Q3 2023: Economic Challenges and Shifting Tides

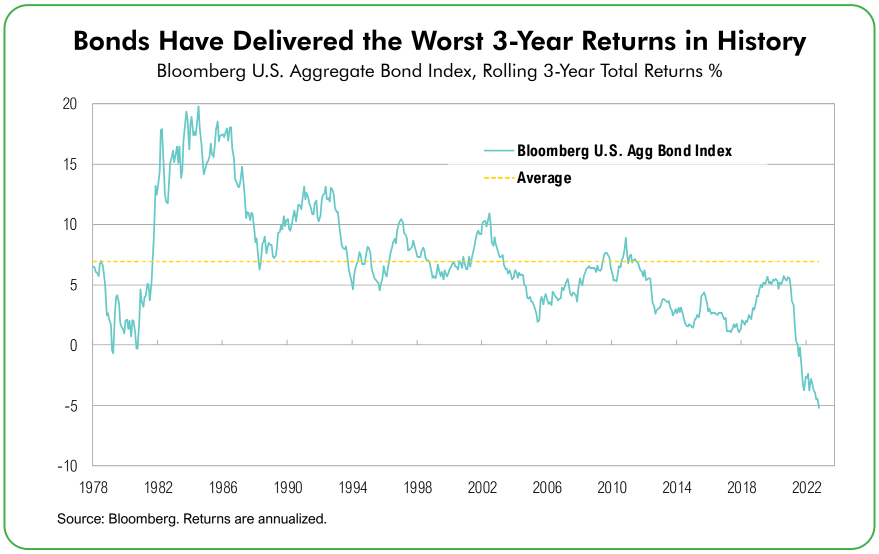
By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. November | 2023

HIGHLIGHTS

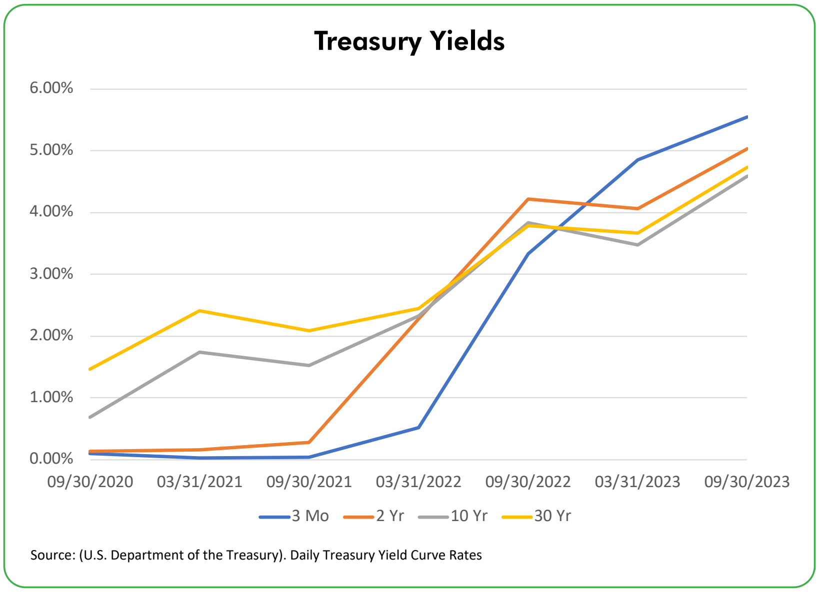
- The S&P 500 ended September down 3.3%, reinforcing September's reputation as the worst month of the year for stocks.
- The Bloomberg U.S. Aggregate Bond Index, which ended the quarter down 3.2%, is down 15% over the past three years in the largest three-year decline in history.
- Strategic Petroleum Reserve inventories are at a 40-year low, the U.S. government deficit is swelling, and pandemic-related savings are drained for most households, signaling economic challenges ahead.
- Looking forward, the good news is that interest rates are higher and opportunities are emerging, meaning investors do not need to stretch for reasonable returns.

Overview

The quarter started with a bang and ended with a whimper. The first and last months of the third quarter have historically been stand-outs for stock performance—albeit for different reasons. July kept its record of historically being the best month of the year for stocks, with the S&P 500 Index ending up 3.2%. In contrast, September, historically the worst month of the year for stocks, saw stocks decline 3.3%. The rally of the Magnificent Seven (a collective term to describe the mega-cap tech companies Apple, Amazon, Microsoft, Nvidia, Meta, Tesla, and Alphabet) has carried the entire stock market in 2023. The S&P 500 is up an impressive 13.1% through Q3; however, without the Magnificent Seven, the so-called "S&P 493" is up only about 5%. Nevertheless, if the quarter is remembered for anything, it will be for the relentless rise in interest rates, which caused bonds to languish. The Bloomberg U.S. Aggregate Bond Index ended the quarter down 3.2% and is now down 1.2% for the year to date. Over the past three years, the index is down 15.0%—by far the largest three-year decline in history.



The 3-month and 2-year bond yields remain inverted with the 10-year yields, yet that gap has shrunk significantly over this quarter, mainly because 10-year yields have been going up much faster than the 3-month and 2-year yields. The graph below is a good visual that shows when the inversion happened and where the rates are relative to one another as of the end of Q3 2023. We expect the yield curves to continue normalizing (longer rates



are higher than shorter rates). The impact of whether or not the inversion will correctly predict a recession is still to be determined.

Inflation

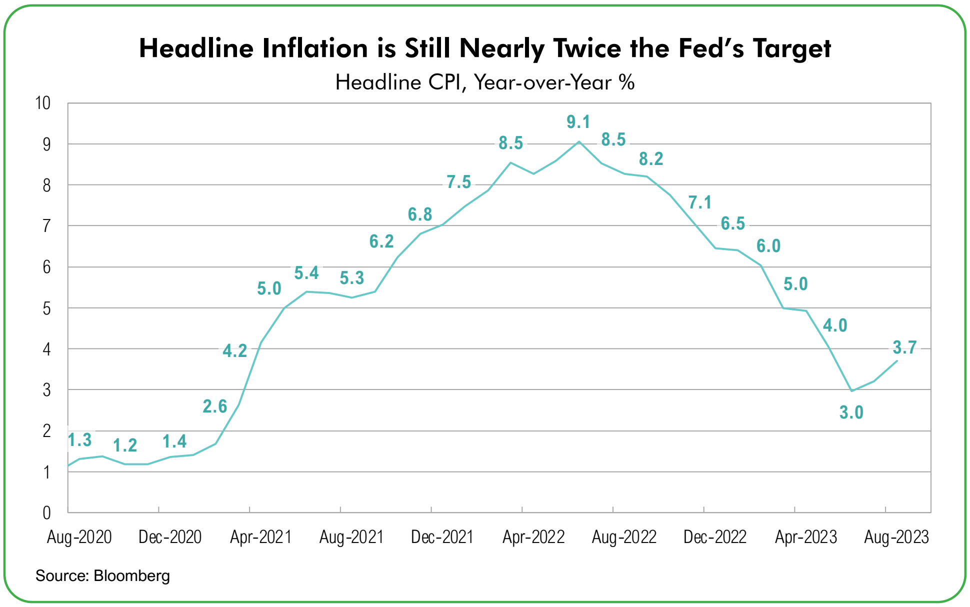
In a real positive for markets and the economy, headline inflation has subsided from its peak of 9.1% year-over-year in June 2022 to 3.7% year-over-year in August 2023. However, this does not mean inflation has been beaten. After bottoming at 3.0% year-over-year in June this year, headline CPI increased to 3.2% in July and ticked up again to 3.7% in August, suggesting the "easy-to-beat" inflation numbers may be behind us. The Federal Reserve remains stuck in a challenging predicament. To calm markets, the Fed hopes to drain excess from the economy and ultimately bring inflation down to its 2% target, but this is not proving easy.

Since June 2022, falling oil prices (down 3.6% year-over-year in August) have played a major role in the decline in overall inflation. This decline was helped by the Biden Administration's decision to release oil from the U.S. Strategic Petroleum Reserve (SPR). Since January 2022, 180 million barrels of crude oil have been removed from the SPR, resulting in the largest-ever continuous release from the SPR without replenishment, draining SPR inventories to a four-decade low. By the end of the third quarter, the SPR held around 351 million barrels of crude oil, translating to about seventeen days' worth of U.S. consumption, the lowest level since August 1983. At its peak in 2011, the SPR held more than 726 million barrels.

There was a dramatic spike in bond yields last quarter to some of the highest levels of the past two decades. After starting the quarter at 3.8%, the 10-year Treasury yield ended the quarter at 4.6%, a level last reached in August 2007. Short-term Treasury yields also climbed to their highest levels since 2001. The 2-year Treasury yield began the quarter at 4.9% and finished marginally higher at 5.0%.

Although the modest re-acceleration in inflation may have been a factor, the larger issue was likely the enormous jump in the supply of bonds needed to fund unrestrained fiscal spending. This has kept fiscal governance, or rather the lack thereof, in the spotlight. On August 1, the ratings agency Fitch downgraded the U.S. from AAA to AA+, citing concerns about fiscal governance and the growing government debt burden. Through the first 11 months of fiscal year 2023, the U.S. deficit has risen to $1.52 trillion, surpassing the $1.38 trillion deficit from the full twelve months of fiscal 2022.

The net effect of high deficits and overspending has been draining government coffers. The U.S. Treasury Department issued a mammoth amount of debt—approximately $1.0 trillion—in the third quarter alone. Since the debt ceiling resolution on June 1, the Treasury has issued $1.3 trillion, and the Treasury is expected

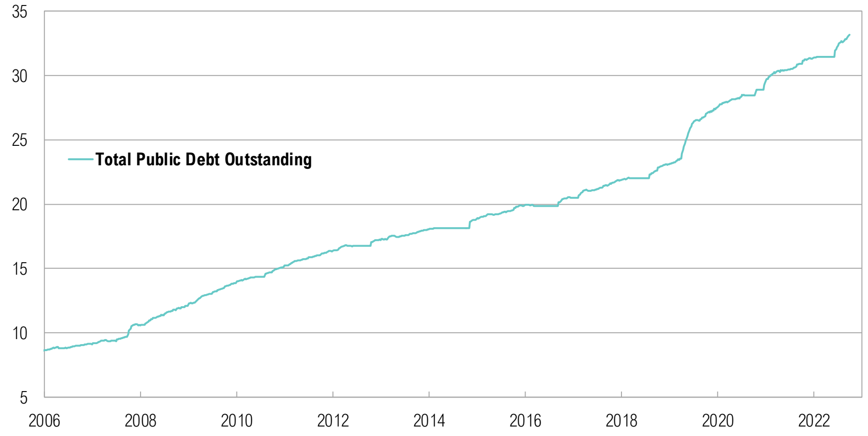


to borrow an additional $852 billion over the fourth quarter of 2023. Total U.S. debt now surpasses $33 trillion. This exorbitant spending spree, while positive for growth (and corporate revenues) in the short term, has consequences for the future. Indeed, it could hinder the government's ability to step in to support the economy in the next recession.

Following a 2-month hiatus, the Federal Open Market Committee (FOMC) met on September 20, keeping interest rates unchanged at 5.25% to 5.50%. Any lingering hopes of a possible rate cut before year-end have also faded away. With inflation still nearly double the Fed's target rate, the Federal Reserve and markets do not anticipate the first rate cut until mid-2024.

Total U.S. Debt Has Surpassed $33 Trillion

U.S. Debt, $Trillion



Source: Bloomberg

Markets

Most asset classes ended the quarter down. Midstream energy was the top-performing asset class over the quarter, up 9.7%, followed by the Bloomberg Commodity Index, which ended the quarter up 4.7%. The worst performers were asset classes most tethered to rising yields. U.S. REITs plunged 7.0%, and international developed market bonds lost 5.5%. In a similar vein, rate-sensitive utility stocks declined 9.2% over the quarter, while the top-performing U.S. equity sector was energy, up 5.0%.

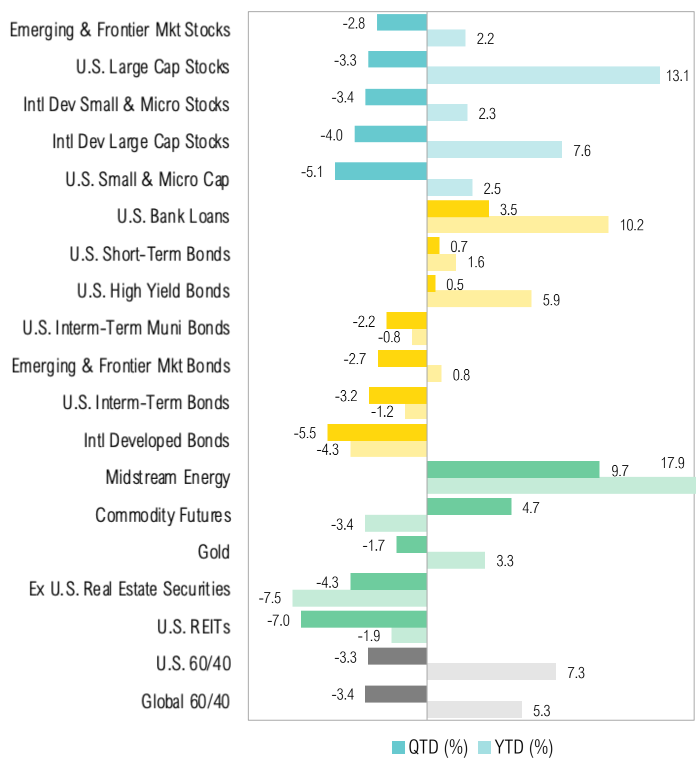
In foreign markets, a stronger dollar, surging U.S. yields, and China's continued sluggish economic recovery all weighed on investor sentiment. Emerging and frontier market stocks ended the third quarter down 2.8%, wiping out most of their gains for the year. International developed market stocks fared worse than their U.S. counterparts, and the MSCI EAFE ended the quarter down 4.0%.

Japan continued to battle its currency woes. Over the quarter, the yen steadily weakened against the U.S. dollar, nearing the same 150-yen mark that in September 2022 triggered a currency intervention from the Japanese government. On October 2, the Bank of Japan announced bond-buying operations of an unspecified amount for 5- to 10-year Japanese Government Bonds (JGBs) after 10-year JGB yields reached the highest level since September 2013.

Looking Forward

Excessive levels of fiscal spending may have been welcomed by markets during pandemic shutdowns, but they are at best unnecessary and at worst irresponsible in an already overheated economy. While the short-term jolt to economic growth may feel helpful, the lingering inflationary pressure on the economy and increasingly negative market reaction to increased bond issuance

Q3 2023 Key Market Total Returns



Source: Bloomberg

may be offsetting any benefit. By stoking inflation, fiscal spending is forcing the Fed to keep short-term interest rates elevated longer, and the increased Treasury issuance is putting upward pressure on longer-term rates, too. We will pay careful attention to this feedback loop in the coming quarters.

While SPR inventories at 40-year lows, swelling government deficits, and drained pandemic-related savings all hint at economic challenges ahead, the draining we are most concerned with is investors' patience with the stock market. As of the end of September, it had been 635 days since the stock market hit a new high. Furthermore, with the sharp move to higher interest rates, the allure of potentially higher returns from risky assets is being undermined by increasingly competitive alternatives.

The other aspect of the negative feedback loop from higher interest rates is the relationship between interest rates and price-to-earnings multiples (the value assigned by investors to each dollar of earnings) for the stock market. Proxied by the S&P 500 Index, a dollar of earnings in the stock market at the end of 2021, when interest rates were near 0% and inflation was believed to be contained, was valued at around $24.7 (down from a peak of $30.8 in February 2021). But for a decade-long period in the 1970s, when inflation and bond yields were much higher, the same dollar of earnings was valued at an average of just $12.7.

Although lower prices have made certain parts of the market more compelling, we maintain that patience is crucial before raising allocations to risky assets.

The next six months or so are critical to see how inflation rates and GDP growth play out, and we may see range-bound markets across many asset classes. The increasing cash equivalent rates and higher yields across the bond universe have been very welcome. If inflation continues to subside, we will be looking for opportunities to extend the duration, which will benefit bonds in an economy of slowing growth or one with more geopolitical turmoil. We have also kept an allocation to Gold, which also benefits in that scenario.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

LISA RUSSELL, CFA
Chief Investment Officer

IMPORTANT INFORMATION

PURPOSE OF THIS MATERIAL

This general market commentary is intended for informational purposes only. The views and opinions expressed represent the judgment of the author based on current market conditions, are subject to change without notice and may differ from those expressed by other departments or employees of Peak Trust Company. This material does not constitute Peak Trust Company research, nor should it be considered a recommendation of a particular investment or investment strategy or a solicitation for the purchase or sale of any security or other financial instrument. Investing involves market risk, including the potential for loss of principal. Past performance and any forward-looking statements are not guarantees of future results.

We believe the information contained in this material to be reliable and have sought to take reasonable care in its preparation; however, we do not represent or warrant its accuracy, reliability or completeness, or accept any liability for any loss or damage (whether direct or indirect) arising out of the use of all or any part of this material. Peak Trust Company does not provide legal, tax or accounting advice so you should seek professional guidance if you have such questions.

Peak Trust Company clients should rely on their custodial statements for the official investment activity records and should contact their custodian with any questions regarding monthly/quarterly receipt of those statements.

ABOUT PEAK TRUST COMPANY

"Peak Trust Company" is the brand for a group of affiliated state chartered professional trust companies headquartered in Anchorage, Alaska. Separate state charters are maintained for operations in Alaska and Nevada as Peak Trust Company-AK and Peak Trust Company-NV. More information about Peak Trust Company, including our services, investment strategies, fees and objectives, are available upon request by calling (888) 544-6775, or visiting www.PeakTrust.com.

Talk to a Trust Expert

(888) 544-6775 expert@peaktrust.com