestic economy…

The U.S. economy has proven to be resilient through the first three quarters of the year, complicating the Fed's stated intention to restrain inflationary pressures. After hitting a bit of a slow patch earlier in the year, the job market appears to be gaining steam heading into the final quarter of 2023. Even when hiring was slowing earlier in the year, companies were reluctant to let go of the workers they had, perhaps still scarred by the troubles experienced when trying to hire new employees following Covid 2020 layoffs.

Labor market remains tight…

The final initial jobless claims report for the quarter was a low 204,000 while September payrolls showed a gain of 336,000 (nearly double what was expected) with upward revisions to the prior months. The unemployment and participation rates were both steady from their prior readings at 3.8% and 62.8%, respectively. Of some comfort, Average Hourly Earnings were tame with growth of just 0.2% month over month and 4.2% year over year. With the Fed hyper-focused on the potential for an overheated jobs market to feed into a wage-price inflation spiral, such metrics will be key going forward.

While the domestic economy has largely surprised with stronger-than-expected growth this year, there are numerous headwinds as the calendar turns to the fourth quarter. When monetary policy is easy (i.e., rates are low/below inflation, government is stimulating the economy) shocks are easier to absorb. As conditions tighten, however, it becomes more difficult for the economy to shrug off outside turbulence.

Consumers facing multiple headwinds…

The sharp rise in the price of oil, high and rising mortgage rates, sticky food inflation and the resumption of student loan payments happening while government Covid stimulus programs roll off and banks tighten lending standards all count as negative hits to the consumer. Such headwinds are starting to show up in consumer surveys, with the Conference Board's Consumer Confidence Index falling for the second straight month in September. Importantly, the Present Situation Index was basically flat; weakness was seen in the Expectations Index with a reading of 73.7 - nearly 10 points lower than August. While consumer spending has, so far, held its own, this will be a data point worth watching.

An end to the global hiking cycle?...

Globally, the economic and central bank picture is similar to the U.S. After aggressive tightening cycles across the globe, most central banks appear poised to hold rates steady and some (including China) have recently made small cuts.

The economic picture in Europe is currently uninspiring. In Germany, the Markit Construction PMI reading for September fell to 39.3 for one of the weakest readings on record, outside of the 2008-9 Global Financial Crisis and Covid disruptions. At the same time, exports - long the engine of the German economy - have been stagnant over the past six years. Beyond Germany, continental neighbors France and Spain have both seen their industrial production weaken recently.

The last time China reported its youth unemployment rate in July, it was 21.3% and in a clearly rising trend. The negative reverberations of the Zero-Covid policy continue to impact the economy while the government seems reluctant to enact more forceful, direct consumer stimulus.

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Investment Implications

For years following the Global Financial Crisis, a basic tenet for equity markets was that "bad news is good news." The reasoning went that any kind of bad news would result in the Fed continuing/expanding their support efforts while good news was also well received as it meant the economy might grow on its own, without further stimulus.

A shift in how the market reacts…

The third quarter clearly heralded in a shift across multiple fronts, which we'll explore below, that has caused the prevailing thinking to shift. Now good news is increasingly greeted as a threat to markets as it stokes fear that the Fed will continue or increase their restrictive policy stance.

Since the Covid lockdowns in 2020, the consumer has been aided on multiple fronts by government largesse. Among the programs enacted over the last three years: enhanced unemployment benefits, suspension of student loan payments, increased Medicare eligibility and SNAP payments and small business tax credits. 2023 saw much of that aid reverse, calling into question the ability of the consumer to continue to power the economy in the coming year.

Tailwinds have quickly reversed…

Regarding monetary policy, the Fed has been clear that they intend to raise rates until they achieve a positive real rate, where the Fed Funds Rate (FFR) is above inflation. After a year and a half, covering 11 hikes in total, bringing the FFR to a range of 5.25-5.5%, that goal has now been accomplished. Positive real rates should slow economic growth and, by extension, inflation. A knock-on effect is that, historically, price-to-earnings multiples also tend to be lower in such an environment.

A new focus for stimulus…

Fiscal policy is also in the midst of a sea change. As mentioned above, much of the consumer-focused stimulus from the previous three years is rolling off. While the headline dollar figure of stimulus into the economy is poised to come down, it would be inaccurate to say that stimulus is drying up completely. Instead, the focus is shifting from consumer to targeted industries. First came a bipartisan infrastructure bill passed in 2021that was soon followed by the Inflation Reduction Act and the CHIPS and Science Act. The combined result of this legislation will see billions spent in the coming years focused on infrastructure, life science and technology.

Enough concerns to build a large "wall of worry"…

These shifting dynamics are showing up in asset performance. In a phenomenon not seen since the late1990's, the stock and bond markets are now positively correlated. For much of the last 25 or so years, the two major asset classes had negative correlation, meaning when one fell the other typically rose, helping to buffer account performance. This correlated price movement was on full display in 2022 (i.e., both major asset classes were down) and while 2023 has seen some reprieve, it has not fully reversed. If sustained, this change in the investing landscape would upend a generation of investment strategy.

The negative effects (for investors) of a resilient economy were seen in the final months of the third quarter as strong employment numbers were met with selloffs in both the bond and stock markets. With the Fed determined to avoid the mistakes of the 1970's, where a lack of commitment to restrictive policy resulted in multiple waves of inflation, any indication of a "hot" economy will likely encourage their current "higher for longer" mindset when it comes to the FFR.

With all the market turmoil and shifting macro dynamics, there remain positives for investors to key on, including seasonality (leaving the historically weakest quarter for the strongest); increasing potential for a Fed pause; the over $1 trillion that has gone into money market funds since the October 2022 low, giving investors ample dry powder; and early signs that corporate margins may be past the worst of the inflation pressures.

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