Third Quarter 2023

The third quarter of 2023 proved challenging for U.S. equity and fixed income investors. For the quarter, the S&P 500 declined 3.3%, the NASDAQ fell 4.1%, and the Russell 2000 index of smaller companies decreased 5.1%. On a year-to-date basis, results are more favorable with the S&P 500 up 13.1%, while the NASDAQ and Russell 2000 are up 26.3% and 2.5%, respectively. A general observation concerning U.S. equity markets for the quarter, and especially the year, is that growth has outperformed value, and that large cap has done much better than small cap. The so-called Magnificent 7 ("M7") large cap tech stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla) have accounted for much of this dramatic outperformance. With respect to fixed income, the Bloomberg U.S. Aggregate index of investment grade bonds fell 3.2% for the third quarter and is down 1.2% for the year. Over the past two years, the index is down 14%.

The negative performance of stocks and bonds this past quarter is largely attributable to the dramatic spike in interest rates, particularly during September. The 10-year Treasury yield began the quarter at 3.81% and closed at 4.57% on September 29th, after peaking at 4.69% on September 28th. We have since surpassed that level here in early October. In 90 days, the cost of long-term money effectively rose 20% and reached levels not seen since 2007. As to why, we would point to two almost certain causes as well as one that is more speculative but very plausible.

First, oil prices spiked even more than interest rates during the quarter. WTI Crude oil (the U.S. benchmark) rose 28.5% in the third quarter. Continued OPEC discipline and restricted Russian supply, reduced U.S. shale drilling, and very tight physical markets and low inventories led to much higher prices. Oil is not as central to the economy as in the past, but it still is important, and this move was exogenous, which tends to shock financial markets. It also is important to note that oil, and ultimately, gasoline prices tend to shape inflation expectations.

Second, and more important, was the Federal Reserve, or more precisely, the market's interpretation of the Fed. The September 20th Federal Reserve Open Market Committee meeting resulted in a hawkish pause, i.e., no rate hike but threats of future hikes if necessary. This was the consensus expectation and presumably already priced into markets. However, markets sagged following Chairman Powell's press conference and review of Committee members' projections for the future path of interest rates. Investors, it seems, finally began to take the Fed at its word that rates would be "higher for longer" to further reduce inflation and ensure that it remained low. While expectations regarding further rate hikes did not change much, expectations for future rate cuts were pushed out well into 2024 as the Fed's message was digested.

Finally, it is possible that the sheer supply of Treasury debt is affecting rates. The national debt now exceeds $33 trillion and is expanding rapidly even as a dysfunctional Congress pursues expansive fiscal policies that result in record peacetime/non-recessionary deficits as a percentage of GDP. Further, much of the $33 trillion is made up of short duration securities requiring refinancing even as many of the prior buyers like foreign sovereigns (China and Japan in particular) have stepped away and the Federal Reserve is no longer buying as part of its Quantitative Tightening ("QT") policy. If/when the Fed does cut rates, the degree to which the longer-term rates decline will give us insight into how much supply has contributed to the increase in rates.

For us at Guyasuta, the expectation of "higher for longer" did not come as a great surprise. While we did not anticipate the spike in oil prices, we have believed for some time that the Federal Reserve would have to raise rates aggressively and leave them elevated for more than just a few months if they were serious about returning inflation to their stated 2% target. One can debate the wisdom of a 2% target, but that is the level where the Fed has anchored and committed to regaining. To be sure, inflation has declined meaningfully from peak levels seen in 2022, but the most recent reading of PCE (the Federal Reserve's preferred measure of inflation) still came in around 4% and does not fully incorporate the recent spike in oil prices. In the face of persistent and elevated service inflation, extremely tight labor markets and now elevated oil prices, it struck us as wishful thinking that the Fed would be cutting rates by now, other than due to extreme economic weakness and recession. Moreover, we have often wondered in these Quarterly Comments when the size and persistence of U.S. deficit spending and aggregate debt would finally impact bond rates. It seems quite possible that we have reached that point and that the Bond Vigilantes of the 1980's are again saddled up.

So far, the economy has held up reasonably well despite higher rates and oil prices. The picture for consumers is mostly positive. Unemployment remains low, real wages are growing, and consumers are still spending at a healthy rate, albeit there are clear signs of pressure for lower end consumers as reflected by loan and credit card delinquencies and sales at mass market retailers when segmented by income. Home prices are stable but overall sales are down meaningfully as record low affordability (high prices and mortgage rates over 7%) limits who can buy a home or afford to give up a low-cost mortgage on an existing home to move to something better. Fortunately, increased supply is bringing down the cost of rental housing and making renting more attractive for those able or willing to rent. Similarly, most businesses remain stable and are managing through a dynamic environment. Supply chains are normalizing, and businesses are working off both elevated backlogs and inventories, while hiring has become somewhat less challenging. Margins are under some pressure with higher wages, input costs and interest rates, but so far, most firms are reluctant to cut employment and continue to invest for future growth.

After predicting a recession for much of the past year, many economists and market strategists have backed away from that call and are calling for a soft landing. On average, recessions have begun 14 months after the beginning of rate hikes, and we are now 18 months into this hiking cycle without clear evidence of a recession. We are, however, less certain about ruling out recession given 17 straight months of declining Leading Economic Indicators and a severely inverted yield curve for much of the past year, particularly now that the yield curve is dis-inverting. We are cognizant of the long and variable lags typically associated with monetary policy, given that rate hikes are at best a blunt instrument and take a long time to filter through the economy. This is especially the case in the post-COVID environment where unprecedented fiscal largesse was deployed in conjunction with extremely accommodating monetary policy dating back to 2008 through much of 2022. From February 2020, the M2 money supply has grown 35% and real interest rates (nominal rate – inflation rate) only went positive sometime in 2023. This was extreme accommodation. For consumers, over a trillion dollars was either directly transferred from the government or indirectly via rent and loan suspensions or other subsidies. Many bought or refinanced homes at rates at or below 3% and have benefited from a robust job market where wages have increased dramatically. Further, the assets they own, homes and securities, have appreciated materially over the past decade. For businesses, many benefited from COVID subsidies and tax breaks, but more importantly, borrowed money was extremely cheap for years and many firms locked in this cheap money for years to come by extending debt maturities or hedging floating rate debt. This opportunity was especially pronounced for larger companies able to access public capital markets. For smaller businesses dependent on floating rate bank debt that they could not or did not hedge, the current rate environment is likely much more challenging. All of this is to say that dramatically higher and more volatile interest rates, tighter lending standards, higher oil prices, and reduced risk appetite among investors will almost certainly slow if not stall the economy, but predicting the timing is difficult, especially given the significant mitigating buffers built up by consumers and businesses.

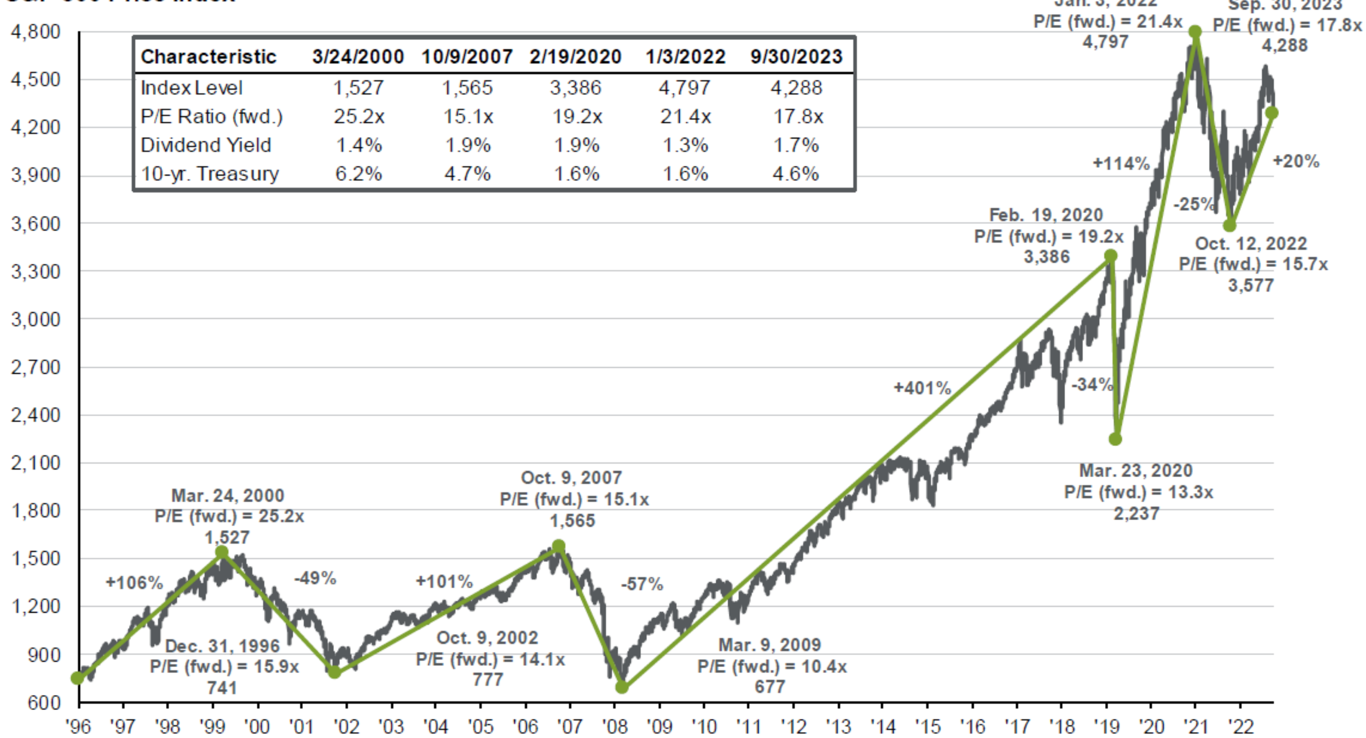
As investors, we expected this changing environment of higher rates and reduced liquidity would provide a challenge for equities and, in a sense, we were correct. The equal-weighted S&P 500 index (where all 500 stocks carry equal weight in the index) and small-cap Russell 2000 are both barely up for the year. We were wrong, however, with respect to high P/E, higher growth tech and communications stocks and the mega-capitalization stocks that make up the M7 noted above. Typically, one expects high multiple long-duration equities to decline in a higher rate environment as future expected (often far off) cash flows are discounted to a present value. As rates rise, P/E multiples are expected to contract. Theory notwithstanding, for much of 2023, investors have disregarded this math and bought these stocks, driving their prices higher as seen in the year-to-date performance of the capitalization-weighted S&P 500 and especially the NASDAQ. We also note that investor enthusiasm over artificial intelligence (“AI”) helped to drive these stocks higher. Earnings estimates, however, have not changed materially outside those of Nvidia, so this year’s gain has been almost entirely a function of higher P/E multiples. We readily acknowledge that many of these stocks became oversold late last year, carry large cash balances and have very sound balance sheets and difficult if not impossible to replicate business models in the case of the M7, but still, many of these technology/communications businesses are fully exposed to economic cyclicality. We are surprised to see them viewed and valued as safe harbor stocks in a stormy market. We might also add that the preponderance of software, chip and emerging technology companies outside of the M7 utilize aggressive pro forma accounting that ignores the meaningful cost of stock compensation. Similarly, we are surprised to see staples, healthcare and utilities, the more traditional safe harbors and less cyclical entities, come under continuous selling pressure, especially as rates have risen. While many of these stocks, especially staples and utilities, had become expensive relative to their modest growth rates and dividends, the selloff suggests to us just how many individuals and institutions had added holdings of dividend-focused stocks and funds over the many years of low rates as an alternative to bonds. Presumably, some of these positions are being unwound as more attractive bond yields are now available.

We continue to believe that when viewed through a yield to maturity lens, the move up in interest rates offers investors, particularly those with a focus on income and predictable liquidity, an opportunity to obtain attractive real yields in bonds. With yields of 5-6% available for investment grade corporate and taxable municipal bonds, and, for high marginal bracket investors, taxable-equivalent yields of 6-7% available in high grade tax free-municipal bonds, we continue to build out fixed income allocations in client portfolios. Our core strategy remains constructing laddered bond portfolios, with final maturities of approximately 10-12 years and overall duration of 5-6 years. We have been adding to portfolios across the maturity spectrum, which allows investors to capture currently available yields while also being reasonably well hedged against interest rate risk.

With respect to equities, we continue with our traditional approach. We remain focused on high quality companies with sustainable competitive advantages combined with meaningful free cash flow generation and solid balance sheets. With money no longer free, balance sheet strength is even more important. As noted above, certainty as to the likelihood and timing of a recession is particularly challenging given recent history and highly accommodative fiscal and monetary policy. Thus, we evaluate potential investments as we always have while stress-testing future earnings expectations even harder than usual against the possibility of recession, both shallow and deep. The current bout of market volatility is disconcerting, but we believe that in retrospect, it will be viewed as having given us attractive entry points for both long-term compounding growth in equities and yield in fixed income. We welcome the opportunity to meet with clients to ensure that their asset allocation and portfolio construction are aligned with their time horizon, investment goals, liquidity needs, and risk tolerance.

S&P 500 Index at inflection points

S&P 500 Price Index



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2023
Index Level	1,527	1,565	3,386	4,797	4,288
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	17.8x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.7%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	4.6%

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Asset Management

S&P 500: Index concentration

P/E ratio of the top 10 and remaining stocks in the S&P 500
Next 12 months, 1996 - present

Weight of the top 10 stocks in the S&P 500
% of market capitalization of the S&P 500

Earnings contribution of the top 10 in the S&P 500
Based on last 12 months' earnings

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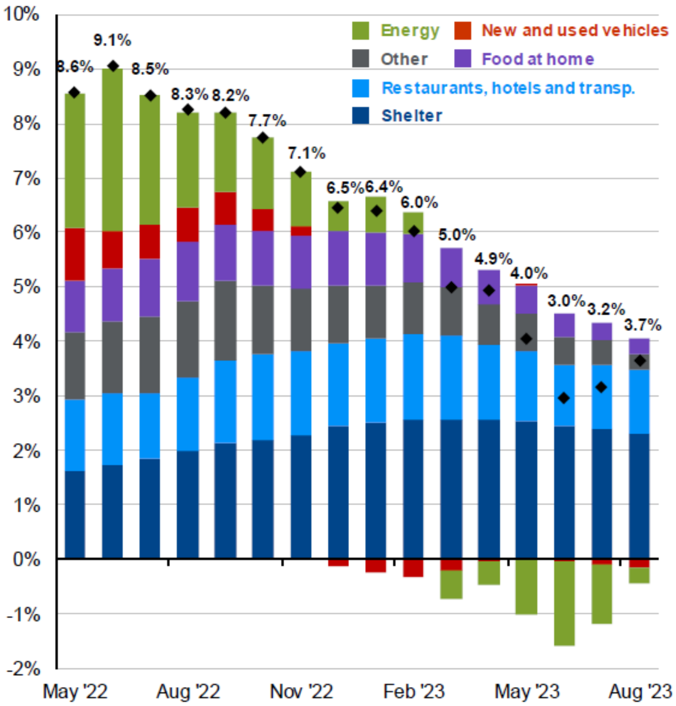
Inflation components

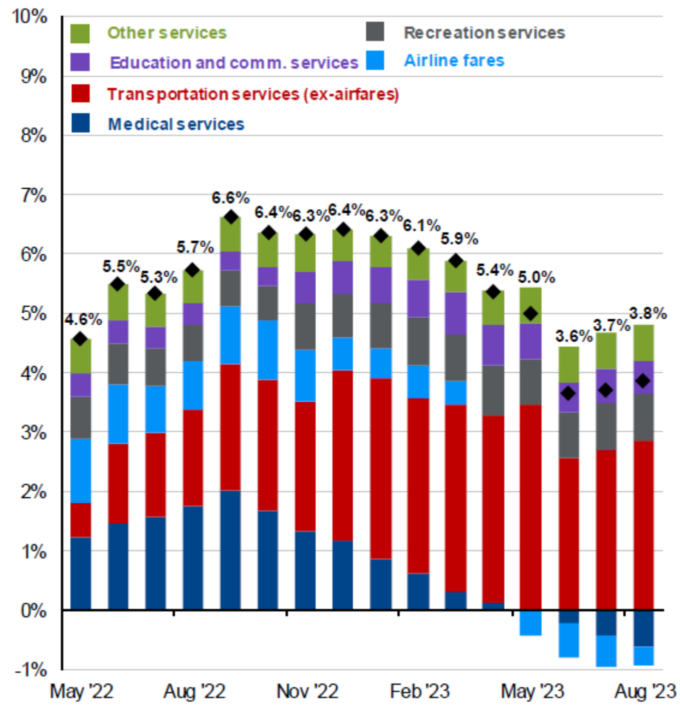
Contributors to headline CPI inflation

Contribution to y/y % change in CPI, non-seasonally adjusted



Contributors to core services ex-shelter CPI inflation*

Contribution to y/y % change in custom CPI index, non-seasonally adj.



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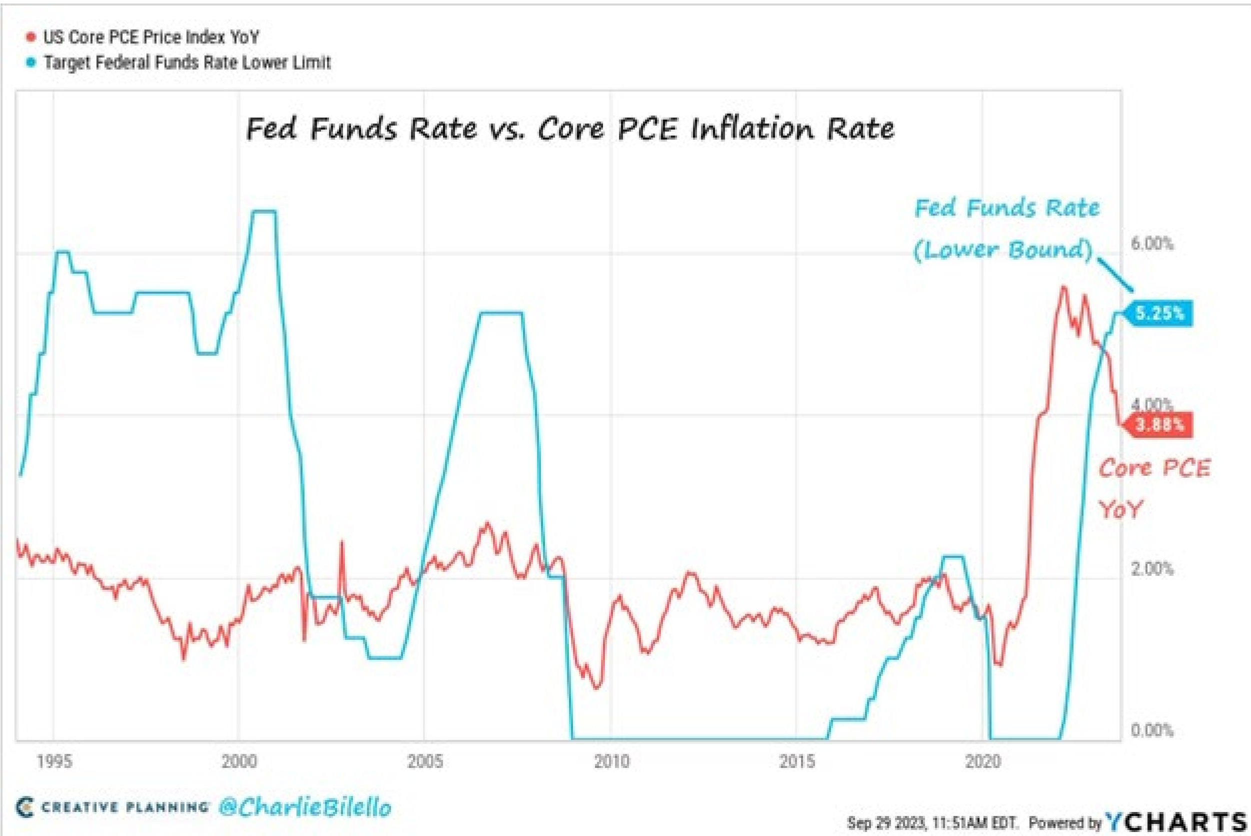
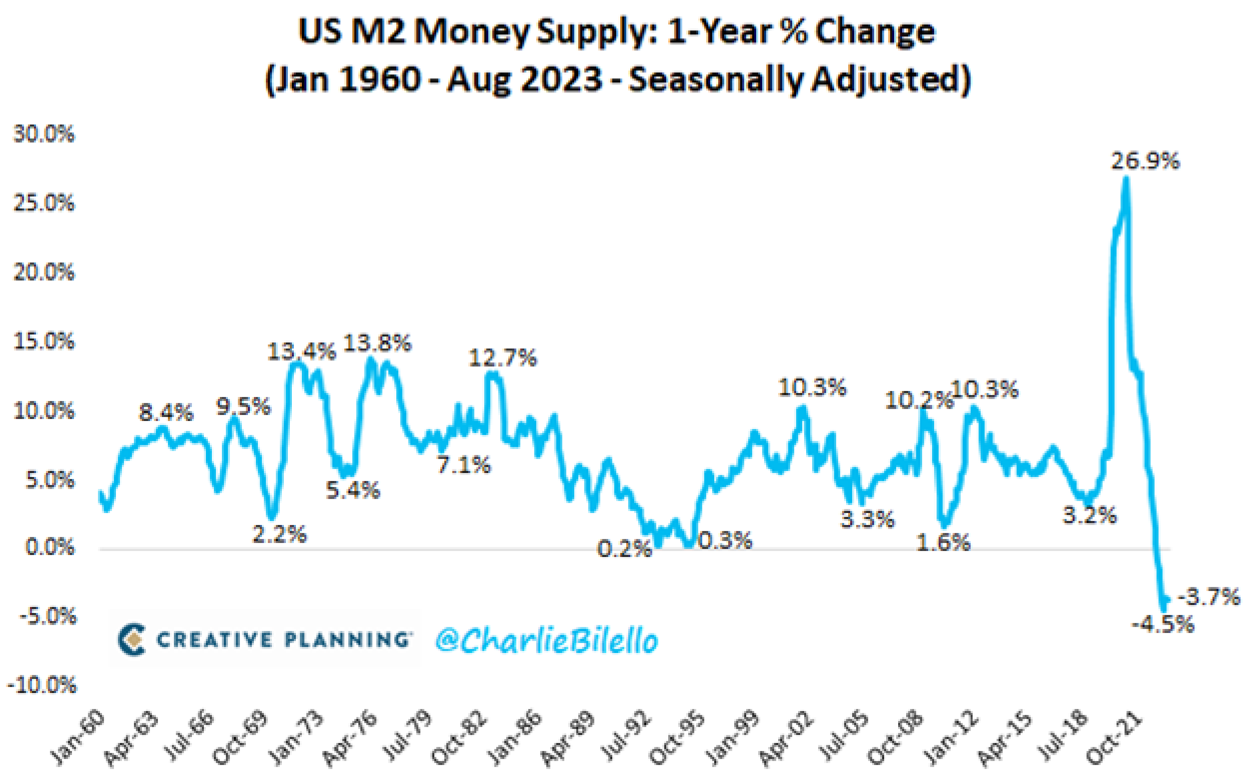
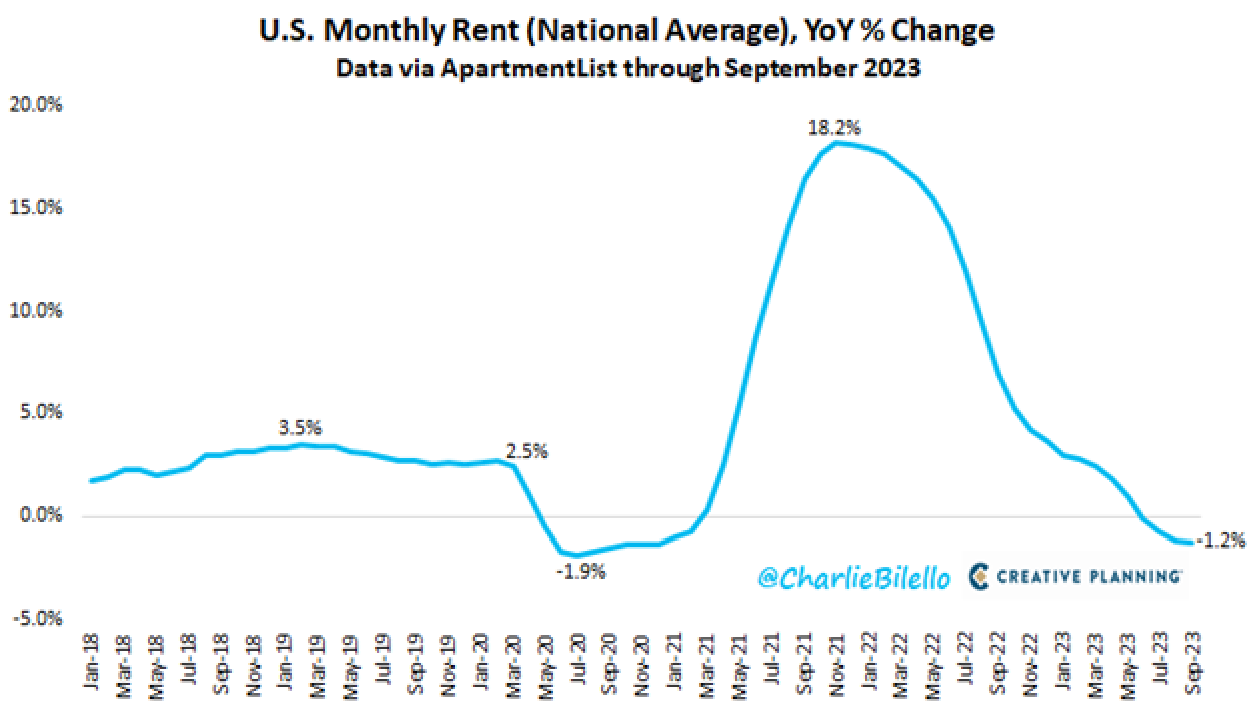
Highest spread since 2007



Money supply decreasing should slow inflation (and the economy)



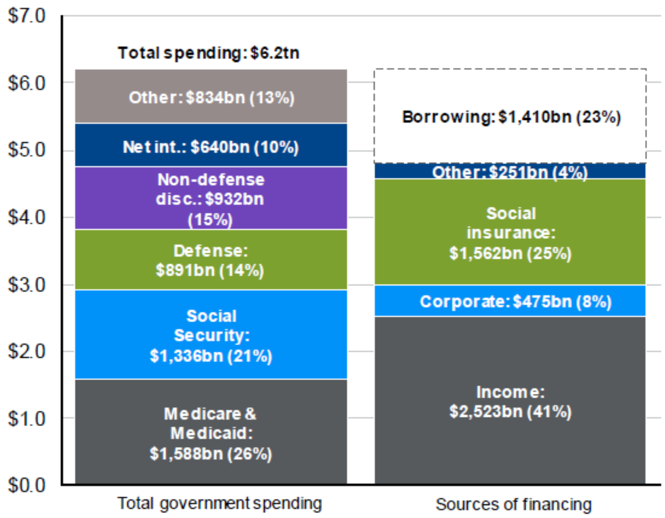
U.S. monthly rent decreasing should also help on inflation front



When will the U.S. have a balanced budget?

The 2023 federal budget

CBO Baseline forecast, USD trillions

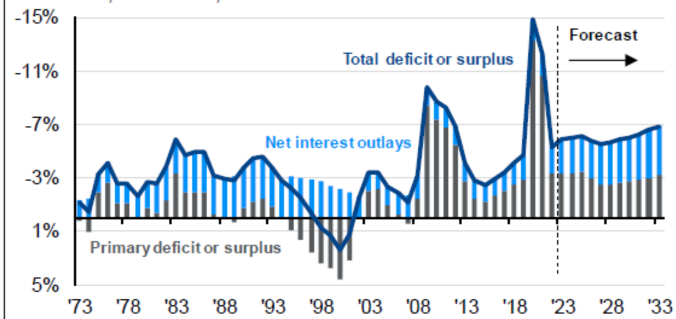


CBO's Baseline economic assumptions

	2023	'24-'25	'26-'27	'28-'33
Real GDP growth	0.9%	2.0%	2.4%	1.9%
10-year Treasury	4.0%	3.8%	3.8%	3.8%
Headline inflation (CPI)	3.3%	2.5%	2.1%	2.2%
Unemployment	4.1%	4.6%	4.5%	4.5%

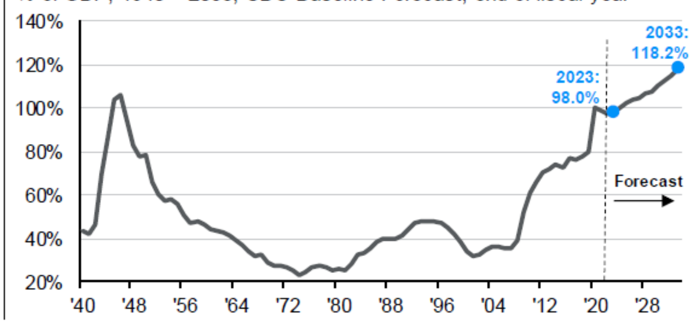
Federal deficit and net interest outlays

% of GDP, 1973-2033, CBO Baseline Forecast



Federal net debt (accumulated deficits)

% of GDP, 1940 – 2033, CBO Baseline Forecast, end of fiscal year



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Growth of U.S. debt is a substantial concern