Third Quarter 2023 Investment Commentary

Jack Chee
Managing Director – CIO, Asset Management US

Market Recap

The S&P 500 reached a 2023 high at the end of July before selling off 7.5% through August and September to finish the quarter down 3.3%. Year-to-date the index remains up a solid 13%. Smaller-cap stocks (Russell 2000) also had momentum early in the quarter but changed course and ended the quarter down 5.1%, though are still positive 2.5% year-to-date.

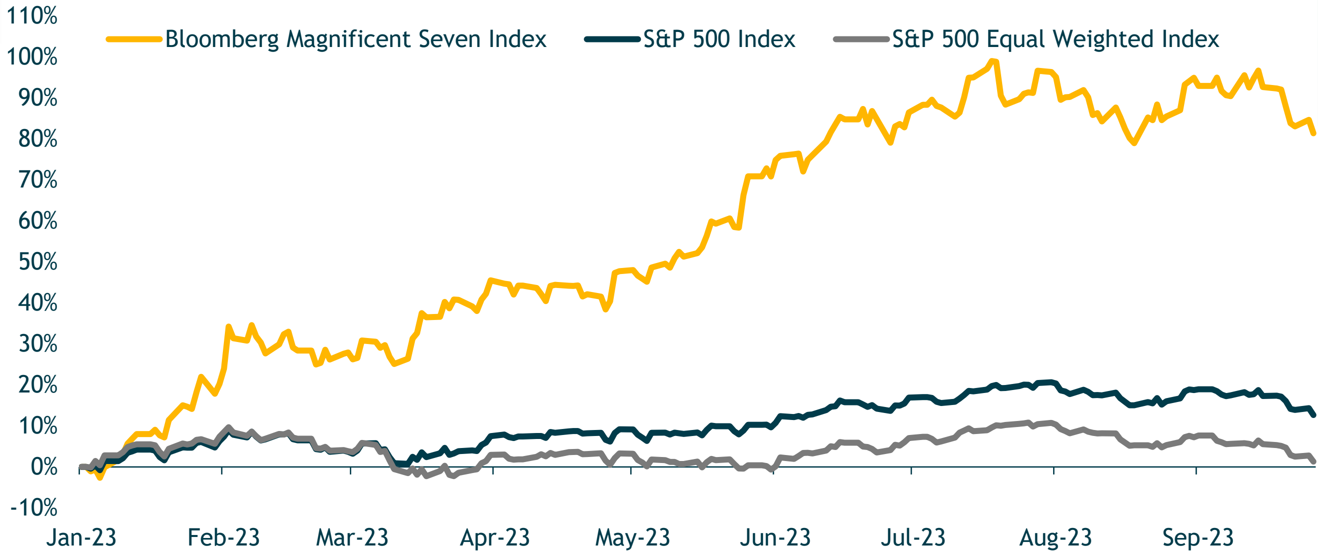
Within foreign markets, developed international stocks (MSCI EAFE) declined 4.1% in the quarter yet remain up just over 7% year-to-date. Emerging market stocks (MSCI EM) fell 2.9% bringing down their year-to-date return to just under 2%. The U.S. dollar (DXY Index) climbed over 3% during the quarter, resulting in a headwind for foreign stock returns.

In bond markets, the 10-year Treasury yield climbed nearly 70bps in the quarter, ending the period at 4.59% – the highest point since before the financial crisis in 2008. As a result, core bonds (Bloomberg U.S. Aggregate Bond Index) fell sharply, declining 3.2% over the quarter. High-yield bonds (ICE BofA US High Yield) managed to eke out a small quarterly gain and are up 6% year-to-date.
Finally, multi-alternative strategies (Morningstar Multistrategy Category) and managed futures (SG Trend Index) demonstrated their diversification benefits. Multi-alternative strategies returned 0.2% and managed futures gained 1.15% in the quarter.

The "Magnificent Seven" Continue to Power U.S. Equity Returns

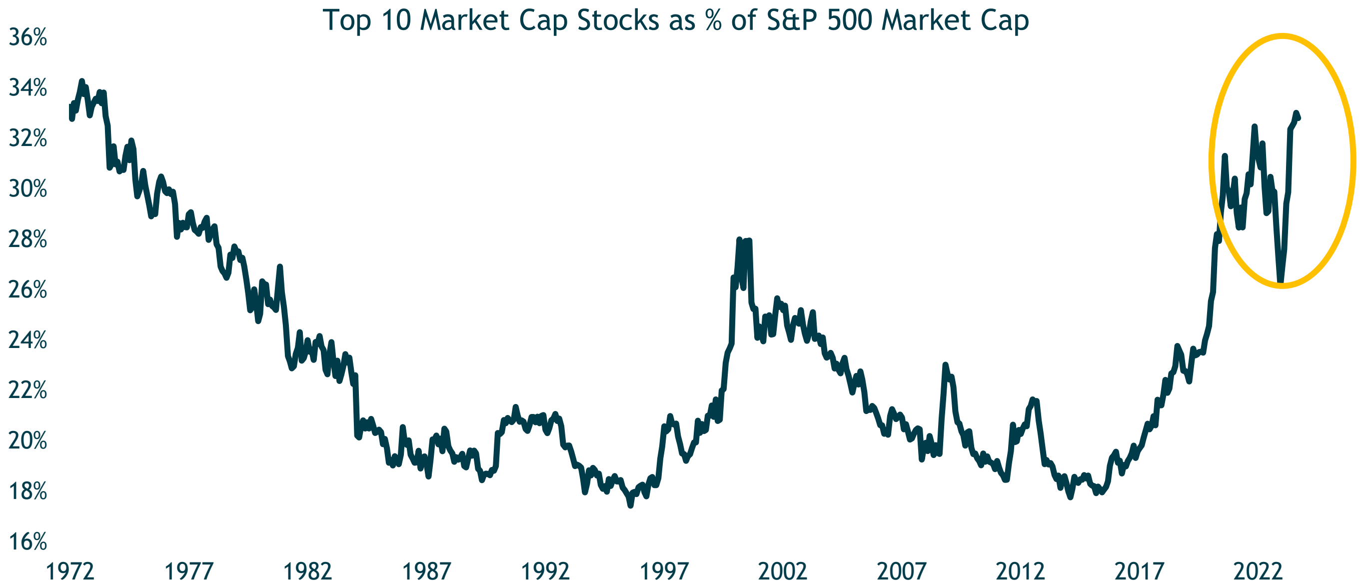
With virtually all segments of the stock market posting gains this year through September, one might think that we're in the midst of a broad-based rally. However, stock gains have remained unusually narrow, with the largest stocks in the index leading the way. The standout performers are those sectors with the largest stocks, while most other sectors have been relatively flat. Consumer discretionary has been driven higher by a 51% gain from Amazon.com and a 103% return from Tesla. The information technology sector has outperformed thanks to Apple (+32%), Microsoft (+33%) and NVIDIA (+198%) year-to-date. Communication services has been propelled higher by a 48% return for Alphabet (Google) and 149% from Meta Platforms (Facebook).

Despite stalling in the latter half of the third quarter, the year-to-date performance of the "Magnificent Seven" stocks continues to explain most of the U.S. stock market's returns. These seven stocks have increased collectively more than 80% this year, while the remaining 493 stocks in the S&P 500 are basically flat.



Source: Bloomberg LP. Data as of 9/26/2023. Magnificent Seven stocks: Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia, Tesla.

As a result of their massive outperformance, the “Magnificent Seven” have a combined $10.7 trillion market cap and constitute more than 30% of the S&P 500 index. This level of concentration at the top of the U.S. market exceeds what was witnessed in 2021 and the tech bubble of the late 1990’s / early 2000’s. We have to travel all the way back to the early 1970’s (remember the “Nifty Fifty”?) to see a market as concentrated as it is today.



Source: Ned Davis Research. Data as of 9/30/2023.

Investment Outlook and Portfolio Positioning

From a macroeconomic perspective, the big question remains whether the U.S. economy can avoid recession or not, and the timing if it does occur. It goes without saying that the answer will likely lead to meaningfully different market outcomes. If the Fed can manage to slow the economy while avoiding recession, we would expect to see the market’s gains broaden out beyond the large-cap technology-related sectors. Conversely, if the Fed’s monetary tightening cycle leads to recession, it would likely lead to broader-based declines.

There are reasons to be cautious – our base-case is for a mild recession looking out to 2024. We have seen one of the quickest and sharpest tightening cycles in history, and lending standards have tightened considerably. Both factors create recessionary conditions, particularly as the Fed has a history of raising rates too far, tipping the economy into recession. Since 1931, there have been 19 hiking cycles and in only three instances did the economy avoid a recession (below).

Beginning of tightening cycle	End of tightening cycle	Duration of tightening cycle (Months)	Total FED Funds increase over tightening cycle (%)	Following recession	Months between end of tightening and recession's start
Feb 1928	Jul 1928	5	1.5	Aug 1929	13
Jan 1948	Jan 1953	60	1	Nov 1948	*
Apr 1955	Aug 1957	28	2	Aug 1957	0
Sep 1958	Sep 1959	12	2.25	Apr 1960	7
Jul 1963	Dec 1965	29	1.5		
Nov 1967	Apr 1969	17	2	Dec 1969	8
Jan 1973	Apr 1974	15	3.5	Nov 1973	*
Aug 1977	Feb 1980	30	7.75	Jan 1980	*
Sep 1980	May 1981	8	4	Jul 1981	2
Sep 1987	Feb 1989	17	1.5	Jul 1990	17
May 1994	Feb 1995	9	2.25		
Aug 1999	May 2000	9	1.5	Mar 2001	10
Jun 2004	Jun 2006	24	4.25	Dec 2007	18
Dec 2015	Dec 2018	36	2.25	Feb 2020	14
Mar 2022	Jul 2023	16	5.25		
	Average	21	2.83		9.89
	Median	17	2.25		10

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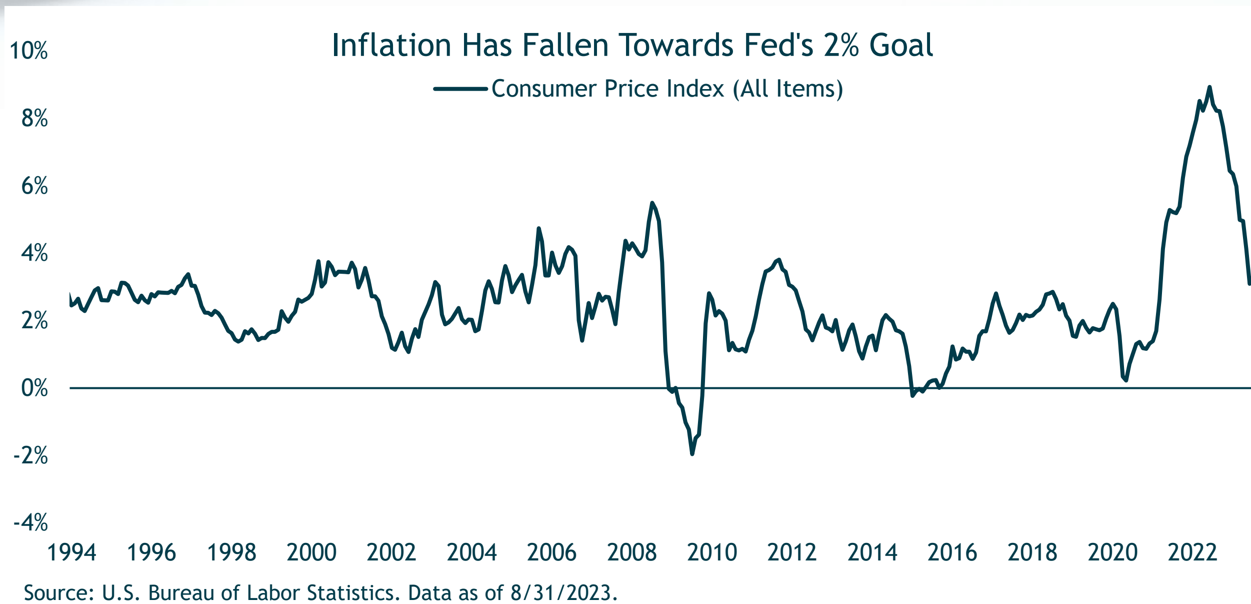
Source: Board of Governors of the Federal Reserve System, IMF, National Bureau of Economic Research (NBER)

However, on the positive side, if the economy falls into recession, we believe it will be relatively mild. One consideration is that the economy has been experiencing a "rolling recession" where slowdowns are spread across industries over time, dampening the impact compared to a recession when industries experience a simultaneous slowdown all at once. For example, housing has already experienced a slowdown and detracted from GDP for several consecutive quarters. In the tech sector, layoffs have already occurred. Finally, a perhaps counterintuitive point is that this recession has been so widely anticipated for so long now, it may actually reduce the risk of a deep recession. Going back to 2022 and early 2023, the press termed this the "most-anticipated recession ever." Amid all this built-up anticipation, some companies, have already laid off workers and slowed hiring. These corporate moves help loosen the labor markets and potentially ease inflationary pressures.

Speaking of inflation, it has come down meaningfully from its June 2022 high of 9.1%, thanks in part to the Federal Reserve's rapid rate hikes. The chart below illustrates year-over-year inflation data, which recently declined to 3.7%, and suggests the Fed's policy has been working and with time inflation could continue to fall.



Source: U.S. Bureau of Labor Statistics. Data as of 8/31/2023.

At this point, it is clear the rate-hike regime is close to an end and we believe the Fed has gotten the upper hand on inflation. The aggressive hiking cycle that started roughly 18 months ago was finally put on pause in late-July—although one more 25 basis point hike could still happen. Since March 2022, the Federal Reserve increased rates from zero to a target level of 5.25%-5.5%.

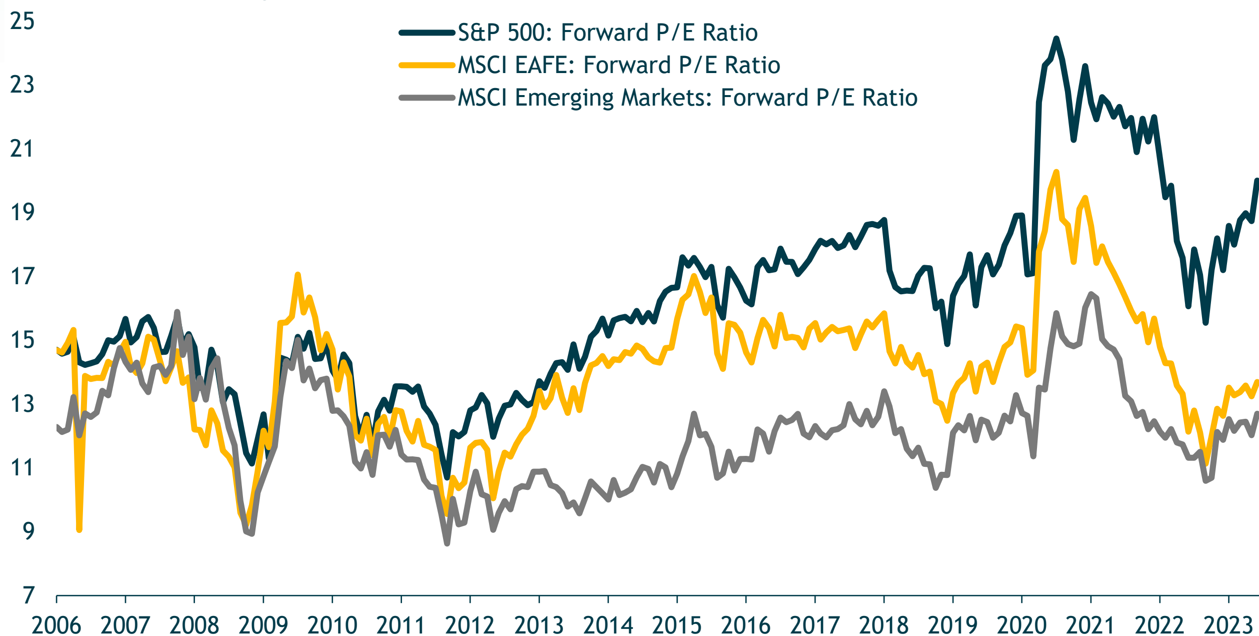
The rise in interest rates has taken a bite out of bond returns, which have suffered steep losses over the past couple years. The silver lining is that looking forward, interest rates (and bond yields) ended the third-quarter at levels not seen in nearly 20 years (the Bloomberg Aggregate Bond Index ended the quarter yielding 5.4%). Higher starting yields, all else equal, should lead to higher expected returns. We remain positive on core bonds given their combination of healthy fundamentals, attractive current yields, and the downside protection they provide portfolios in the event of a recession.

Historically, stock market returns over the next six to 12 months following a pause in a tightening cycle are mixed depending on the inflation environment. As we can see in the following chart, most of the negative outcomes occur during bouts of higher inflation when the Fed will typically maintain a more restrictive policy, i.e., it will take them longer to pivot and cut rates (i.e., pre-1980’s). On the other hand, when inflation is not elevated, the Fed can move to a more accommodative stance much sooner, leading to better equity market outcomes (i.e., post-1980’s).

Final Rate Hike	S&P 500 Return Three Months Later	S&P 500 Return Six Months Later	S&P 500 Return Nine Months Later	S&P 500 Return One Year Later
Jan 53	-5.4%	-6.4%	-7.2%	-2.3%
Aug 57	-8.2%	-8.7%	-1.4%	7.2%
Sep 59	2.6%	-5.5%	1.0%	-2.9%
Dec 65	-2.8%	-6.4%	-15.7%	-9.8%
Apr 69	-1.1%	-7.4%	-7.2%	-11.2%
Apr 74	-8.0%	-21.7%	-18.5%	-3.3%
Feb 80	-7.0%	8.9%	18.8%	10.0%
May 81	1.8%	-5.9%	-10.0%	-8.9%
Feb 89	11.2%	22.1%	19.8%	12.9%
Feb 95	9.5%	18.8%	25.4%	35.2%
May 00	2.0%	-6.7%	-11.2%	-12.1%
Jun 06	4.9%	11.4%	11.6%	18.1%
Dec 18	12.7%	17.8%	19.4%	28.5%
Jul 23	?	?	?	?
Average	0.9%	0.8%	1.9%	4.7%
Median	1.8%	-5.9%	-1.4%	-2.3%

Source: iM Global Partner and Board of Governors of the Federal Reserve System.
Data as of 9/30/2023. S&P 500 Index price returns shown.

Today, inflation remains elevated but on a clear path downwards. Of note, however, since the day of the Fed's last rate hike (potentially) the S&P 500 began its current 7.5% drawdown. This may be a signal that the market expects inflation to persist and for the Fed to maintain interest rates "higher for longer."



Source: Bloomberg LP. Data as of 9/20/2023.

Closing Thoughts

As we look ahead, a mild recession is still our base-case looking out to 2024. Of course, the timing and magnitude of the Fed's response to economic data will be critical to the outcome. However, we can't rule out the possibility that the Fed threads the economic needle and successfully guides us to the rare soft landing of lower inflation and slower economic growth without recession. Given the uncertainty, we expect volatility and we think that it will be more critical than ever to keep our pencils sharp and be ready to take advantage of market dislocations. This is not to suggest that we are changing our stripes as long-term investors. We continue to believe that taking a disciplined long-term view is the path to successful investing. We will maintain a balance of offense and defense, seeking attractive risk-reward opportunities that are supported by thorough analysis.

Thank you for your continued trust and confidence.

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Estimated Returns Disclosure

Scenario Definitions:

***Downside**: The economy falls into a deep recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of our five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation, 10-year Treasury nominal and real yields are below the Fed's long-term targets.*

***Base**: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is moderately higher than the Fed's 2% target level (i.e., around 3%) and 10-year Treasury real yields are slightly positive. For equity markets, we bookend our Base Case with Lower-end and Upper-end estimates:*

- *In our Base Lower scenario, we assume nominal economic growth is higher than the average due to moderately higher inflation. We assume some additional profit margin compression and moderately lower valuations compared to the Base Upper scenario.*
- *In our Base Upper scenario, we assume nominal economic growth is higher than average due to both moderately higher inflation and strong real growth. As such, we assume S&P 500 profit margins remain elevated (although below their all-time highs) and valuation multiples are also elevated versus historical averages.*

Upside: This is the "Goldilocks" scenario for stocks. S&P 500 earnings end the period well above their Base Case trendline, driven by both higher sales growth and high profit margins. Valuation multiples are well above average and higher than the Base Upper assumption. Inflation is under control, around or slightly higher than the Fed's 2% long-term target. The fed funds rate is around the Fed's estimate of "neutral," the yield curve is positively sloped, and 10-year Treasury real yields are modestly positive.

What the Table Shows: Our five-year, annualized asset class return estimates under several broad economic scenarios. Collectively, the scenarios we use encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations.

Why We Use Scenarios: Considering how each asset class might react under a consistent set of scenarios allows us to calibrate our return expectations across asset classes. We believe this helps us make better asset allocation decisions.

These Scenarios Can Change: As the overall economic environment changes it will at some point necessitate changes to the scenarios we consider. Therefore, there could be times when we are reassessing scenarios and temporarily suspend providing updates for one or more scenarios. When this happens, we will clearly note it and give guidance on when we expect to complete this process.

Any projections provided regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including the potential loss of principal, and investors should be guided accordingly.