

# Quarterly Commentary

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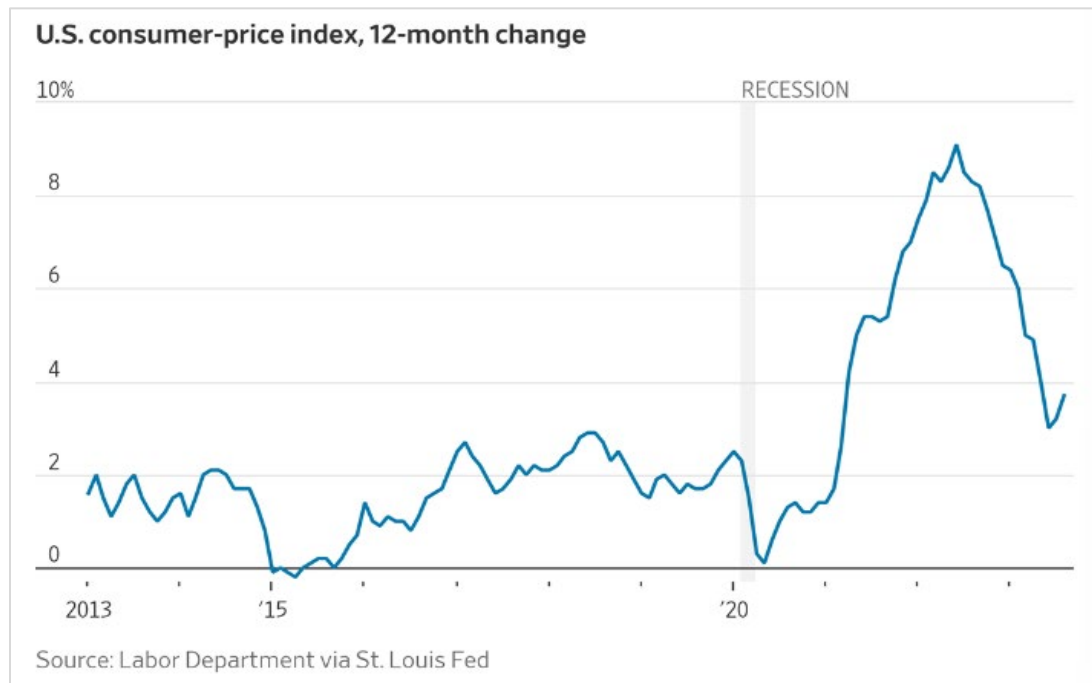
Q3 2023



## Equities Reverse Positive Trend as Yields Push Higher

Equity markets retreated in the final month of the quarter as the S&P 500, Nasdaq Composite, and Dow Jones Industrial Average finished down 3.3%, 3.9%, and 2.1%, respectively. The last month saw many concerns that were present at the start of the year return and provide an uncertain economic outlook for investors. Interest rates were held steady at the most recent meeting of the US Federal Reserve in September. Still, market data and Fed commentary suggest at least one more hike is expected before the end of the year. While inflation has continued its downward trend for the year, the recent surge in energy prices, resilient consumer spending, and continued strength in the labor market threaten to put upward pressure on inflation. For most of the year, equity markets had sidestepped worries of an impending economic recession and posted strong returns. However, the final two months of the third quarter saw a reversal of that trend as hawkish Fed commentary and narrow equity leadership dragged down investor sentiment.

The probability for another rate hike this year neared 50% at quarter end as traders priced in an expectation that the Federal Reserve will follow through with an additional hike in 2023. The recent JOLTS Job Openings report after the quarter end came in higher than expected, with openings reported at 9.6 million vs the expected 8.8 million, further proving to traders that higher rates may be coming. Despite the surprise rise in monthly job openings, economists point to the longer trend of relatively flat hiring, declining quits rate, and rising labor force participation as evidence that the broader labor market is cooling.

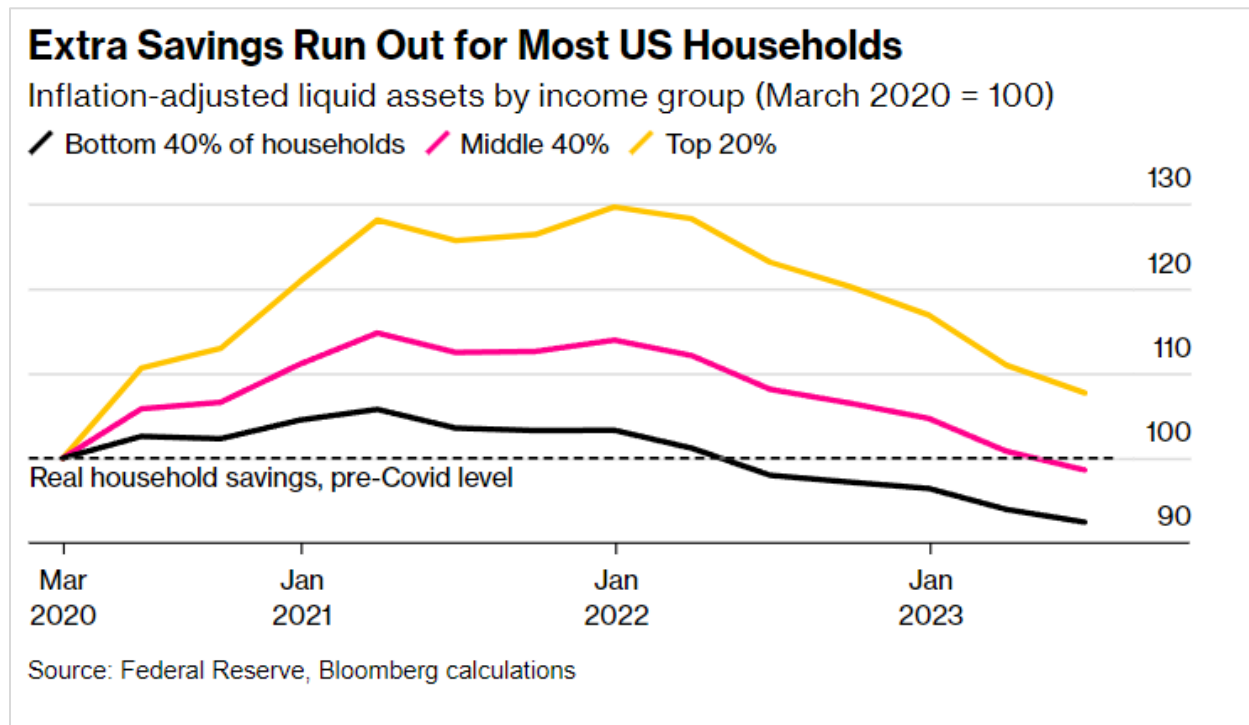


Source: <https://economics.cmail20.com/t/d-e-vitkuul-ijgktujm-r/>

Though consumer sentiment as measured by surveys has been negative this year due to the psychological impact of inflation, actual consumer spending increased in August to 5.8% year-over-year. Economists and financial advisors point to a shifting trend in spending and saving habits as consumers put short-term needs and goals above long-term ones. A particularly tough housing market with high borrowing rates and rapidly rising housing prices combined with pandemic-related instability in health, work, and day-to-day life have meant more people are prioritizing once-in-a-lifetime experiences as they worry they may not be able to do them later. Airlines and concert ticket sellers have seen record

profit margins as Delta Air Lines reported record profits in the second quarter. Ticketmaster increased sales by 18% in the first half of the year over the prior period in 2022. It is difficult to determine whether it is a short-term reversal in typical habits or a new normal.

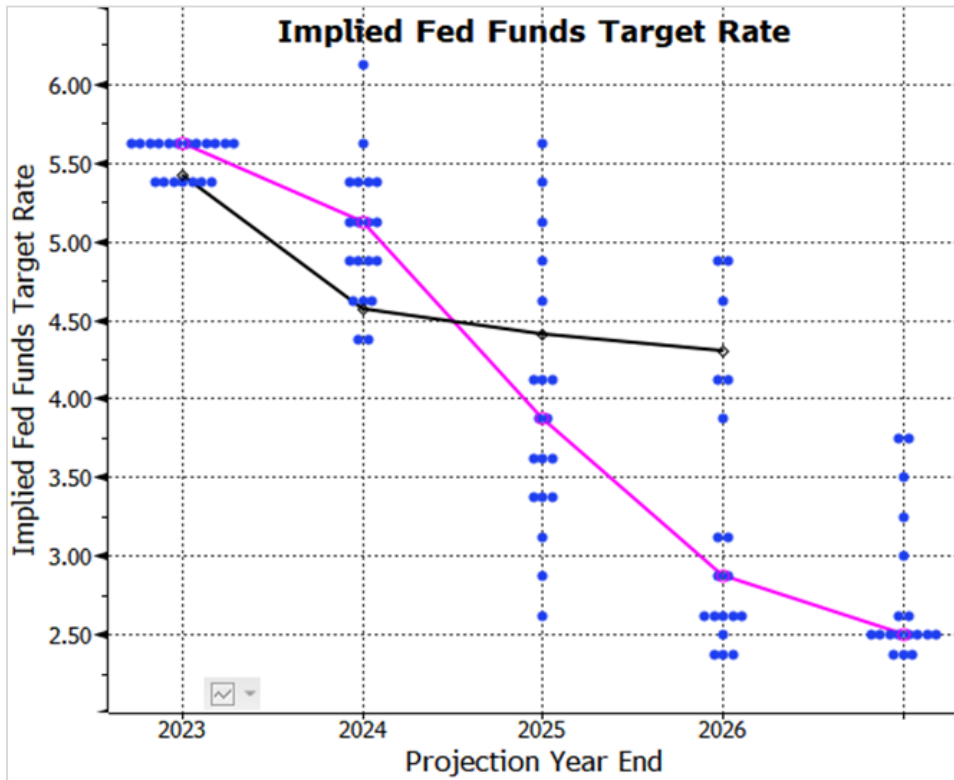
The recent trend in splurge spending may not persist as labor strikes, student loan repayments, and rising gas prices could curtail spending. Historically, consumer spending continues right up until a recession and is not a good indicator of a potential soft-landing scenario. In a recent report from the San Francisco Fed, the extra savings accumulated during the pandemic were projected to run out by the end of September. The level of savings for the lowest income bracket shows that savings have fallen below their pre-pandemic level.



Source: <https://www.bloomberg.com/news/articles/2023-10-01/6-reasons-why-a-us-recession-is-likely-and-coming-soon?srnd=premium>

## Domestic Fixed Income Markets

During September's meeting, Fed officials voted to hold rates steady at a range of 5.25% to 5.5%, a 22-year high. However, 12 of the 19 policy makers expected an additional increase for the year and fewer cuts in 2024 than previously anticipated. Much of the messaging from the committee has centered around the need to bring inflation in line with the 2% goal and noting that many risks remain to the upside, including rising gas prices that strongly resonate with consumers.

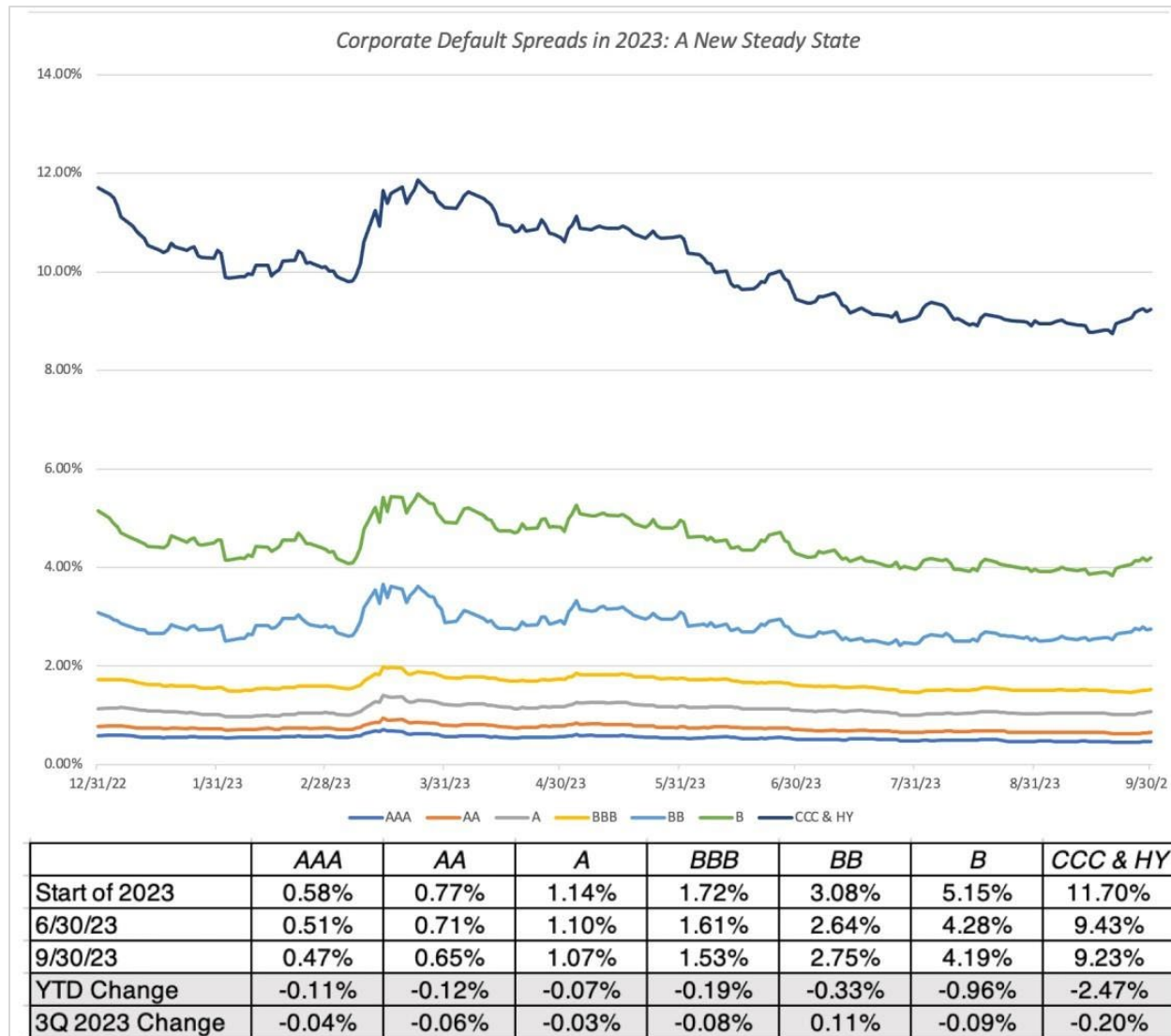


Source: Bloomberg

The surge in bond yields at the end of the quarter continued to drive worries that a soft landing may be more complex than previously thought. During the 3<sup>rd</sup> quarter, many economists and investors believed that the strength of the US consumer and economy would power the markets to a soft landing as the Fed continued its fight against inflation by hiking rates to levels not seen since the early 2000s.

Yields on the 10-year US Treasury ended September at rates last seen in the fall of 2007. The combination of slumping equities, a strengthening dollar, and falling bond prices could meaningfully slow the US and global economy for the remainder of 2023 and 2024.

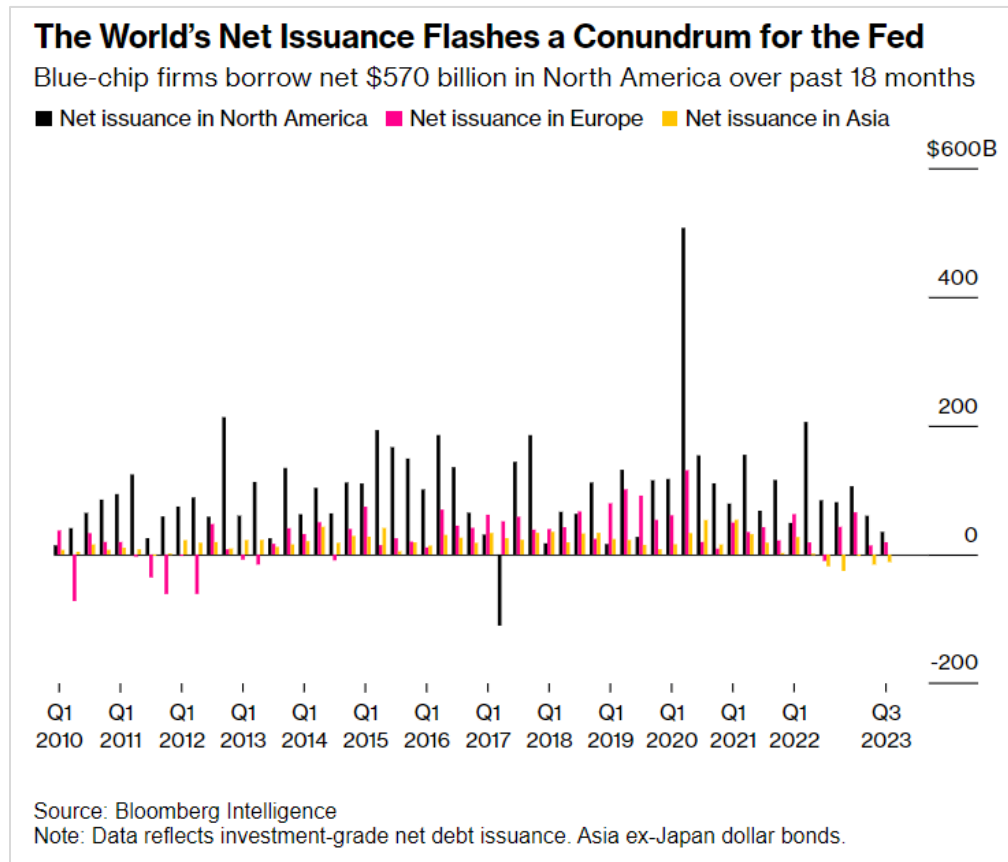
In the last few weeks of the quarter, the spreads on corporate debt widened on some of the riskier pockets of bonds. After the initial spike in the first quarter, due to the financial sector’s stresses after the collapse of SVB, the spreads narrowed for much of the rest of the summer and into the final month before ticking back up. The high yield spread climbed to 9.23% at the quarter’s end after starting the year near 11.7% and coming in at 9.43% at the end of quarter 2.



Source: <https://aswathdamodaran.blogspot.com/>

Long-dated US Treasuries have experienced significant pain recently. Investors have been speculating that a swelling US budget deficit and inflation are driving a need for higher compensation and term premia to hold the debt. US corporations have continued to issue new debt in the face of rising rates to upgrade their operations and finance share buy-backs. The Fed may not have sufficiently cooled the economy as they had hoped.

Interest rate hikes from the Fed have not meaningfully slowed the economy as intended. US corporations have continued to borrow money to upgrade their operations, expand businesses, and finance share buy-backs. The higher interest rates have not deterred C-suite executives as investment- and non-investment-grade businesses have piled on debt over the last 18 months.



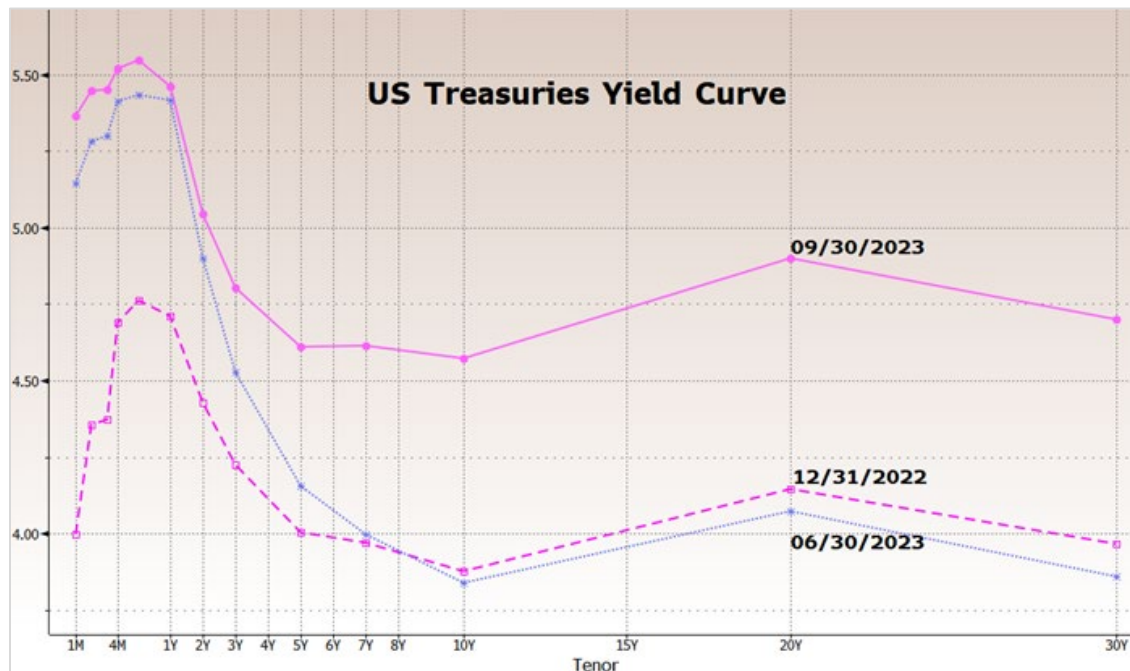
Source: <https://www.bloomberg.com/news/features/2023-10-05/corporate-america-ignores-powell-warnings-borrows-another-570-billion>

Some cracks are starting to show in the credit markets as the financial health of investment-grade companies has begun to deteriorate. Interest coverage ratios of firms have started to fall, a key gauge in businesses' ability to repay loans. In the lower-rated non-investment grade segment, defaults have picked up in the retail and real estate sectors.

Few investors believe we have seen peak rates as expectations push yields higher and lower bond prices. Returns for the domestic fixed-income market showed broad underperformance across most sectors, with only leveraged loans and high-yield debt posting positive returns of 3.5% and 0.5%, respectively. The 30-year US Treasury fell 12.94% for the quarter, followed by 10-year US Treasuries with a return of -5.2%. The rate rise at the end of the quarter saw a flattening trend at the long end of the yield curve as the longer-dated treasuries rose faster than the shorter maturities.

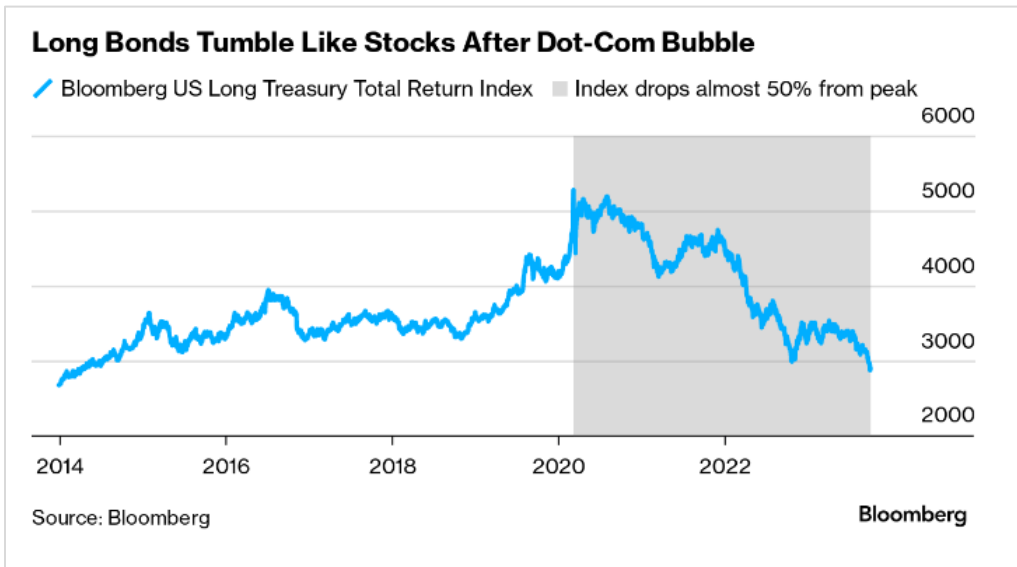
Sector Performance	QTD%	Rates	QTD%
Bloomberg US Treasury 20+ Yr TR USD	-12.99	USTREAS T-Bill Cnst Mat Rate 1 Mon	1.33
Bloomberg US Convertible Comp TR USD	-2.36	USTREAS T-Bill Cnst Mat Rate 3 Mon	1.34
Bloomberg Treasury 7-20 Yr TR USD	-6.82	USTREAS T-Bill Cnst Mat Rate 2 Yr	0.91
Bloomberg US Corporate High Yield TR USD	0.46	USTREAS T-Bill Cnst Mat Rate 10 Yr	-5.18
ICE BofA US Corporate TR USD	-2.71	USTREAS T-Bill Cnst Mat Rate 30 Yr	-12.94
Morningstar Leveraged Loan Index TR USD	3.55	Bloomberg US Treasury Bills TR USD	1.34
Bloomberg Municipal TR USD	-3.95		
<b>Bloomberg US Agg Bond TR USD</b>	<b>-3.23</b>		

Source: Morningstar Direct



Source: Bloomberg

The Bloomberg US Long Treasury Index has fallen close to 50% from a 2020 peak as its losses rival those suffered by equities during the collapse of the dot-com bubble. Bill Gross, the "Bond King", noted that retail investors who have dumped bonds recently might have done so as the US budget deficit swells with little sign that it will be controlled.

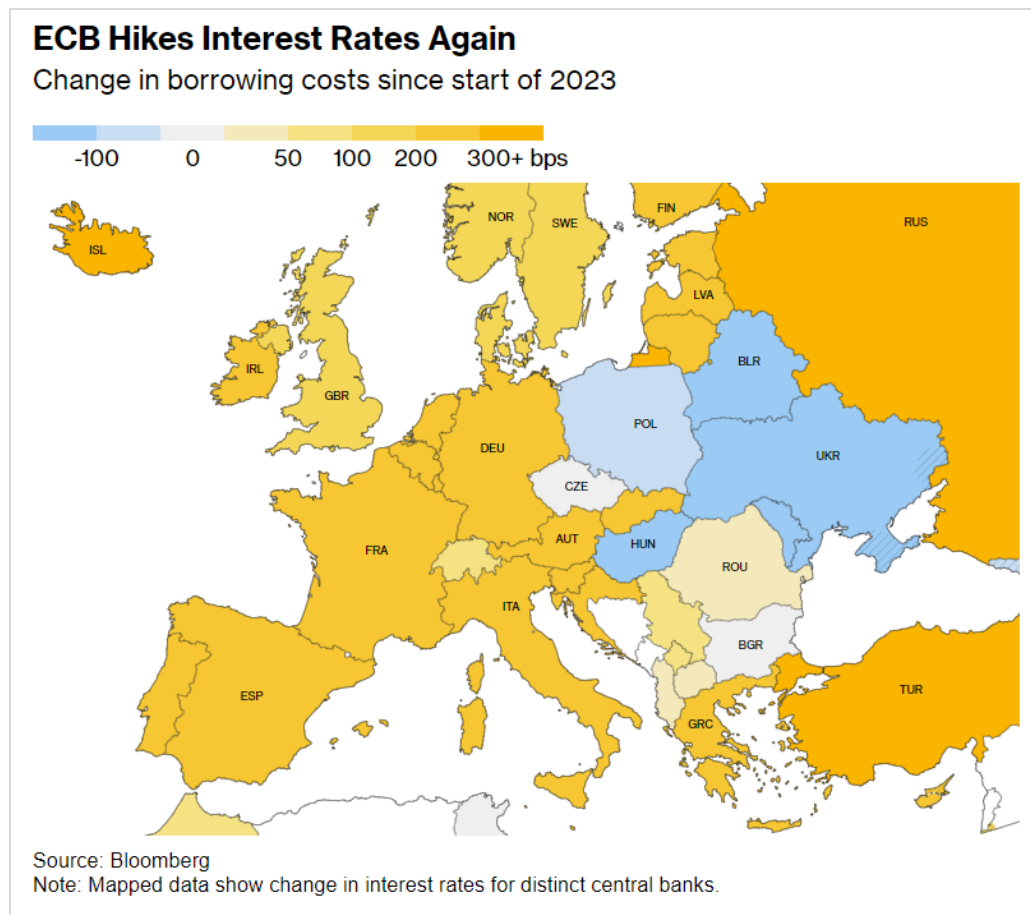


Source: [https://www.bloomberg.com/news/newsletters/2023-10-06/stock-markets-today-exxon-oil-payrolls-jobs-treasuries-bond-yields?cmpid=BBD100623\\_MKT](https://www.bloomberg.com/news/newsletters/2023-10-06/stock-markets-today-exxon-oil-payrolls-jobs-treasuries-bond-yields?cmpid=BBD100623_MKT)

The dollar had a strong run in September, reaching a 10-month high against a basket of major currencies. The euro fell to a nine-month low, and the yen neared intervention territory. US investors anticipate the US economy will outperform its competitors, which would result in an environment of higher interest rates in the US than other significant foreign countries.

## International Fixed Income Markets

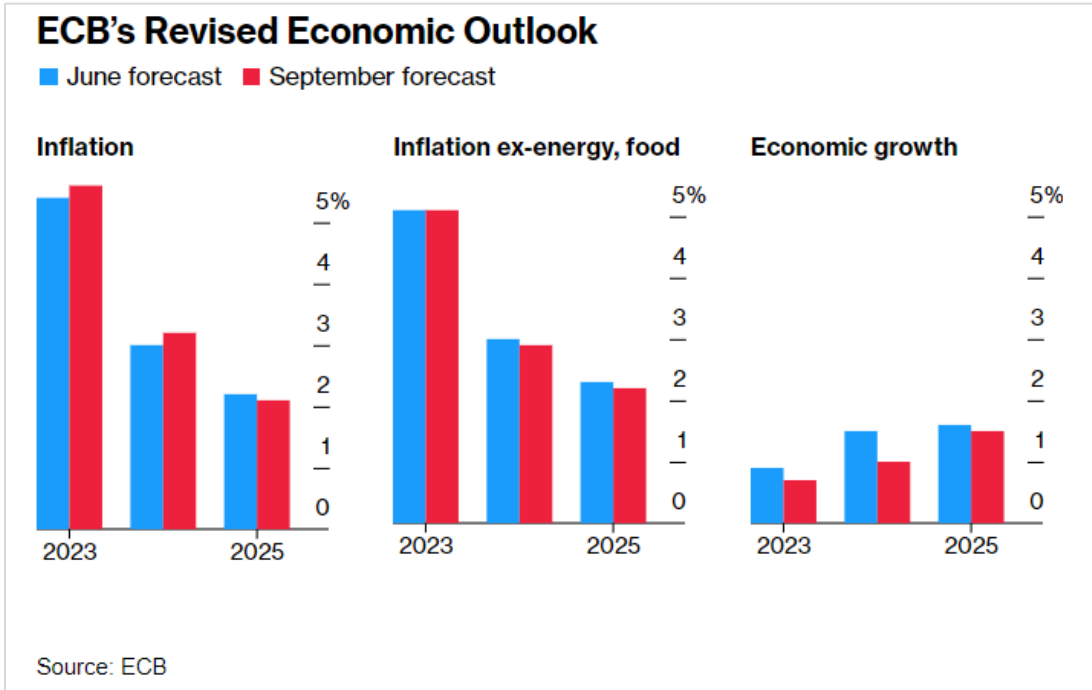
The European Central Bank (ECB) continued with a rate hike for the 10<sup>th</sup> consecutive time at the September meeting with an increase to the policy rate of 25 basis points. Peter Kazimir, ECB Governing Council member, noted, "I strongly believe that our rate hike at the last meeting was the last one... We'll need to wait for the December and March forecasts. Only real data can persuade us that we're at the peak. Only then can we start to focus on other monetary-policy tools". ECB President Christine Lagarde shared a similar sentiment that this is likely the last interest rate increase in the campaign to bring inflation down. The dovish commentary from the ECB president and members reverberated through markets as the euro slid against the dollar and bond yields fell.



Source: <https://www.bloomberg.com/news/articles/2023-09-14/ecb-hikes-interest-rates-again-in-10th-salvo-to-quash-inflation>

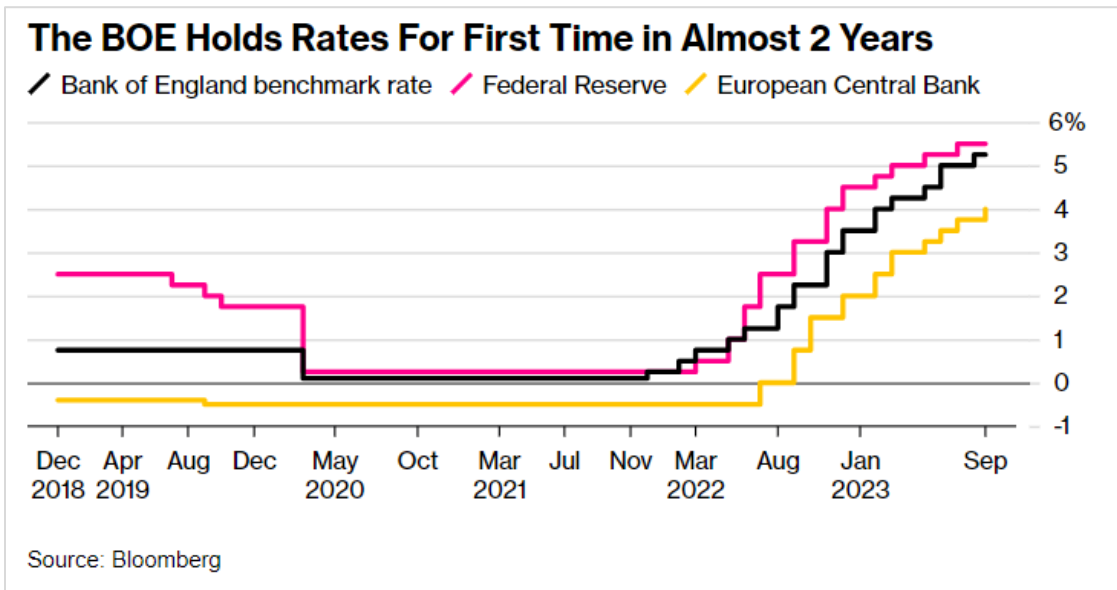
Investors on both sides of the Atlantic believe central bank rate hikes may be near an end, with cuts coming as early as the spring of 2024. However, the ECB has not seen price pressures fall as quickly as in the US. In August, the inflation rate stood at 5.3% for the Eurozone and was unchanged from the prior month, while inflation in the US has trended to 4.3%. A worsening outlook for Europe stemming from slowing growth in China and a decline in global manufacturing has led to sluggish economic growth in the region. The economic weakness in Europe may limit the ECB's room to maneuver and may put a cap on how much more restrictive monetary policy will be for the region moving forward, particularly relative to the US. Some economists point to the slowdown as evidence that the rate hikes are acting as intended and weighing on asset prices and loan demand. However, it remains unclear whether the increase in policy

rates is the direct cause or if other factors related to natural gas prices may have helped drive down inflation. Expectations for the future path of inflation show a slowdown to 3.2% in 2024 before dropping closer to the 2% target in 2025.



Source: <https://www.bloomberg.com/news/articles/2023-09-14/ecb-hikes-interest-rates-again-in-10th-salvo-to-quash-inflation>

Interest rate hikes were halted at the Bank of England's (BoE) most recent meeting as a surprise slowing in price growth resulted in a narrow voting margin, 5-4, to keep the policy rate unchanged at 5.25%. The pause was the first time since December 2021 that the BoE did not increase the lending rates and highlights that rate hikes are filtering down through the economy. The BoE also cut its growth forecast in September to just 0.1% for the third quarter from 0.4% in August. Growth is expected to slow for the rest of the year as weakness in the housing market continues. The BoE forecasts CPI inflation to fall further due to lower annual energy prices despite renewed upward pressures on crude oil. BoE Monetary Policy Committee members noted, "Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures<sup>1</sup>" as they worked to bring inflation down to its 2% target from the 6.7% reading in August.



<sup>1</sup> <https://www.reuters.com/markets/europe/bank-england-halts-run-interest-rate-hikes-economy-slows-2023-09-21/>

## US Equity Markets

Equity markets gave back some of the returns they had earned year-to-date in the final few weeks of September as high-growth tech companies retreated. Seven mega-cap companies have been driving the performance in equity markets this year. The "Magnificent 7" has accounted for roughly \$3.7 trillion in market cap increases out of the total \$5.2 trillion for 2023.

Name/Ticker	Index Weighting (%)	YTD Return (%)	YTD Contribution to Index Return (%)
Apple AAPL	6.18	35.10	1.85
Nvidia NVDA	1.98	184.83	1.82
Microsoft MSFT	5.50	33.09	1.60
Alphabet GOOGL	3.11	47.63	1.28
Amazon.com AMZN	2.51	53.71	1.09
Meta Platforms META	1.29	148.53	1.09
Tesla TSLA	1.38	98.90	0.89

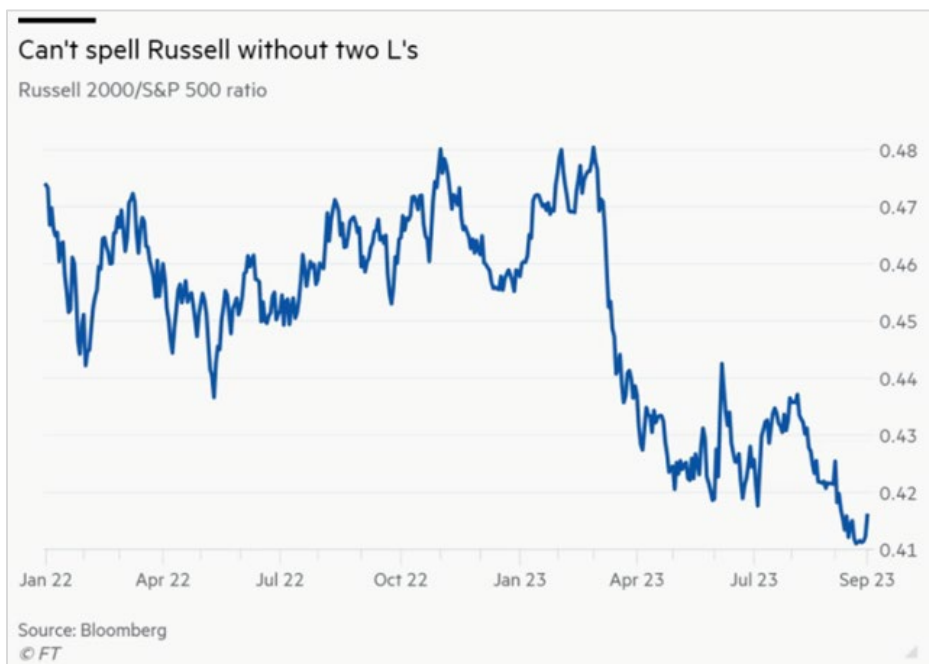
Source: Morningstar. Data as of Sept. 25, 2023. For Illustrative Purposes Only.

Across both market cap and style, all major equity segments fell for the quarter as the growth trend faded, and the Magnificent 7 gave back some of their gains. In the sector performance, only energy provides positive returns as the reduction in supply from OPEC+ helped to drive up crude oil prices. As expected, industries highly correlated with interest rates and inflation have posted the lowest returns, with the real estate and utilities sectors posting losses of 9.3% and 8.9%, respectively.

US Equity Size	QTD%	Sector Performance	QTD%
Russell 1000 Growth TR USD	-3.13	S&P Cons Staples Select Sector TR USD	-6.60
Russell 1000 TR USD	-3.15	S&P Consumer Disc Select Sector TR USD	-5.06
Russell 1000 Value TR USD	-3.16	S&P Energy Select Sector TR USD	12.27
Russell Mid Cap Growth TR USD	-5.22	S&P Financial Select Sector TR USD	-1.13
Russell Mid Cap TR USD	-4.68	S&P Health Care Select Sector TR USD	-2.65
Russell Mid Cap Value TR USD	-4.46	S&P Industrial Select Sector TR USD	-5.16
Russell 2000 Growth TR USD	-7.32	S&P Materials Select Sector TR USD	-4.76
Russell 2000 TR USD	-5.13	S&P Real Estate Select Sector TR USD	-8.90
Russell 2000 Value TR USD	-2.96	S&P Technology Select Sector TR USD	-5.55
<b>Benchmark 1: Russell 3000 TR USD</b>	<b>-3.25</b>	S&P Telecom Select Industry TR USD	-8.27
		S&P Utilities Select Sector TR USD	-9.25
		<b>Benchmark 1: S&amp;P 500 TR USD</b>	<b>-3.27</b>

Source: Morningstar Direct

Earlier in the year, small-cap equities looked poised to have a breakout as the valuations remained cheaper than their large-cap peers, and talk of no recession or a soft-landing scenario would have acted as a positive catalyst. However, that catalyst did not materialize. Since the start of the year, small caps compared to the S&P 500 have continued to underperform even as they near ultra-cheap valuation territory. Small-cap equities tend to outperform when the economy is in an early cycle and typically sell off in mature and recessionary environments. The strong rally follows mature cycles and recessions, and small caps rally when growth begins to reaccelerate. With the recent downward revisions in GDP from 3% to 2%, it would look like we are in a maturing late-cycle environment, but it is more ambiguous than expected. Higher interest rates have also taken a toll on small-cap equities as the interest expense per share for the S&P 600 hit a record high. The profile of small-cap companies tends to be unprofitable or thin-margin businesses, and the increase in expenses due to rising rates is unfavorable for them.



Source: <https://www.ft.com/content/e68965ca-249a-4761-badf-1c5b2da9bb94?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft.notification:daily-email:content>

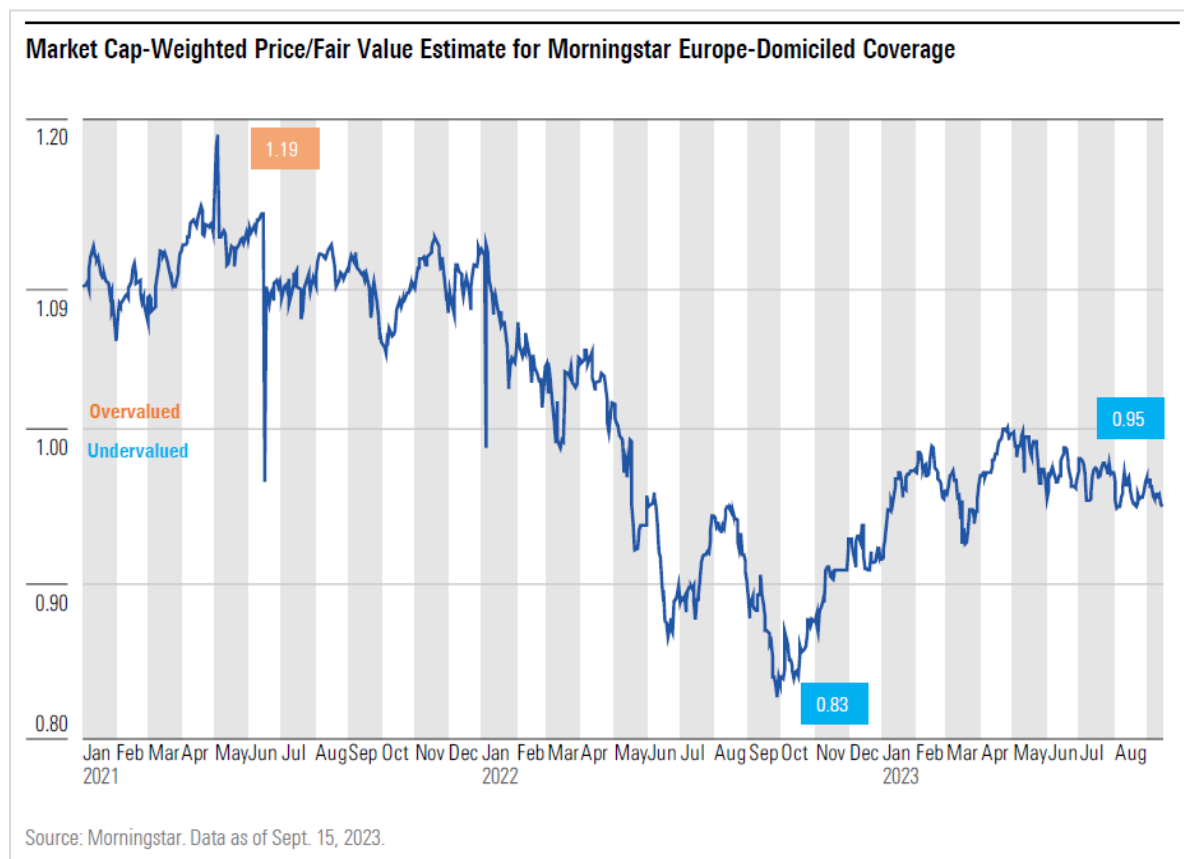
## International Equity Markets

International equities had a similarly rough quarter, as most regions posted negative returns. Most developed markets posted negative returns except for Norway, Israel, and Denmark, which posted quarterly gains of 7.3%, 1.5%, and 1.0%, respectively. It was a tough quarter for European equities as growth remains sluggish and the European Central Bank continues a rate-hiking campaign. The GDP growth remained flat in Europe year over year in the second quarter, while the manufacturing purchasing managers' index has not been in growth territory since the middle of 2022.

UK & EU Select Country Returns	QTD%
S&P France BMI NR USD	-6.89
S&P Germany BMI NR USD	-7.55
S&P Norway BMI NR USD	7.33
S&P Switzerland BMI NR USD	-5.37
S&P United Kingdom BMI NR USD	-1.92

Source: Morningstar Direct

Valuations remain at a slight discount of roughly 5%, but the overall market has moved closer to being fairly valued and is less attractive than in late 2022 when it had a roughly 20% discount to fair value.



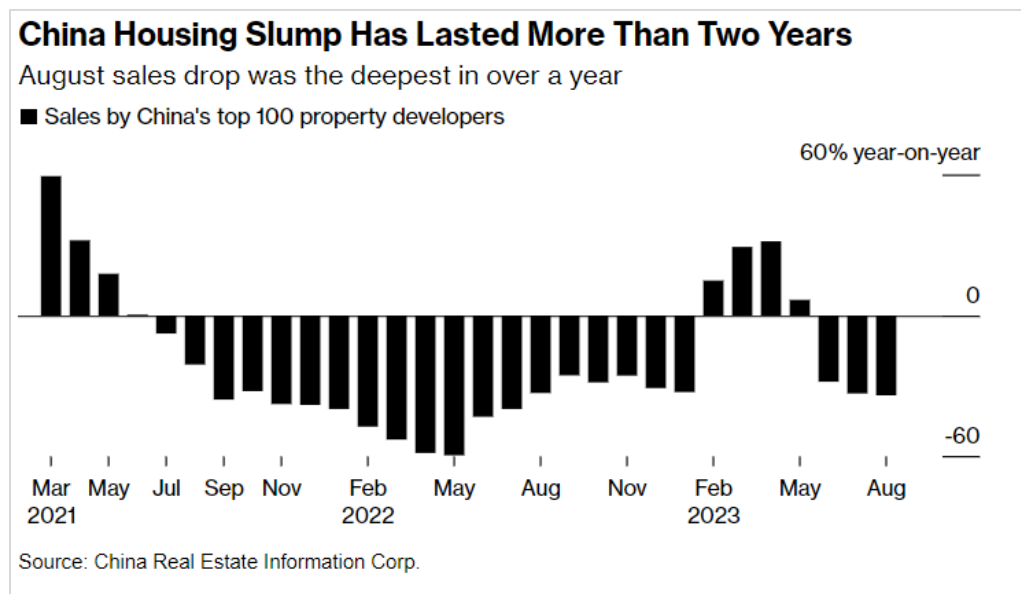
Source: <https://www.brighttalk.com/webcast/19058/595261>

Emerging market equities posted negative returns, with the MSCI Emerging Market Index falling 2.9% for the quarter. Regional performance showed little dispersion as the Emerging Market Latin America Index fell 4.8% after posting double-digit gains in the second quarter. A slowing growth in China and a surging US dollar hurt most EM countries.

Intl Equity	QTD%
MSCI China NR USD	-1.94
MSCI AC Asia NR USD	-2.68
MSCI EM Asia NR USD	-2.90
MSCI FM Asia NR USD	-0.64
MSCI ACWI NR USD	-3.40
MSCI World ex USA NR USD	-4.10
MSCI ACWI Ex USA PR USD	-4.43
MSCI EAFE PR USD	-4.71
MSCI Europe NR USD	-4.96
MSCI EM NR USD	-2.93
MSCI EM Latin America NR USD	-4.75
Nikkei 225 Average NR JPY	-3.42
<b>Benchmark 1: MSCI ACWI Ex USA NR USD</b>	<b>-3.77</b>

Source: Morningstar Direct

The Chinese property market continues to drag on the country’s growth and GDP prospects as the country sees a multiyear-long slump weigh heavily on domestic demand. The real estate market has lagged since 2021 when the government tightened credit to developers and issued orders to slow mortgage approvals. The intent was to decrease the economy’s reliance on the property sector. Still, housing and its related industries for steel, cement, and glass combined make up nearly 20% of GDP. The result of the recent policy decisions has led to a plunge in housing sales, and property investment has contracted. Goldman Sachs estimates that the property sector’s problems will reduce China’s GDP by 1.5% this year. The slowdown in the property market also impacts local municipalities as they rely heavily on housing and land sales revenue.

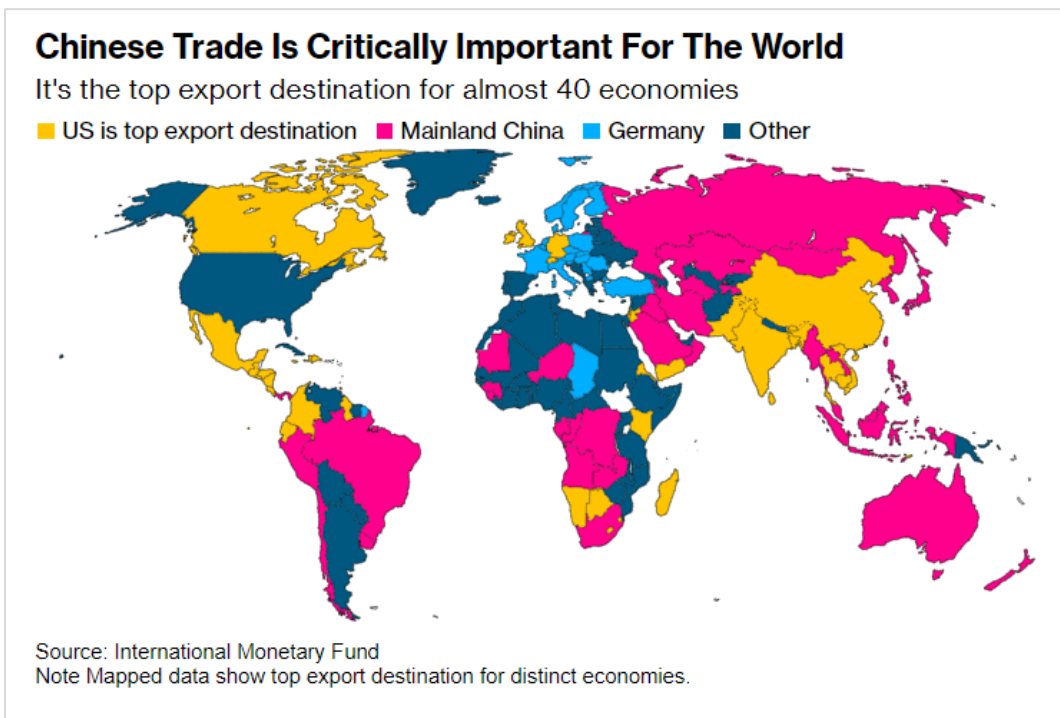


Source: <https://www.bloomberg.com/news/articles/2023-09-04/why-china-hasn-t-used-bazooka-stimulus-to-rescue-economy?srnd=premium>

The cutbacks and contraction have already trimmed roughly 1.0% of GDP in the year's first half. In addition to a weakening housing market, the country's strong exports have experienced double-digit declines, and unemployment remains high, especially for the younger generations, where unemployment rates were last reported at 20%.

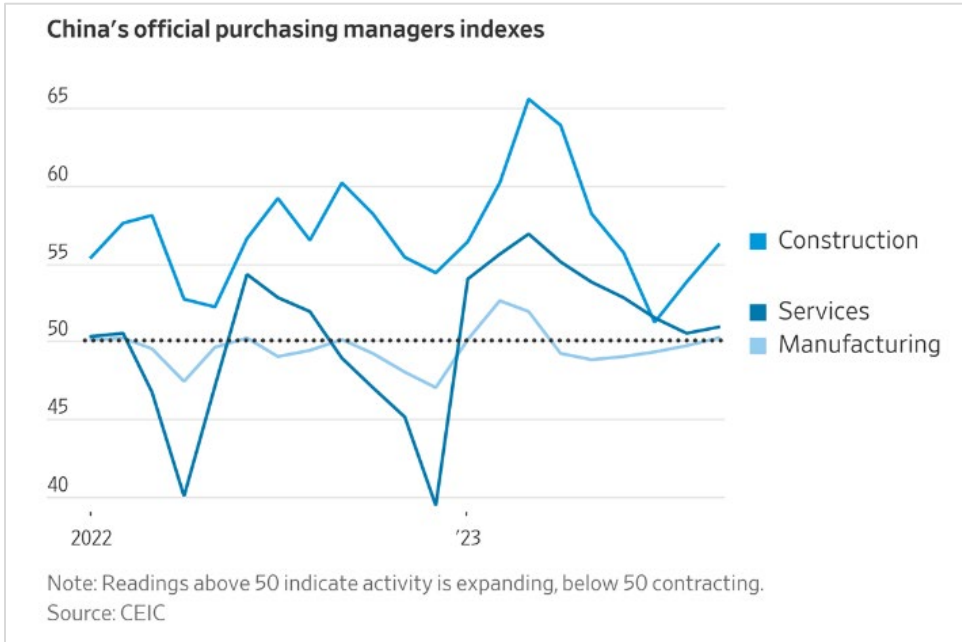
Beijing has been reluctant to take further measures to bolster the economy. Still, President Xi intends to pursue an economic expansion of quality growth. The government has continued to message the need to move away from real estate, local government debt, and expansion of white-elephant projects (projects that fail to live up to their financial expectations) and industrial overcapacity.

Globally, a slowdown or pick up in GDP by the world's second-largest economy can increase GDP for countries who are trading partners by 0.3% for a 1% change in China, according to the International Monetary Fund. Countries that export raw materials, exporters of oil, and technology producers all suffer when China's economy slows down.



Source: <https://www.bloomberg.com/news/articles/2023-09-04/why-china-hasn-t-used-bazooka-stimulus-to-rescue-economy?srnd=premium>

Towards the end of the 3<sup>rd</sup> quarter, there were some positive signs and glimmers of hope as factories reported their first expansion in activity since the spring. At the same time, railway and flight bookings jumped as a weeklong National Day holiday approached. However, the broader economy is still far from a significant turnaround.



Source: [https://www.wsj.com/world/china/chinas-economy-picks-up-steam-for-holiday-2d8b2fc?mod=djemRTE\\_h](https://www.wsj.com/world/china/chinas-economy-picks-up-steam-for-holiday-2d8b2fc?mod=djemRTE_h)

## Investment Strategy and Outlook

The two most significant concerns for the market remain unresolved through the 3<sup>rd</sup> quarter: how much longer inflation will remain above the Fed's 2% target and when or if a recession will occur. While many economists and investors believed a soft landing was probably the case mid-summer, the last quarter changed many assumptions. Federal Reserve members suggested more hikes may be necessary and equity and bond markets falling in tandem.

Heading into the final quarter of 2023, investors must closely monitor the expected path of interest rates, inflation, and the potential for a recession or soft landing. Suppose inflation remains stubborn and interest rates rise even further. In that case, there may be more pain as earnings expectations come in lower and the economy heads towards a recession. However, suppose inflation continues to subside, and the economy strengthens. In that case, there is more upside for equities and bonds as earnings expectations increase and equity valuations increase. The most probable scenario is hard to predict. It leads us to stay active and aware of the market trends heading into the final months 2023. As previously mentioned, the increase in rates along the longer date treasuries has shown a need to find the sweet spot along the yield curve in moving slightly further out in duration to 5-7 yrs. During our September reallocation to the model portfolios, we took the opportunity to move towards our neutral stance on growth and value for equities.

One final idiosyncratic risk that remains on the very near-term horizon is the inability of US House lawmakers to find a bilateral measure to fund the US government. The recent last-minute deal in the House to pass a 45-day funding measure was met with further chaos as House Speaker McCarthy was removed from his speakership in a first for the country. The sudden removal of the speaker at a critical point in negotiations over funding our government leaves the country in uncharted territory. A prolonged government shutdown threatens to add volatility to equity and bond markets. It threatens the publication of important economic data from the Labor Department's Bureau of Labor Statistics, the Commerce Department's Census Bureau, and the Bureau of Economic Analysis.

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Except as otherwise specifically stated, all information and portfolio manager commentary are as of September 30, 2023.