PERFORMA

Q3 2023

MARKET COMMENTARY

A QUARTERLY REVIEW OF THE MARKETS FEATURING MACRO AND GENERAL ASSET CLASS COMMENTARY

MACROECONOMIC OVERVIEW

Sometimes it takes a minute for markets to hear and believe communications from the Federal Reserve. Serving as only the latest example, the Fed has been saying for quite some time that they expect to keep interest rates “higher for longer” and that message was finally received by markets during the third quarter. The result was a dramatic selloff in 10-year U.S. Treasury yields (which jumped 73 basis points during the quarter) and a pullback in the S&P 500 (which was down -3.27% for the quarter). The most recent Summary of Economic Projections, published by the Fed in September, indicates we might see an additional 25 basis point rate hike in 2023. That potential rate increase is by no means a certainty and will be heavily influenced by incoming inflation data and is very much data dependent. Whether the Fed increases rates one more time this year or not, financial conditions certainly tightened during the third quarter as markets did some of the Fed’s work for them.

The spike in interest rates during the third quarter sent 30-year mortgage rates towards 8%, which is an added headwind for the housing sector. For context, restrictive mortgage rates and limited inventory have resulted in existing home sales falling to levels that match the lows from the initial COVID-19 pandemic lockdown and the Global Financial Crisis doldrums. While housing activity has struggled, the weakness has not yet extended to house prices, which remain elevated. A crucial factor helping to support house prices is a still-strong labor market. Job creation has been robust, with the 3-month moving average increasing to 266,000 as of September, while initial jobless claims continue to suggest a historically tight labor market. Meanwhile, additional progress was made on the inflation side of the Fed’s mandate. However, with inflation still above their 2% target, their job is not yet complete.

In aggregate, the third quarter looks to have been a solid one for economic activity. High frequency indicators (e.g., TSA throughput, hotel occupancy and restaurant activity) suggest that consumers are still active. Additionally, the ISM Services survey reversed some softness and posted three healthy readings for the quarter. The question becomes: how much of this momentum will transfer over to the fourth quarter and into 2024?

ASSET CLASS OVERVIEW

INVESTMENT GRADE BONDS: The Federal Reserve resumed their hiking campaign for the 11th time, raising the overnight borrowing by 25 bps to a 22-year high range of 5.25%-5.50% at their July meeting. Hawkish rhetoric continued from Chairman Jerome Powell as he noted they still have "a long way to go" to tame inflation, leaving the door open for one more hike in 2023. Market participants finally heeded the "higher for longer" mantra late in Q3, with the one-month U.S. Treasury Bill increasing 22 bps to 5.36%, while further out the curve, 5-year and 10-year U.S. Treasuries yields jumped 45 basis points (bps) and 73 bps to 4.61% and 4.57%, respectively. The Bloomberg U.S. Aggregate Index, a broad measure of the investment grade bond market, lost -3.23% during Q3. Spreads were resilient however, with the index widening only 3 bps to an option-adjusted spread (OAS) of 52 bps. Meanwhile, U.S. credit spreads tightened/rallied 2 bps to an OAS of 112 bps. All sectors in the Aggregate index were negative over the period, except for asset-backed securities (ABS), which gained 0.25%. Sovereign debt (-5.37%) and MBS passthrough securities (-4.05%) were down the most, followed by utilities (–4.03%). Returns were mixed on ratings basis with AAA's returning -2.00%, AA's -3.20%, A's -3.24 and BBB's -2.88%. The yield-to-worst (YTW) on the Aggregate index rose 58 bps to 5.39% over the quarter, while the modified duration shortened slightly to 6.15 years.

HIGH YIELD BONDS: During Q3, the ICE BofA U.S. Cash Pay High Yield Index gained 0.52%. The return was comprised of -1.09% in negative price performance driven by rising rates (yields up, prices down) but buoyed by income/coupon that produced a return of 1.61% during the period. Spreads held in well with the index tightening 3 bps to an OAS of 398 bps. The effective yield on the index increased 43 bps to 8.74% as rising rates easily outpaced spread tightening. Meanwhile, the effective duration of the index shortened 1/10th of a year to finish the quarter at 3.65 years. Of the major sectors within the index, banking (2.99%) gained the most followed by media bonds (2.08%) and energy (1.71%). Transportation bonds (-0.80%) lost the most followed by real estate (-0.46%) and health care (-0.31%). Lower-rated bonds outperformed their higher rated peers over the period with C's up 8.57%, CC's 5.49%, CCC's up 2.74%, B's 0.96%, while BB's lost -0.33%.

U.S. EQUITIES: After three consecutive quarters of gains, the S&P 500 Index, widely regarded as the best single gauge of large-cap U.S. equities, fell -3.27% during Q3. All sectors were lower over the period except for energy stocks (12.25%), driven by a 32.23% rise in WTI crude oil. Communication services stocks gained 3.07%, with Alphabet and Meta contributing the most. Interest rate sensitive sectors were down the most as rates jumped; utilities lost -9.25%, while real estate stocks were down -8.89%. Year-to-date, the index is up 13.07% with the top 10 names responsible for 86% of the return.

Mid-cap stocks, as represented by the Vanguard Mid-Cap ETF, underperformed their larger cap peers, falling -5.06% during Q3. Consumer staple stocks were down the most (-11.34%), led lower by Dollar Tree (-25.82%), which slumped after their Q3 EPS outlook missed estimates. Health care stocks were collectively down -10.13%. Despite crushing Q2 earnings, Dexcom (-27.40%), and other stocks that focus on the diabetes treatment space, sold off significantly during Q3 after Danish drugmaker Novo Nordisk announced its weight-loss drug, Wegovy, which reduces the risk of cardiovascular events in overweight adults. The only two sectors that finished the quarter higher were energy (10.79%) and financials (1.95%).

Small-cap stocks, as represented by the iShares 2000 ETF, erased their Q2 gain of 5.19%, losing -5.20% during Q3 with growth stocks (-7.36%) underperforming value stocks (-3.08) by a wide margin. Health care stocks (-15.17%), utilities (-11.84%) and information technology stocks (-9.33%) lost the most. Like their mid-cap peers, energy (18.79%) and financials (1.16%) were the only positively contributing sectors.

INTERNATIONAL EQUITIES: The MSCI EAFE Index, which covers developed countries in Europe, Australasia, Israel and the Far East, lost -4.11%, underperforming U.S. stocks in a period where the U.S. dollar gained 3.17% against a basket of major world currencies. Technology stocks (-10.67%) led index sectors lower, with chip maker ASML Holding (-18.01%) and automation manufacturer, Keyence Corp (-20.56%), detracting the most (-0.33% and -0.12%). Energy stocks gained the most (11.74%), led by TotalEnergies (16.39%) and Shell PLC (7.93%), contributing 0.14% and 0.10%, respectively.