

Climbing the Wall of Worry Brick by Brick

October 2023 Market Commentary

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Economic Outlook: U.S. Economy Slowing from Torrid 3rd Quarter Pace But Recession on Hold



Headlines throughout October 2023:

1. Israel / Hamas Conflict: Localized or the Potential to Spread?
2. China Property Defaults and Ongoing Asian Market Malaise
3. U.S. Treasuries Sell Off Again with 10-Year Rate Reaching 5%
4. Global Equities and Commodities Turn Lower
5. Investor Sentiment Continues to Favor Big Tech



Underneath the Surface:

1. Energy Sector M&A (Exxon-Pioneer, Chevron-Hess)
2. Q3 S&P Earnings: 49% Reported So Far w/ YOY 2.7% Increase
3. Bonds Pressured by Treasury Supply and Hotter Economy
4. Fed Funds Terminal Rate Likely Peaked at 5,50%



2023 GDP Bloomberg Consensus:

1. US: +2.2% (↑ from +0.3% in 4Q22)
2. Europe: +0.5% (↑ from -0.1% in 4Q22)
3. Japan: +1.9% (↑ from +1.2% in 4Q22)
4. China: +5.1% (↑ 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 Freedom Investment Management, Inc. Managed Model Portfolios (Risk-Based ETFs, Risk-Based DFA Funds, Lee Adaptive Large Cap Sector) as of 10/31/2023

Key Benchmarks: Performance and Characteristics as of 10/31/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	-2.1%	-2.1%	10.7%	17.6x	14.6x		22.9x
MSCI EAFE	-4.1%	-4.1%	2.7%	12.4x	11.2x		18.3x
MSCI Emerging	-3.9%	-3.9%	-2.1%	11.1x	9.5x		15.3x
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg U.S. Aggregate	-1.6%	-1.6%	-2.8%	US REITs	-3.1%	-3.1%	-8.5%
Bloomberg U.S. High Yield	-1.2%	-1.2%	4.6%	GSCI Commodities	-4.2%	-4.2%	2.8%
Bloomberg Global Agg ex U.S.	-0.9%	-0.9%	-4.1%	GSCI Prec Metals	6.9%	6.9%	7.4%

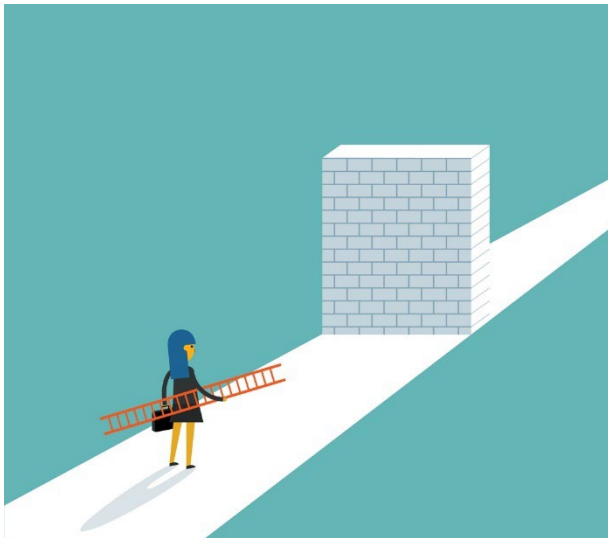
Data Source: Bloomberg

October 2023 Highlights:

- Global equity markets gave up more ground in October although markets rebounded from initial selling pressure following the breakout of hostilities between Israel and Hamas in Gaza earlier in the month. The MSCI All-Country World Index (ACWI) returned -3.0% for the month of October.
- Ongoing concerns over China's economy, including reports of pending defaults on offshore debt obligations by some of China's prominent property developers, and continued slowdown in industrial activity throughout Europe also weighed on global growth sentiment. U.S. equities came under pressure following weak earnings releases across much of the traditional retail and industrial landscape although have come in stronger for many communication and software companies.
- Across major regions, once again, U.S. equities retained their leadership as the S&P 500 outperformed all other regions in October, returning -2.1% followed by MSCI Europe (-3.7%), MSCI Emerging Markets (-3.9%). MSCI Pacific ex Japan and MSCI Japan underperformed, returning -4.1% and -4.8%, respectively for the month.
- The U.S. dollar remained steady (although it strengthened against pan-Asian currencies) even as interest rate differentials between the U.S. and the rest of the world continue to widen. The Japanese Yen and Chinese Yuan depreciated against the U.S. dollar, with the former under continued pressure over the Bank of Japan's monetary stance of maintaining short-term negative rates and tight controls around long rates.

- Within the U.S., small caps underperformed large caps as smaller caps continue to struggle this year, encapsulating the narrowness of this year's U.S. equity advance, primarily from the Magnificent 7 megacap tech companies. S&P Pure Value underperformed Pure Growth, with the former dragged down by the underperformance of financials and industrial/consumer cyclicals. For the month of October, the S&P 500 Index returned -2.1% versus -5.7% for the S&P 600. S&P Pure Value underperformed with Pure Growth, returning -5.7% and -2.8%, respectively.
- Across sectors, defensive sectors (Utilities, Staples) and growth technology outperformed commodity and consumer cyclical sectors (Consumer Discretionary, Energy). Despite some high profile M&A announcements (Exxon-Pioneer Natural Resources and Chevron-Hess), the Energy sector was weighed down by a drop in oil prices which sold off over diminishing gasoline demand.
- Among major risk factors, in October, Minimum Volatility, High Quality, and Momentum outperformed High Value and High Dividend. This month's factor leaders were helped by the strong month-end performance of technology and defensive stocks such as utilities and staples.
- The Fixed Income market suffered another month of higher interest rates as U.S. Treasury yields rose in anticipation of more Treasury issuance to fund U.S. fiscal deficits, pressure from the sell-off in Japanese Government Bonds, and few signs that the U.S. economy is slowing down. The Bloomberg U.S. Aggregate Bond Index returned -1.6% for the month, although the index was down 2.5% earlier in the month as the 10-Year Treasury yield briefly reached 5%. Corporate bonds continue to outperform as borrowing spreads remain near their YTD bottom levels despite widening later in the month with the sell-off in equities.
- Within equity alternatives, Precious Metals outperformed as gold prices briefly touched \$2000/ounce. Commodities were hurt by lower oil and industrial metal prices while Real Estate remains under pressure over rising rates, tighter credit conditions, and lower market values. The S&P GSCI Commodities Index returned -4.2% for the month while the Dow Jones REIT Index returned -3.1%, as interest rate volatility and ongoing concerns over the commercial office sector continue to weigh on real estate sentiment.

Climbing the Wall of Worry Brick by Brick



Source: istockphoto.com

“While pullbacks are painful, we’re reminded that selloffs like these aren’t all that unusual. Going back to 1980, the average year has seen a drawdown of around -14%. This year’s selloff is just about half that. What’s more, staying invested tends to be a rewarding mantra for investors. Despite those drawdowns, stocks have gone on to finish the year higher 75% of the time.”

– J.P. Morgan Market Outlook 9/29/2023¹

Following a third straight month of negative stock and bond market returns, investors, especially those invested in classic risk-based programs (think 60/40), are starting to feel nervous, as those bricks in the metaphorical wall-of-worry are piling up.

The above-referenced JP Morgan report provides a list of bricks on investors’ minds even in the midst of full employment, nominal wage gains, and higher productivity helping businesses to maintain profitability in the face of higher input costs and debt financing. These bricks that are building the wall of worry include:

1. Profligate government spending (fiscal deficits as a % of GDP at elevated levels with a robust economy);
2. Higher real (inflation-adjusted) rate environment that looks to persist well into 2024, per Federal Reserve messaging;
3. Lingering inflation (higher energy prices, elevated core ex-housing pricing pressures);
4. Consumer pain points (housing affordability, or lack thereof, due to limited supply and high mortgage rates not seen since before the 2008 Great Financial Crisis);
5. China economic slowdown worsened by the ongoing financial travails of its property developers;
6. Geopolitical uncertainty (Russia/Ukraine and now the Middle East).

And we would add to this list:

1. A U.S. economy that is slowing down, whether consumer spending, company hires, or net exports;
2. Environments that produce positive earnings growth and a meaningful Fed pivot in the form of substantial rate cuts cannot easily co-exist. Even a soft landing (low inflationary growth) implies top-line slowdown that could pressure profit margins and/or drive down operating expenses in order to maintain margins such as cutting back on investment and hiring.

¹ “J.P. Morgan Market Outlook,” 9/29/2023

After outlining these bricks, the report concludes:

“In the end, we think markets can climb the wall of worry, even if it takes some time. And with stocks and bonds now accounting for a fair degree of pain, that seems to offer an even more attractive entry point for multi-asset class investors.”

From a long-term strategic perspective, the report is correct, especially in the context of this year’s volatility which is roughly half that experienced in 2022 when the worst of the sell-off in equities and bonds were felt following post-pandemic level peak performance. Going from 3.50% to 5.00% on the 10-Year Treasury is painful but still only half as painful as going from 0.50% to 3.50%.

And U.S. equities, as proxied by the S&P 500, are still positive this year even if the advance has been narrowly driven by a handful of megacap technology stocks. Although U.S. equity valuations have de-rated from a multiple of over 20x forward earnings to around 17x, earnings growth for the S&P 500 are expected to be slightly positive in 2023 and are expected to grow around 12% in 2024, according to the 10/27/2023 edition of Factset Earnings Insight.²

And all those bricks don’t seem to have damaged the soft-landing scenario for the U.S. economy that projects inflation slowing down against a lower real growth backdrop. As hard as it is to accept by some macroeconomic prognosticators, the Fed’s outlook appears to be coming to fruition although it remains cautious as it expects nominal rates to remain high for the foreseeable future (**Figure 1**). The Fed Funds Target Rate looks to have peaked at 5.50% with the first rate cut expected to occur at the June 2024 FOMC meeting (**Figure 2**).

However, the Fed is also likely to maintain its tightening bias as it desires maximum flexibility in deviating from the current policy path, even if such a deviation catches the market by surprise.³ Despite an expected slowdown in 4th quarter GDP from the torrid 4.9% advanced print for the 3rd quarter, consumer spending remains robust while labor costs remain elevated from a combination of higher wages and costlier benefits (i.e. medical insurance). However, the Fed’s preferred inflation reading, core PCE, is now tracking to undershoot the Fed’s forecast, with core PCE likely ending the year at 3.6% vs the Fed’s forecast of 3.7%. Progress is being made on slowing down inflation pressures but getting from current levels to the 2% long-term average target is proving to be more difficult than its initial slowing from prior year peak levels.

² [Factset Earnings Insight, 10/27/2023](#)

³ [“US PREVIEW: FOMC to Extend Pause, Maintain Tightening Bias,” Bloomberg, 11/1/2023](#)

Figure 1 – Consensus for the Fed Funds Rate Path Is Lining Up with the Fed’s Own Projections

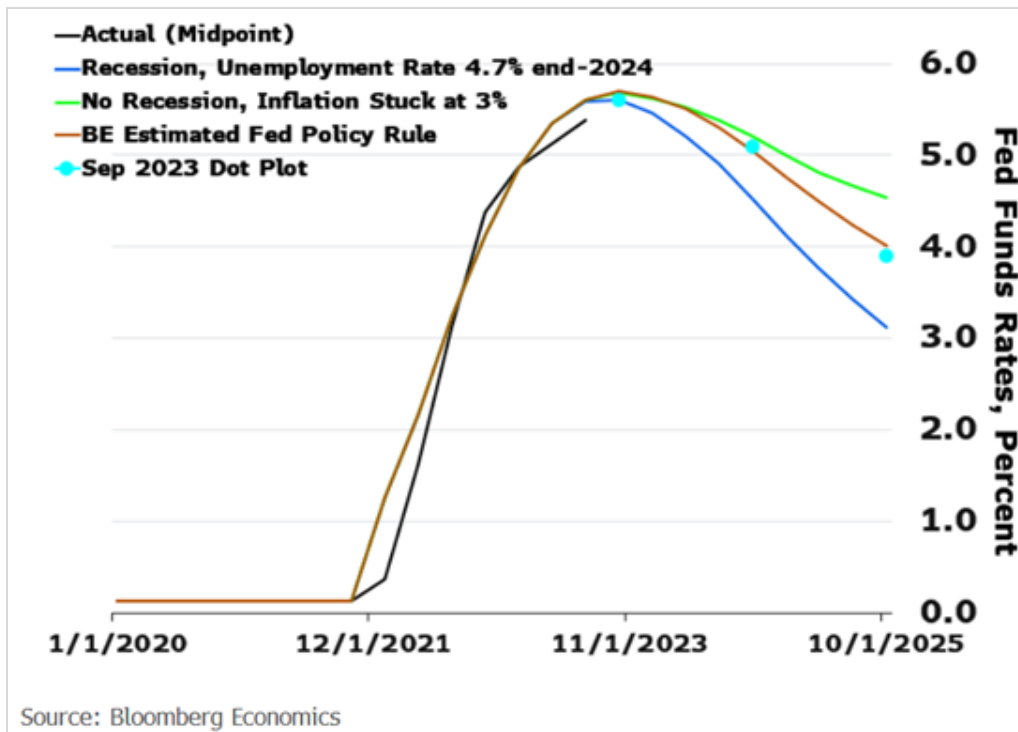


Figure 2 – Terminal Fed Funds Reached with the First Rate Cut to Occur Around June 2024

Region: United States »		Instrument: Fed Funds Futures »			
Target Rate	5.50	Pricing Date	10/31/2023		
Effective Rate	5.33	Cur. Imp. O/N Rate	5.329		
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M. ▲
11/01/2023	+0.000	+0.0%	+0.000	5.329	0.250
12/13/2023	+0.271	+27.1%	+0.068	5.396	0.250
01/31/2024	+0.415	+14.4%	+0.104	5.433	0.250
03/20/2024	+0.270	-14.5%	+0.068	5.396	0.250
05/01/2024	-0.077	-34.7%	-0.019	5.310	0.250
06/12/2024	-0.524	-44.7%	-0.131	5.198	0.250
07/31/2024	-1.035	-51.1%	-0.259	5.070	0.250
09/18/2024	-1.615	-58.0%	-0.404	4.925	0.250
11/07/2024	-2.130	-51.5%	-0.532	4.796	0.250
12/18/2024	-2.629	-49.9%	-0.657	4.672	0.250
01/20/2025	-2.955	-47.6%	-0.764	4.565	0.250

Source: Bloomberg

U.S. consumer spending remains the workhorse of the post-pandemic growth regime, as inflation-adjusted spending continues to trend higher (Figure 3) despite higher borrowing costs. Consumer spending accounted for nearly half of the 4.9% real GDP growth reported for 3Q (Figure 4).

Figure 3 – The U.S. Consumer Workhorse Continues to Plod Along

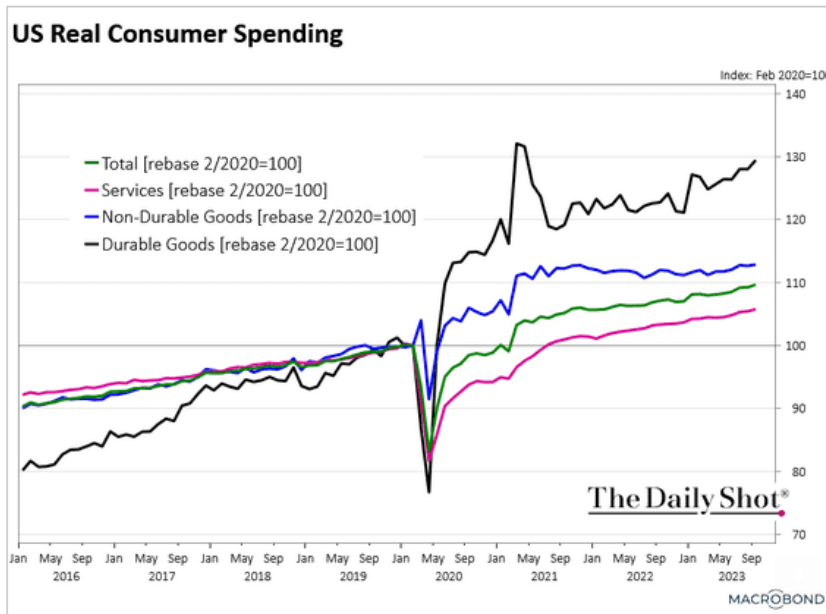
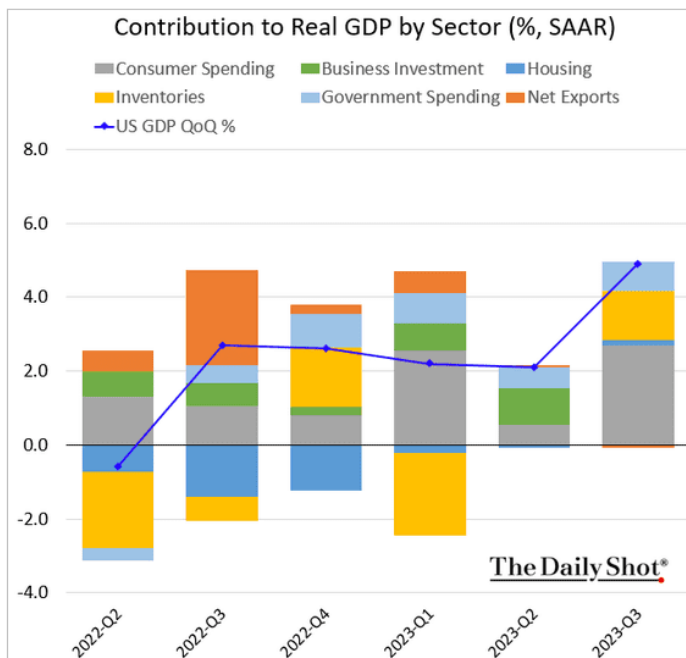
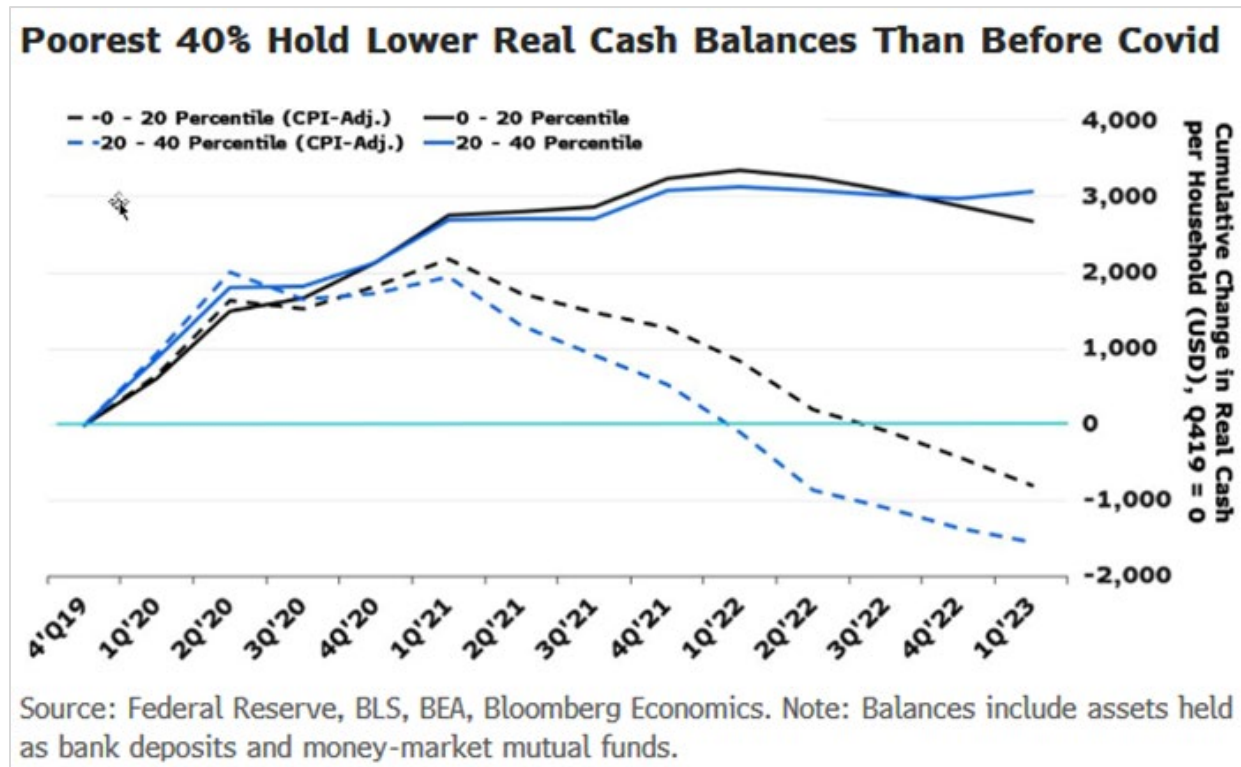


Figure 4 – Consumer Spending Accounted for Nearly Half of 3Q2023 Real GDP Growth



Yet, a K-shaped picture of the consumer is emerging underneath the surface as the lower income cohorts are struggling with higher credit costs relative to the upper income cohorts while the former has seen their cash balances turn negative (Figure 5). Can the U.S. consumer workhorse plod ahead even as its legs grow increasingly tired?

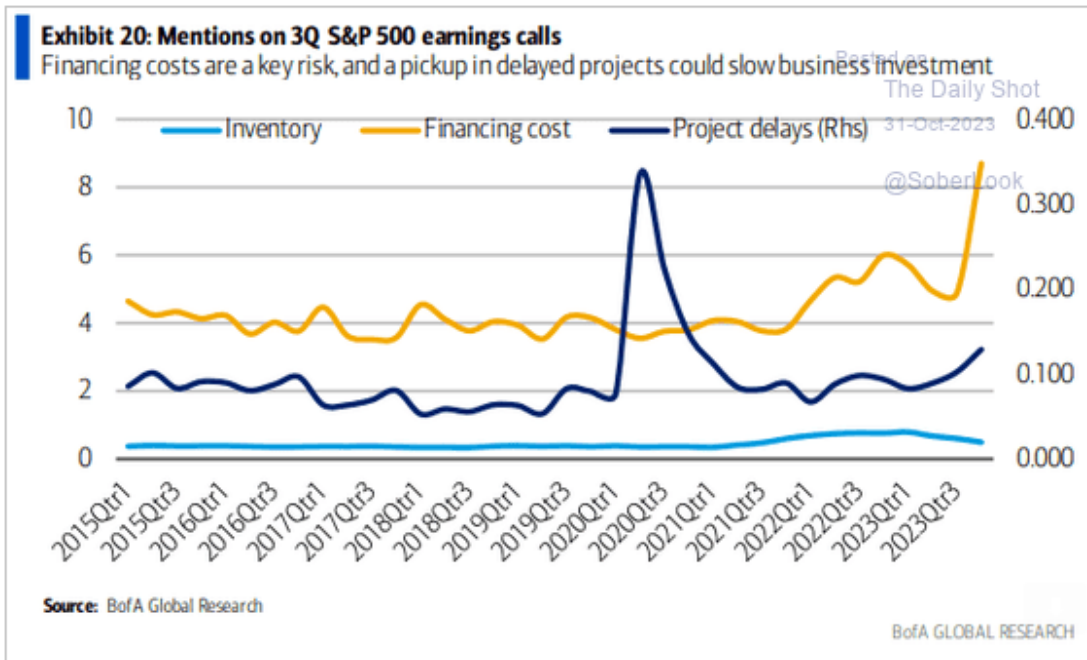
Figure 5 – But a K-Shaped Consumption Profile Is Emerging Underneath the Surface



Source: Bloomberg

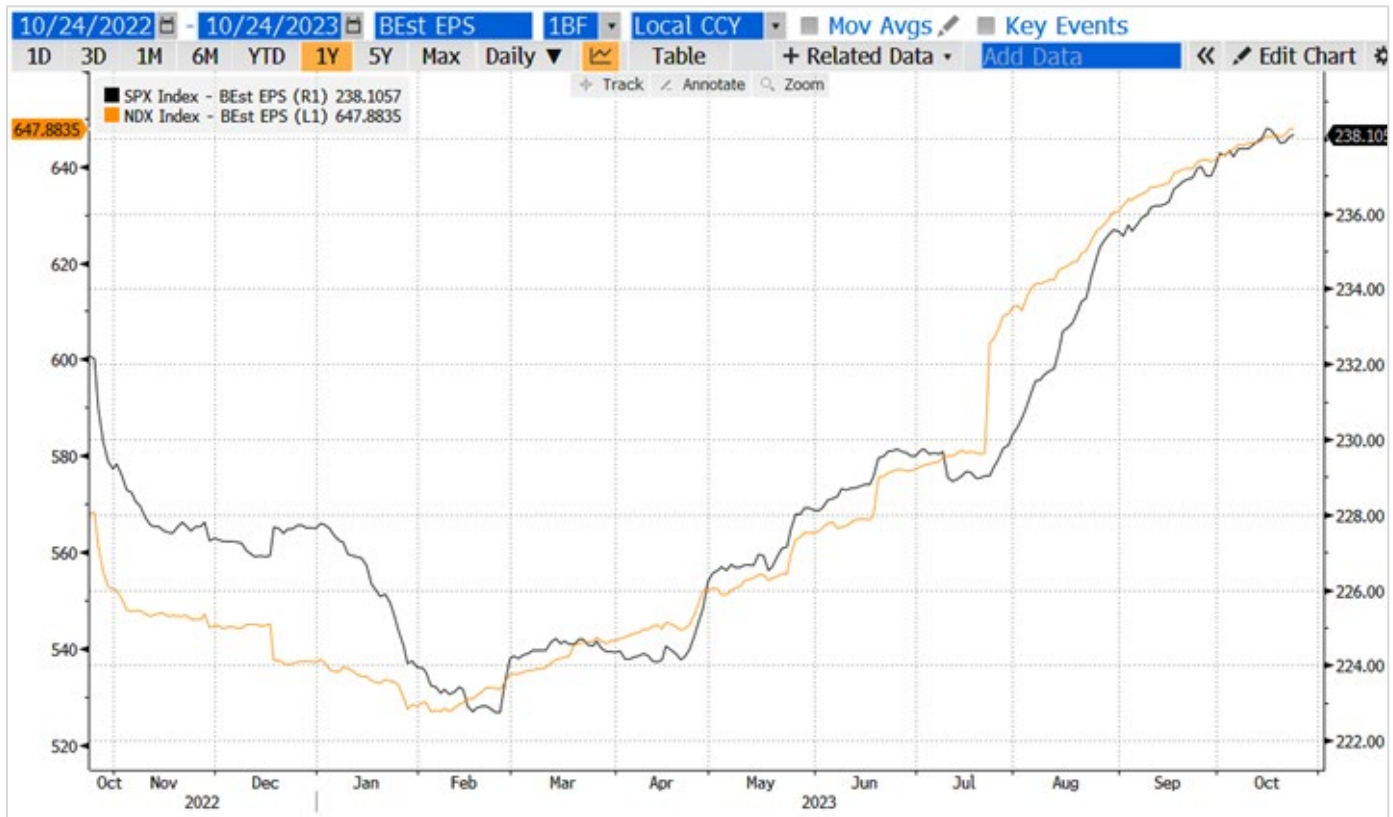
With respect to rising borrowing costs, a K-shaped profile is also increasingly evident between large companies who took advantage of record low borrowing rates just after the pandemic and small/medium-sized businesses that are more sensitive to borrowing rates, especially funding working capital needs. But higher borrowing costs are starting to affect corporate decision-making even at the large company level. Higher financing costs were frequently mentioned on S&P 500 3Q earnings calls as impacting future investment projects and potentially future hiring (Figure 6).

Figure 6 – Even Larger Companies Are Citing Higher Financing Costs as a Key Risk For Future Long-Term Planning



Despite struggles and earnings misses underneath the surface, the overall outlook for U.S. earnings growth remains robust, especially for the Nasdaq 100 companies which are benefiting from a surge in capital investment driven by various generative A.I. initiatives, where A.I. has become a high frequency buzzword in tech earnings calls. Sellside analysts continue to raise estimates (**Figure 7**) over the next year despite the building wall-of-worry.

Figure 7 – Sellside Earnings Estimates Are Climbing Over That Wall of Worry



Source: Bloomberg

The last three months have witnessed a de-rating of valuations for both equities and fixed income, as investors are demanding higher risk premiums in the face of these wall-of-worry bricks. Over the last two quarters, the S&P 500 price/earnings multiple has compressed even in the face of positive earnings (**Figure 8**) while the rise in Treasury yields have not been driven by higher inflation expectations but by higher term premiums (the additional risk of owning longer maturities – **Figure 9**).

Figure 8 – Contraction in the S&P 500 Price/Earnings Multiple Has Contributed to the Negative Performance Over the Last Two Quarters

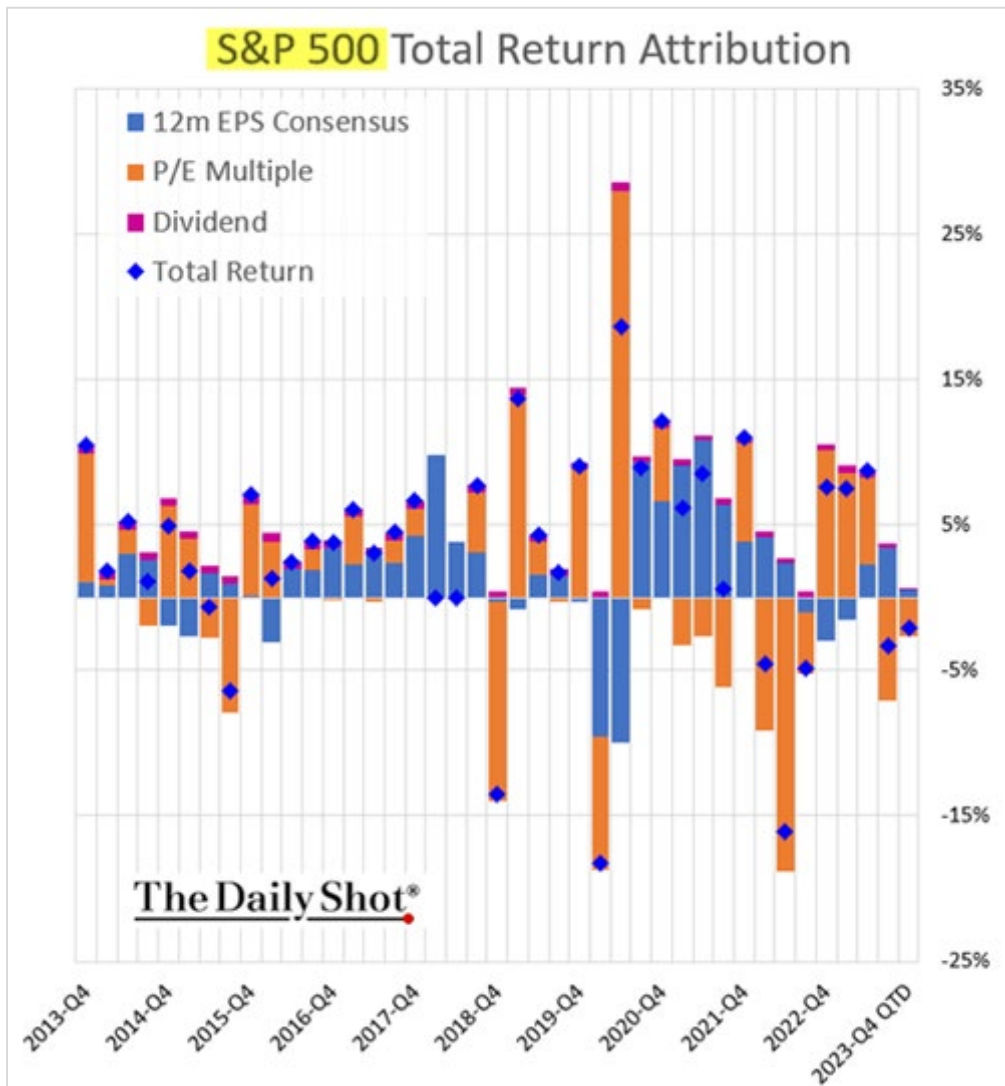
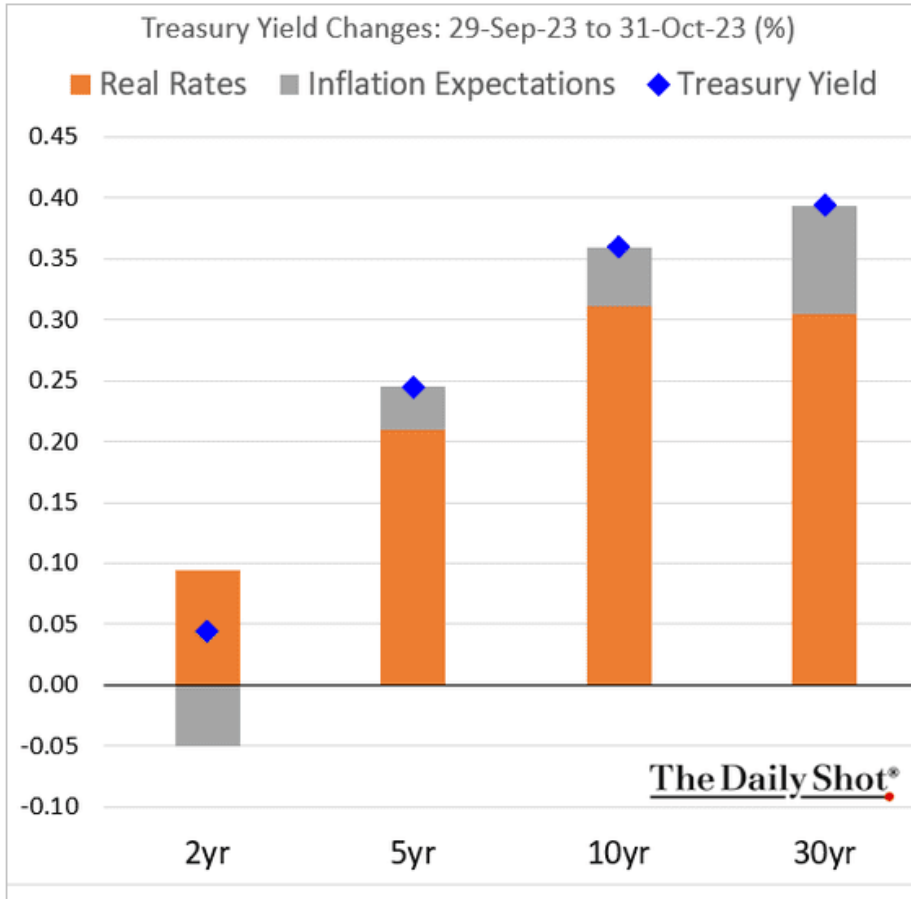
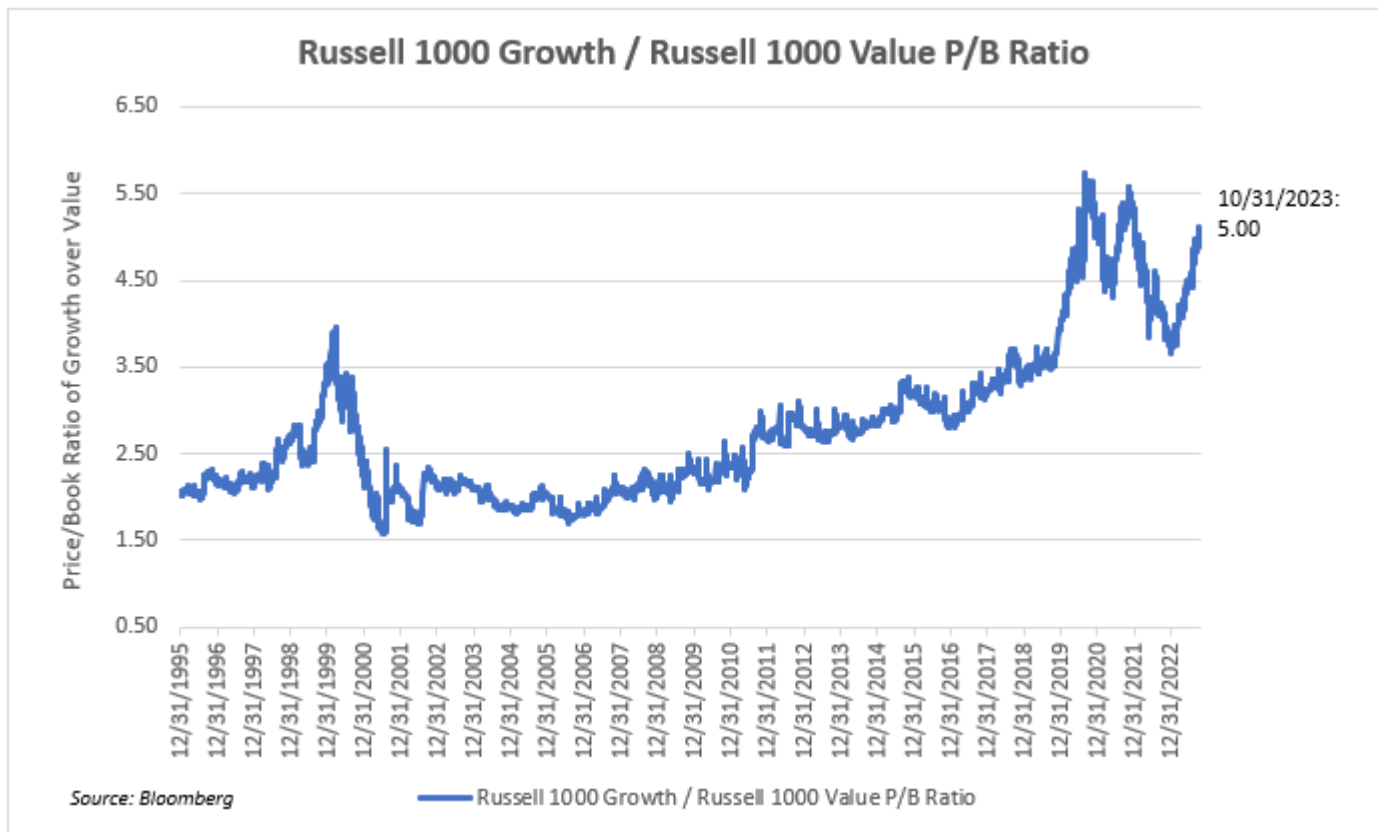


Figure 9 – Investors Are Demanding Higher Term Premiums (Real Rates) That Have Driven Treasury Rates Higher As Opposed to Expressing Higher Inflation Expectations



The investment landscape is being set up where the classic 60/40 equity/fixed income portfolio has become the new maximum pain trade. Many investors only want to hold cash yielding 5% as opposed to locking in longer-term rates due to higher sensitivity to rate volatility, and investors are increasingly hiding out in the megacap technology stocks as valuations between large cap growth and value have only widened so far this year and approaching peak valuation gaps seen in 2020-2021 (**Figure 10**). The wall may not represent worries over threats to the market narrative but perhaps the market narrative itself that has left many investors behind.

Figure 10 – Valuation Gap Between Large Growth versus Value Continues to Widen



October 2023 Market Review

Global equity markets gave up more ground in October although markets rebounded from initial selling pressure following the breakout of hostilities between Israel and Hamas in Gaza in early October. Ongoing concerns over China's economy, including reports of pending defaults on offshore debt obligations by some of China's prominent property developers, and continued slowdown in industrial activity through Europe also weighed on global growth sentiment. The U.S. dollar remained steady (although strengthened against pan-Asian currencies) even as interest rate differentials between the U.S. and the rest of the world continue to widen. U.S. equities also came under pressure following weak earnings releases across much of the traditional retail and industrial landscape although have come in stronger for many communication and software companies. The MSCI All-Country World Index (ACWI) returned -3.0% for the month of October.

Across major regions (**Figure 11**), once again, U.S. equities retained their leadership as the S&P 500 outperformed all other regions in October, returning -2.1% followed by MSCI Europe (-3.7%), MSCI Emerging Markets (-3.9%). MSCI Pacific ex Japan and MSCI Japan underperformed, returning -4.1% and -4.8%, respectively for the month. The U.S. dollar (**Figure 12**) held steady in October and remains near its YTD high levels. The Japanese Yen and Chinese Yuan depreciated against the U.S. dollar (**Figure 13**), with the former under continued pressure over the Bank of Japan's monetary stance of maintaining short-term negative rates and tight controls around long rates.

Figure 11 – Pan-Asian Markets Underperform the Rest of the World

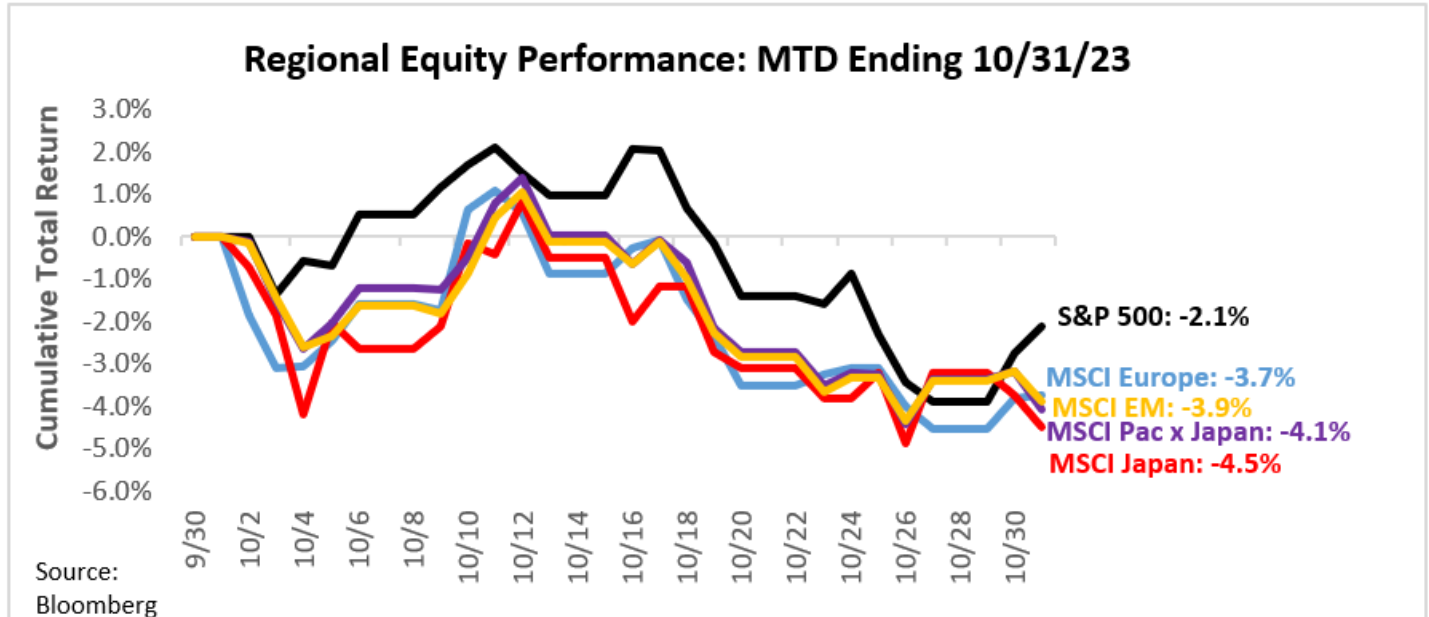


Figure 12 – The U.S. Dollar Held Steady Even as U.S. Rate Differentials Widened vs Other Sovereign Bond Issuers

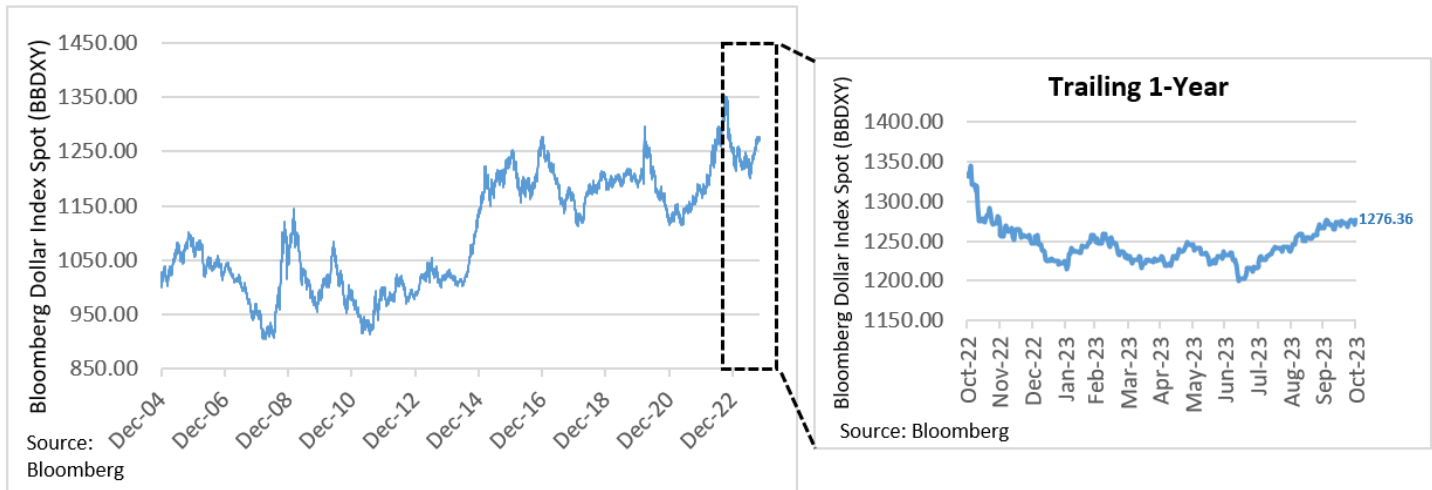
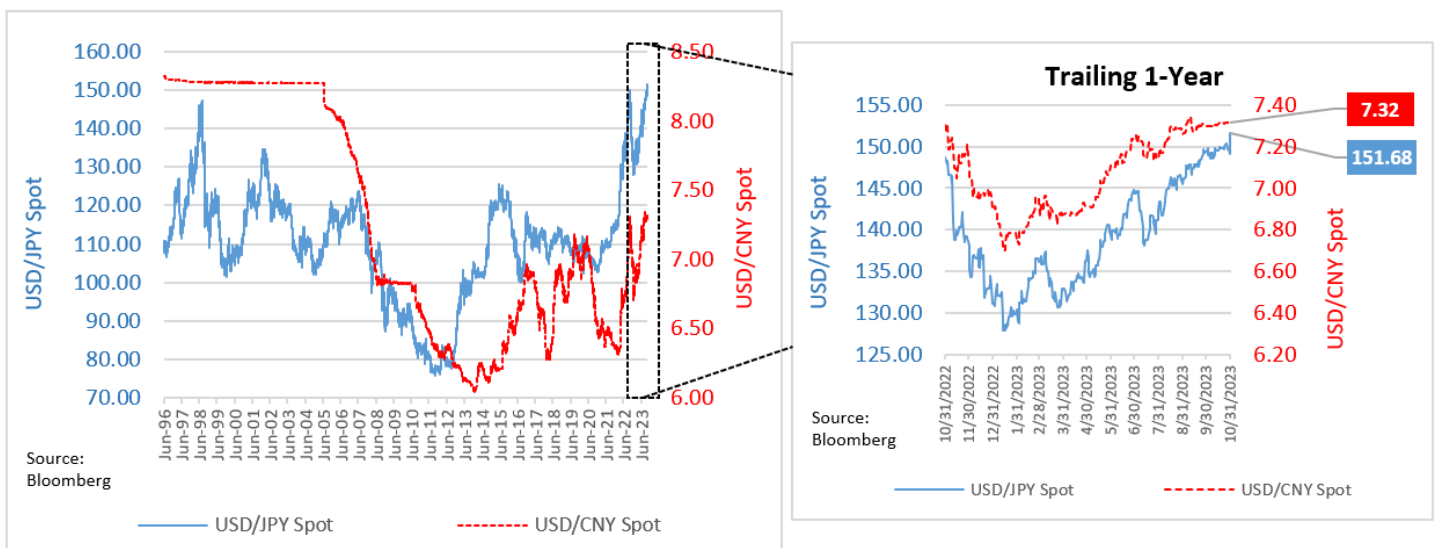
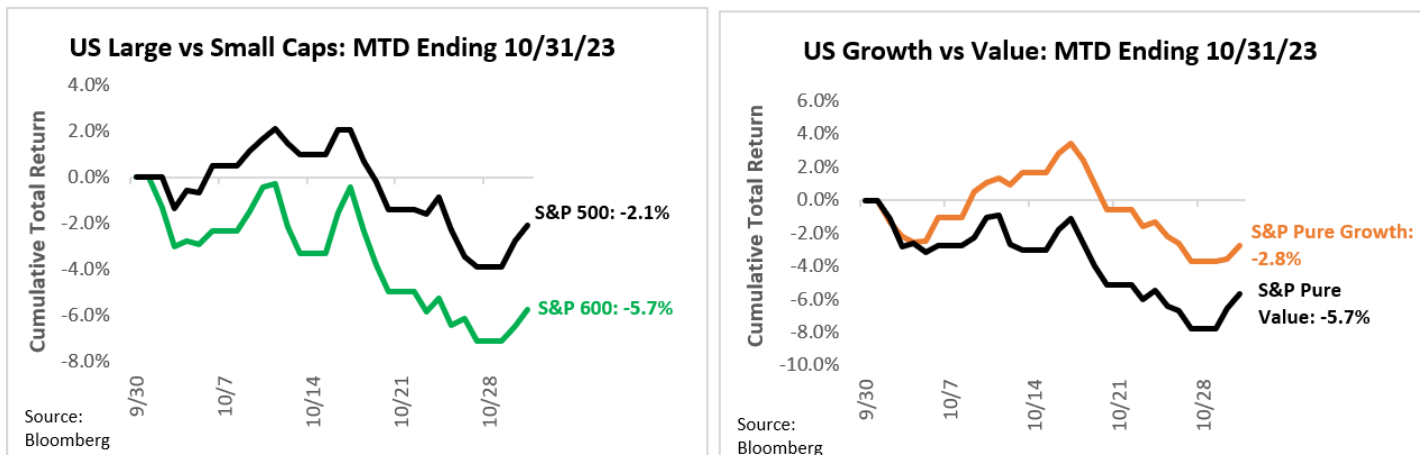


Figure 13 – The Japanese Yen and China Yuan Weakened Against the US Dollar to 1-Year Lows



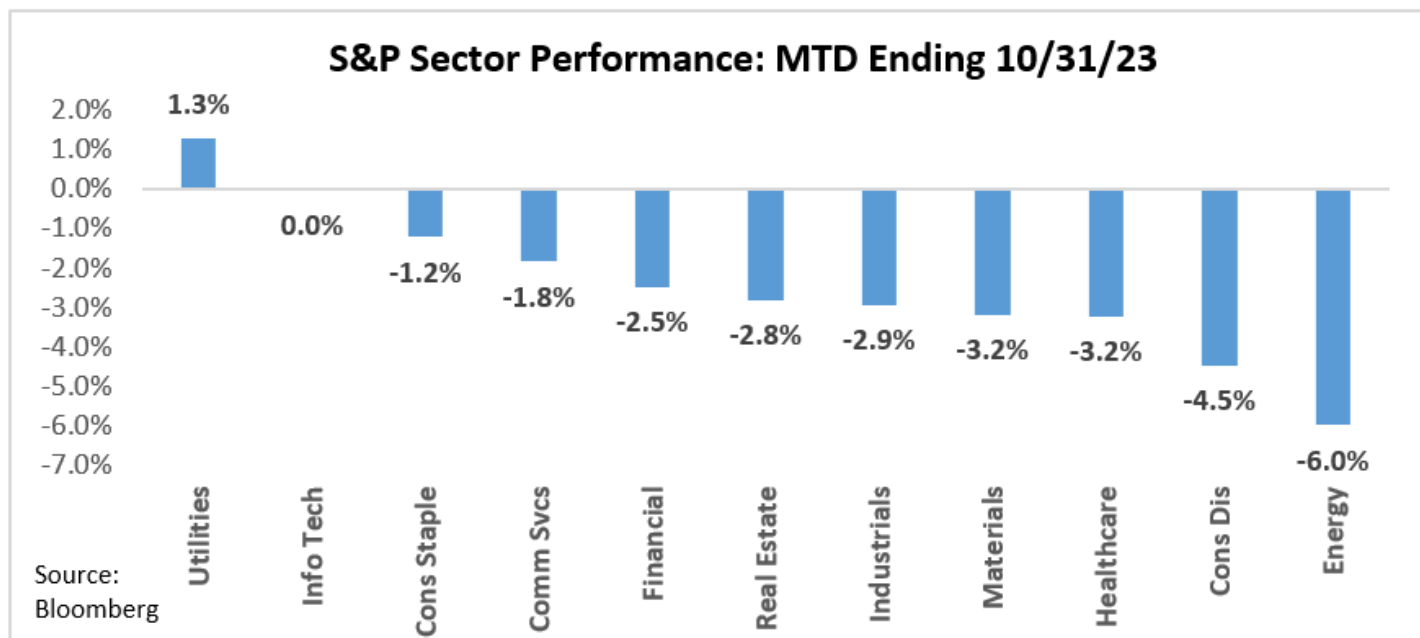
Within the U.S., small caps underperformed large caps as smaller caps continue to struggle this year, encapsulating the narrowness of this year’s U.S. equity advance, primarily from the Magnificent 7 megacap tech companies. S&P Pure Value underperformed Pure Growth, with the former dragged down by the underperformance of financials and industrial/consumer cyclicals. For the month of October (Figure 14), the S&P 500 Index returned -2.1% versus -5.7% for the S&P 600. S&P Pure Value underperformed with Pure Growth, returning -5.7% and -2.8%, respectively.

Figure 14 – Small Caps Underperformed Large Caps and Value Underperformed Growth



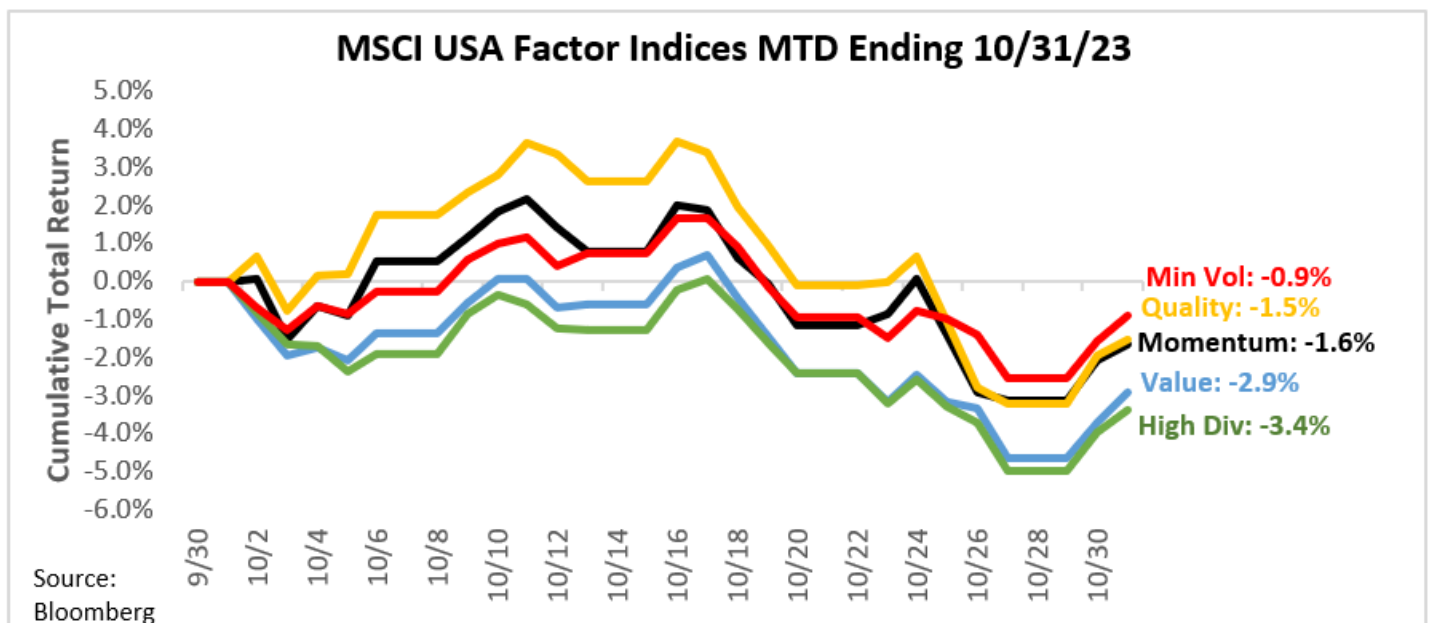
Across sectors (Figure 15), defensive sectors (Utilities, Staples) and growth technology outperformed commodity and consumer cyclical sectors (Consumer Discretionary, Energy). Despite some high profile M&A announcements (Exxon-Pioneer Natural Resources and Chevron-Hess), the Energy sector was weighed down by a drop in oil prices which had sold off over diminishing gasoline demand.

Figure 15 – Defensive Sectors (Utilities, Staples) and Technology Outperformed



Among major risk factors, in October (**Figure 16**), Minimum Volatility, High Quality, and Momentum outperformed High Value and High Dividend. This month's factor leaders were helped by the strong month-end performance of technology and defensive stocks such as utilities and staples.

Figure 16 – Minimum Volatility, High Quality, and Momentum Outperformed Value and High Dividend



Fixed Income markets suffered another month of higher interest rates as U.S. Treasury yields rose in anticipation of more Treasury issuance to fund U.S. fiscal deficits, pressure from the sell-off in Japanese Government Bonds, and few signs that the U.S. economy is slowing down. The Bloomberg U.S. Aggregate Bond Index returned -1.6% for the month (**Figure 17**), although the index was down 2.5% earlier in the month as the 10-Year Treasury yield briefly reached 5%. Corporate bonds continue to outperform as borrowing spreads (**Figure 18**) remain near their YTD bottom levels despite widening later in the month with the sell-off in equities. The Global ex-U.S. Aggregate Index returned -0.9%, outperforming the U.S. Agg, as European yields did not rise as much in conjunction with the rise in U.S. rates (**Figure 19**). Bloomberg Emerging Market Local Currency also outperformed U.S. fixed income, returning -0.6% for the month, while Bloomberg US High Yield continued its strong outperformance over investment grade, returning -1.2%, as lower quality bonds are benefiting from shorter maturity profiles and investor appetite for higher yields.

The 10-Year U.S. Treasury yield ended the month at 4.93%, up from 4.57% at the beginning of the month. The 2-10 Year Term structure (**Figure 20**) steepened throughout October with the curve nearly flat between the short and long end. Inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields are creeping higher, suggesting that the U.S. may be entering a sustained period of higher-than-2% inflation.

Figure 17 – Fixed Income Came Under Pressure from Rising Interest Rates

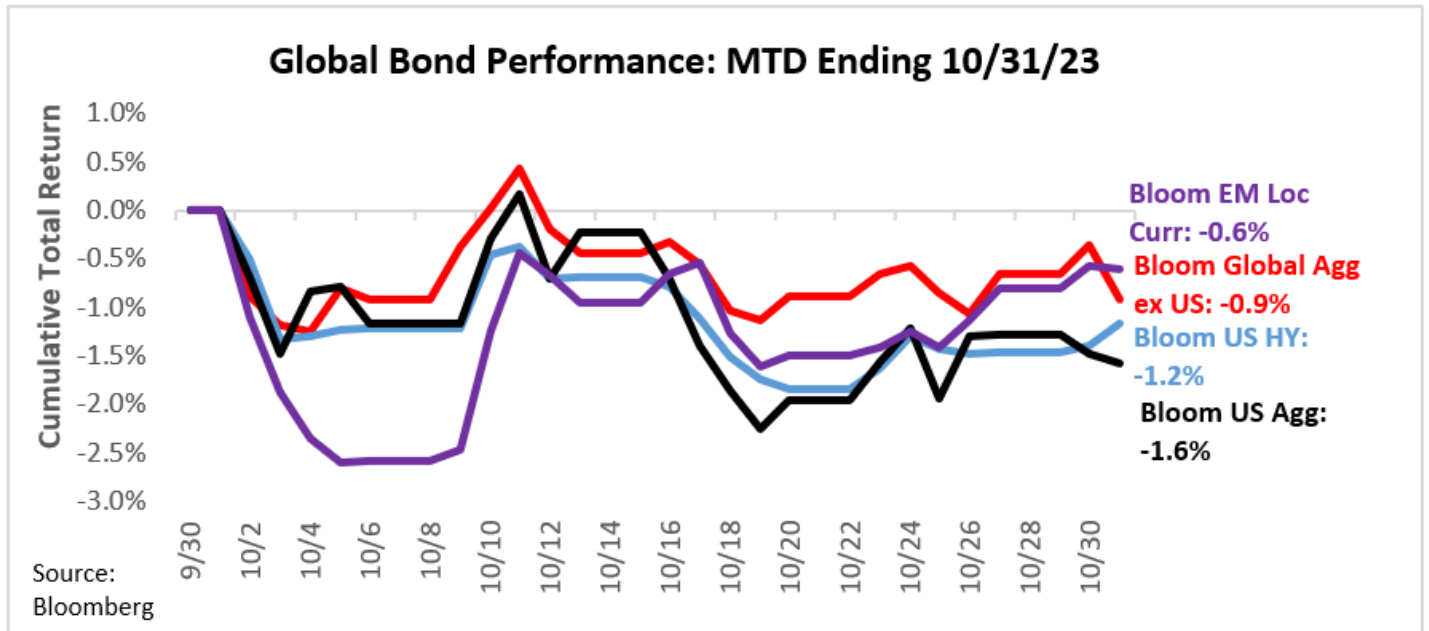


Figure 18 – Corporate Borrowing Spreads Have Widened But Remain Near 1-Year Low Levels

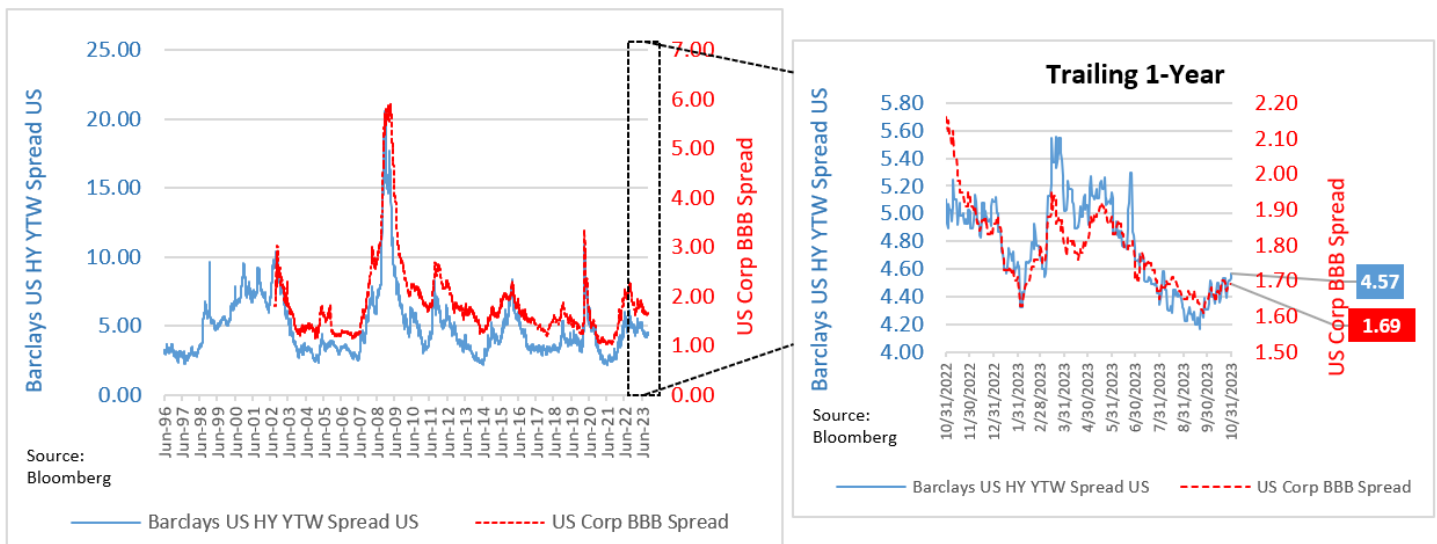


Figure 19 – 2-10 Year Term Structure Steepened While Inflation Breakeven Rates Settle Down

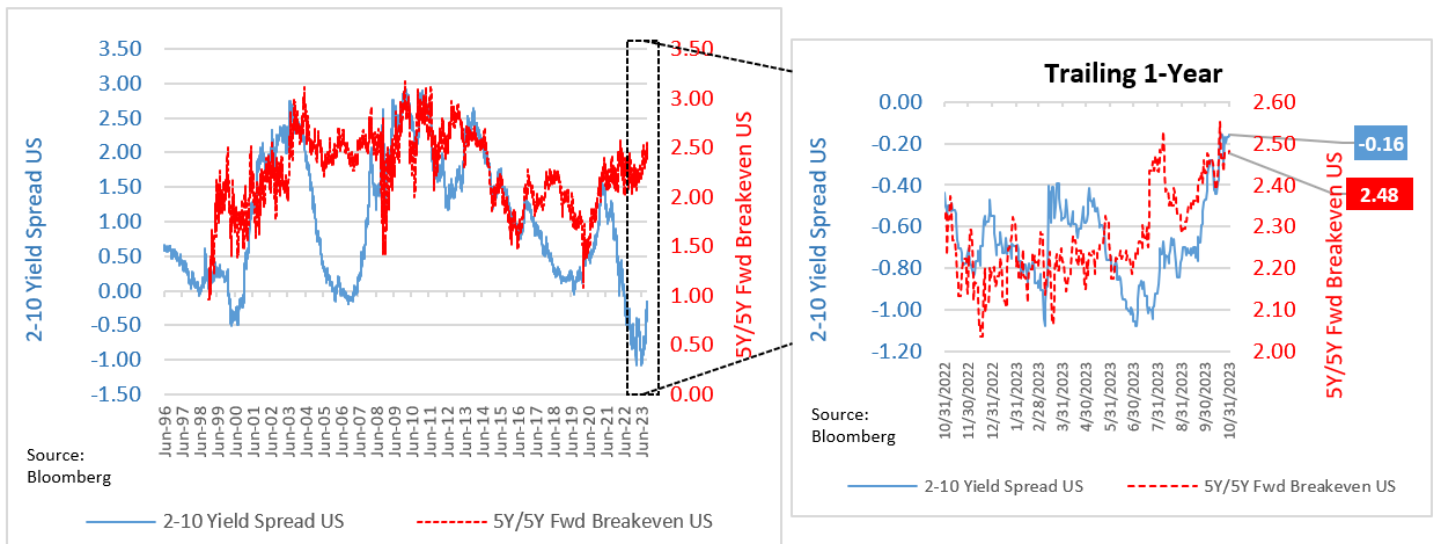
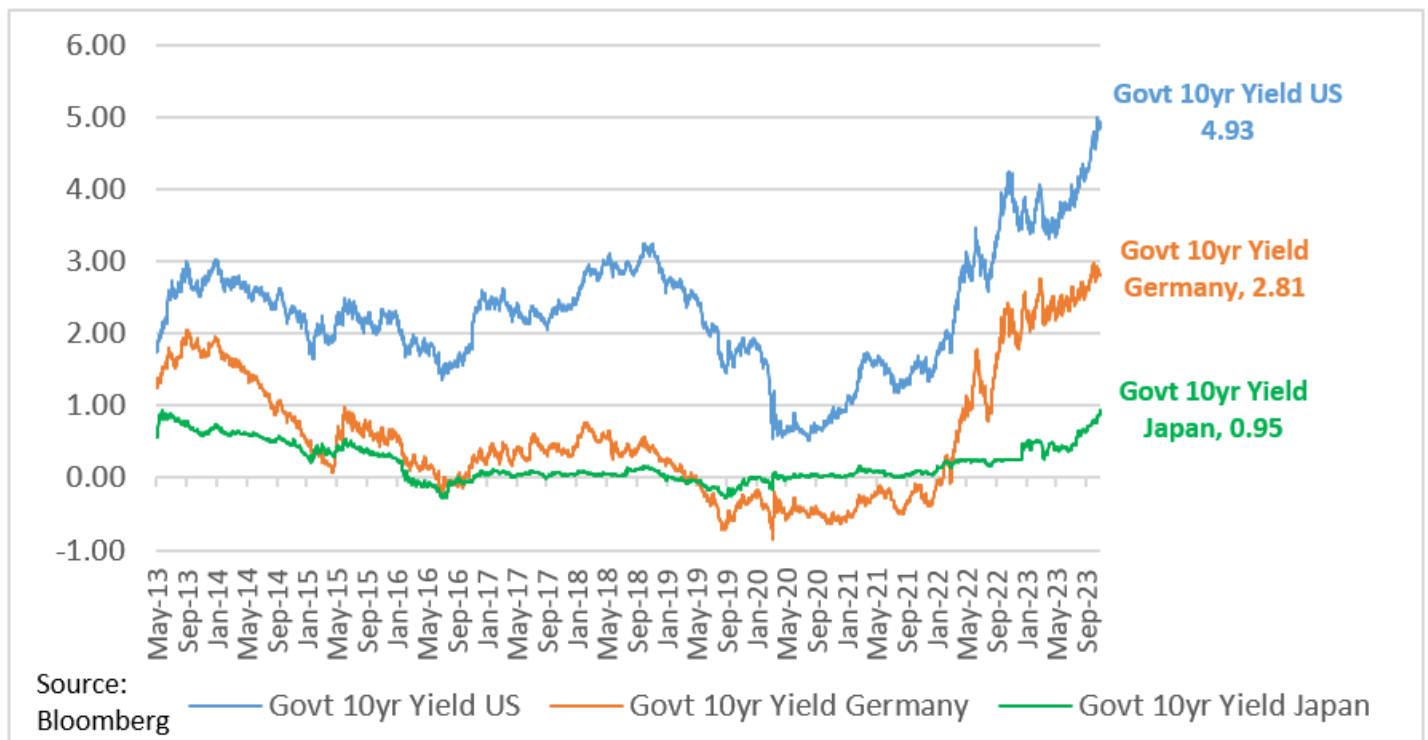


Figure 20 – Key Sovereign Bond Yields Are Hovering Above 10-Year High Levels



Within equity alternatives (**Figure 21**), Precious Metals outperformed as gold prices briefly touched \$2000/ounce. Commodities were hurt by lower oil and industrial metal prices (**Figure 22**) while Real Estate remains under pressure over rising rates, tighter credit conditions, and lower market values. The S&P GSCI Commodities Index returned -4.2% for the month while the Dow Jones REIT Index returned -3.1%, as interest rate volatility and ongoing concerns over the commercial office sector continue to weigh on real estate sentiment.

Figure 21 – In October, Precious Metals Outperformed Other Real Estate and Commodities as Gold Prices Briefly Touched \$2,000/Ounce

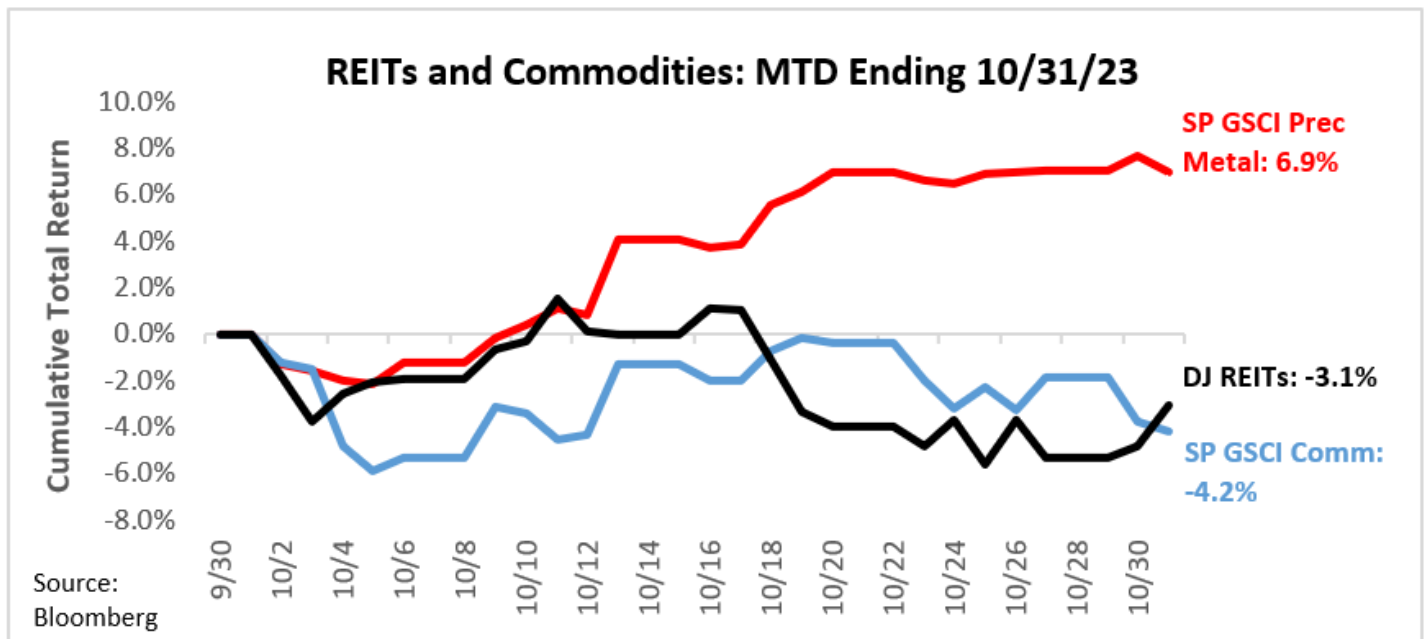
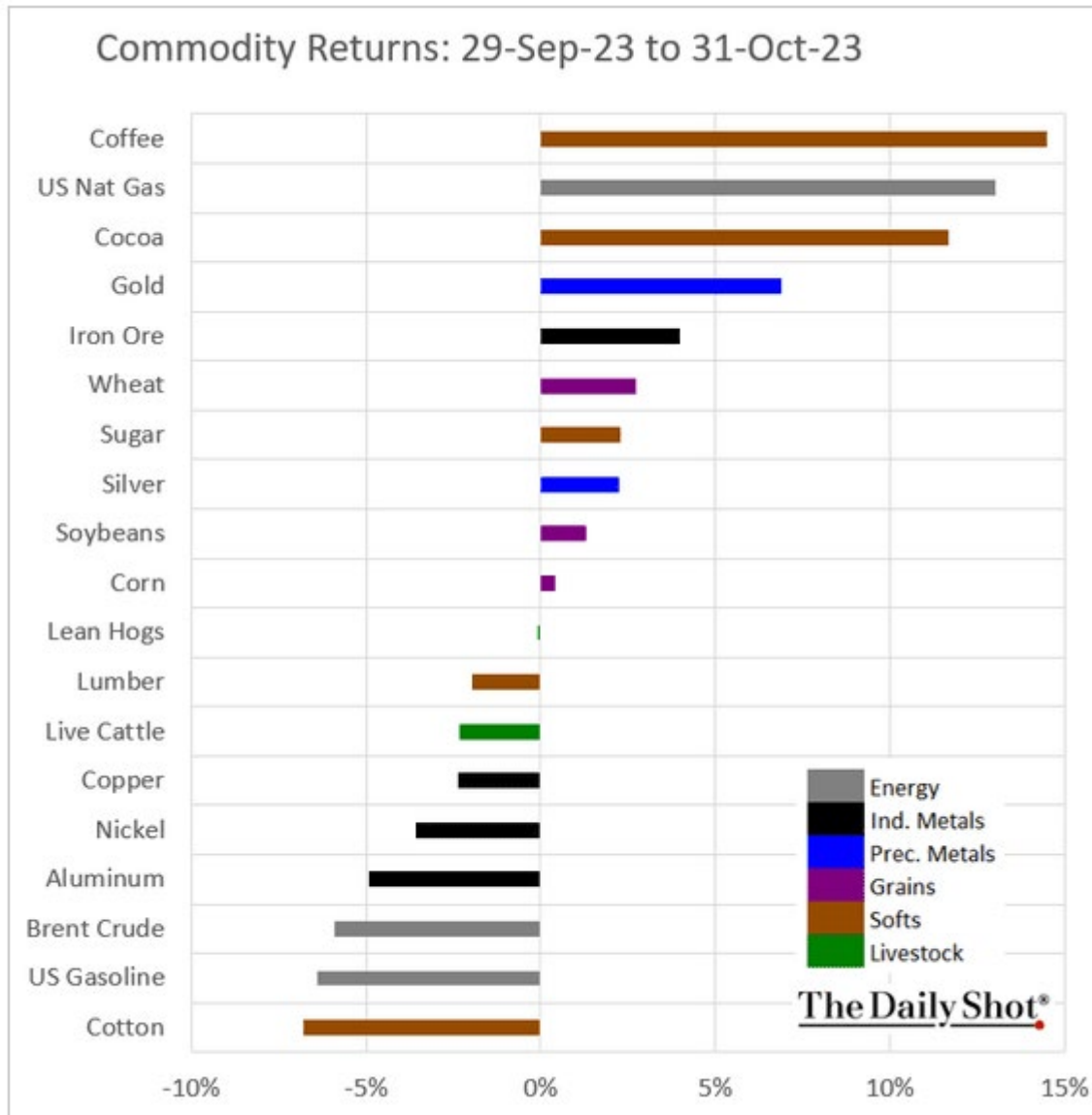


Figure 22 – Oil Prices and Industrial Metals Weakness Offset by Agricultural and Natural Gas Strength





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