



A Freedom Advisors Company

Defense Caught Offsides

2023 3rd Quarter
Market Commentary



Economic Outlook: Soft Landing in Sight but Defensive Positioning Hurt by Higher Rates



Headlines throughout 3rd Quarter 2023:

1. Fed on Hold as Inflation Slows
2. U.S. Economy Buttressed by Consumption and Investment
3. Commodity Markets Turn Higher Led by Oil and Metals
4. Global Equities Turn Lower as Real Rates Move Higher
5. Generative Artificial Intelligence Viewed as a Secular Growth Theme



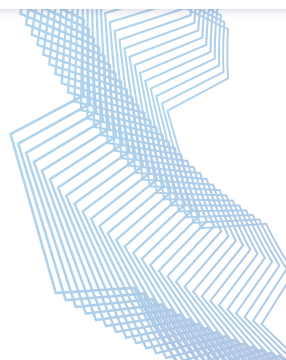
Underneath the Surface:

1. Strong U.S. Dollar Pressuring Foreign Markets and Currencies
2. U.S. Fiscal Deficit Spending Contributing to Higher Rates
3. Leadership Rotation: Value Back to Growth
4. Growing Debt Burden for Consumer and Business Borrowers



2023 GDP Bloomberg Consensus:

1. US: +2.1% (↑ from +0.3% in 4Q22)
2. Europe: +0.5% (↑ from -0.1% in 4Q22)
3. Japan: +1.8% (↑ from +1.2% in 4Q22)
4. China: +5.0% (↑ from +4.8% in 4Q22)



Positioning Update*: Focus on the Here and Now

Time Horizon	Risk Category	Positioning Themes / Targets
Current Distribution (1-3 Years)	<ul style="list-style-type: none"> ▪ Capital Preservation ▪ Current Income 	<ol style="list-style-type: none"> 1. Emphasize liquidity over illiquidity 2. Favor shorter maturity bonds and TIPS 3. Defensive on overall credit risk 4. Favor investment grade MBS/ABS
Later Distribution (3-10 Years)	<ul style="list-style-type: none"> ▪ Strategic: Conservative to Moderate ▪ Deferred Income ▪ Tactical 	<ol style="list-style-type: none"> 1. Greater mix of fixed income to equities with some equity buffers 2. Strategic: Favor smaller caps, high quality, value and dividend-paying stocks; global diversification 3. Tactical: Fully invested across all sectors 4. Fixed Income: Defensive on credit risk and rate volatility 5. Favor investment grade MBS/ABS
Strategic (> 10 Years)	<ul style="list-style-type: none"> ▪ Strategic: Moderate to Aggressive 	<ol style="list-style-type: none"> 1. Greater mix of equities to fixed income with some equity buffers 2. Strategic: Favor smaller caps, high quality, value and dividend-paying stocks; global diversification 3. Fixed Income: Defensive on credit risk and rate volatility 4. Favor investment grade MBS/ABS and taxable municipal

*Positioning Update Implied by 3D/L Capital Management, LLC. Managed Model Portfolios (Risk-Based ETFs, Risk-Based DFA Funds, Lee Adaptive Large Cap Sector) as of 9/30/2023

Key Benchmarks: Performance and Characteristics as of 9/30/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	-4.8%	-3.3%	13.1%	18.0x	14.6x	22.9x	
MSCI EAFE	-3.4%	-4.1%	7.1%	12.8x	11.2x	18.3x	
MSCI Emerging	-2.6%	-2.9%	1.8%	11.5x	9.5x	15.3x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg U.S. Aggregate	-2.5%	-3.2%	-1.2%	US REITs	-7.0%	-8.4%	-5.6%
Bloomberg U.S. High Yield	-1.2%	0.5%	5.9%	GSCI Commodities	4.1%	16.0%	7.2%
Bloomberg Global Agg ex U.S.	-3.3%	-4.0%	-3.2%	GSCI Prec Metals	-5.1%	-3.8%	0.5%

Data Source: Bloomberg

September and 3rd Quarter 2023 Highlights:

- Global equity markets pulled back in the 3rd quarter as slowing global growth prospects, a still-hawkish Fed, and rising global interest rates weighed on overall risk sentiment. The MSCI All-Country World Index (ACWI) dropped 4.1% for the month of September and was down 3.4% for the 3rd quarter of 2023.
- Across major regions, U.S. markets lagged the rest of the world in September while Pan-Asia recovered from their underperformance in August to lead major markets. In September, MSCI Japan returned -2.1% followed by MSCI Emerging Markets (-2.6%), MSCI Asia ex Japan (-2.7%), MSCI Europe (-4.0%) and S&P 500 (-4.8%). In 3Q 2023, MSCI Japan returned -1.6% followed by MSCI Emerging Markets (-2.9%), the S&P 500 (-3.3%), MSCI Asia ex Japan (-3.4%), and MSCI Europe (-5.0%).
- The U.S. dollar strengthened throughout the quarter as the Federal Reserve retained a hawkish stance, signaling 'higher for longer' on forward interest rates despite inflation pressures easing from 2022 peak levels. Asian currencies, notably the Japanese Yen and the Chinese Yuan, came under further selling pressure, approaching or exceeding last year's weak levels during the U.K. Gilt sell-off.
- Within the U.S., small caps underperformed large caps in September as the latter benefited from mega-cap growth technology companies comprising an increasing concentration of market value across the main U.S. large cap indices, while S&P Pure Value performed in line Growth with the former benefiting from a sharp advance in

energy stocks. For the month of September, the S&P 600 Index returned -6.0% versus -4.8% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -3.9% versus -3.5%, respectively, both styles outperforming the S&P 500 Index. For 3Q 2023, the S&P 600 Index returned -4.9% versus -3.3% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -4.5% versus -0.9%.

- Across sectors, only Energy had a positive return in September helped by higher oil and gasoline prices, while interest rate sensitive sectors (Real Estate, Utilities) and cyclical growth (Industrials, Consumer Discretionary, Technology) underperformed. In 3Q 2023, Energy and Communication Services (benefiting from social media landscape) outperformed interest-sensitive sectors (Real Estate, Utilities) and cyclicals (Industrials, Technology).
- Among major risk factors, in September, factor dispersion was narrow with Minimum Volatility, High Dividend, and Value outperforming Momentum and High Quality. In 3Q 2023, High Quality and Minimum Volatility outperformed although factor dispersion was narrow.
- In September, fixed Income market returns were hurt by an end-of-quarter steepening of the Treasury yield curve with long maturity rates rising faster than short maturity rates following the September Fed meeting (FOMC) which signaled higher-for-longer interest rates despite signs of slowing inflation. The Bloomberg U.S. Aggregate Bond Index dropped 2.5% for the month while the Global ex-U.S. Aggregate Index returned -3.3%, hurt by a strengthening dollar. US High Yield continues its outperformance across broader fixed income, as the high yield market is not as interest rate sensitive versus investment-grade. The Bloomberg High Yield Index returned -1.2% while Bloomberg Emerging Market Local Currency returned -3.7%, hurt by the strengthening U.S. dollar. For the 3rd quarter, the Bloomberg U.S. Aggregate Bond Index returned -3.2%, outperforming the Global ex-U.S. Aggregate Index which returned -4.0%. Bloomberg US High Yield outperformed global investment grade, returning +0.5% for the quarter.
- Within equity alternatives, Commodities outperformed in September on the strength of higher oil prices as well as a counterrallies in industrial metals. Real Estate and Precious Metals were hurt by rising real (inflation-adjusted) interest rates. The S&P GSCI Commodities Index returned +4.1% for the month, led by higher industrial metals and crude oil while the S&P GSCI Precious Metals Index returned -5.1% as gold prices dropped below \$1,900/ounce. Dow Jones REITs dropped 7.0%, hurt by rising real rates and ongoing concerns over the commercial office sector. For 3Q 2023, S&P GSCI Commodities Index rose 16.0% while the S&P GSCI Precious Metals and the Dow Jones REIT Index dropped 3.8% and 8.4%, respectively.

Defense Caught Offsides



"I'm still trying to process why long-end interest rates are increasing."

– Austan Goolsbee, CEO Federal Reserve Bank of Chicago and voting member on the Federal Reserve Board during Q&A following a policy speech to the Peterson Institute for International Economics, 9/28/2023¹

Source: istockphoto.com

The third quarter began with a continuation of the risk-on rally from the 2nd quarter that initially saw a counterrally in this year's laggards, notably Asian equities and global small caps; however, the optimism that fueled the initial market rally dissipated throughout the remainder of the quarter, despite further indications of slowing inflation, resilient economic growth activity, and rising earnings optimism over technology spending fueled by generative artificial intelligence. By the end of the quarter, real (inflation-adjusted) interest rates sharply rose, especially on the long end of the yield curve, pressuring interest-sensitive assets and foreign currencies and pushing up borrowing rates for consumers and businesses to levels not experienced since prior to the 2008 Great Financial Crisis.

As the above-referenced quote from Austan Goolsbee, it wasn't entirely clear the exact catalyst for the sell-off in fixed income markets as core inflation readings (**Figure 1**) continue to trend lower towards the Fed's long-term target of 2%, hence, an acknowledgement that an economic soft landing (a scenario that sees inflation coming down without a recession) can possibly be achievable as more progress is made on the inflation front.

Some have suggested that the rise in interest rates is a global phenomenon (**Figure 2**), pressured by rising interest rates on Japanese government debt, which have historically anchored global long-term rates. Persistently higher inflation in Japan could eventually force the Bank of Japan to abandon yield curve control and quantitative easing, as the benchmark 10-year yield rose to the upper end of the expanded threshold established by BOJ Governor Kazuo Ueda. However, Ueda keeps dispelling notions that the BOJ is about to end the "radical stimulus programs" established by his predecessor Haruhiko Kuroda, suggesting that there was "still a distance to go" before ending ultraloose monetary policy.²

¹ "Policy Speech by Austan D. Goolsbee," YouTube, 9/28/2023

² "BOJ's Ueda Dispels View that Risk Will Impede Easy-Policy Exit," Nikkei Asia, 9/30/2023

Figure 1 – Latest Core Inflation (ex-Housing) Came in Soft and is Trending Towards the Fed’s Desired Long-Term Target

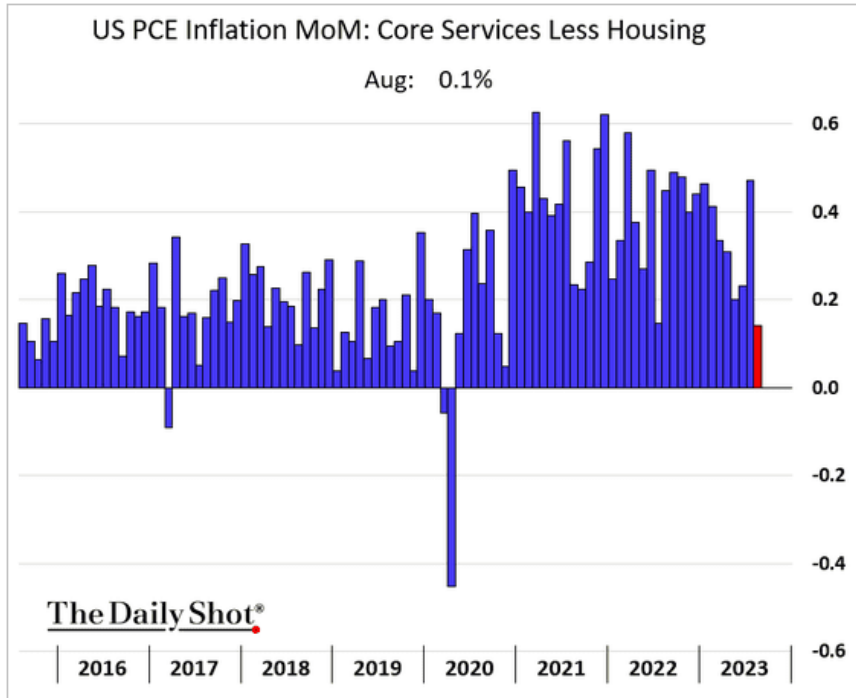
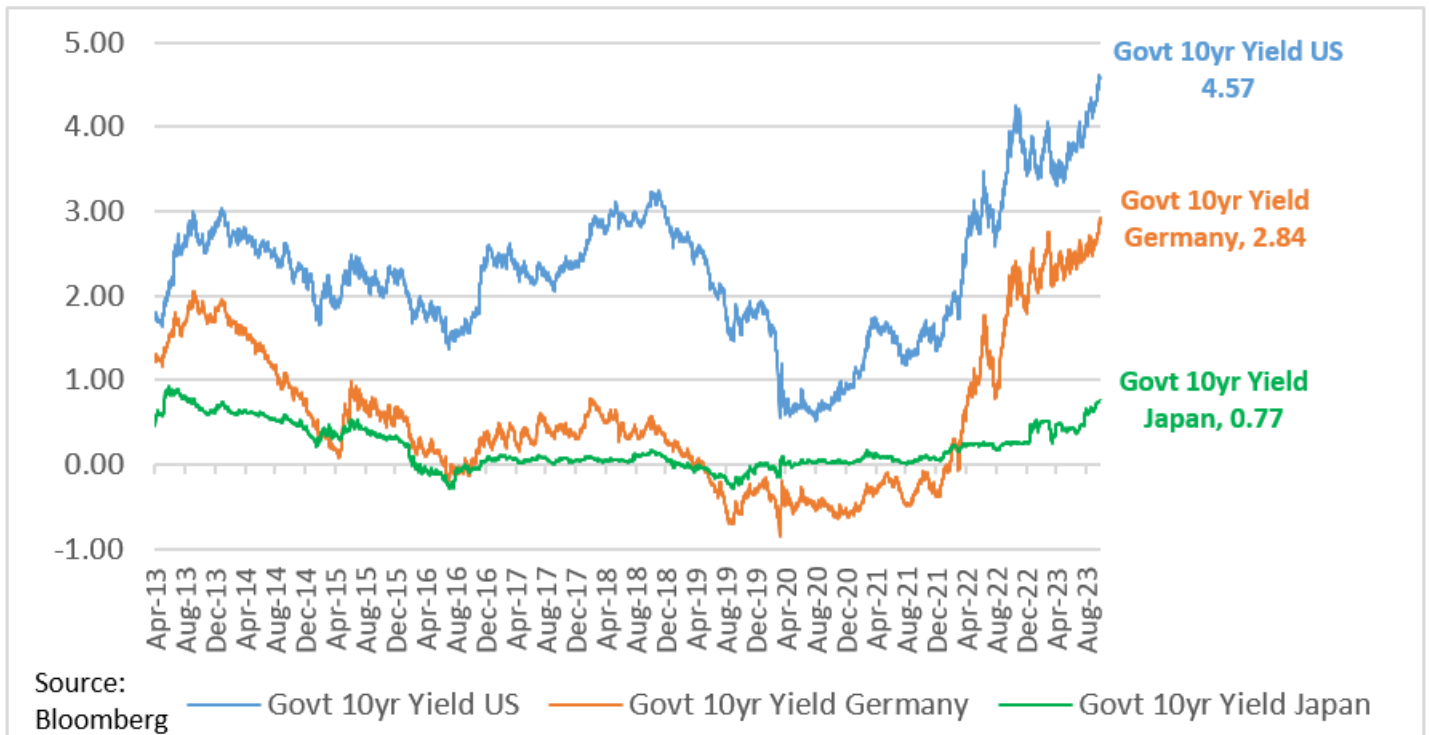


Figure 2 – But Global Bond Yields Rose to New 10-Year Highs Despite Slowing Inflation



U.S. economic activity does not appear to be slowing down, especially personal consumption, as indicated by the Atlanta Fed GDPNow forecast, which is projecting 4.9% annualized real GDP growth for 3Q2023 (**Figure 3**), which could be pressuring the Fed to remain hawkish. But other private surveys of consumer spending (BofA, JPMorgan) reveal a marked slowdown in consumer spending. Although payroll growth has softened, overall employment conditions remain strong (as indicated by elevated wage growth and low jobless claims) such that the Fed has largely conceded its initial goal set in 2022 of bringing about a significant softening of labor market conditions (read higher unemployment) in order to slow down inflation.³

Figure 3 – Atlanta Fed GDPNow Estimates Annualized 3Q GDP Growth of 4.9%, Led by Strong Personal Consumption, Investment, and Net Trade Activity

Atlanta Fed GDPNow estimates for 2023: Q3, growth rates and changes

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Exports	Imports	Change in net exp.	Change in CIPI
30-Aug	Latest BEA estimate for 23:Q1	2.0	4.2	-8.9	3.1	15.8	-4.0	5.0	7.8	2.0	30	-133
30-Aug	Latest BEA estimate for 23:Q2	2.1	1.7	7.7	2.2	11.2	-3.6	3.3	-10.6	-7.0	-4	-5
28-Jul	Initial GDPNow 23:Q3 forecast	3.5	3.1	0.0	6.3	-3.2	-1.9	2.9	4.7	2.9	2	33
	Personal income and outlays, NIPA underlying detail tables, GDP (8/30),											
31-Aug	Adv Econ Indicators (8/30)	5.6	4.3	3.2	6.1	-3.1	8.8	2.5	5.3	2.3	12	66
5-Sep	M3-2 Manufacturing, Auto sales	5.4	3.9	1.3	5.9	0.1	7.1	2.3	5.1	2.0	13	72
6-Sep	Int trade, ISM Nonmanuf Index	5.6	4.0	0.1	5.9	0.2	7.2	2.3	6.4	1.9	23	72
8-Sep	Wholesale trade	5.6	4.0	0.1	5.9	0.2	7.3	2.3	6.4	1.9	22	71
	Consumer Price Index, Monthly											
13-Sep	Treasury Statement	5.5	4.0	0.2	5.9	0.2	7.4	1.9	6.5	2.0	22	69
14-Sep	Retail trade, Producer Price Index	4.9	3.5	0.2	5.9	-0.1	6.8	1.9	6.4	1.9	22	63
15-Sep	Import/Export Prices	4.9	3.6	0.3	5.9	-0.2	6.8	1.9	6.8	2.2	22	55
19-Sep	Housing starts	4.9	3.6	0.2	5.9	-0.2	6.3	1.9	6.7	2.2	22	55
21-Sep	Existing-home sales	4.8	3.6	0.2	5.9	-0.2	5.4	1.9	6.7	2.2	22	55
26-Sep	New-home sales	4.8	3.6	0.2	5.9	-0.2	4.9	1.9	6.7	2.2	22	55
27-Sep	Advance Census manuf (M3-1)	4.9	3.6	0.5	5.9	-0.2	4.9	1.9	6.7	2.2	22	60
	Maximum forecast of real GDP growth											
24-Aug	Advance Census manuf (M3-1)	5.9	4.8	2.4	6.2	-2.8	8.7	2.5	5.4	3.5	2	71
	Minimum forecast of real GDP growth											
28-Jul	Initial GDPNow 23:Q3 forecast	3.5	3.1	0.0	6.3	-3.2	-1.9	2.9	4.7	2.9	2	33

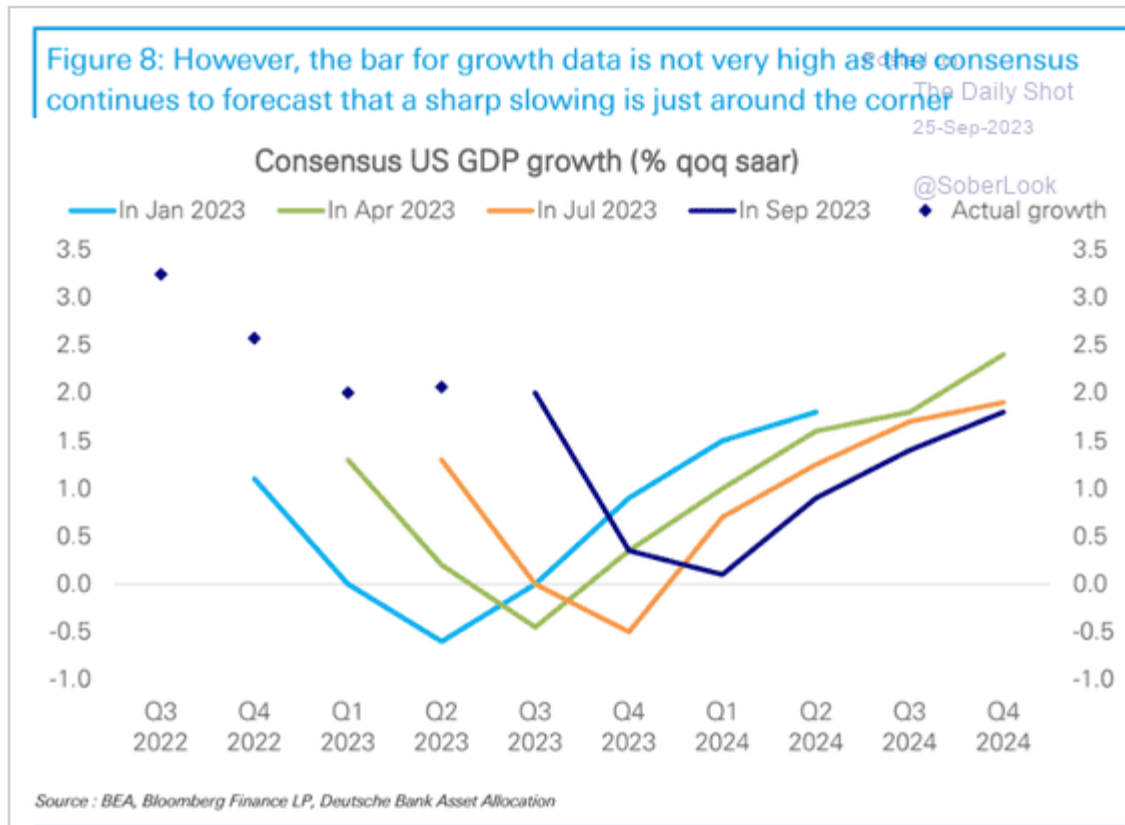
Note: The first two rows are published BEA estimates for the most recent two quarters. Rows including and below row three are GDPNow forecasts. CIPI is "change in private inventories." Changes in net exports and CIPI are both in billions of 2012 dollars (SAAR). All other numbers are quarterly percent changes (SAAR). The table does not necessarily include all estimates for the quarter; see tab "TrackingHistory" in the [online Excel file](#) for the entire history.

Sources: US Bureau of Economic Analysis and Federal Reserve Bank of Atlanta

³ "Fed's Goolsbee Sees Risk of 'Error in View that Low Inflation Needs High Unemployment,'" Reuters, 9/28/2023

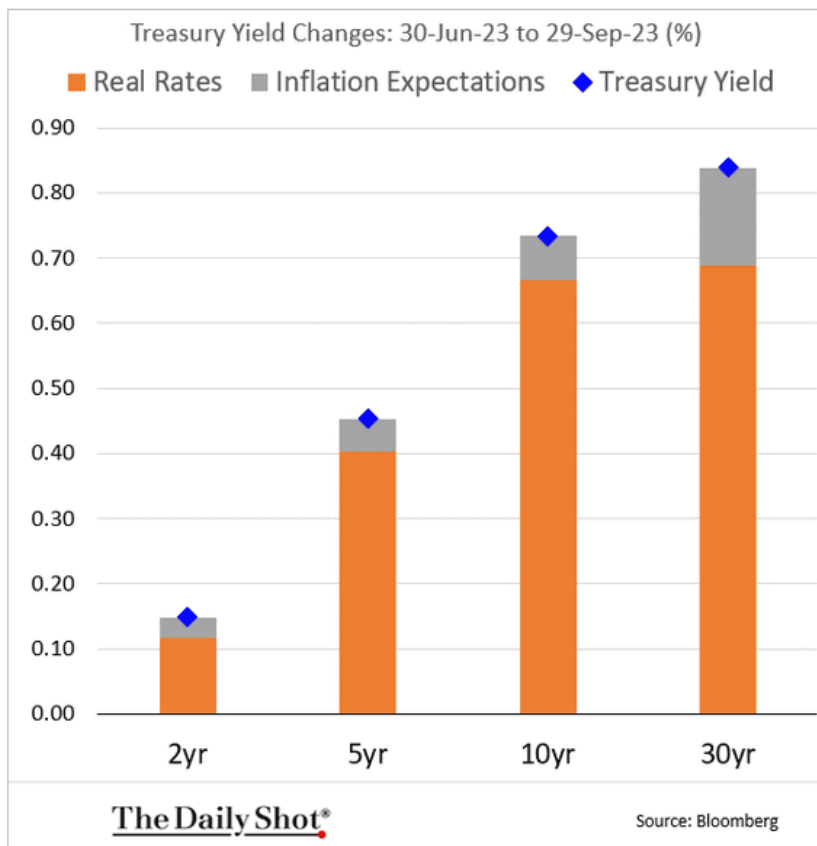
Indeed, consensus economic forecast for the next slowdown (no longer contraction) continues to be pushed further out (see dark blue line in **Figure 4**) as current economic momentum shows few signs of exhaustion.

Figure 4 – Economic Consensus No Longer Projecting a Recession but a Slowdown and Later into 2024



This quarter's rise in interest rates can be attributed to a rise in real rates as opposed to rising inflation expectations. In other words, the risks associated with holding Treasury bonds rose due to factors not tied to rising inflation (**Figure 5**). Some of attributed the rise in real rates to the sovereign debt downgrade of the U.S. by Fitch Ratings following the debt ceiling drama back in June.

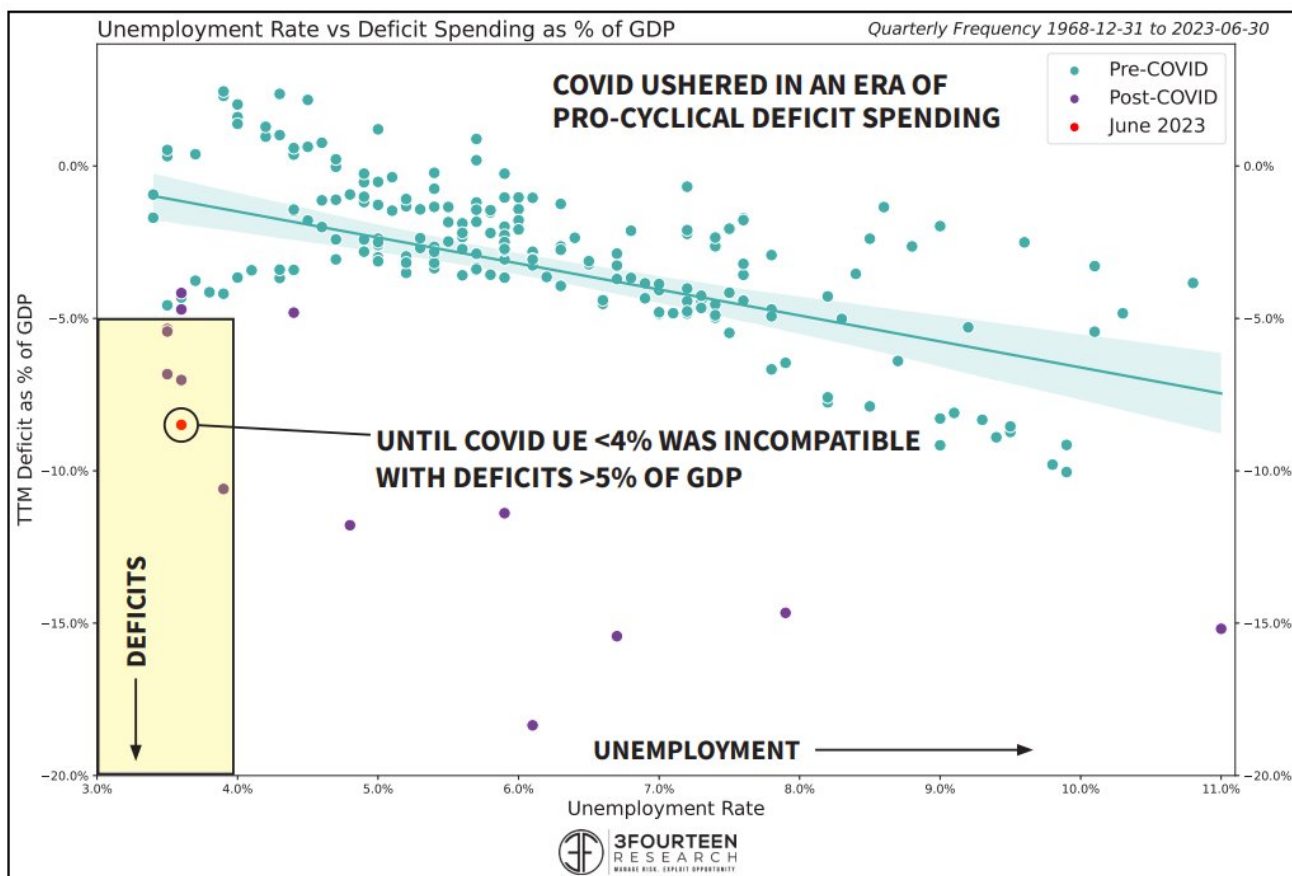
Figure 5 – This Quarter's Sharp Rise in Treasury Rates Due to Factors Not Tied to Inflation



Perhaps, the sharp rise in Treasury rates is also due to unrelenting fiscal borrowing with deficit financing expected to exceed 5% of GDP this year, atypical during an economic expansion and low unemployment, and then eventually to 7% by 2033, according to CBO projections.⁴ And this assumes U.S. GDP does not collapse as it did during prior recessions, most recently the 2020 COVID lockdowns. **Figure 6** displays a scatterplot from 3Fourteen Research between unemployment rates and fiscal deficit spending as a % of GDP. In the circled area of the chart, 3Fourteen argues that until the COVID lockdowns occurred, <4% unemployment rates were incompatible with deficits exceeding 5% of GDP, which have been the case since the emergency spending measures were implemented following the COVID shutdowns. Perhaps the infamous [Bond Vigilantes](#), once quipped by former Bill Clinton political strategist James Carville, have re-emerged to price in higher real borrowing rates as a signal of fiscal spending imprudence.

However, the near-term deficit picture could meaningfully change assuming a normal resumption of student loan payments not to mention storm-related delayed federal tax receipts from California, although should higher rates remain persistent, then higher rates would only add to the worries over the fiscal trajectory.⁵ The potential for more revenue should be incorporated into real rates if fiscal imprudence has become the dominant factor.

Figure 6 – Has Something Fundamentally Changed in the Relationship Between Labor Market Conditions and Pro-Cyclical Fiscal Deficit Spending Since COVID?

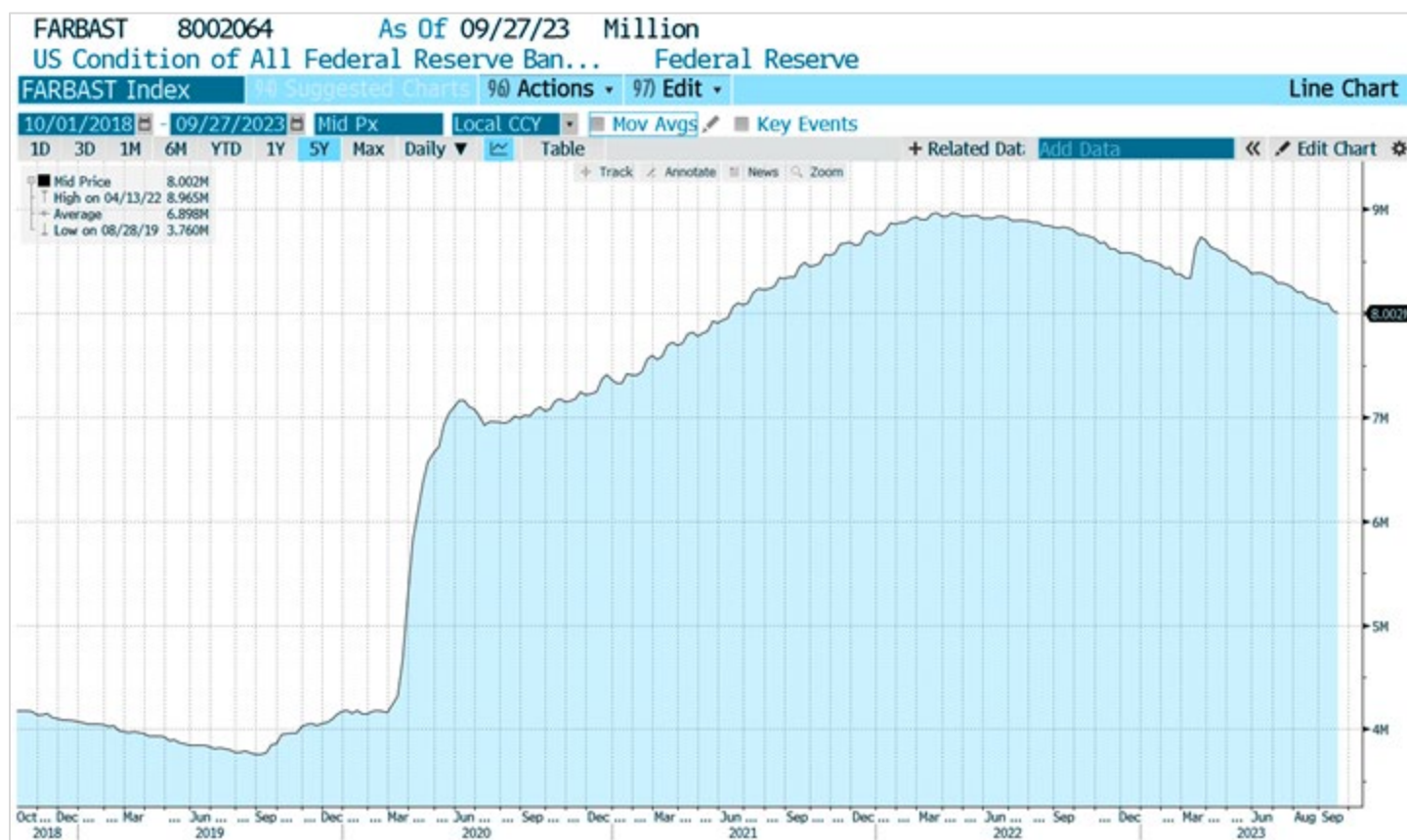


⁴ "The Budget and Economic Outlook: 2023 to 2033," Congressional Budget Office, February 2022

⁵ "No need to panic about the budget deficit," Brookings Institute, 9/20/2023

The rise in Treasury rates began just after the debt ceiling showdown with the U.S. Department of Treasury issuing new rounds of debt to replenish its General Account (TGA). Wall Street strategists, such as Barclays, maintained that ramp-up in issuance added fuel to the sell-off in Treasuries.⁶ This wall of issuance is occurring as the Fed picks up the pace on paring back its balance sheet (quantitative tightening) as assets have dropped to \$8 trillion (**Figure 7**). A combination of higher supply and lower price-insensitive demand, as reflected by quantitative tightening, not to mention continued de-risking of bank balance sheets following the March/April regional banking stress, would add to technical net selling pressures throughout the quarter.

Figure 7 – Quantitative Tightening, or Paring Down the Fed Balance Sheet, Has Helped Exacerbate the Selling Pressure on Treasuries in Addition to Increased Issuance



Source: Bloomberg

⁶ "US Ramps Up Debt Issuance, Adding Fuel to Selloff in Treasuries," Bloomberg, 8/2/2023

But, both the Treasury issuance and Fed quantitative tightening have been well telegraphed throughout the quarter, yet the bond market saw its steepest sell-off during the last two weeks of the quarter, shortly after the September FOMC, when the Fed chose not to raise rates but tempered expectations that rate cuts in 2024 were imminent until meaningful progress had been achieved on the inflation front. Although the Fed did not raise its benchmark overnight rate, they wanted to leave all options on the table including the possibility of another rate hike in late 2023 should conditions warrant it (although the bar was set high for another rate hike).⁷ Despite the sharp rise in the long end of the Treasury curve (see market summary below), near-term expectations for Fed Funds Rate remained largely unchanged even though the first rate cut was pushed out from spring to late summer 2024 (**Figure 8**). The signaling of the end of the rate hike cycle was initially interpreted as a dovish pivot, but the bond market sell-off picked up steam soon thereafter.

By the way, if the Fed were to change policy in 2024 and start cutting rates, it would likely need to do so well before the start of the fall election campaign to maintain the optics of political neutrality.

Figure 8 – Another Fed Funds Rate Hike Seems Less Likely for 2023 but the First Rate Cut Has Been Pushed Out from Spring to Late Summer in 2024

Region: United States »		Instrument: Fed Funds Futures »				
Target Rate	5.50	Pricing Date	09/29/2023			
Effective Rate	5.33	Cur. Imp. O/N Rate	5.327			
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.	
11/01/2023	+0.186	+18.6%	+0.047	5.374	0.250	
12/13/2023	+0.391	+20.5%	+0.098	5.425	0.250	
01/31/2024	+0.400	+0.9%	+0.100	5.428	0.250	
03/20/2024	+0.240	-16.0%	+0.060	5.388	0.250	
05/01/2024	-0.091	-33.1%	-0.023	5.305	0.250	
06/12/2024	-0.526	-43.5%	-0.132	5.196	0.250	
07/31/2024	-1.030	-50.4%	-0.258	5.070	0.250	
09/18/2024	-1.660	-63.0%	-0.415	4.912	0.250	
11/07/2024	-2.227	-56.7%	-0.557	4.771	0.250	
12/18/2024	-2.835	-60.8%	-0.709	4.619	0.250	
01/29/2025	-3.320	-48.5%	-0.830	4.497	0.250	

Source: Bloomberg

⁷ "Fed declines to hike, but points to rates staying higher for longer," CNBC, 9/20/2023

Defense Caught Offsides

2023 3rd Quarter Market Commentary



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This leads us (the long way around perhaps) to our title for this quarter's commentary, "Defense Caught Off-Sides." There were unconfirmed reports of significant selling pressure and unwinding of long maturity Treasury positions from the institutional investor community. Fixed income securities, particularly sovereign debt such as Treasuries, have historically served as the ballast in a portfolio comprised of risky assets, whether equities, real estate, or commodities. The low correlation with risky assets is what has contributed to the widely adopted 60/40 equity/fixed income portfolio mix. Typically, long duration Treasuries perform well in a volatile risk-off environment, as investors price in a lower interest rate regime on expectations of a deflationary-driven growth slowdown.

However, playing defense with long duration has not followed the typical 60/40 playbook of low asset correlations between stocks and bonds over the past two years. You can thank a higher inflation regime mixed with stimulative fiscal policy in a tight labor environment for that breakdown. To highlight how investors playing defense with long duration fixed income were caught offsides, **Figure 9** displays the third quarter return of a popular cross-asset strategy known as risk parity, as proxied by the S&P Risk Parity Index (15% Vol Target) and the Advanced Research Risk Parity Index, which significantly underperformed the underlying asset components (equities, commodities, fixed income) with most of that return drawdown occurring the last two weeks of the quarter.

Figure 9 – Risk Parity Significantly Underperformed the Underlying Asset Components, Likely Due to the Leveraged Position in Fixed Income Relative to Equities and Commodities



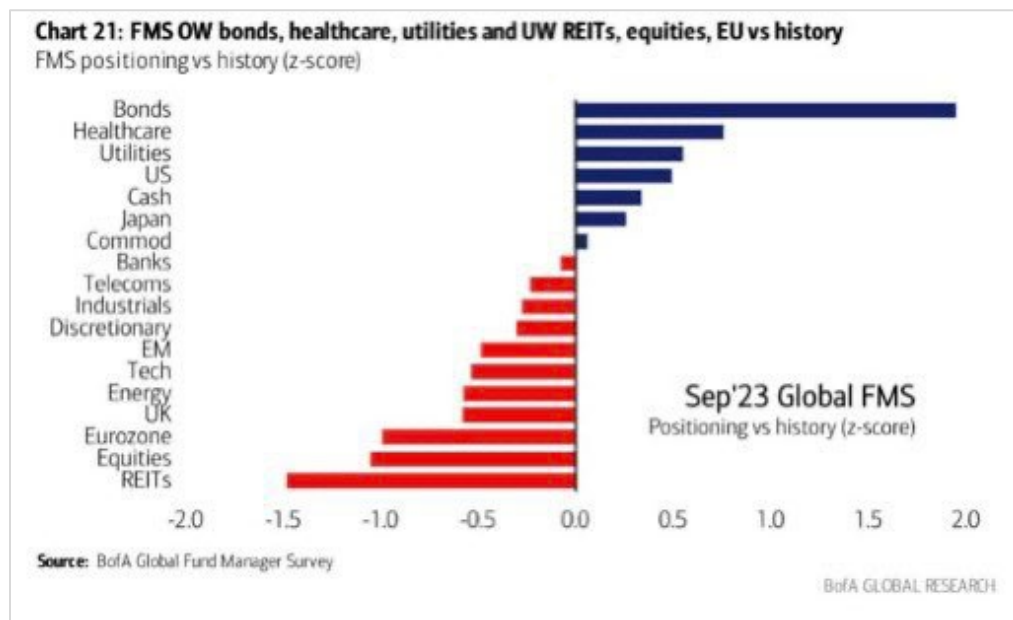
Source: Bloomberg

Risk parity seeks to allocate to fixed income, equity, and commodities in such a way as to make the marginal contribution to volatility equal to one another. This typically involves leveraging up a position in fixed income to make the overall risk contribution on par with equities and commodities, which have historically higher volatility than fixed income. Higher risk targets typically involve more leverage. The key for this strategy rests on estimating the cross-asset correlations correctly. The post-COVID environment has thrown a wrench into these historical relationships (not to mention many econometric models).

The unwinding of these leveraged risk positions could have contributed to the sharp selling pressure towards the end of September, as those historically low cross-asset correlations were anything but low. Leveraged positions can be difficult to maintain in a rising volatile environment, particularly for fixed income which is meant to serve as the low volatility component within a cross-asset strategy.

Needless to say, much of the institutional world beyond risk-parity seems to have been caught offsides playing defense with bonds. According to the latest Bank of American Fund Manager Survey (**Figure 10**), fund managers' preference for bonds are at historically high levels and that preference has greatly increased from the same survey at the beginning of the year. Given that long-term inflation expectations (as measured by TIPS yields versus nominal Treasury yields) still hover between 2% and 2.5%, a 10-Year Treasury yielding 3.5% back in the 2nd quarter, would have seemed highly attractive as real rates turned positive for the first time in quite a while. With 10-Year Treasuries yielding above 4.5%, that real rate is turning near irresistible.

Figure 10 – Preference for Bonds by Fund Managers Have Reached Historically High Levels



And who can blame fund managers preferring fixed income over equities, with the trailing 12-months earnings yield (inverted price/multiple) of the S&P 500 now below the 2-year Treasury yield, which only occurred during the dotcom boom of the late 1990s in recent memory (**Figure 11**). By most measures, fixed income valuations appear very attractive relative to equity valuations, even with Wall Street projecting positive earnings growth throughout 2024 (**Figure 12**). The forward P/E multiple is currently 18x, below the near 20x reached earlier in the year, resulting in multiple contraction contributing to the bulk of this quarter's loss in the S&P 500 as opposed to earnings growth (**Figure 13**). High interest rates, slowing nominal growth, and an uncertain earnings outlook outside of big tech spending are starting to weigh on U.S. equity valuations.

Figure 11 – 2-Year Treasury Yield Now Exceeds the S&P 500 Earnings Yield (P/E Multiple Inverted), Which Last Occurred During the Dotcom Era of the Late 1990s

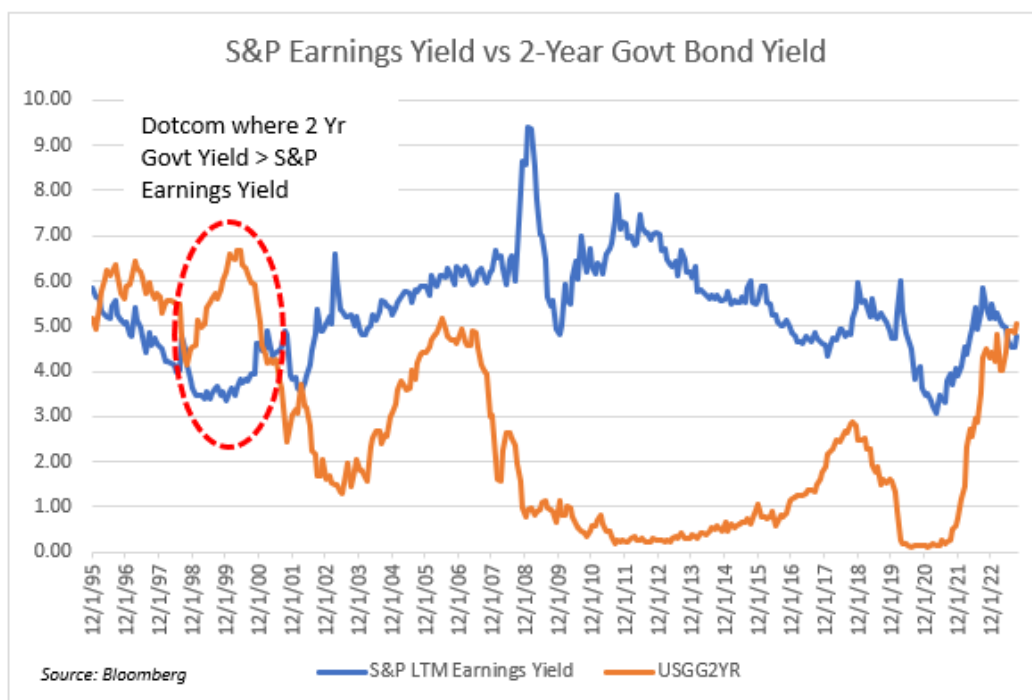


Figure 12 – Analysts Continue to Raise Next Year’s Earnings for the S&P 500

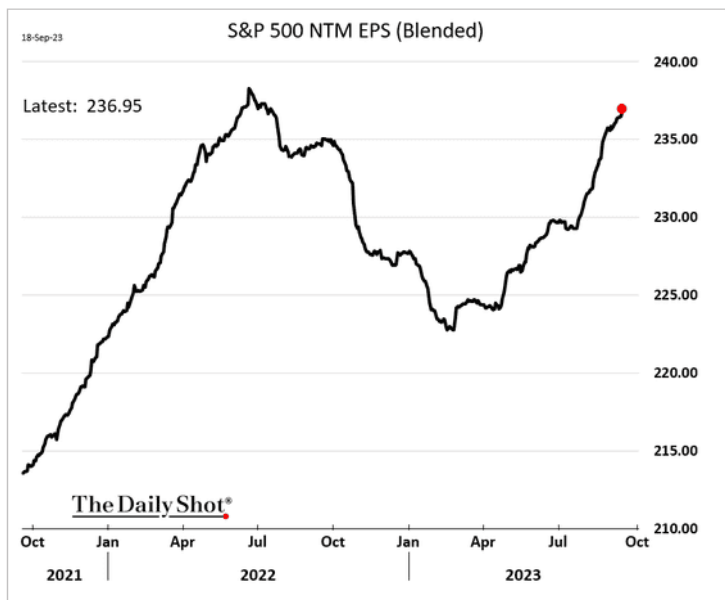
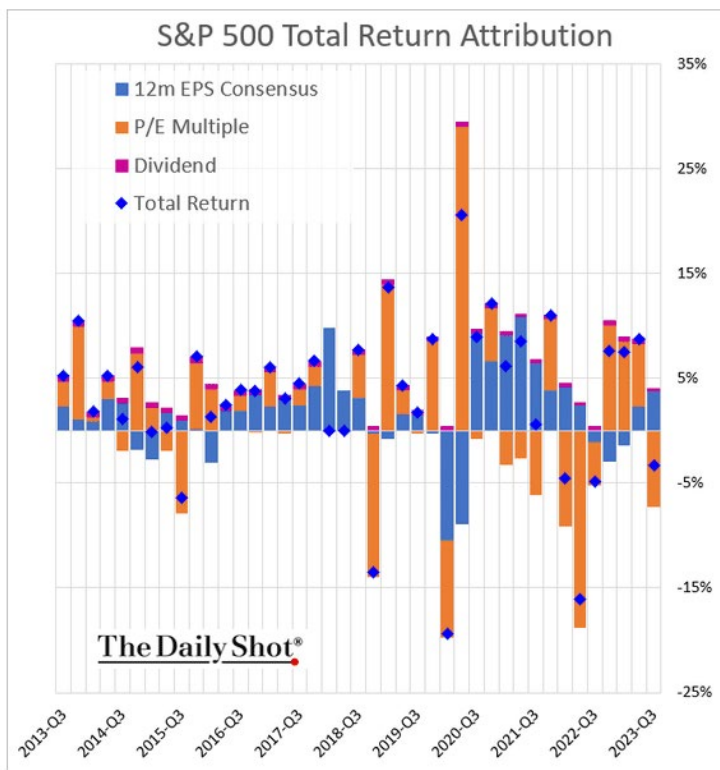
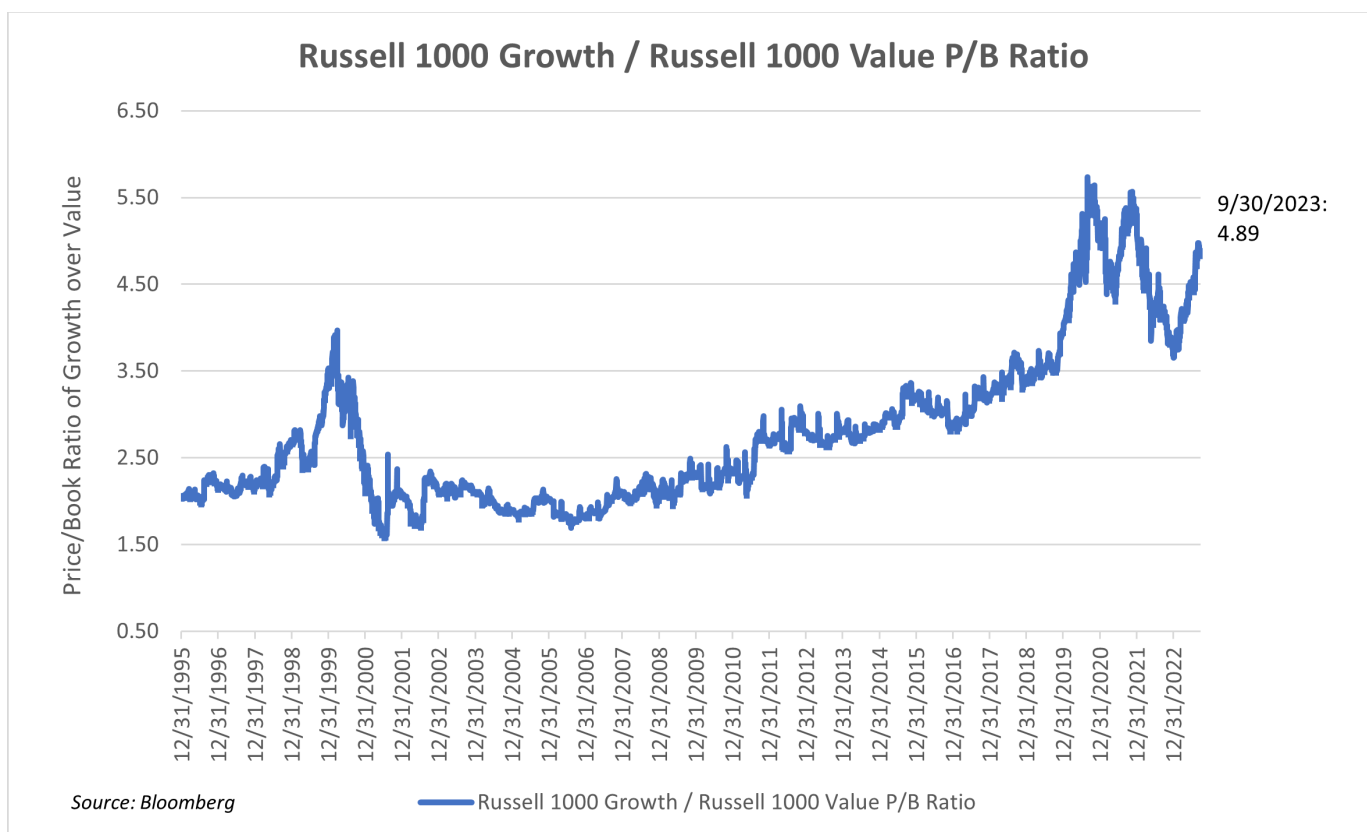


Figure 13 – 3rd Quarter Saw the Deepest Negative Contribution to Total Return from Multiple Contraction to S&P 500 Returns, Ending a String of Positive Contributions Over the Prior Three Quarters



It is this prospect of near-certain earnings growth that is contributing to investors flocking to large cap growth premium stocks over discounted value stocks as the price/book valuation gap continues to widen this year, but yet remains below the peak gaps seen in 2020-2021 (**Figure 14**). Value stocks are increasingly being left in the cold in an environment of higher real interest rates as growth stocks are now viewed as being better positioned to weather higher rates (helped by the huge sums of cash accumulated on tech company balance sheets).

Figure 14 – The Valuation Disparity Between Large Growth Versus Value Continues to Widen but Still Below Post-Pandemic Peak Levels



This has resulted in a new cross-asset playbook barbelled between less interest sensitive assets (cash, short duration) and pro-cyclical growth scarcity (growth stocks and commodities). Investors are playing a new kind of defense and hope to not be caught offsides as with the old defense of long duration safety embedded in U.S. Treasuries.

September and 3rd Quarter 2023 Market Review

Global equity markets pulled back in the 3rd quarter as slowing global growth prospects, a still-hawkish Fed, and rising global interest rates weighed on overall risk sentiment. The MSCI All-Country World Index (ACWI) dropped 4.1% for the month of September and was down 3.4% for the 3rd quarter of 2023.

Across major regions, U.S. markets lagged the rest of the world in September while Pan-Asia recovered from their underperformance in August to lead major markets. In September (**Figure 15**), MSCI Japan returned -2.1% followed by MSCI Emerging Markets (-2.6%), MSCI Asia ex Japan (-2.7%), MSCI Europe (-4.0%) and S&P 500 (-4.8%). In 3Q 2023 (**Figure 16**), MSCI Japan returned -1.6% followed by MSCI Emerging Markets (-2.9%), the S&P 500 (-3.3%), MSCI Asia ex Japan (-3.4%), and MSCI Europe (-5.0%).

Figure 15 – The U.S. Underperforms the Rest of the World in September

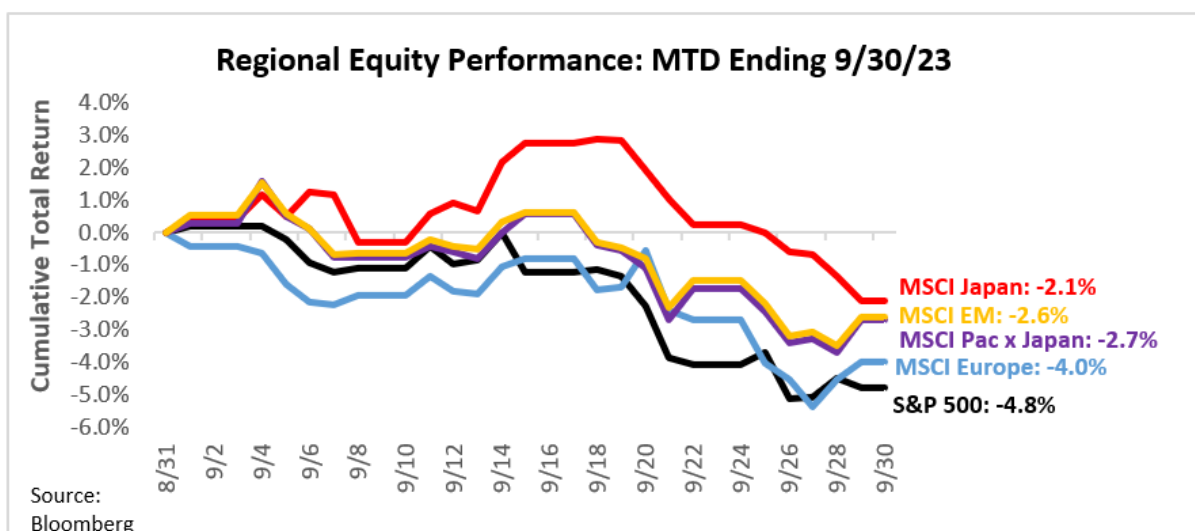
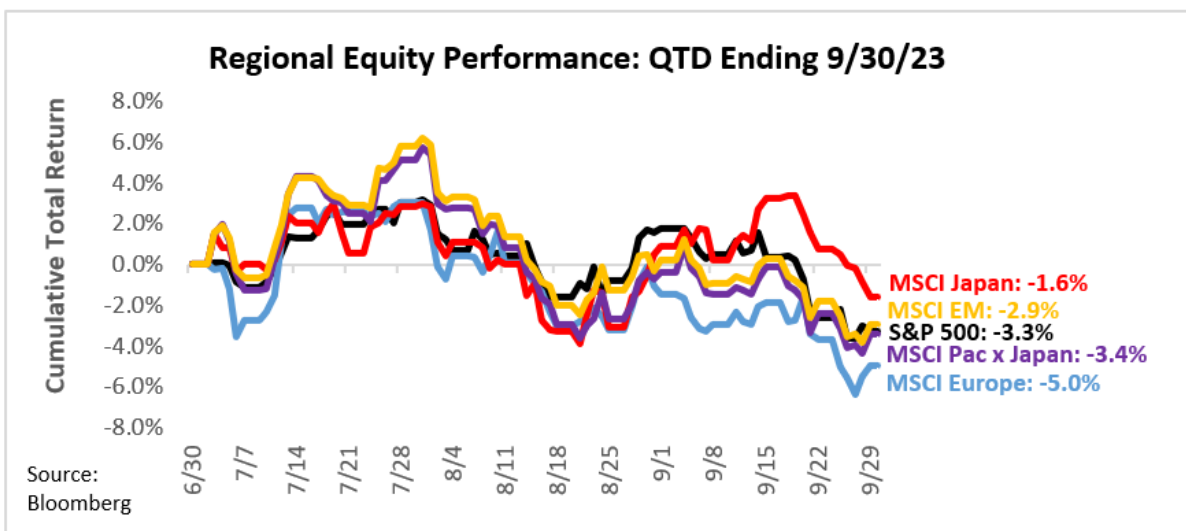


Figure 16 – Japan and Emerging Markets Outperformed in the 3rd Quarter



Defense Caught Offsides

2023 3rd Quarter Market Commentary



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The U.S. dollar (**Figure 17**) strengthened throughout the quarter as the Federal Reserve retained a hawkish stance, signaling ‘higher for longer’ on forward interest rates despite inflation pressures easing from 2022 peak levels. Asian currencies, notably the Japanese Yen and the Chinese Yuan (**Figure 18**), came under further selling pressure, approaching or exceeding last year’s weak levels during the U.K. Gilt sell-off.

Figure 17 – The U.S. Dollar Strengthened Throughout the 3rd Quarter on Expectations that U.S. Monetary Policy and Financial Conditions Would Remain Tight

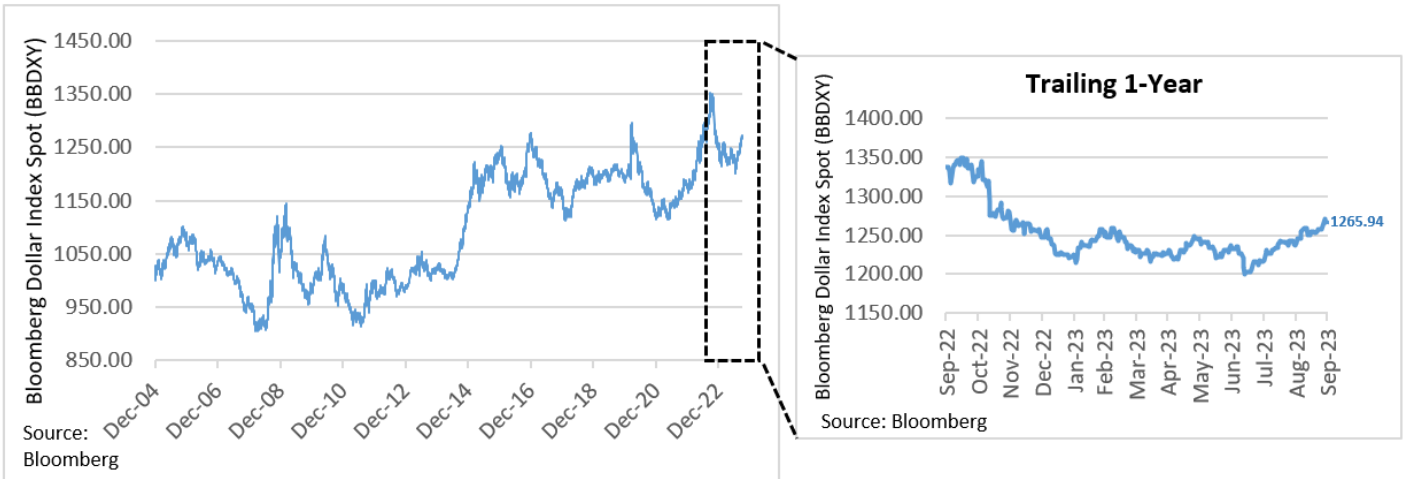
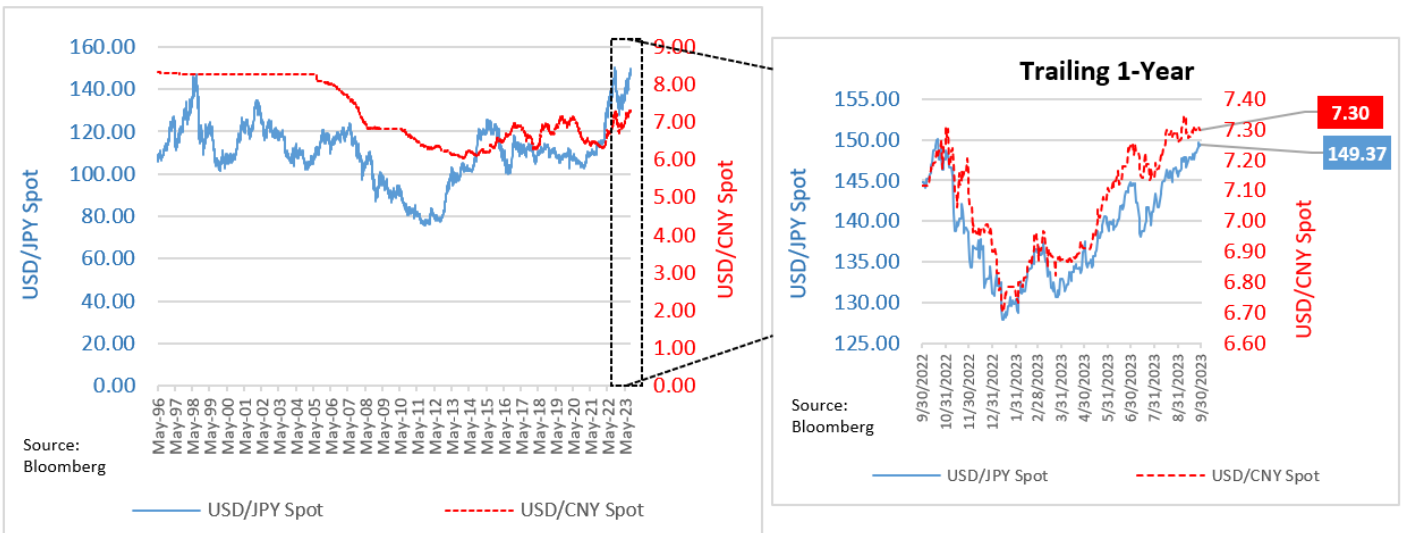


Figure 18 – The Japanese Yen and China Yuan Continued Their Depreciation Against the U.S. Dollar as Both Countries Contend with Slowing Trade Activity and Domestic Consumption



Within the U.S., small caps underperformed large caps in September as the latter benefited from mega-cap growth technology companies comprising an increasing concentration of market value across the main U.S. large cap indices, while S&P Pure Value performed in line Growth with the former benefiting from a sharp advance in energy stocks. For the month of September (**Figure 19**), the S&P 600 Index returned -6.0% versus -4.8% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -3.9% versus -3.5%, respectively, both styles outperforming the S&P 500 Index. For 3Q 2023 (**Figure 20**), the S&P 600 Index returned -4.9% versus -3.3% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -4.5% versus -0.9%.

Figure 19 – In September, Small Caps Underperformed Large Caps While Value Underperformed Growth

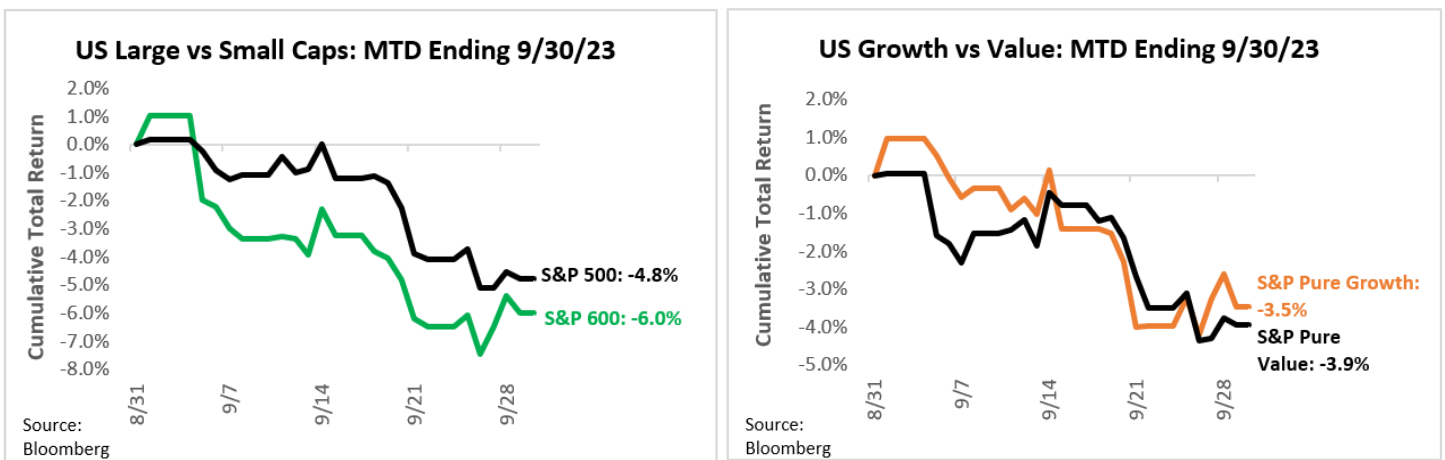
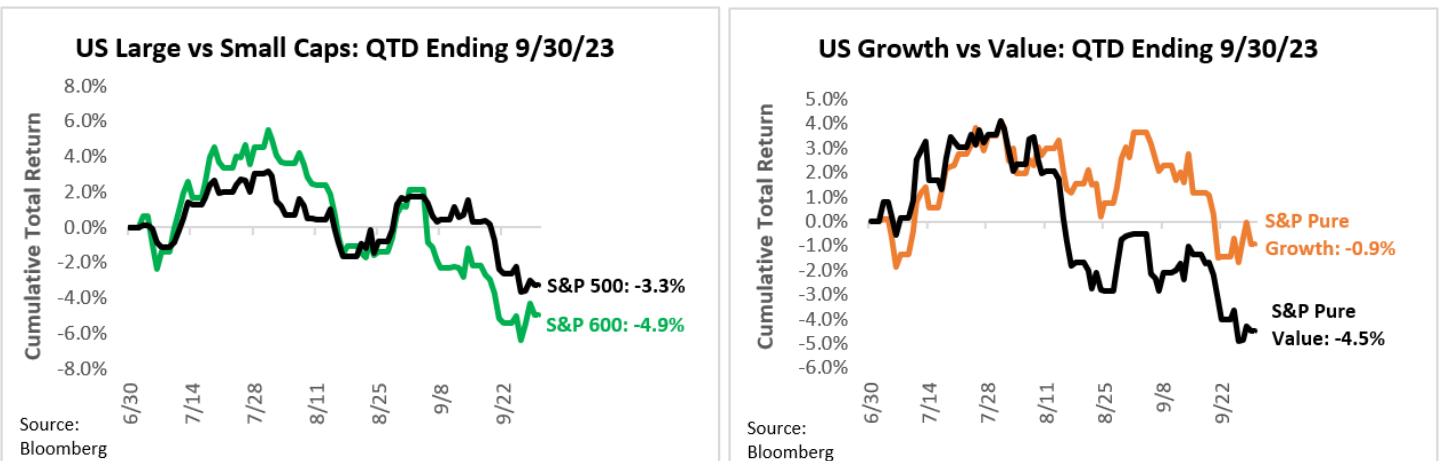


Figure 20 – In 3Q 2023, Small Caps Underperformed Large Caps and Pure Value Underperformed Growth, the Latter Helped by the Outperformance of Megacap Technology



Across sectors, only Energy had a positive return in September helped by higher oil and gasoline prices, while interest rate sensitive sectors (Real Estate, Utilities) and cyclical growth (Industrials, Consumer Discretionary, Technology) underperformed (Figure 21). In 3Q 2023 (Figure 22), Energy and Communication Services (benefiting from social media landscape) outperformed interest-sensitive sectors (Real Estate, Utilities) and cyclicals (Industrials, Technology).

Figure 21 – In September, Energy Was the Only Positive Performing Sector Helped By Higher Oil Prices While Interest-Sensitive and Cyclical Growth Sectors Underperformed

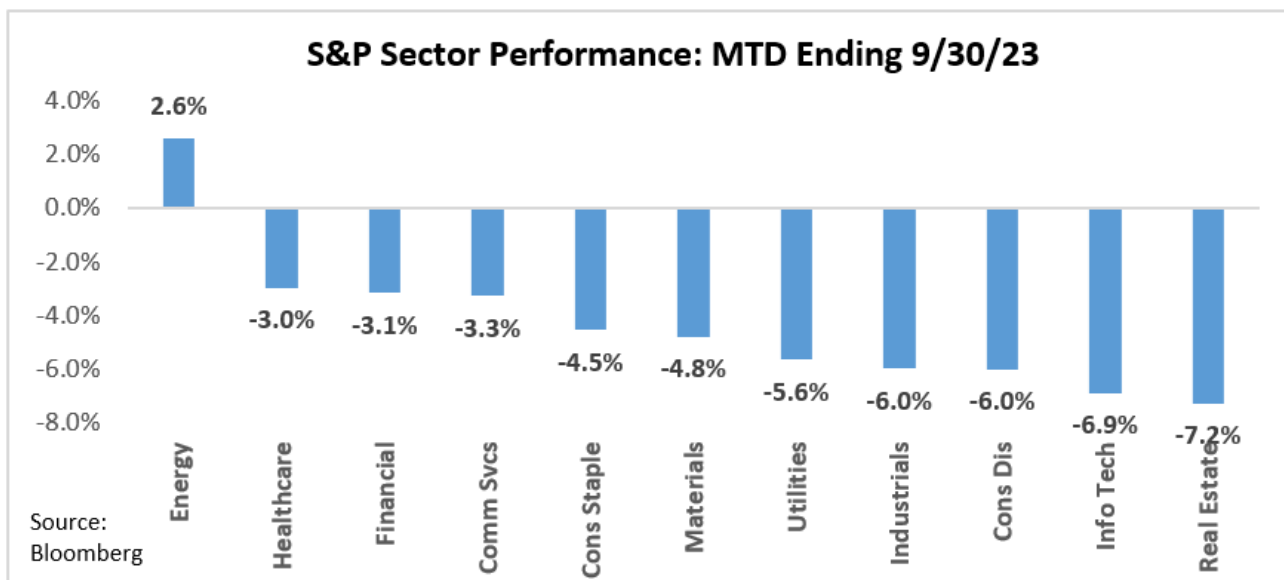
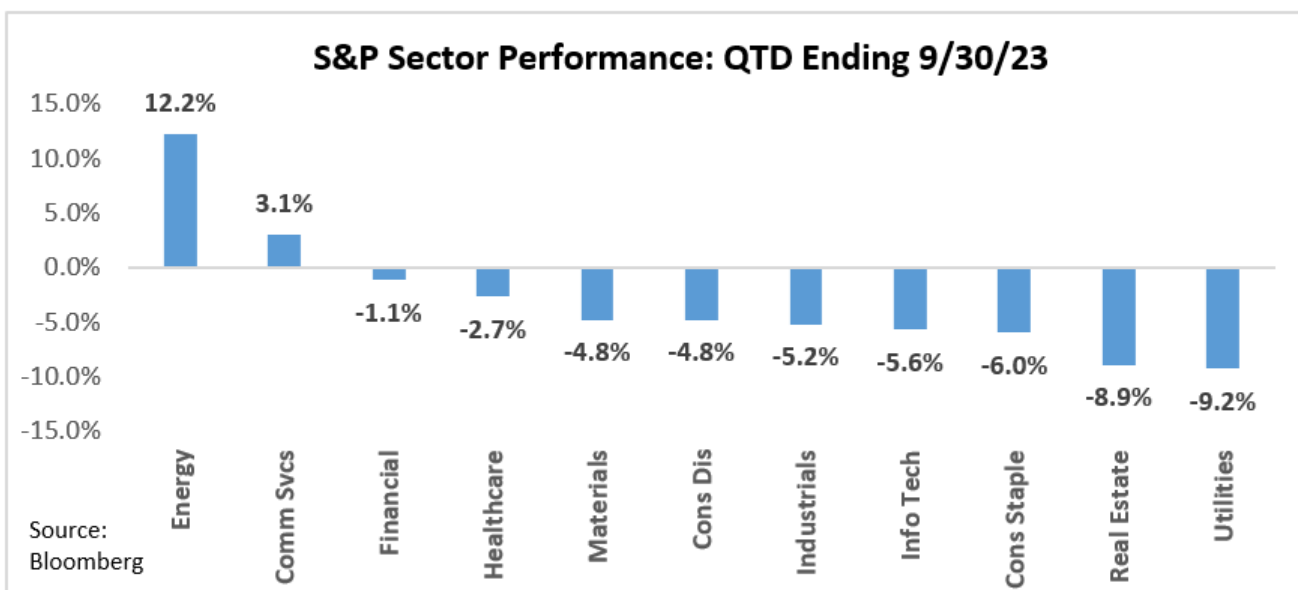


Figure 22 – In 3Q 2023, Energy and Communication Services Outperformed While Interest Sensitive and Cyclical Sectors Underperformed



Among major risk factors, in September (Figure 23), factor dispersion was narrow with Minimum Volatility, High Dividend, and Value outperforming Momentum and High Quality. In 3Q 2023 (Figure 24), High Quality and Minimum Volatility outperformed although factor dispersion was narrow.

Figure 23 – In September, Factor Dispersion Was Narrow but Minimum Volatility, High Dividend, Value Outperformed Momentum and High Quality

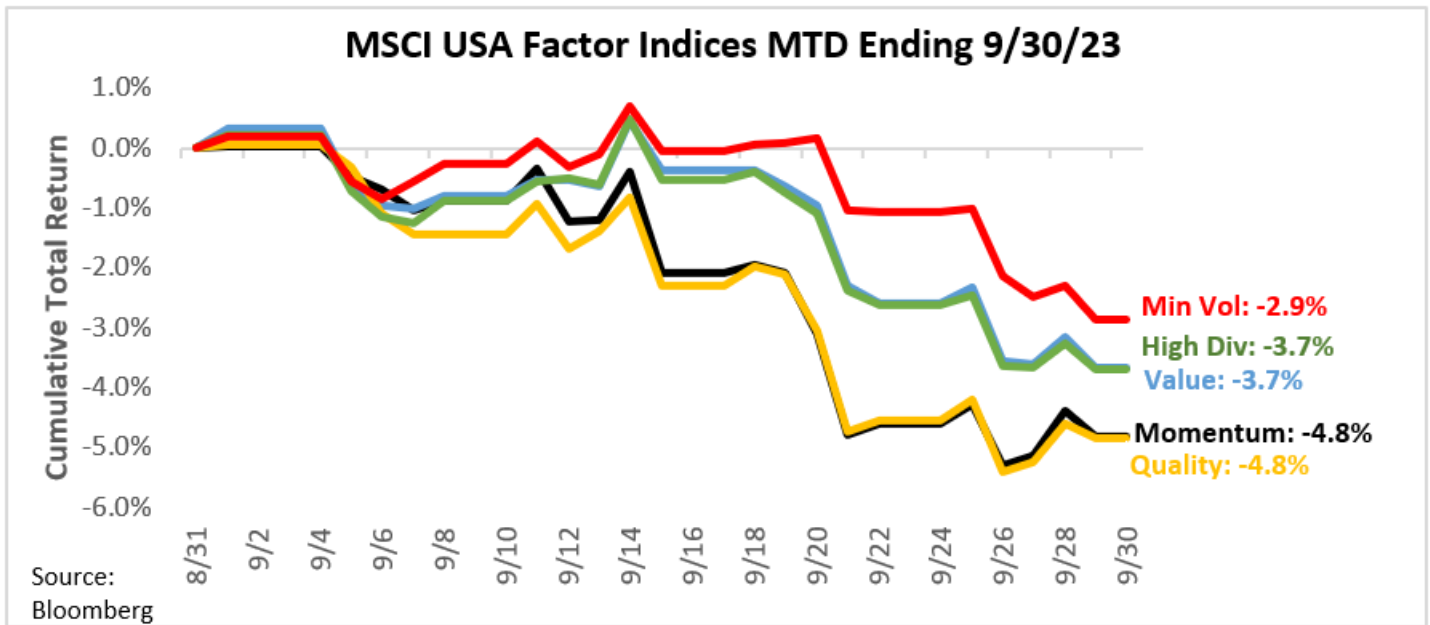
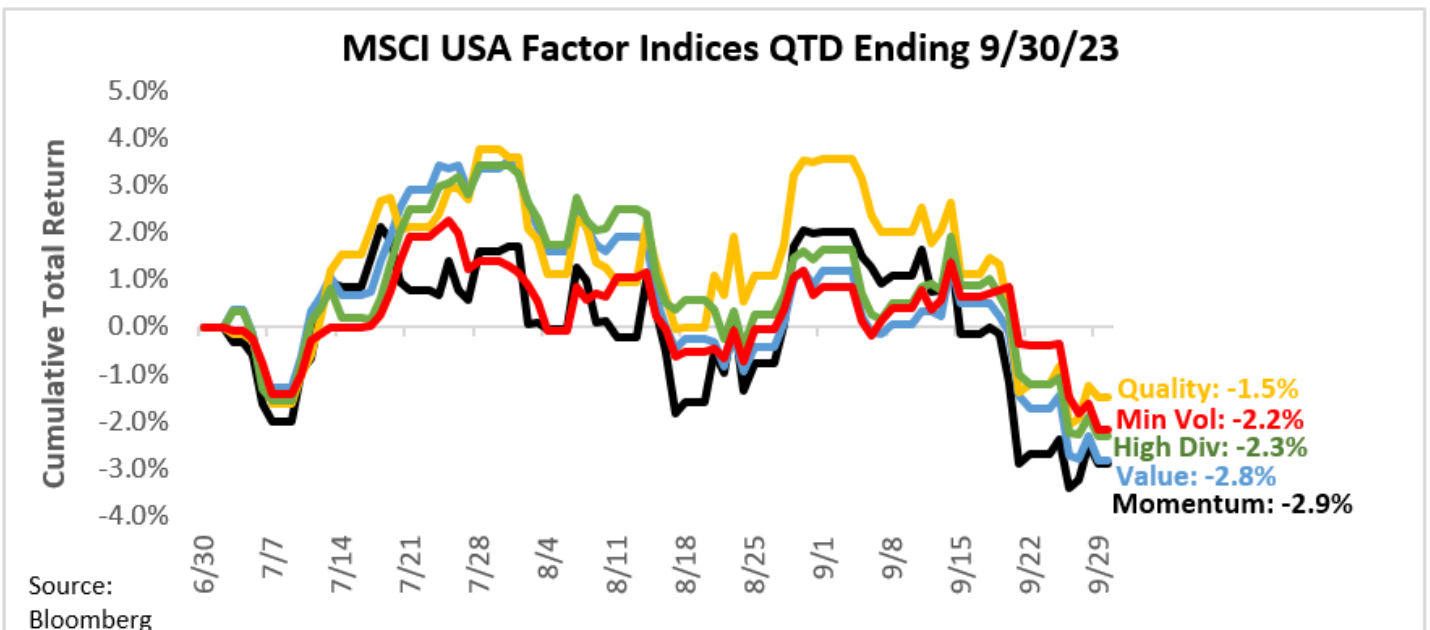


Figure 24 – In 3Q 2023, High Quality and Minimum Volatility Outperformed Although Factor Dispersion Was Narrow



In September, fixed income market returns were hurt by an end-of-quarter steepening of the Treasury yield curve with long maturity rates rising faster than short maturity rates following the September Fed meeting (FOMC) which signaled higher-for-longer interest rates despite signs of slowing inflation. The Bloomberg U.S. Aggregate Bond Index dropped 2.5% for the month (**Figure 25**) while the Global ex-U.S. Aggregate Index returned -3.3%, hurt by a strengthening dollar. US High Yield continues its outperformance across broader fixed income, as the high yield market is not as interest rate sensitive versus investment-grade. The Bloomberg High Yield Index returned -1.2% while Bloomberg Emerging Market Local Currency returned -3.7%, hurt by the strengthening U.S. dollar. For the 3rd quarter (**Figure 26**), the Bloomberg U.S. Aggregate Bond Index returned -3.2%, outperforming the Global ex-U.S. Aggregate Index which returned -4.0%. Bloomberg US High Yield outperformed global investment grade, returning +0.5% for the quarter.

The 10-Year U.S. Treasury yield ended the month at 3.8%, up from 3.6% at the beginning of the month and from the near YTD lows of 3.4% at the beginning of the quarter. The 2-10 Year Term structure (**Figure 27**) steepened sharply towards the end of September following the FOMC meeting as the long end of the curve rose in response to hawkish rhetoric from Federal Reserve officials and ongoing concerns over fiscal deficit spending. Inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields rose sharply in line with the steepening in the yield curve. Corporate credit spreads held steady although widened towards the end of the quarter (**Figure 28**).

Figure 25 – In September, Rising Interest Rates Hurt Investment Grade Fixed Income While High Yield Outperformed as the Index is Less Rate Sensitive Than Investment Grade

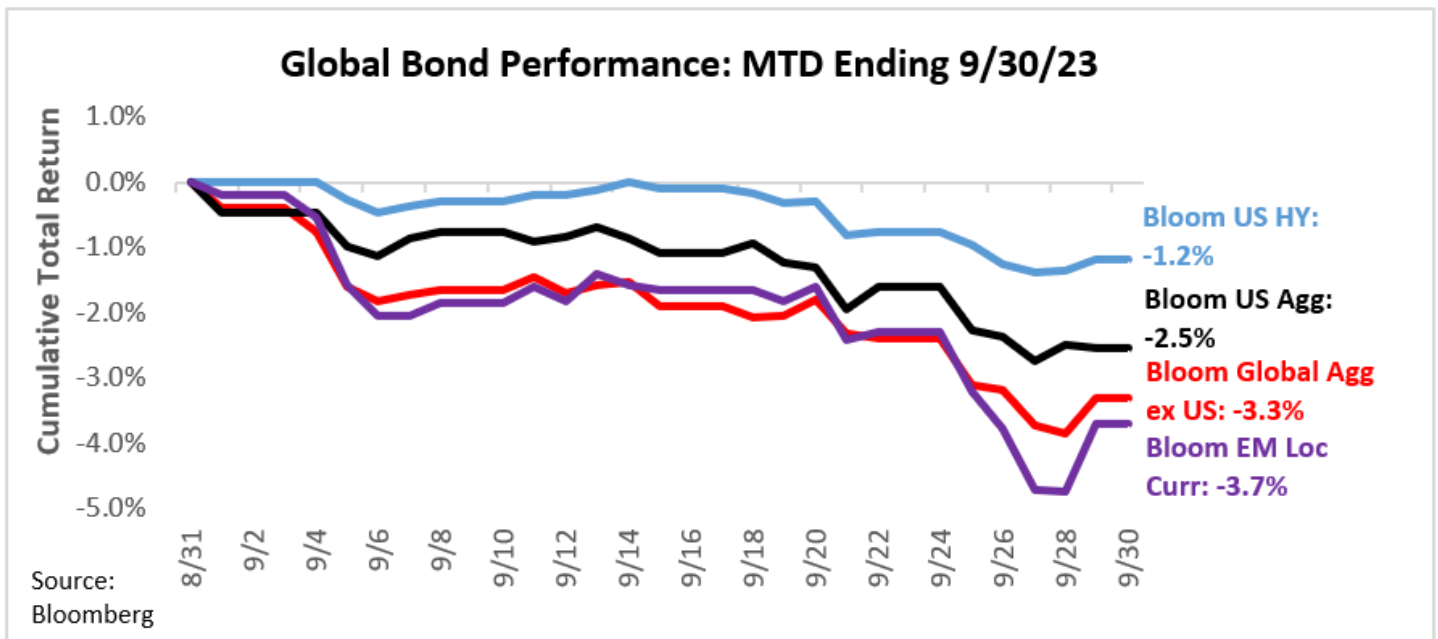


Figure 26 – In 3Q 2023, High Yield Outperformed Broader Investment Grade

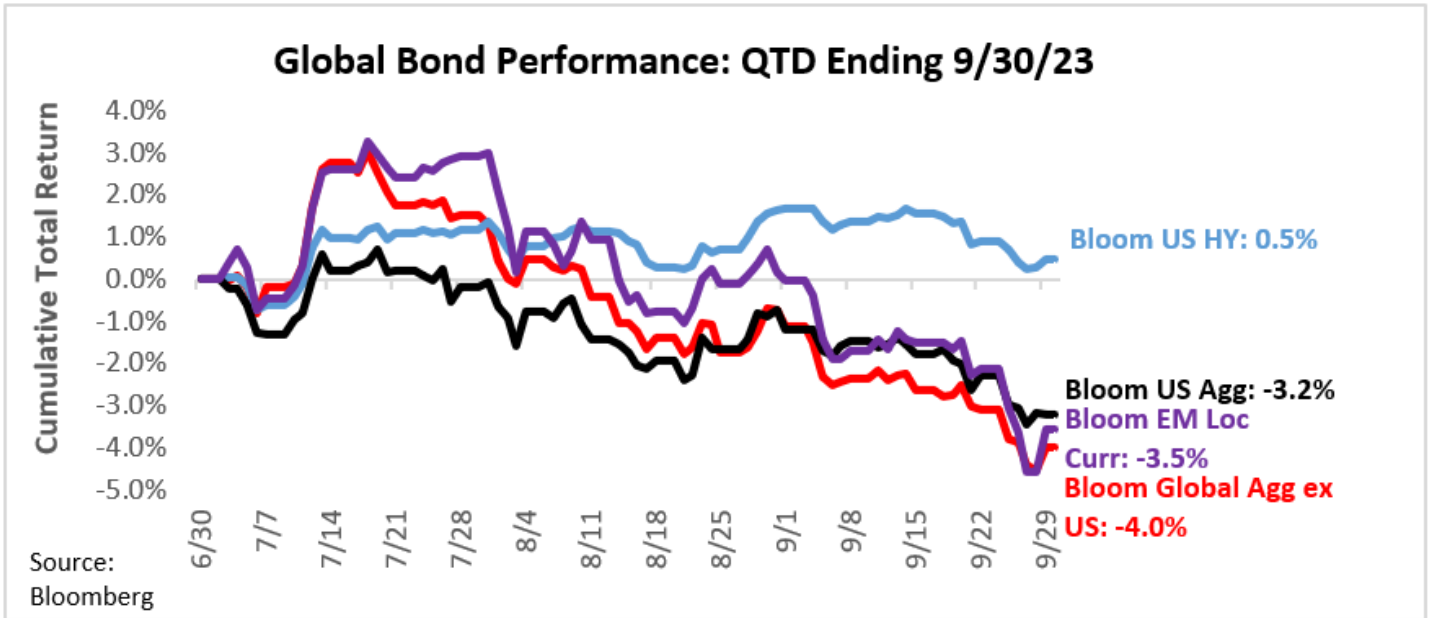


Figure 27 – 2-10 Year Term Structure Steepened in Late September Following the FOMC While Inflation Expectations (Breakeven Rates Between TIPS vs Nominal Treasuries) Also Rose in Sympathy

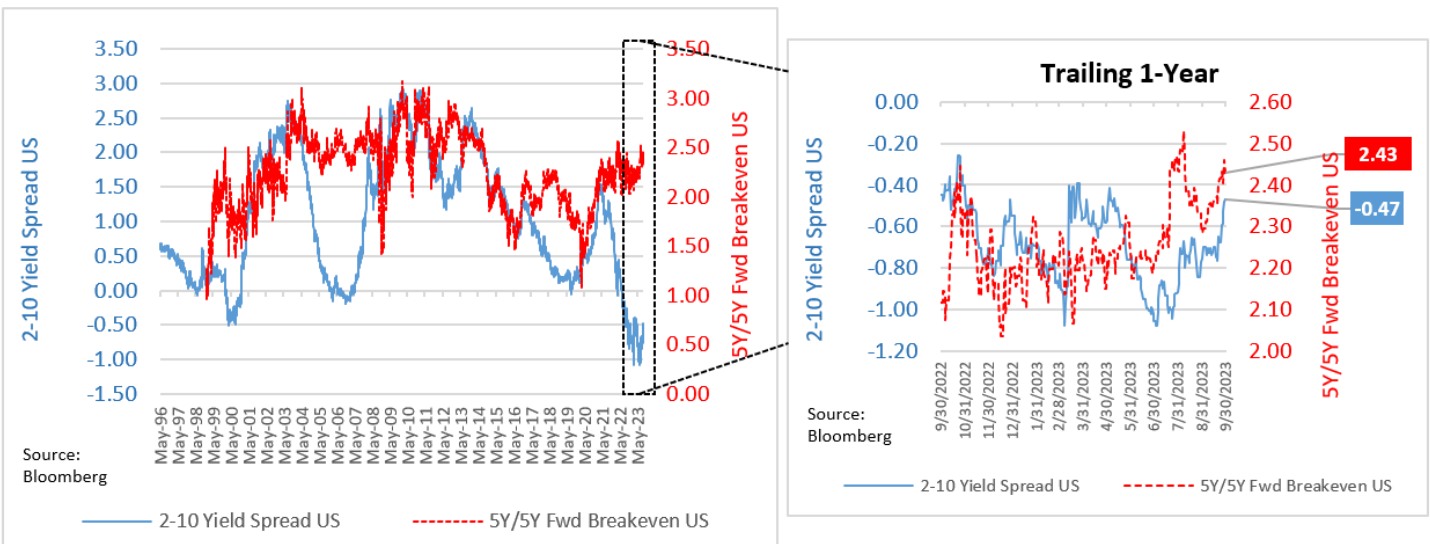
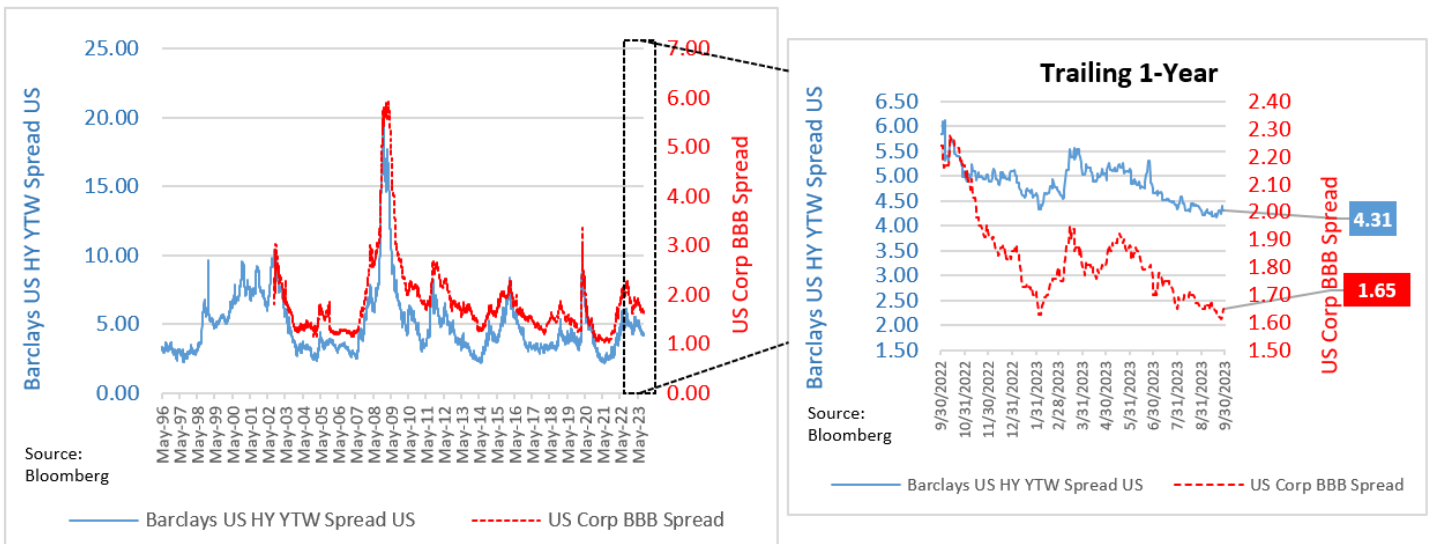


Figure 28 – Corporate Credit Spreads Held Steady Throughout the Quarter



Within equity alternatives, Commodities outperformed in September on the strength of higher oil prices as well as a counterrallies in industrial metals. Real Estate and Precious Metals were hurt by rising real (inflation-adjusted) interest rates. The S&P GSCI Commodities Index returned +4.1% for the month (**Figure 29**), led by higher industrial metals (aluminum, iron ore) and crude oil (**Figure 30**) while the S&P GSCI Precious Metals Index returned -5.1% as gold prices dropped below \$1,900/ounce. Dow Jones REITs dropped 7.0%, hurt by rising real rates and ongoing concerns over the commercial office sector. For 3Q 2023 (**Figure 31**), S&P GSCI Commodities Index rose 16.0%, helped by higher oil and metals (**Figure 32**) while S&P GSCI Precious Metals and the Dow Jones REIT Index dropped 3.8% and 8.4%, respectively.

Figure 29 – In September, Commodities Outperformed Risk Assets While Precious Metals and Real Estate Were Hurt by Rising Real Rates

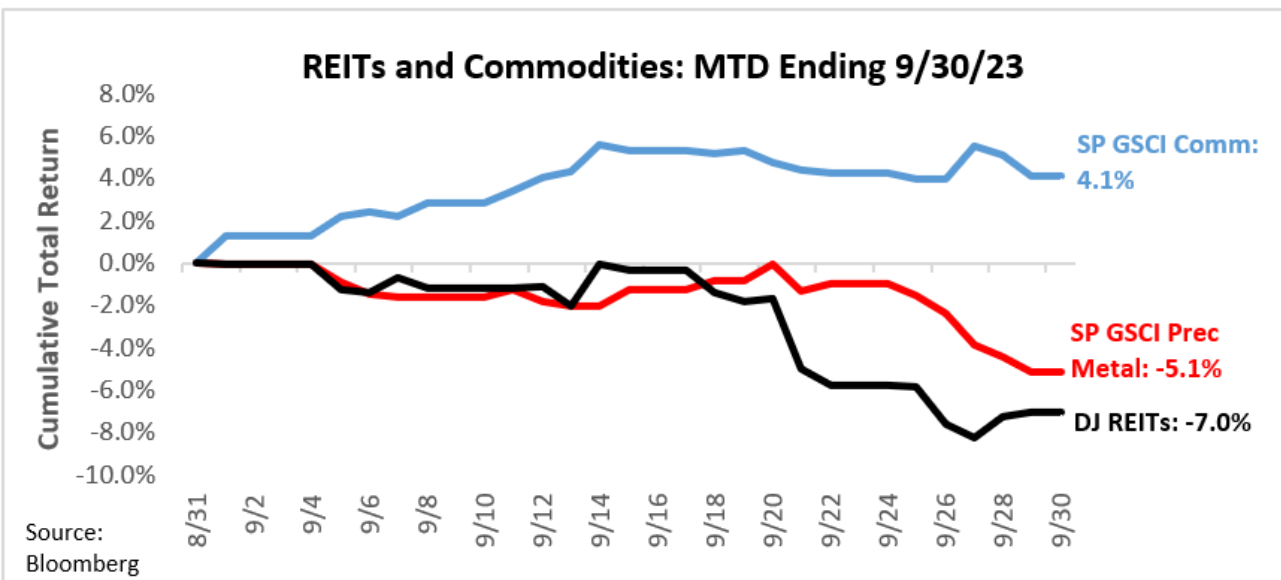


Figure 30 – Industrial Metals and Crude Oil Led Commodities in September

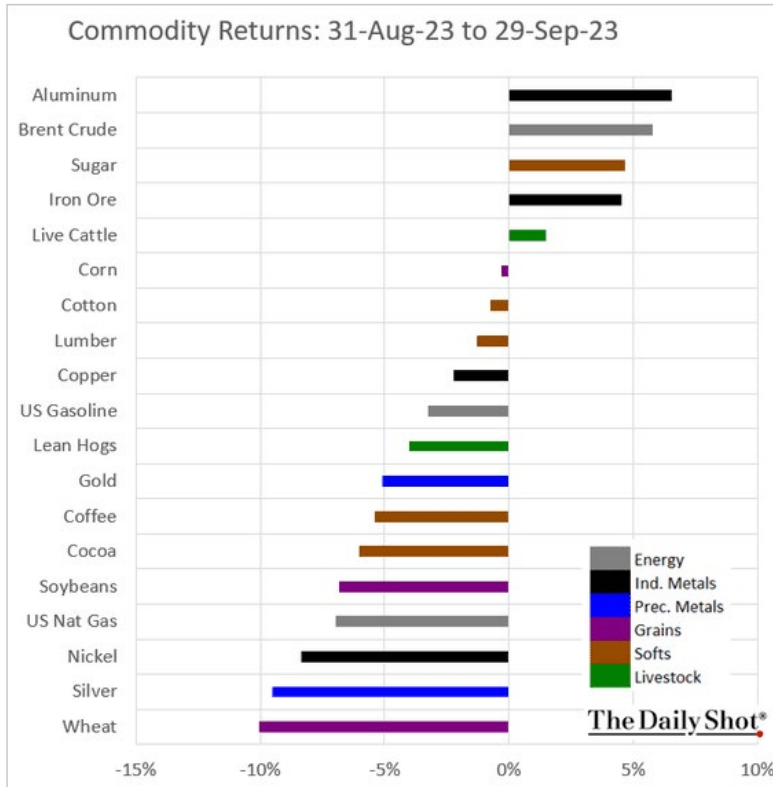


Figure 31 – In 3Q 2023, Commodities Posted a Strong Return Led by Higher Energy Prices While Precious Metals and Real Estate Lagged, Pressured by Higher Real Rates

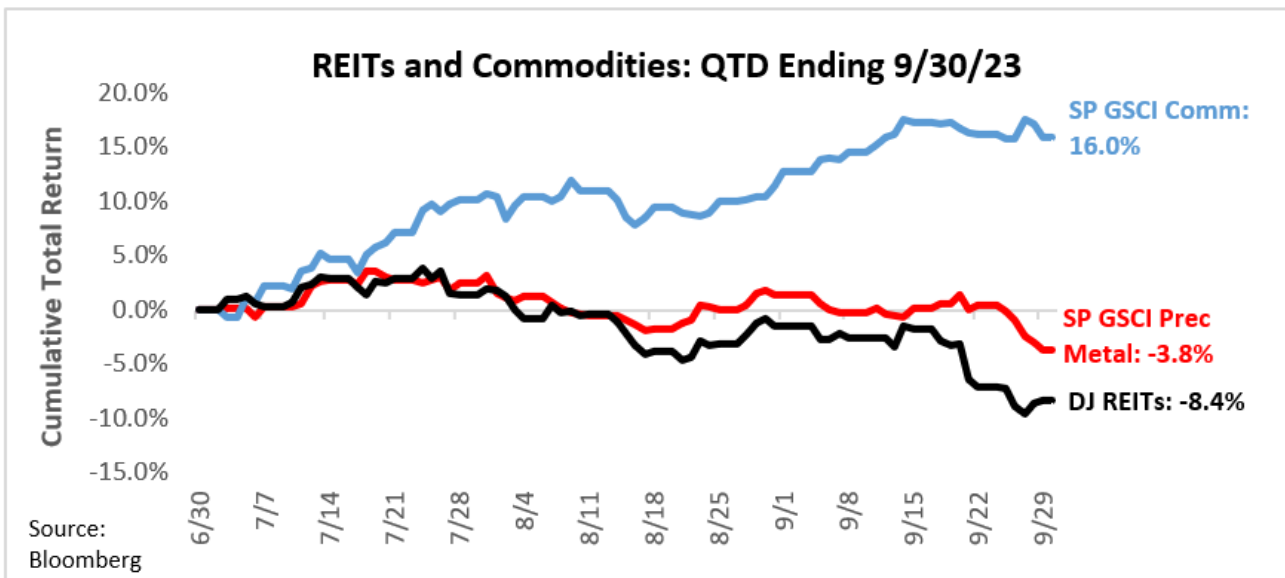
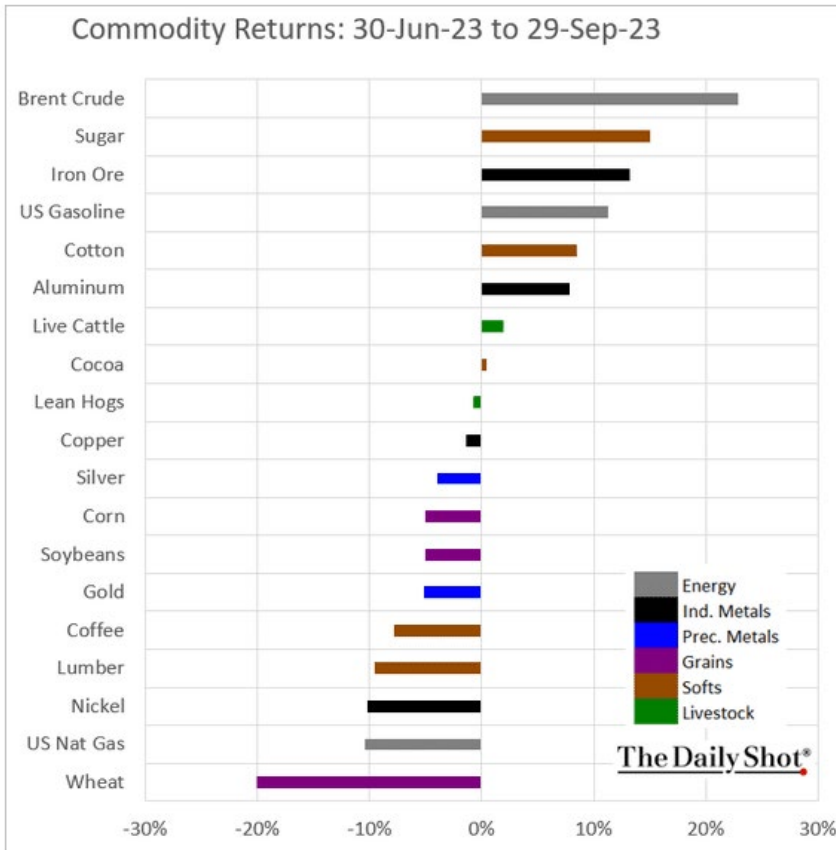
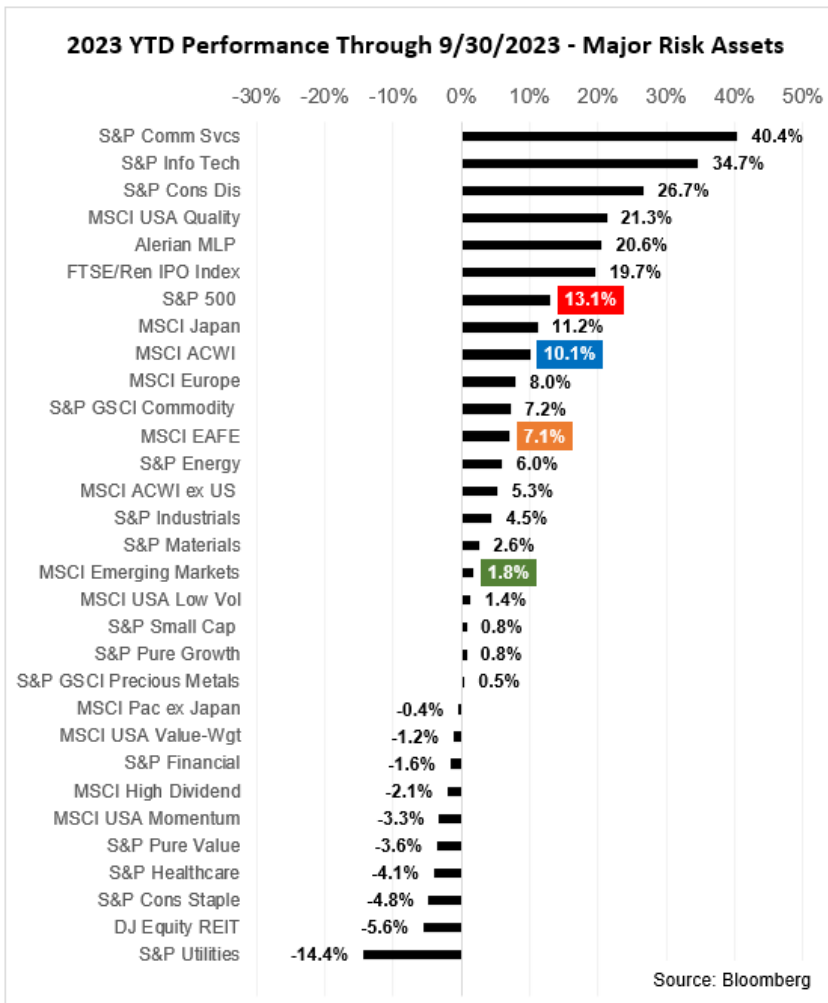
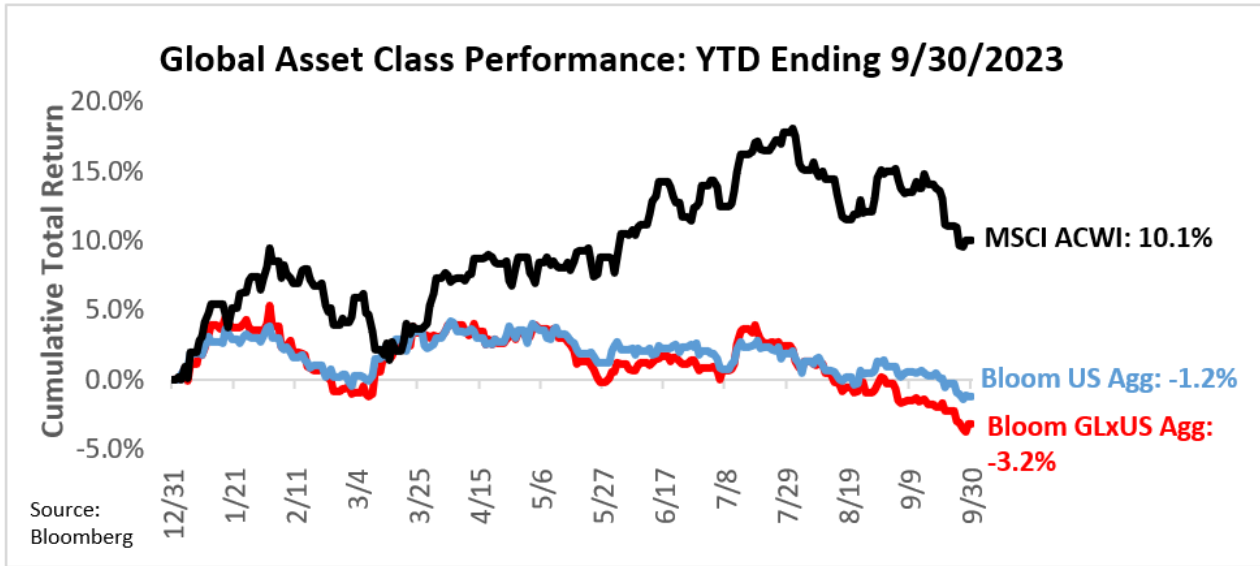


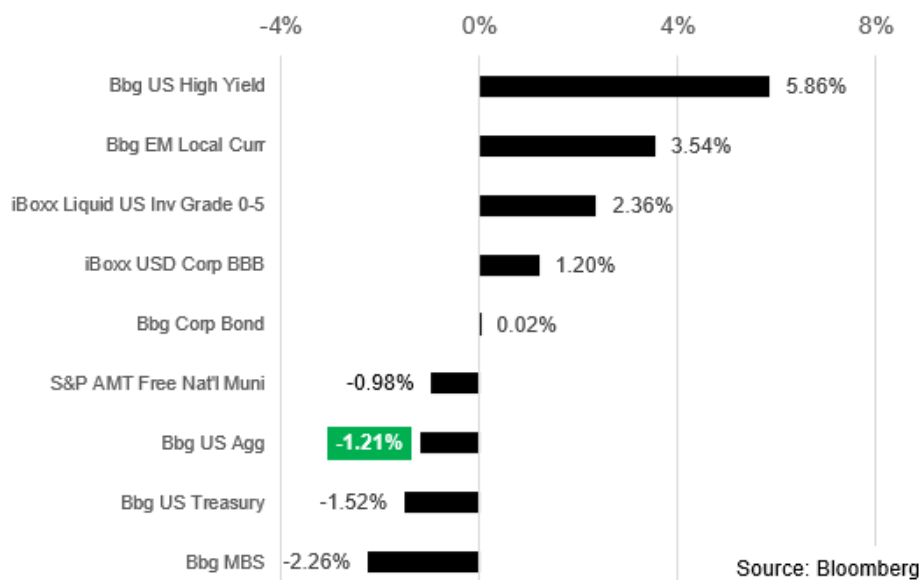
Figure 32 – Industrial Metals and Crude Oil Led Commodities in September



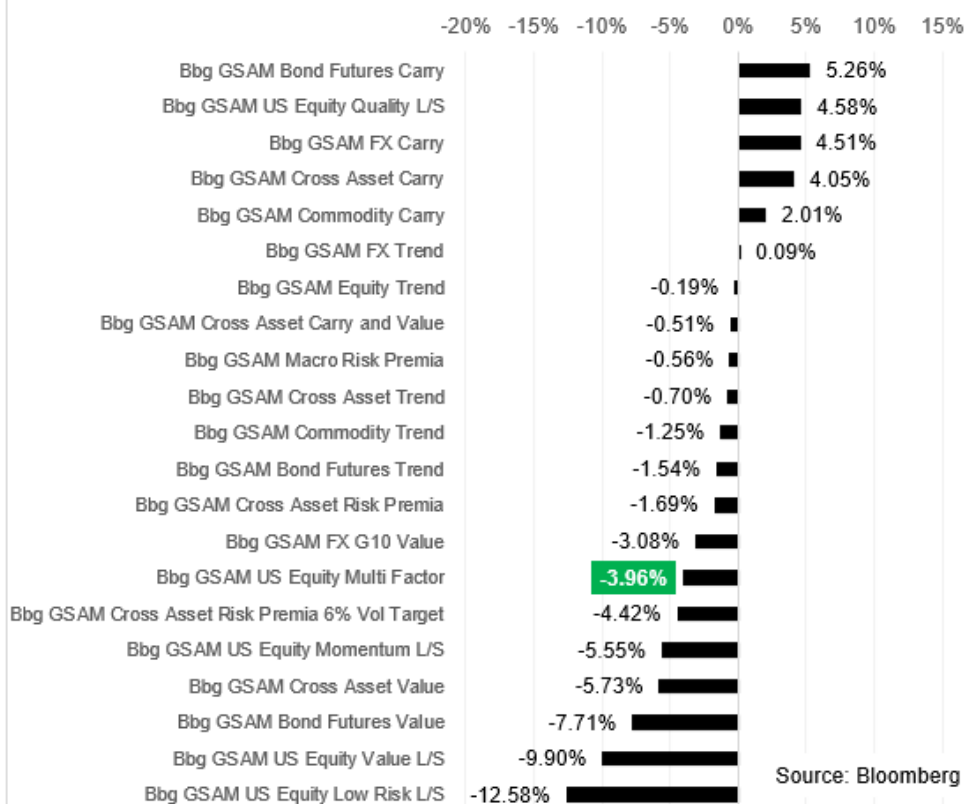
YTD 2023 Market Performance Through 9/30/2023



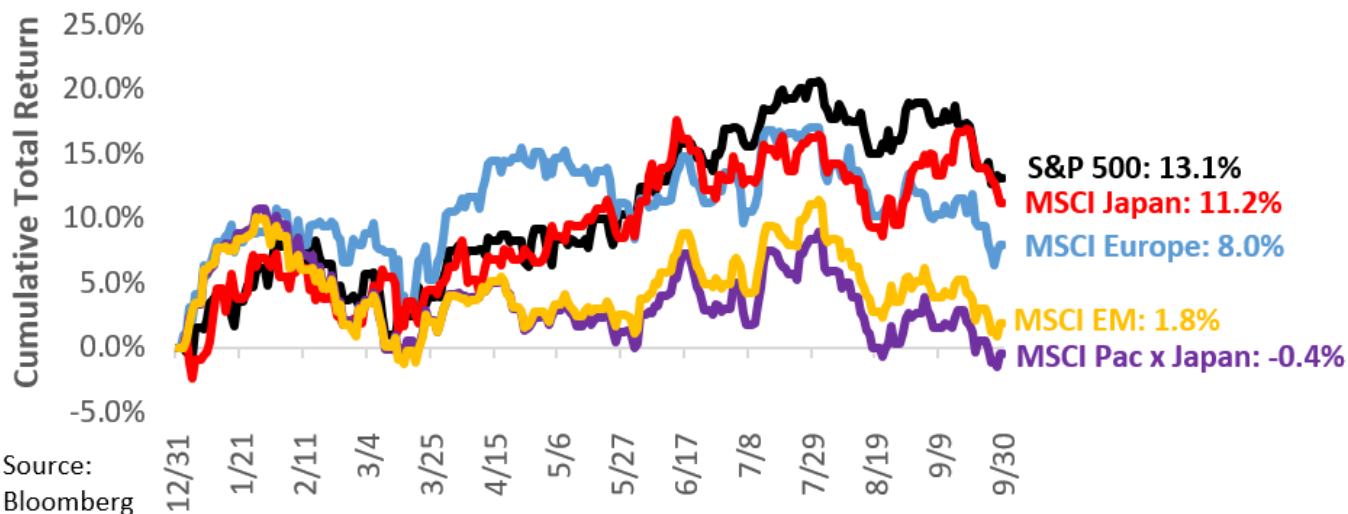
2023 YTD Performance Through 9/30/2023 - Fixed Income Markets



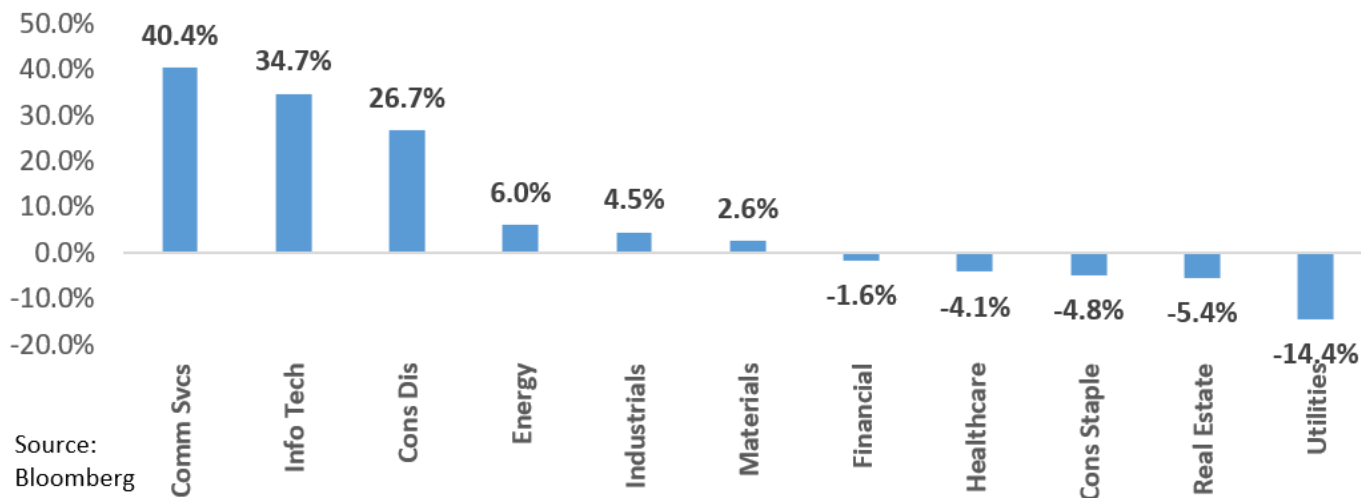
2023 YTD Performance Through 9/30/2023 - Alternative Risk Premia

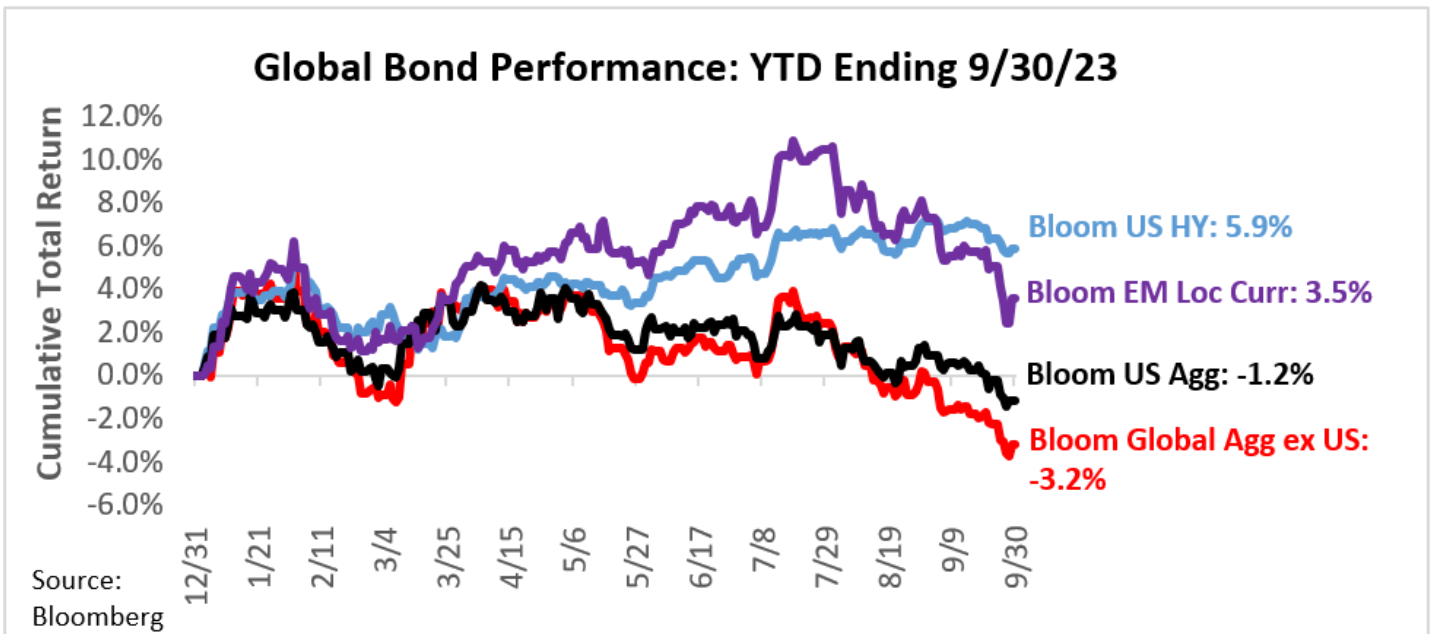
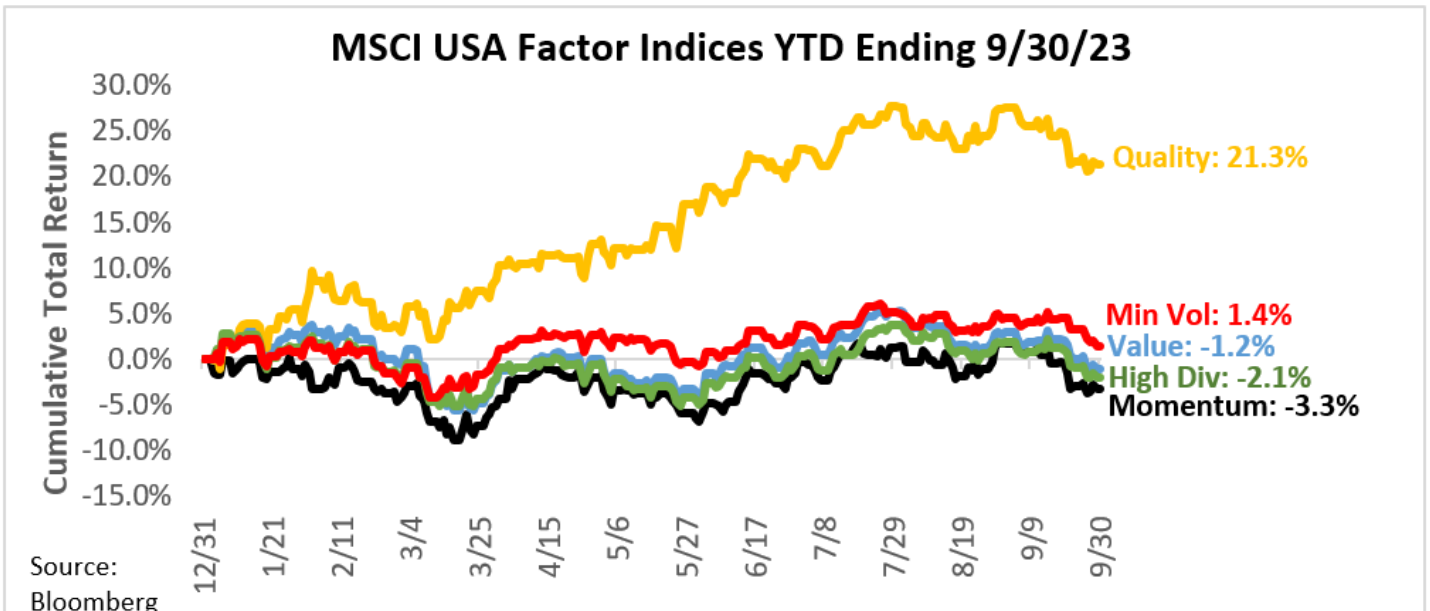


Regional Equity Performance: YTD Ending 9/30/23



S&P Sector Performance: YTD Ending 9/30/23



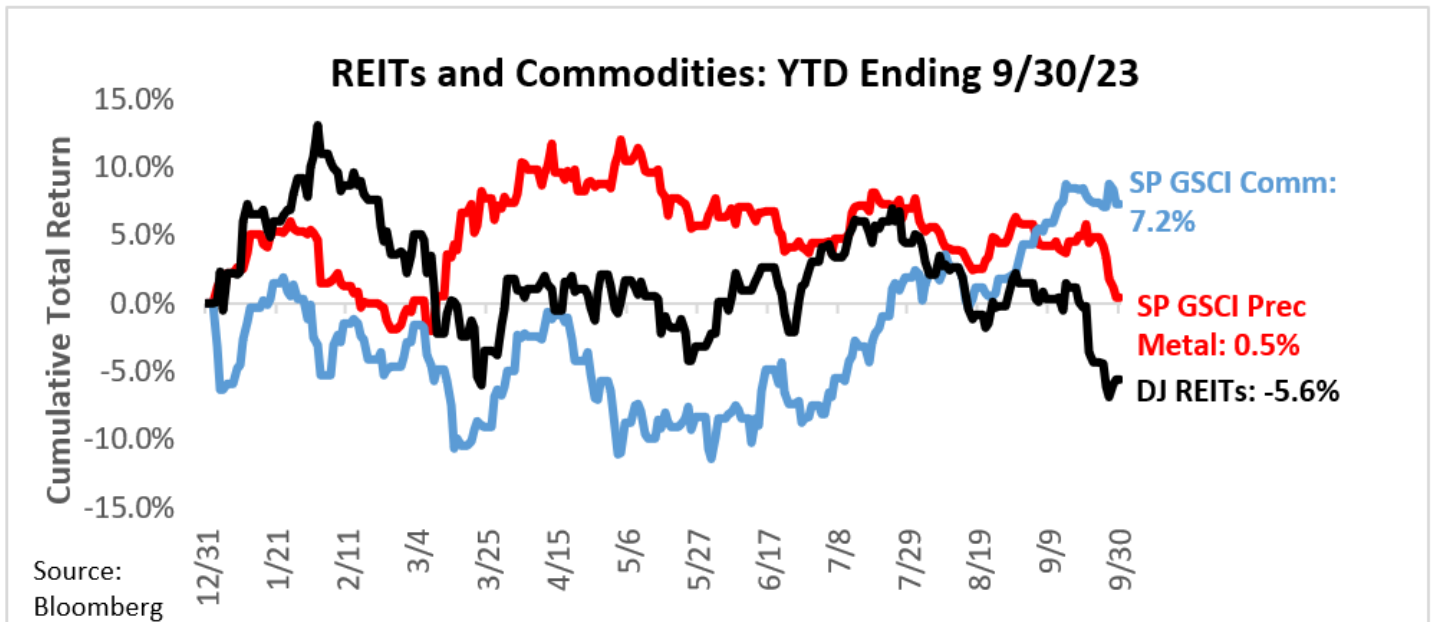


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