



A Freedom Advisors Company

Soft Landing in Sight

August 2023 Market Commentary



Key Benchmarks: Performance and Characteristics as of 8/31/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	-1.6%	1.6%	18.7%	19.1x	14.1x	22.9x	
MSCI EAFE	-3.8%	-0.7%	10.9%	13.3x	11.2x	18.3x	
MSCI Emerging	-6.2%	-0.3%	4.6%	11.9x	9.5x	15.2x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg Barc U.S. Aggregate	-0.6%	-0.7%	1.4%	US REITs	-3.3%	-1.5%	1.5%
Bloomberg Barc U.S. High Yield	0.3%	1.7%	7.1%	GSCI Commodities	0.6%	11.4%	3.0%
Bloomberg Barc Global Agg ex U.S.	-2.0%	-0.7%	0.1%	GSCI Prec Metals	-1.7%	1.4%	5.9%

Data Source: Bloomberg

August 2023 Highlights:

- Global equity markets gave up some ground in August but partially recovered from a steeper sell-off earlier in the month. The MSCI All-Country World Index (ACWI) returned -2.8% for the month of August, recovering from a 6% drop earlier in the month.
- Ongoing concerns over China's economy, including reports of further financial troubles facing the country's property developers as well as missed payments on income trusts from major financial firms, produced steep selloffs across equities and the Chinese Yuan. The U.S. dollar strengthened following a hawkish speech from Fed Chair Jerome Powell at the annual Jackson Hole Summit that the market initially interpreted as further rate hikes were on the table before those expectations were scaled back towards the end of the month. U.S. equities also came under pressure following weak earnings releases from major retailers but then risk sentiment shifted back towards the red-hot technology sector as generative artificial intelligence spending continues to propel major technology stocks higher.
- Across major regions, emerging markets reversed their July leadership as weak sentiment around China helped drag down the broader pan-Asian region. Once again, U.S. equities retained their YTD leadership as the S&P 500 outperformed all other regions in August, returning -1.6% followed by MSCI Japan (-2.4%) and MSCI

Europe (-4.0%). MSCI Pacific ex Japan and MSCI Emerging Markets underperformed developed markets, returning -6.1% and -6.2%, respectively for the month.

- Within the U.S., small caps underperformed large caps following two prior months of outperformance, as the latter continues to benefit from mega-cap growth technology companies. S&P Pure Value underperformed Pure Growth, returning -4.5% and -1.4%, respectively, with the former dragged down by the underperformance of financials and traditional cyclicals. For the month of August, the S&P 500 Index returned -1.6% versus -4.1% for the S&P 600.
- Across sectors, Energy was the only positive sector in August, helped by an increase in oil and gas prices. Growth-focused sectors (Communication Services, Healthcare, Consumer Discretionary, and Technology) outperformed Financials and Cyclicals while defensive sectors (Staples, Utilities) were the worst performers.
- Among major risk factors, in August, Momentum, High Quality and Minimum Volatility outperformed High Dividend and Value. The month's factor leaders were helped by the strong month-end performance of technology and consumer discretionary growth stocks.
- The fixed income market suffered from higher interest rates as U.S. Treasury yields rose in anticipation of more Treasury issuance to fund U.S. fiscal deficits and few signs that the U.S. economy is slowing down. The 10-Year U.S. Treasury yield ended the month at 4.11%, up from 3.96% at the beginning, although down from the intramonth high (4.35%). The Bloomberg U.S. Aggregate Bond Index returned -0.6% for the month, although the index was down 2.5% earlier in the month. Corporate bonds continue to outperform as borrowing spreads narrowed to 1-year lows.
- Within equity alternatives, Commodities outperformed Precious Metals and Real Estate in August as the former benefited from a sharp rally in oil prices and metals (especially iron ore). The S&P GSCI Commodities Index returned +0.6% for the month while the Dow Jones REIT Index returned -3.3%, as interest rate volatility and ongoing concerns over the commercial office sector continue to weigh on real estate sentiment. The S&P GSCI Precious Metals Index was initially hurt by a selloff in precious metals (gold, silver) but then recovered later in the month.

Soft Landing in Sight



"I'm kind of, I'm closet optimistic ... my forecast is that we manage this, that we walk the fine line of the path that we get inflation down, not immediately but at a reasonable pace without a big, a huge increase, in unemployment."

– Chicago Federal Reserve President, Austan Goolsbee, 8/1/2023¹

Source: istockphoto.com

At the beginning of 2023, consensus economic and market opinion generally scoffed at the notion of the U.S. Federal Reserve achieving an economic soft landing: a scenario that results in a slowdown in consumer demand and labor market conditions sufficient to bring inflation closer to the Fed's long-term 2% target without the economy falling into deep recession. Despite the benchmark Fed Funds rate hiked to 5.50% at the July FOMC and warnings from Fed officials that policy tightening may persist longer than what is expected by the markets, economic consensus has (grudgingly) accepted soft landing as the base case outcome and that the Fed has achieved its policy goals with no need for further rate hikes.

The global economy is manifesting signs of a slowdown, although somewhat uneven depending on the region, but an outright contraction appears to be far off on the horizon with the U.S. recession watch being pushed out further into 2024. The growth of the U.S. economy and labor markets are slowing from their post-COVID accelerated pace, but other areas appear to be on the precipice of another contraction, whether Western Europe or China. Indeed, it appears that economic fortunes across the Western Hemisphere (U.S., Central and South America) are diverging from those of the Eastern Hemisphere. As of 8/31/2023, the Bloomberg U.S. economic consensus for U.S. 2023 Real GDP growth is now 2% (up from 0.3% at the beginning of 2023) versus 0.6% for Europe (-0.1% expected at the beginning of the year), 1% for Japan (unchanged), and 4.8% for China (5.1% expected at the beginning of the year).

¹ ["US Fed officials see pathway to soft landing," Reuters, 8/1/2023](#)

In August, global markets came under initial pressure from reports of further China economic deceleration as indicated by a weakening Yuan amidst capital outflows. Equities and bonds issued by key property developers sold off over reports of delayed interest rate payments and stalled development programs. Ongoing property market weakness has also contributed to missed scheduled payments from income trusts sponsored by major non-bank financial companies². China sought to counter this new round of weakness by lowering interest rates and required bank reserves as well as relaxing lending standards to provide mortgage borrower relief. The stimulus measures provided a brief respite from the market sell-off but were deemed insufficient by investors³. Even better than expected earnings releases from technology and electric vehicle companies could not offset the selling pressure. After a strong recovery in July, China's equity market sell-off contributed to broader emerging market weakness (**Figure 1**).

Figure 1 – China's Equity Market Weakness Dragged Down Broader Emerging Markets



Source: Bloomberg

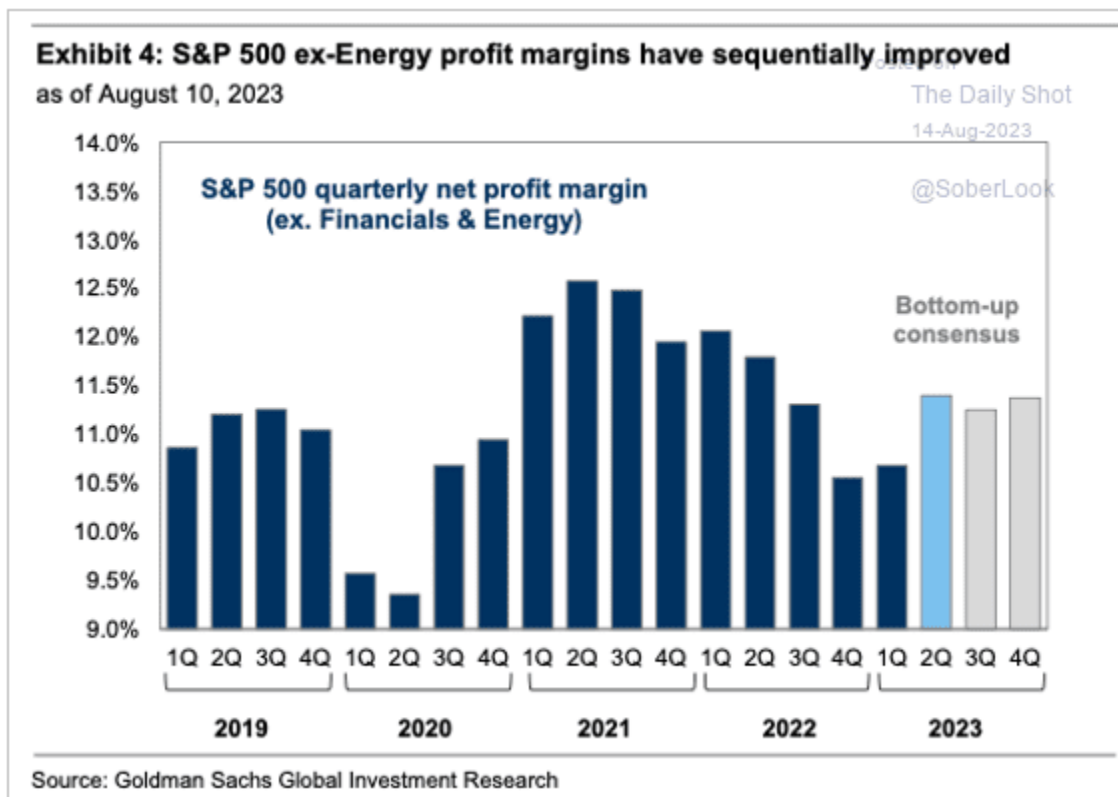
² [“China Finance Giant’s Missed Payments Alarm Regulators, Market,”](#) Bloomberg, 8/13/2023

³ [“China’s Market Rescue Is Failing as Xi Holds Back on Stimulus,”](#) Bloomberg, 8/25/2023

In the U.S., equity markets had succumbed to weaker earnings releases from the retailer sector, much of that weakness driven by increased reserves for bad debt as well as “shrinkage” (or theft)⁴; however, technology and e-commerce companies continue to benefit from the increased shift to digital-based consumption and the capital spending fueling artificial intelligence initiatives⁵. According to the [9/1/2023 edition of Factset Earnings Insight](#), sellside analysts are expecting 1.2% earnings growth (2.4% revenue growth) for CY-2023 and 12% earnings growth (5.6% revenue growth) for CY-2024, as operating profit margins are expected to improve from the depressed levels reached in 2022 (**Figure 2**).

Company profitability has not suffered as one would expect with a slowdown in revenue growth, as large companies have been able to maintain pricing power while absorbing higher costs. Per Factset’s analysis of conference call transcripts, fewer companies are also cautious on their outlooks with fewer mentions of recession versus 2022.

Figure 2 – S&P 500 Profit Margins Normalizing to Pre-Pandemic Levels

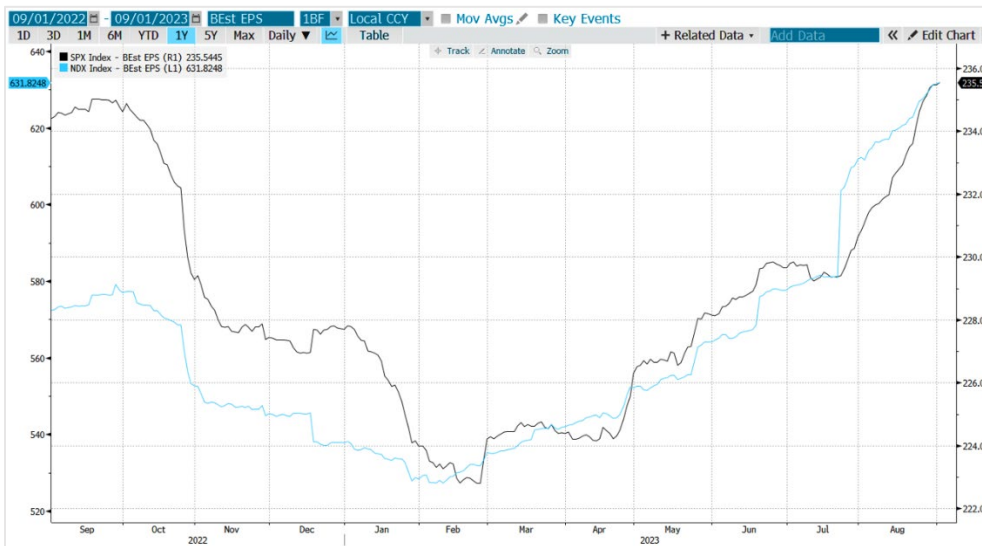


⁴ “Macy’s, Dick’s, and Lowe’s are sounding alarms on US shoppers,” Insider, 8/22/2023

⁵ “Retailers’ AI Spending Expected to Quadruple by 2028,” Invision, 8/28/2023

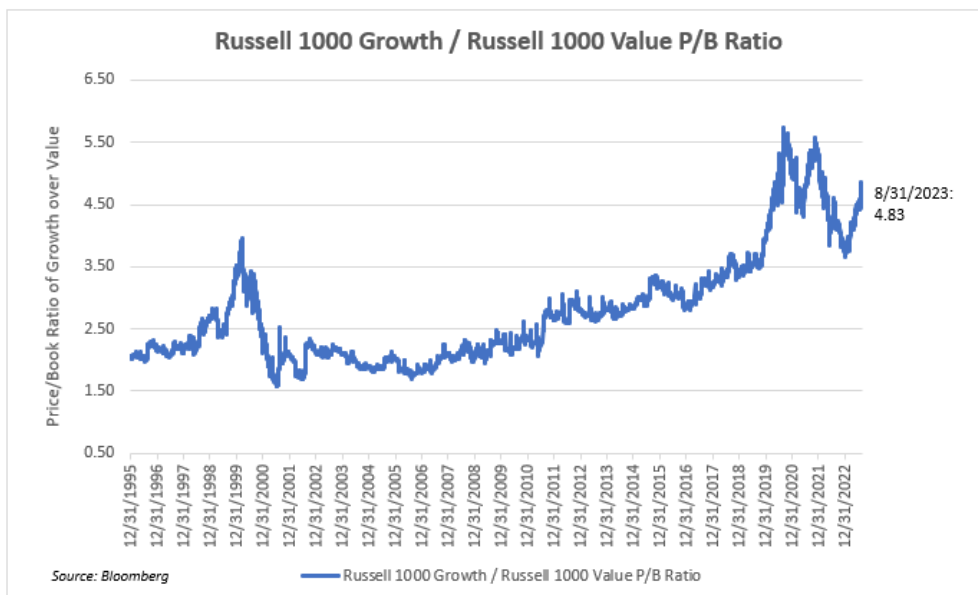
Investor appetite for premium-price growth technology is reflected in higher estimates for the Nasdaq 100 Index (as well as the overall S&P 500 Index (**Figure 3**) but also contributing to a widening valuation gap between large cap growth and value indices (**Figure 4**), leaving much of the non-technology sectors further behind. It would seem this investor appetite for the secular, exponential growth potential of SAAS, cloud, and AI-driven spending can withstand any tightening of capital market conditions engineered by Fed rate hikes or lower liquidity through Quantitative Tightening.

Figure 3 – Blended 12-Month Earnings Estimates for U.S. Large Caps Continue to Gap Higher on Tech Growth Optimism



Source: Bloomberg

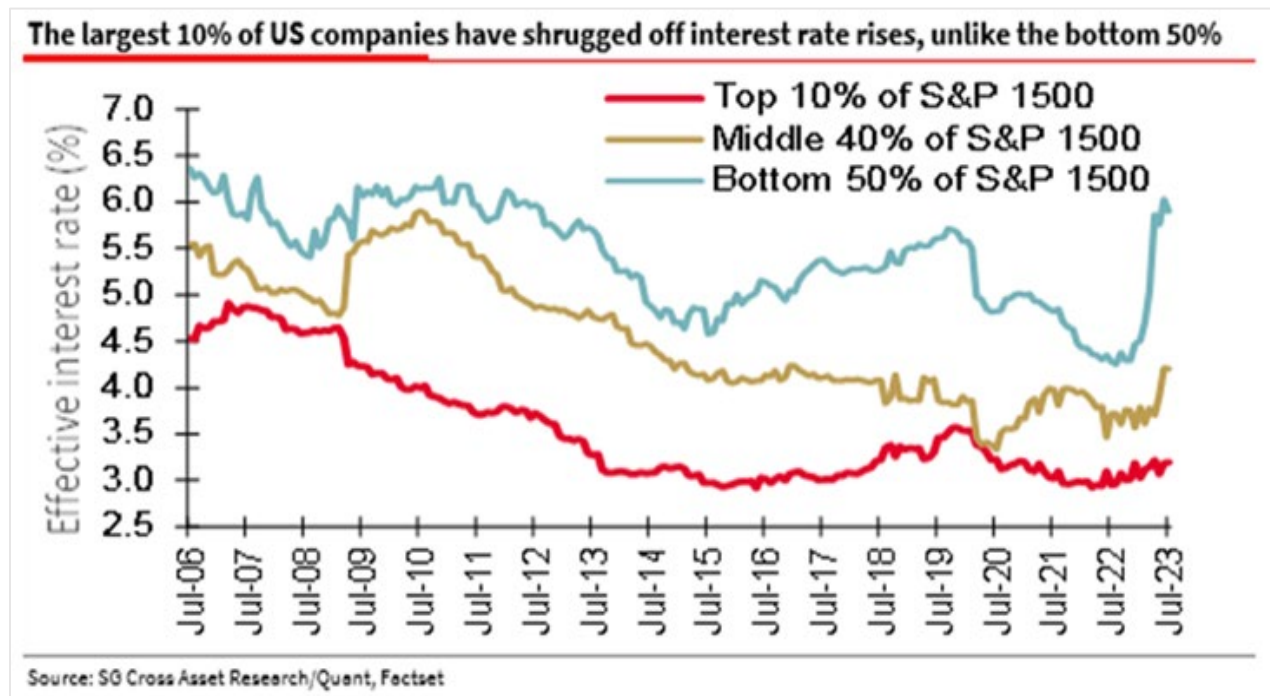
Figure 4 – The Renewed Surge in Investor Appetite for Growth Technology is Re-Widening the Valuation Gap Between Growth vs Value Stock Indices



Source: Bloomberg

For the rest of us not blessed with blank check financing and monopoly-strengthened profit margins, higher interest rates are starting to be felt, first by the marginal borrower but increasingly spreading up the credit food chain. The long and variable lag of monetary policy posited by Milton Friedman manifests itself first in its impact on the marginal borrower - whether subprime consumers, small/medium-sized enterprises, or Class B/C commercial real estate. Even smaller publicly traded companies are seeing a sharp rise in effective borrowing costs (**Figure 5**), unlike the largest companies which are enjoying large cash assets on the balance sheet and having termed out debt maturities when interest rates were at rock bottom levels just after COVID.

Figure 5 – It’s Good to Be of Size: The Largest Enjoy the Lowest Borrowing Costs



The impact from higher rates is also being felt at the personal finance level as debt servicing (interest payments % of disposable income) and the cost/financing of auto purchases continue to trend higher and are now surpassing pre-pandemic levels (**Figure 6 and Figure 7**). This could weigh on future consumer spending although inflation-adjusted spending on goods and services shows few signs of faltering (**Figure 8**). A soft landing may be in sight for the aggregate but will likely feel a lot bumpier for those on the margins.

Figure 6 – The Debt Service Burden Grows for the Personal Borrower

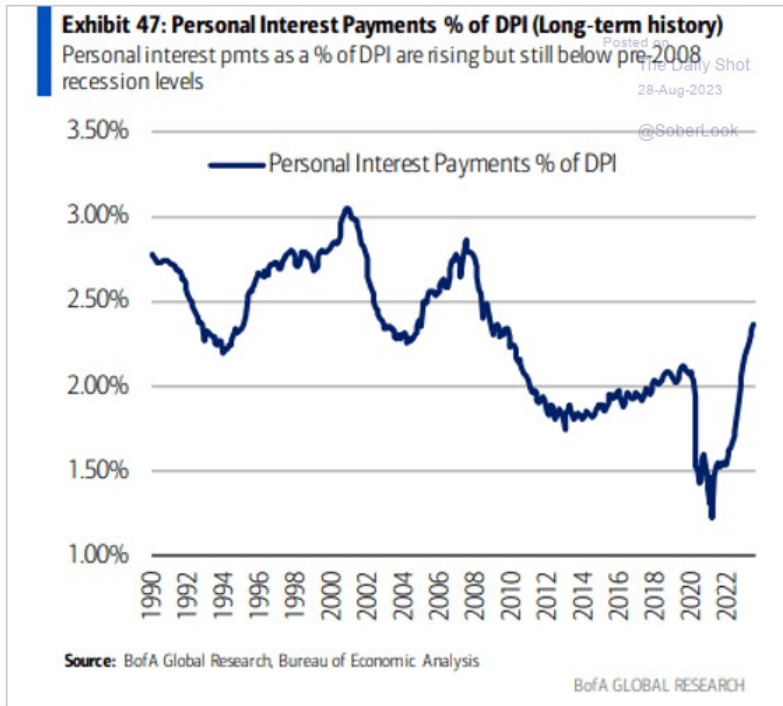


Figure 7 – The Debt Service Burden Grows for the Auto Purchaser

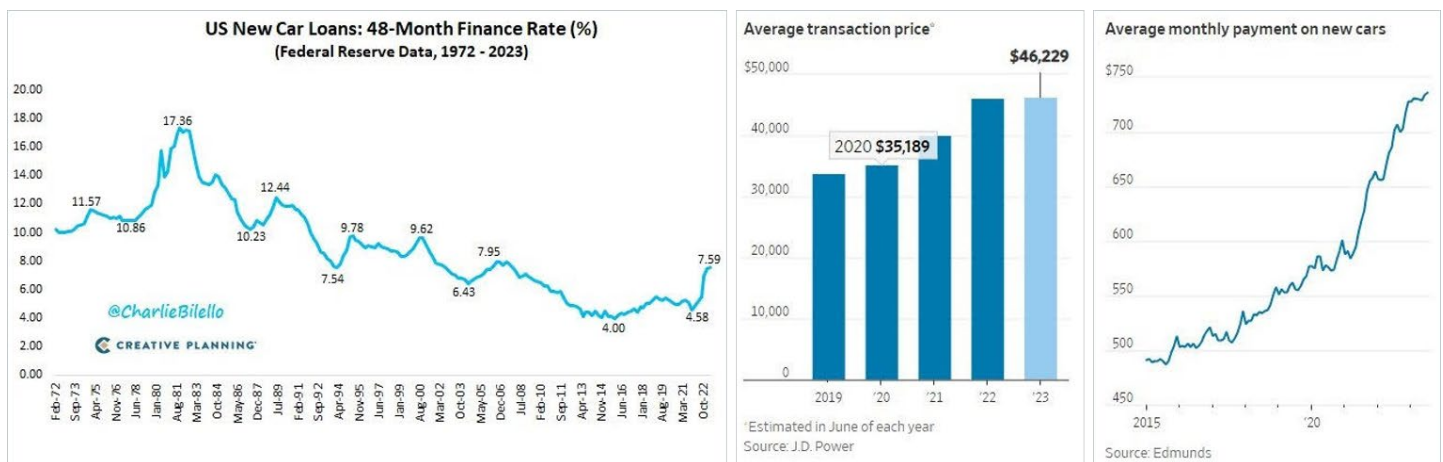
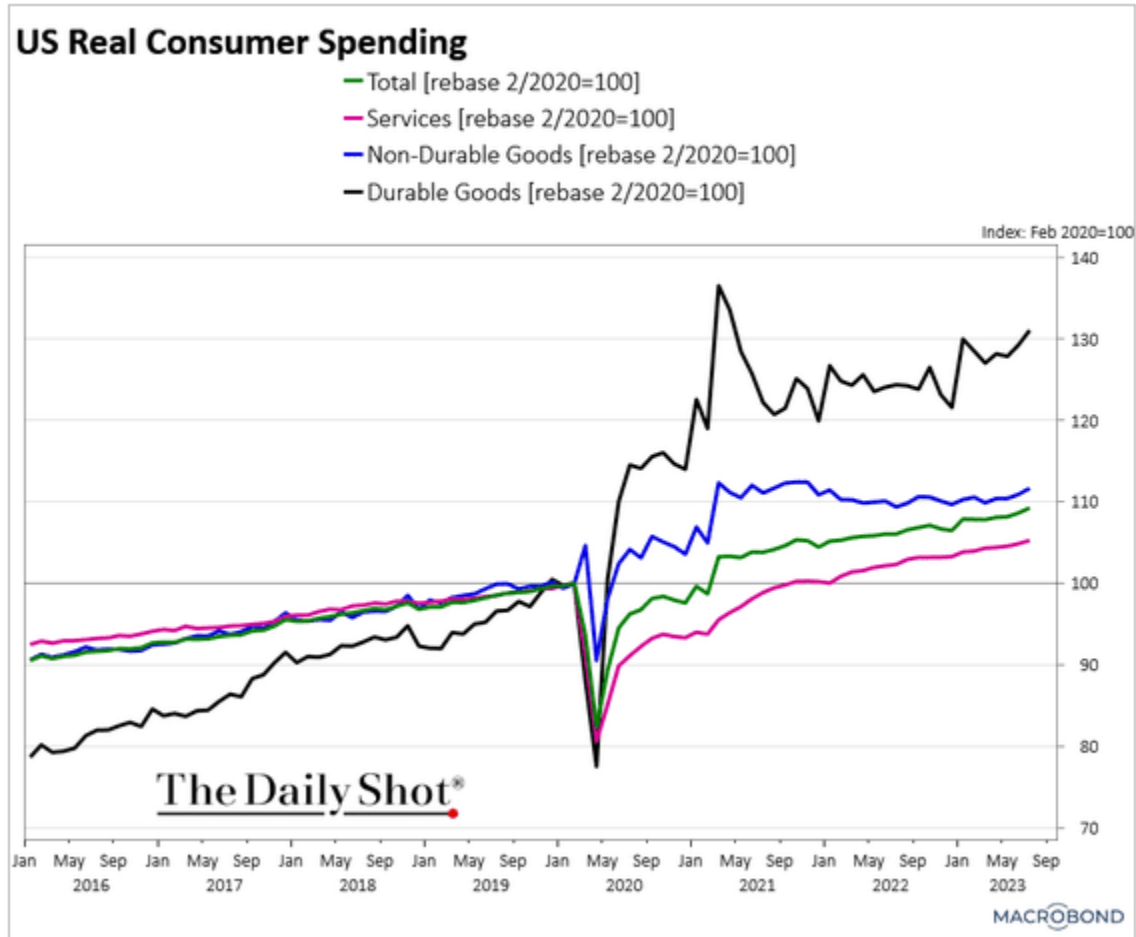


Figure 8 – Yet Inflation-Adjusted Consumer Spending on Goods and Services Shows Few Signs of Abating



Much of the U.S. economic story remains an income-driven story, first with pandemic emergency spending and then fiscal stimulus (infrastructure) that has helped contribute to both strong personal spending and labor market hiring. With the most recent employment releases (August non-farm payrolls and August JOLTS survey), there are increasing signs of labor market softness in hiring only and not outright job losses. The JOLTS survey shows a lower hiring rate over the past year, but the current rate remains well above prior economic regimes given the current unemployment rate. **Figure 9** displays the Beveridge curve that posits a nonlinear relationship between jobs hiring rate and unemployment – the latest softening trends in hiring still portend a tight labor market relative to the pre-pandemic period and pre-Great Financial Crisis period.

Figure 9 – Labor Market Conditions Are Softening But Still At Levels That Would Indicate a Tight Labor Market

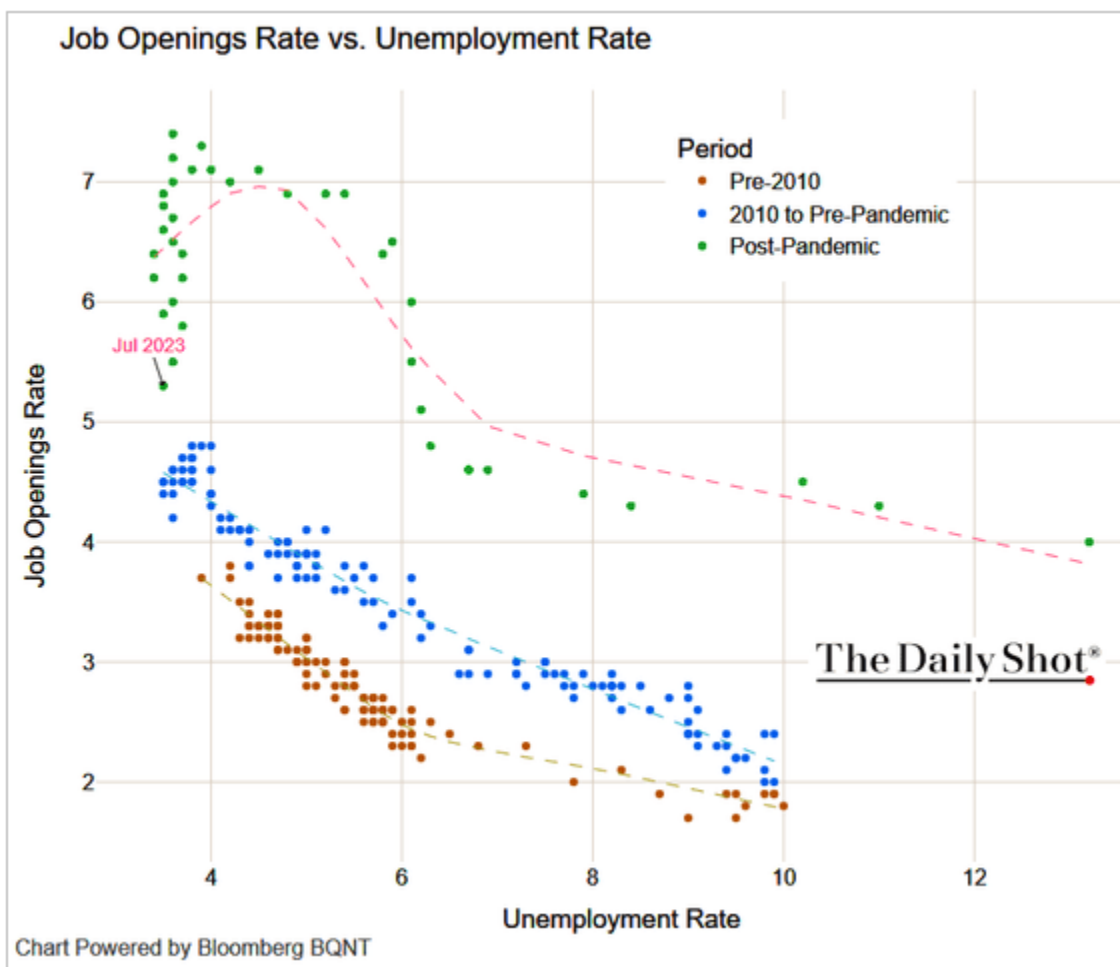
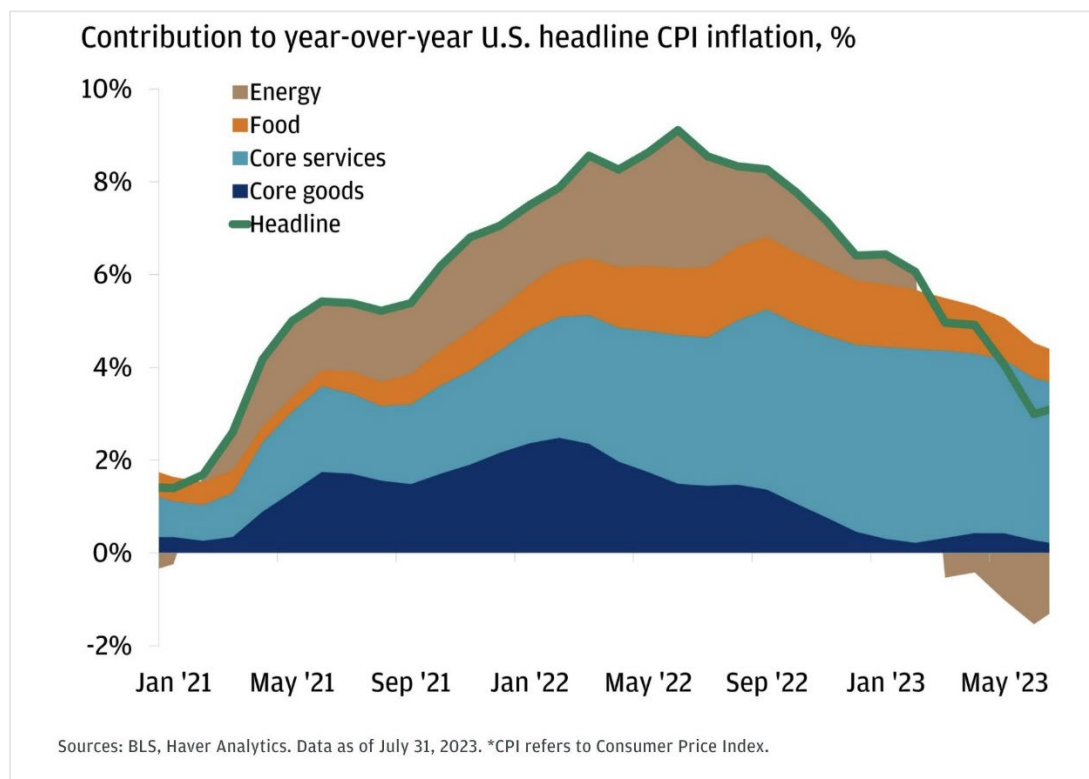


Chart Powered by Bloomberg BQNT

Year-over-year inflation continues to trend lower, and one could argue that inflation has dropped close to the Fed's long-term target of 2% if you exclude the lagged effects from the shelter components (**Figure 10**). However, supercore inflation or inflation core services ex housing remains stubbornly elevated at 4.7% (**Figure 11**). Hence, even though Fed officials grow increasingly confident of a soft landing, their prepared remarks will also reflect caution around inflationary pressures resulting from excess demand and tight labor market conditions.

But as Karl Smith wrote in an opinion piece for Bloomberg⁶, labor market conditions may be normalizing rather than correcting just as we've seen with economic data spanning spending and borrowing conditions. Labor market normalization would help the disinflation story. The next key item to normalize is wage growth which remains elevated versus pre-pandemic trends and can only be maintained with higher productivity. There are also increasing number of calls for the Fed to abandon the Phillips Curve (relationship between inflation and labor market conditions) altogether as the reason for maintaining tight policy, since much of the inflation spike can be attributed to supply chain issues that have been largely addressed⁷.

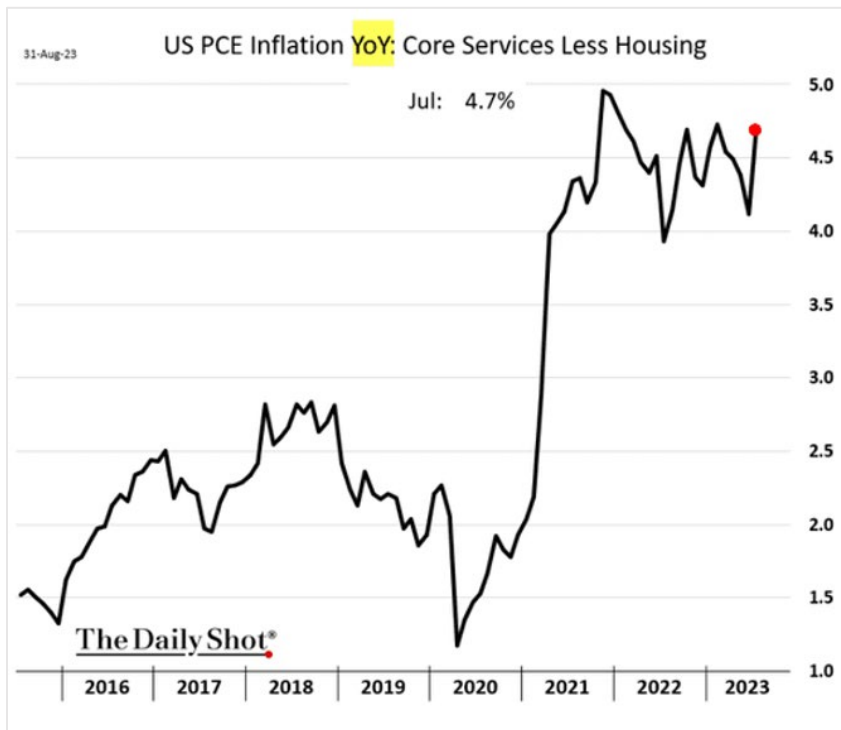
Figure 10 – Year-Over-Year Inflation Is Trending Lower Except for Services Held Up By The Lagged Shelter Components



⁶ ["We May Finally Be Witnessing a Normal Labor Market: Karl Smith,"](#) Bloomberg, 9/1/2023

⁷ ["Good Riddance to Fed Obsession With Job Openings: Jonathan Levin,"](#) Bloomberg 8/29/2023

Figure 11 – But PCE Supercore (Services ex Housing) Remains Stubbornly Elevated



So, despite this month's modest pullback, global asset markets reflect an increasingly confident of a soft-landing outcome with decelerating inflation trends and a softening labor market that looks nowhere near recessionary. At least, that's the outlook for the U.S. economy (as reflected by elevated equity valuations, narrow credit spreads, and higher commodity prices), which retains its global oasis status of economic stability while much of the rest of the world is grappling with even slower conditions as their central banks struggle to keep up with the Fed on rate policy.

The burden of proof remains with the macro bears and their calls for an imminent recession. Barring an extreme exogenous shock, they may have a little longer to wait.

August 2023 Market Review

Global equity markets gave up some ground in August but partially recovered from a steeper sell-off earlier in the month. Ongoing concerns over China’s economy, including reports of further financial troubles facing the country’s property developers as well as missed payments on income trusts from major financial firms, produced steep selloffs across equities and the Chinese Yuan. The U.S. dollar strengthened following a hawkish speech from Fed Chair Jerome Powell at the annual Jackson Hole Summit that the market initially interpreted as further rate hikes were on the table before those expectations were scaled back towards the end of the month. U.S. equities also came under pressure following weak earnings releases from major retailers but then risk sentiment shifted back towards the red-hot technology sector as generative artificial intelligence spending continues to propel major technology stocks higher. The MSCI All-Country World Index (ACWI) returned -2.8% for the month of August, recovering from a 6% drop earlier in the month.

Across major regions (Figure 12), emerging markets reversed their July leadership as weak sentiment around China helped drag down the broader pan-Asian region. Once again, U.S. equities retained their YTD leadership as the S&P 500 outperformed all other regions in August, returning -1.6% followed by MSCI Japan (-2.4%), MSCI Europe (-4.0%). MSCI Pacific ex Japan and MSCI Emerging Markets underperformed developed markets, returning -6.1% and -6.2%, respectively for the month. The U.S. dollar (Figure 13) strengthened in August, recovering from July’s YTD lows as Fed officials retain their hawkish stance, commenting on the risk of an accelerating economy will pose on progress in bringing down inflation. The Japanese Yen and Chinese Yuan depreciated against the U.S. dollar (Figure 14), threatening to reach levels not seen since the U.K. Gilt crisis in the fall of 2022.

Figure 12 – Emerging Markets and Pan-Asian Markets Underperformed Developed Markets

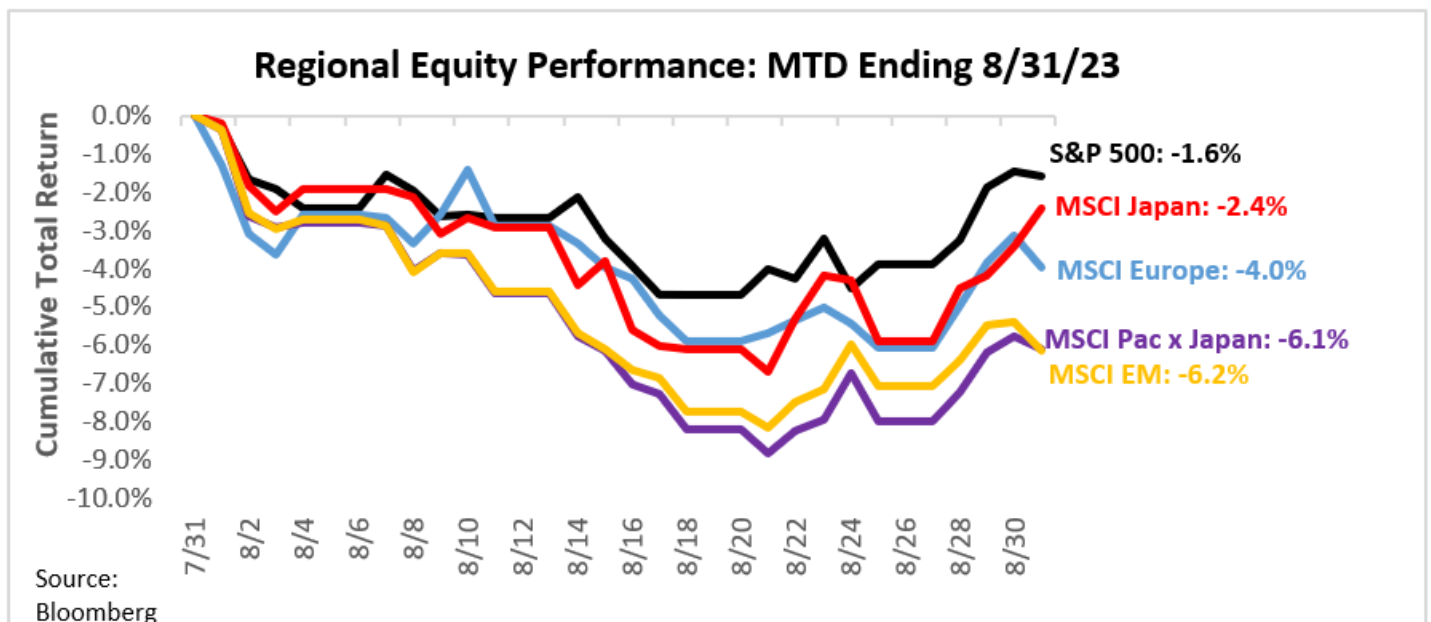


Figure 13 – The U.S. Dollar Strengthened as the Federal Reserve Retains Its Hawkish Bent

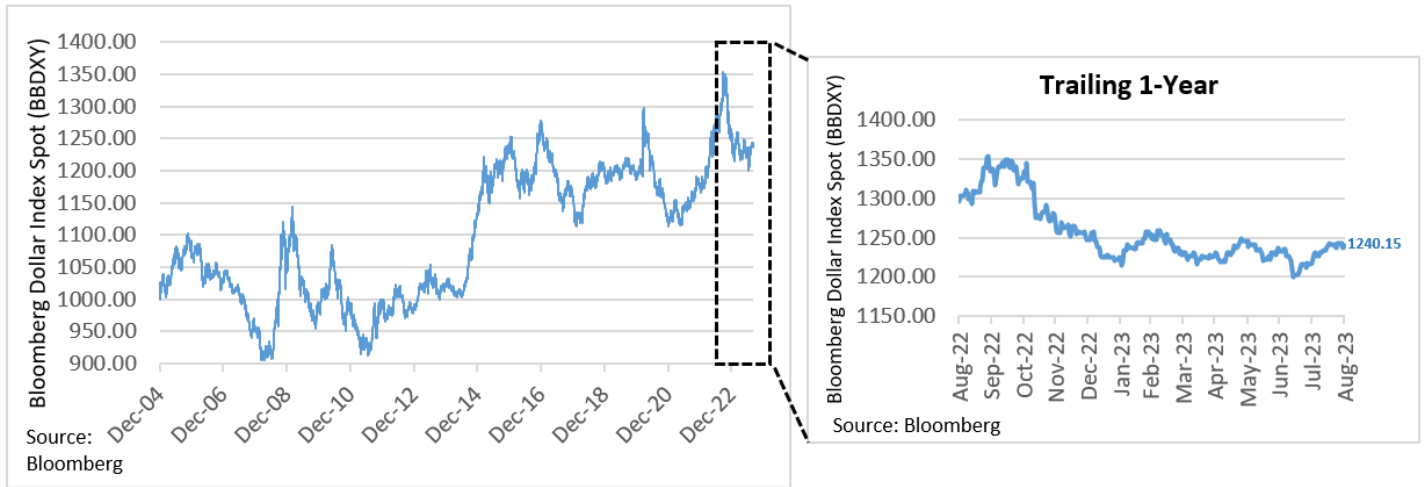
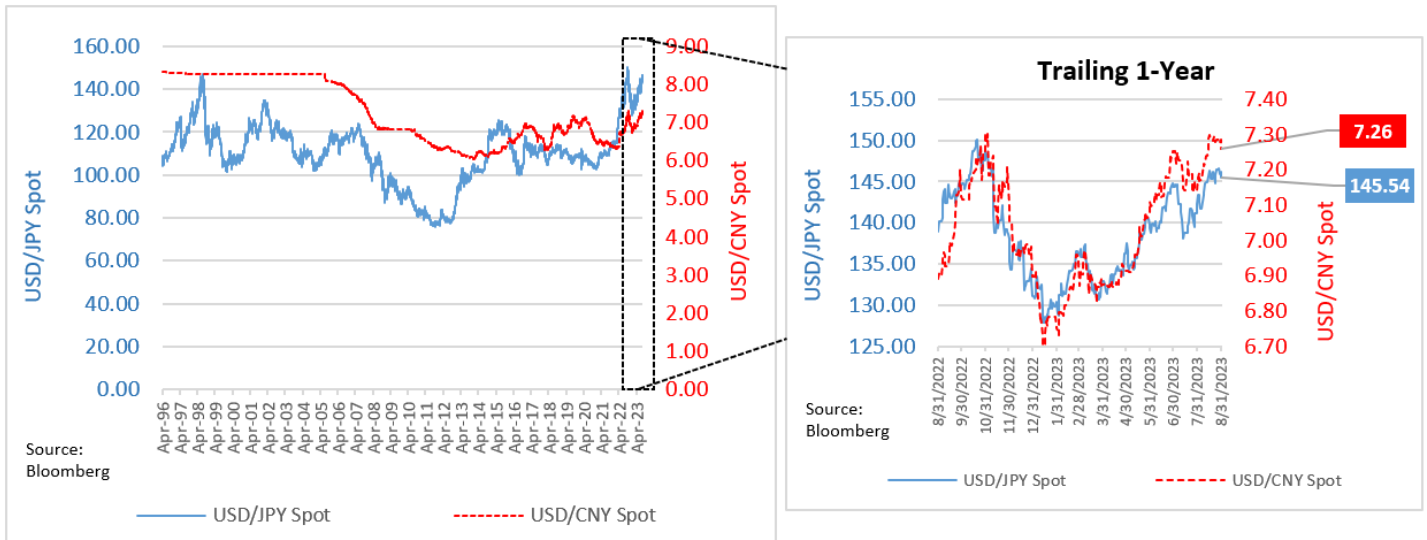
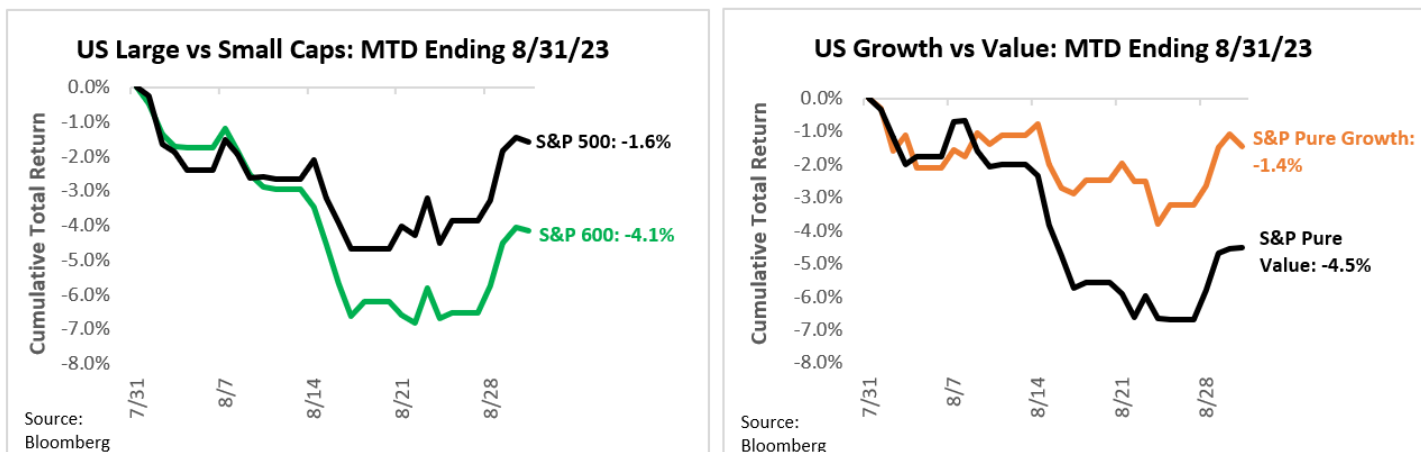


Figure 14 – The Japanese Yen and China Yuan Weakened Against the US Dollar to 1-Year Lows Following Reports of Ongoing Stress Across China’s Property and Financial Sectors



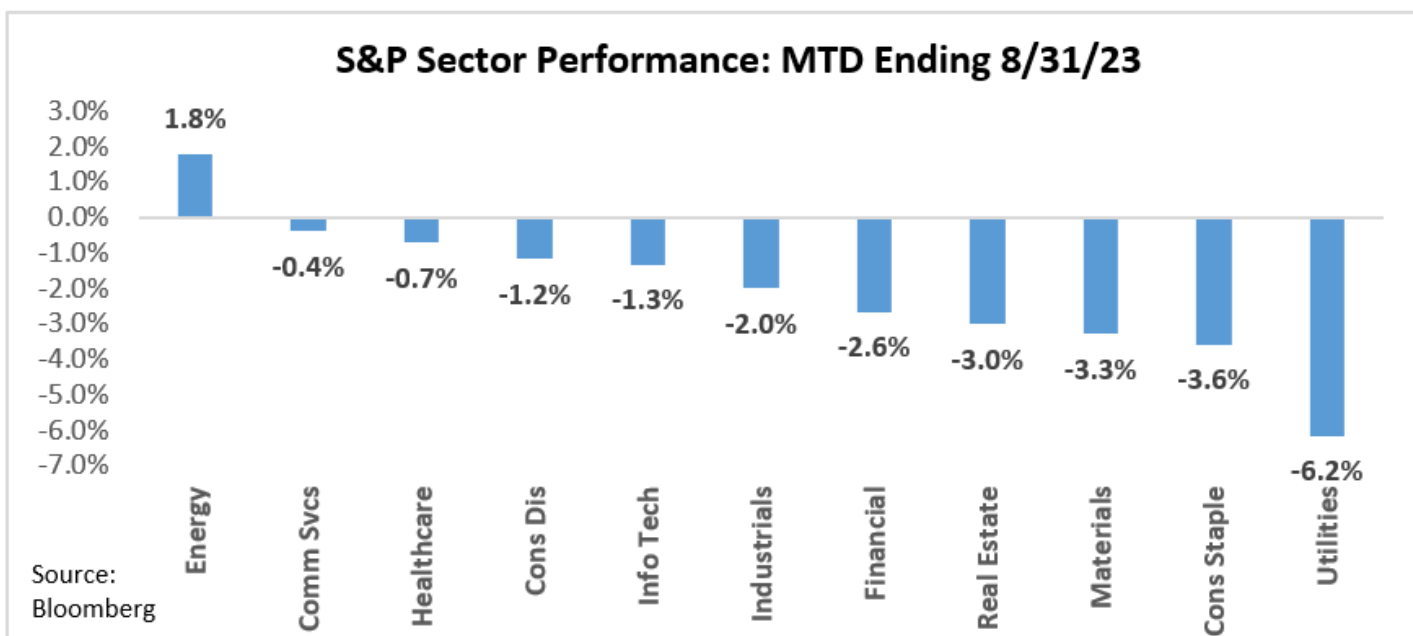
Within the U.S., small caps underperformed large caps following two prior months of outperformance, as the latter continues to benefit from mega-cap growth technology companies. S&P Pure Value underperformed Pure Growth, with the former dragged down by the underperformance of financials and traditional cyclicals. For the month of August (Figure 15), the S&P 500 Index returned -1.6% versus -4.1% for the S&P 600. S&P Pure Value underperformed Pure Growth, returning -4.5% and -1.4%, respectively.

Figure 15 – Small Caps Underperformed Large Caps and Value Underperformed Growth



Across sectors (Figure 16), the Energy sector was the only positive performer in August, helped by an increase in oil and gas prices. Growth-focused sectors (Communication Services, Healthcare, Consumer Discretionary, and Technology) outperformed Financials and Cyclicals while defensive sectors (Staples, Utilities) were the worst performers.

Figure 16 – Outside of Energy, Growth-Focused Sectors Outperformed Financials and Defensive Sectors



Soft Landing in Sight

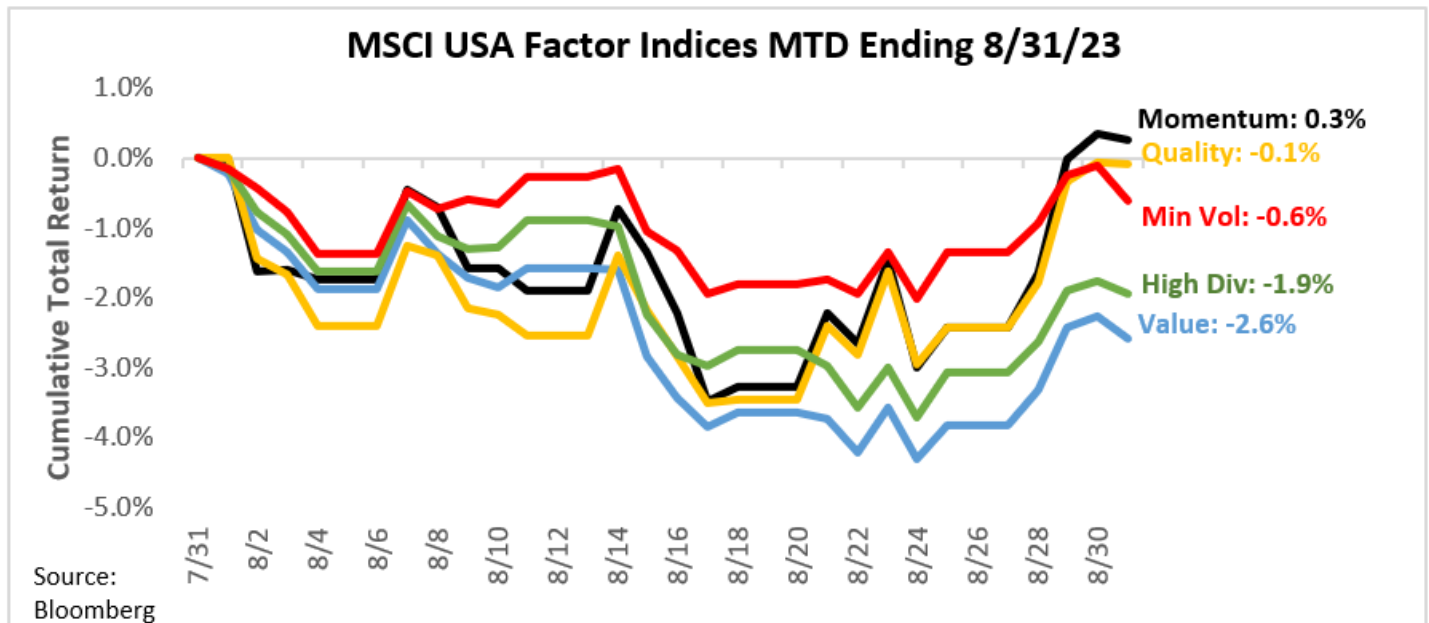
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Among major risk factors, in August (Figure 17), Momentum, High Quality, and Minimum Volatility Outperformed High Dividend and Value. This month's factor leaders were helped by the strong month-end performance of technology and consumer discretionary growth stocks.

Figure 17 – Momentum, High Quality, and Minimum Volatility Outperformed High Dividend and Value



Fixed Income market suffered from higher interest rates as U.S. Treasury yields rose in anticipation of more Treasury issuance to fund U.S. fiscal deficits and few signs that the U.S. economy is slowing down. The Bloomberg U.S. Aggregate Bond Index returned -0.6% for the month (**Figure 18**), although the index was down 2.5% earlier in the month. Corporate bonds continue to outperform as borrowing spreads (**Figure 19**) narrowed to 1-year low levels. The Global ex-U.S. Aggregate Index returned -2.0%, hurt by a strengthening dollar as European yields rose in sympathy with the U.S. (**Figure 20**). Bloomberg Emerging Market Local Currency also underperformed U.S. fixed income, returning -2.8% for the month, but Bloomberg US High Yield continued its strong YTD run, returning 0.3%, as lower quality bonds are benefiting from a favorable maturity profile and investor appetite for higher yields.

The 10-Year U.S. Treasury yield ended the month at 4.11%, up from 3.96% at the beginning, although down from the intramonth highs (4.35%). The 2-10 Year Term structure (**Figure 21**) steepened throughout August although remains deeply inverted as the short end of the curve remains anchored to rising short-term rates. Inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields dropped towards the end of the month having spiked.

Figure 18 – Fixed Income Came Under Pressure from Rising Interest Rates

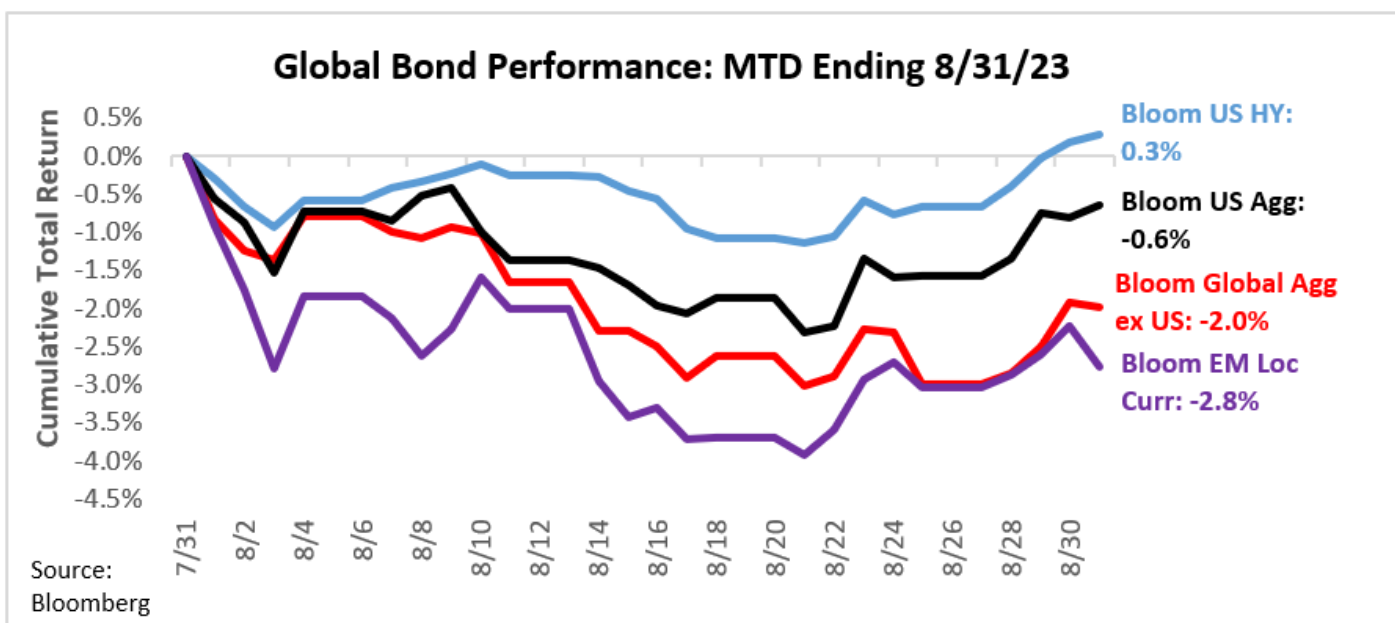


Figure 19 – Corporate Borrowing Spreads Continue to Narrow (Near 1-Year Low Levels)

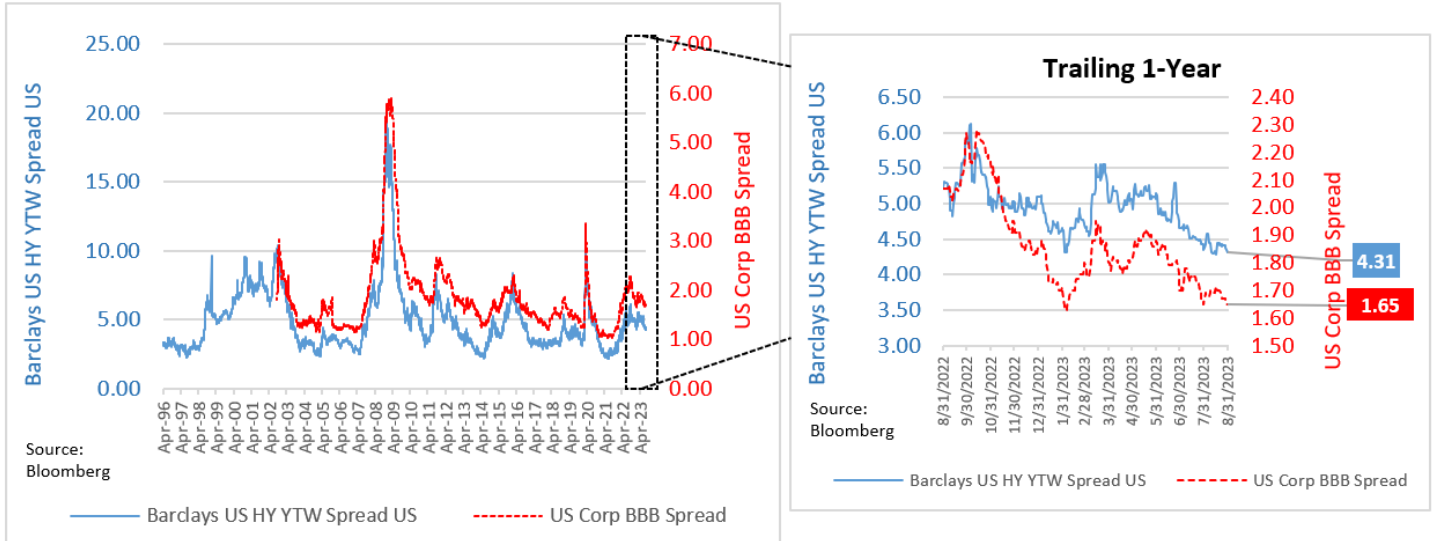


Figure 20 – 2-10 Year Term Structure Steepened While Inflation Breakeven Rates Settle Down

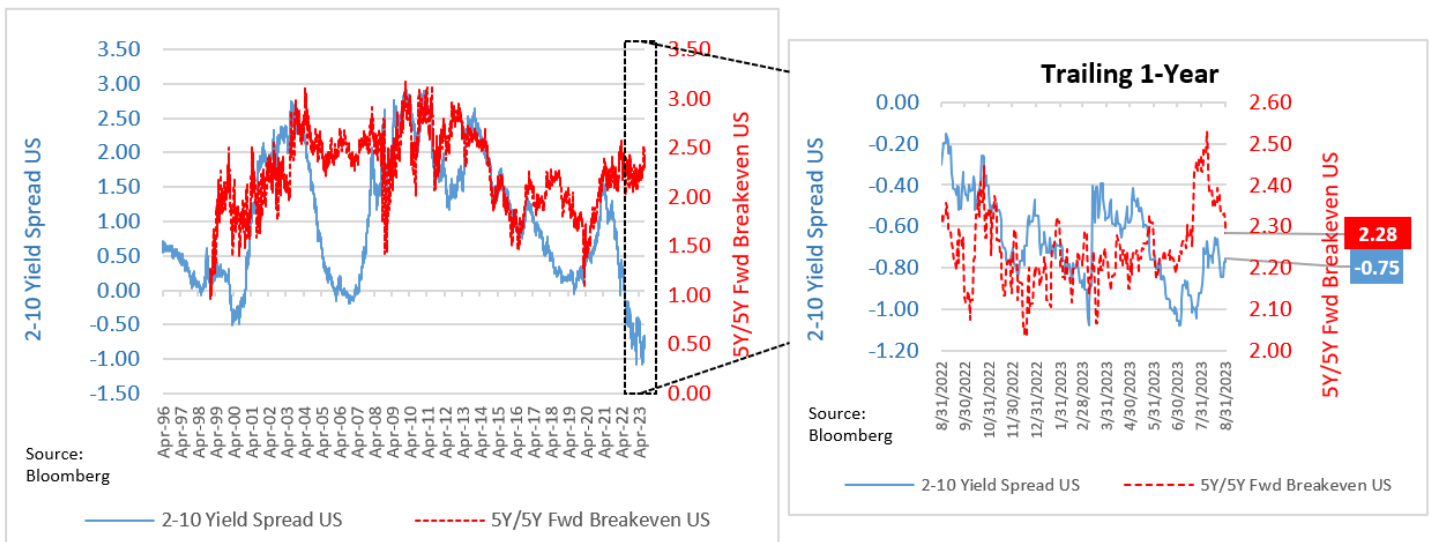
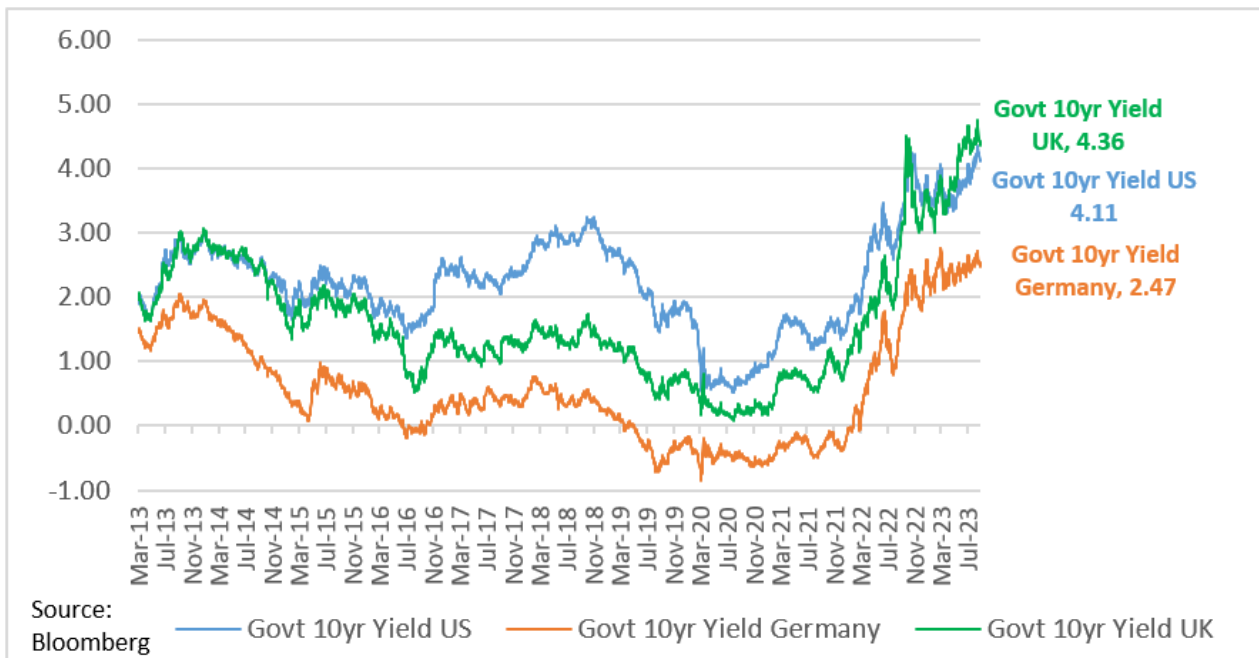


Figure 21 – Key Sovereign Bond Yields Are Hovering Near 1-Year High Levels



Within equity alternatives (**Figure 22**), Commodities outperformed Precious Metals and Real Estate in August as the former benefited from a sharp rally in oil prices and metals (especially iron ore) (**Figure 23**). The S&P GSCI Commodities Index returned +0.6% for the month while the Dow Jones REIT Index returned -3.3%, as interest rate volatility and ongoing concerns over the commercial office sector continue to weigh on real estate sentiment. The S&P GSCI Precious Metals Index was initially hurt by a selloff in precious metals (gold, silver) but then recovered later in the month.

Figure 22 – In August, Commodities Outperformed Other Risk Assets, Helped by Higher Energy and Industrial Metal Prices

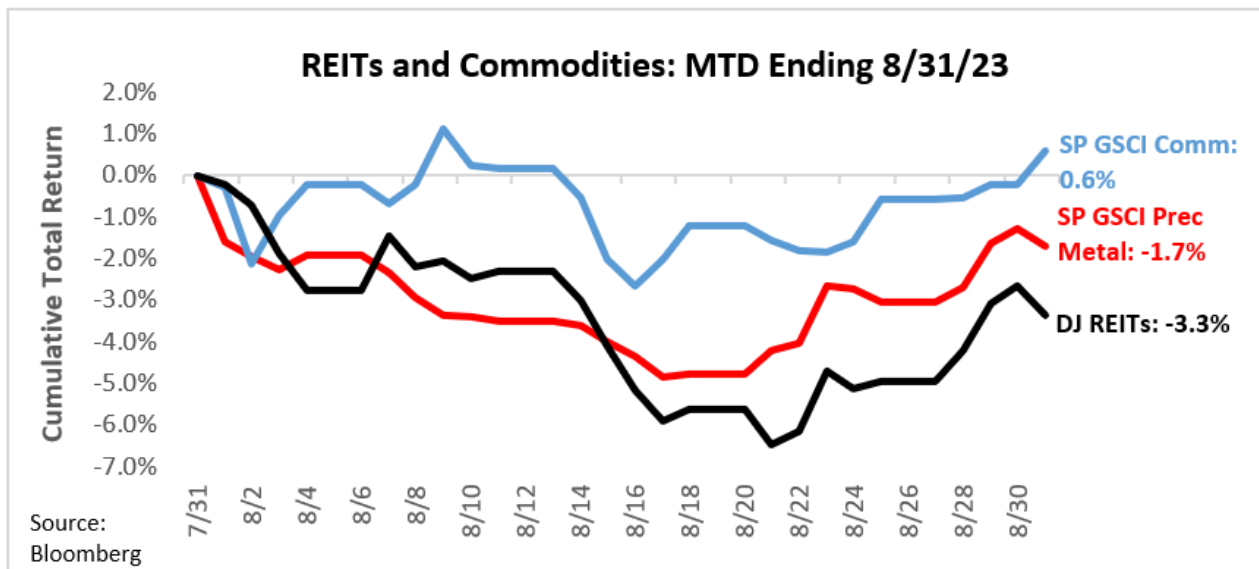
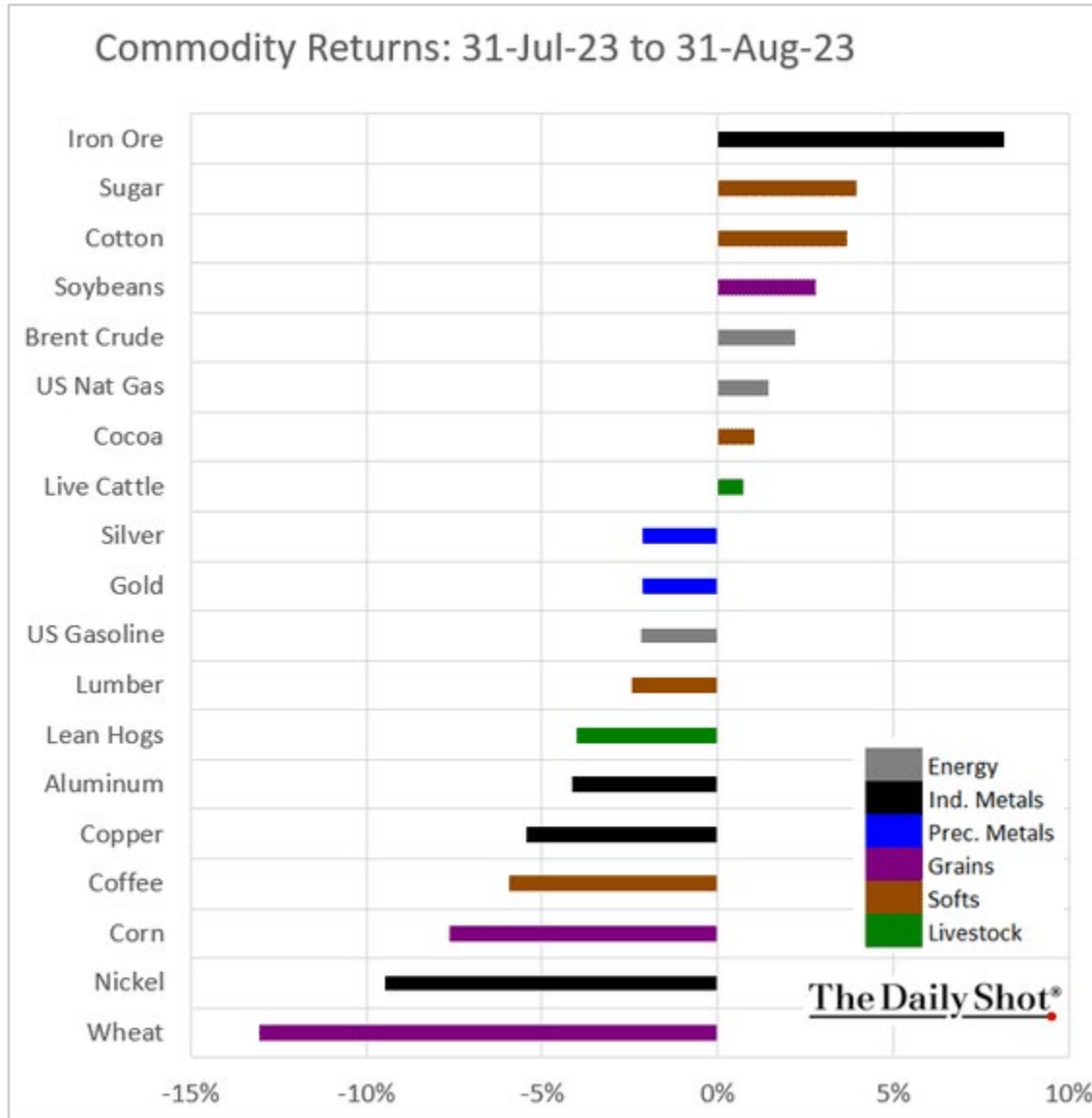


Figure 23 – Oil Prices and Industrial Metals (Iron Ore) Strength Offset by Agricultural and Other Metal Weakness





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Disclosure:

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