AMI Quarterly Commentary

Growth Through Stability

Q3 ▪ 2023

Capital Market Outlook

The stock market, as defined by the S&P 500, fell 3.3% in Q3, driven by spiking Treasury yields, and concerns over both the Federal Reserve's tightening and the path forward for the economy. In prior quarters, good economic news has been viewed as bad for rates and vice versa, however, investors seemed to react to both positive and negative economic data with some degree of negativity in Q3. The labor market remains quite strong, but employment is a lagging economic indicator, and a near-term recession still seems likely. Given the gains seen in equity markets this year, up 13.07%, we remain somewhat cautious on the balance of the year, but we are bullish on the long-term outlook for stocks.

The sharp increase in long-term interest rates during the quarter was the main driver of weak equity performance, in our view, with the 10-year yield moving higher by more than 60bps in September and currently higher by 100 bps year-over-year to levels not seen since 2007. There were several drivers of this move, including ongoing quantitative tightening by the Fed (selling of bonds), a stronger dollar hurting international demand for Treasuries, concerns about government deficit spending adding new supply of Treasuries, and the threat of a government shutdown. The higher yields offered by bonds are an attractive alternative to stocks, especially those that pay dividends like Utilities and Consumer Staples, which were unsurprisingly some of the worst performing sectors during the quarter. Tech was also under pressure in Q3, as the cash flows generated by these companies in future years are now being discounted at higher rates.

Following a somewhat unprecedented pause throughout the summer, the Federal Reserve raised rates by 25 bps again in September, and the Fed Funds range now stands at 5.25-5.5%. The commentary from members of the Federal Reserve Board remains surprisingly hawkish, with guidance from the meeting suggesting more hikes this year and no cuts until late 2024. Indeed, "higher-for-longer" seems to be the new reality facing investors.

The labor market remained remarkably strong, with the economy adding 336K jobs in September, versus the 170k estimate. Employment numbers for both July and August reversed the 2023 trend of downward revisions and were revised upward. In a positive sign for moderating inflation, average hourly earnings only rose 0.2% from August (4.2% y/y), which was below estimates and the smallest annual advance since mid-2021. However, this pace of wage gains is likely still too high for the Fed to feel comfortable that inflation will continue to fall. Adding to the Fed's challenge are recent labor union strikes in various industries demanding higher wages and shorter work weeks.

While inflation has certainly cooled, it remains stubbornly above the Fed's 2.0% target, causing some investors to question whether the target needs to be revised. The Consumer Price Index (CPI), when adjusting for food and energy prices, was up 4.3% in August and well off the near 7.0% inflation last year. Given that Fed rate hikes have a lagged effect, the early hikes are likely causing inflation to ease with the latter hikes still yet to kick in. Expectations that the Fed will raise rates again this year now stand at 35% for November and 20% for December based on the ongoing strength in the labor market.

Capital Market Outlook

Manufacturing continues to contract and while Services, as measured by the Purchasing Managers Index (PMI) survey, are still expanding, this area of the economy is starting to show cracks. There is likely no doubt that the consumer is under increasing pressure from inflation and higher interest rates, and we are beginning to see some impact on consumer spending, the largest driver of the U.S. economy. A spike in oil prices, which rose 26% throughout the quarter, is a clear headwind to spending as are higher rates on credit cards, autos, and mortgages. Student loan payments will also resume in October and could add pressure to this group. Consumers' willingness to spend over the upcoming holiday season will likely be a key test for equities as we move through Q4.

Looking forward, we remain optimistic on equity markets for the long-term, but we see some near-term risk given our expectation for a mild recession in the first half of 2024. Interestingly, according to a study by Bloomberg Economics, news media mentions of a "soft landing" have spiked as of late and tend to peak right before the economy enters a recession. However, we still believe that an economic contraction will be mild, especially if the Fed recognizes the slowdown and begins to cut rates. While it may be tempting to try to time the market when the outlook is uncertain, it is important to remember that "time in the market" rather than "timing the market" is a better long-term strategy in our view. We at AMI continue to focus on owning high-quality companies with durable business models that should protect the downside in challenging markets and participate in any recovery once the economy improves.

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