Third Quarter 2023 Market Commentary

"Higher for Longer"

In Washington

With only hours to spare and against significant odds, the Republican-led House of Representatives Saturday evening passed a stop-gap funding bill to keep the federal government open. All but one Democrat voted to support the legislation, while 90 Republicans voted against it, resulting in a vote of 335-91. Shortly thereafter, the Senate approved the bill by a vote of 88-9, with only Republicans voting no.

House Democrats supported Speaker McCarthy's last-minute proposal for a 45-day "continuing resolution" that includes disaster relief funds, an extension of a federal flood insurance program and reauthorization of the Federal Aviation Administration.

The CR does not include funding for Ukraine, despite the fact that there is widespread bipartisan support to provide ongoing aid. It's expected that a separate bill that authorizes a supplemental package for Ukraine will quickly be put to a vote.

The final version passed by Congress did not include any of the draconian spending cuts that members of the GOP Freedom Caucus had been pushing for. By relying on support from Democrats to keep the government open, Speaker McCarthy may have cost himself the job he endured 15 rounds of voting to win.

The Economy

The strike by the United Auto Workers union has entered its third week. The UAW went out on strike against Ford, GM and Stellantis three weeks ago, the first time in the union's history it targeted all three companies at once. Unusually, the strike started small at just three assembly plants, leaving most of the automakers' production unaffected.

However, a week later the union expanded the strike to the parts distribution centers of GM and Stellantis, but not Ford, acknowledging the significant concessions that Ford has been willing to make at the negotiating table.

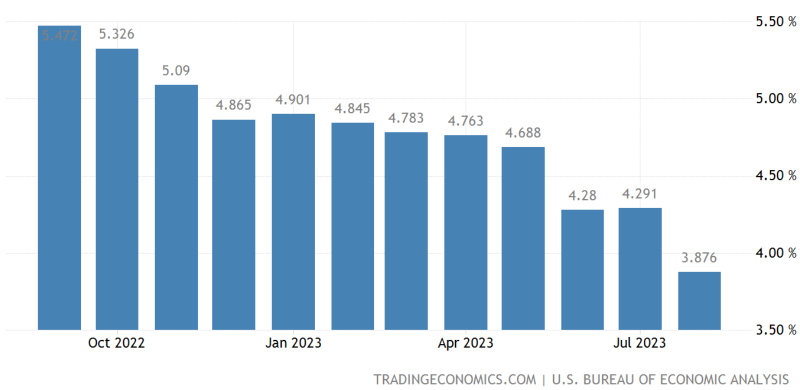
The strategy, which the UAW describes as a "stand-up strike", is intended to gradually increase the pressure on the three auto manufacturers, rather than having all of the union's nearly 150,000 members walk off at once.

The UAW's wish list includes working 32 hours per week but being paid for 40 hours, the return of defined benefit pension plans, and improving retiree health care benefits. The union argues that it made significant concessions during the 2008-09 Great Recession to help keep the car companies afloat.

Inflation & Interest Rates

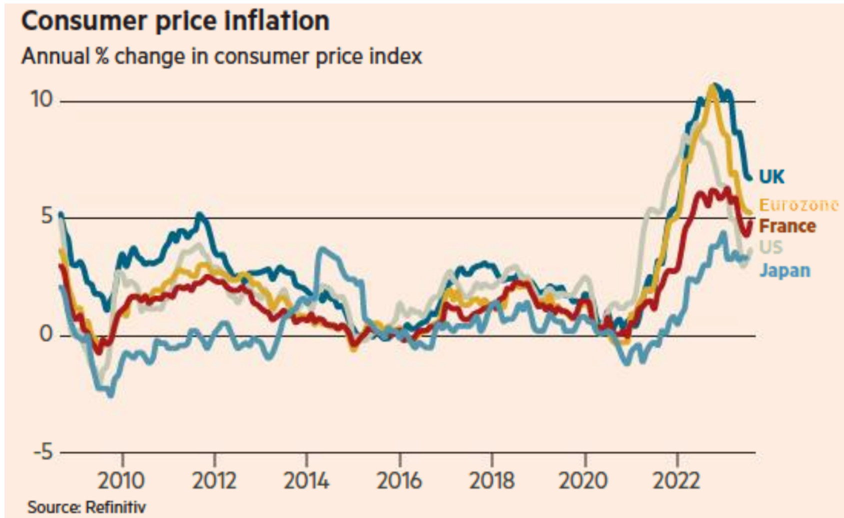
The Fed's determined efforts to bring down inflation from its recent peak last year continue to bear fruit.

The US core PCE price index, the central bank's preferred gauge to measure inflation, rose by 3.9% for the twelve months to August 2023, the smallest year-on-year rise since May 2021 and in line with market expectations. On a monthly basis, core PCE prices went up 0.1%, less than the market's forecast of 0.2%.



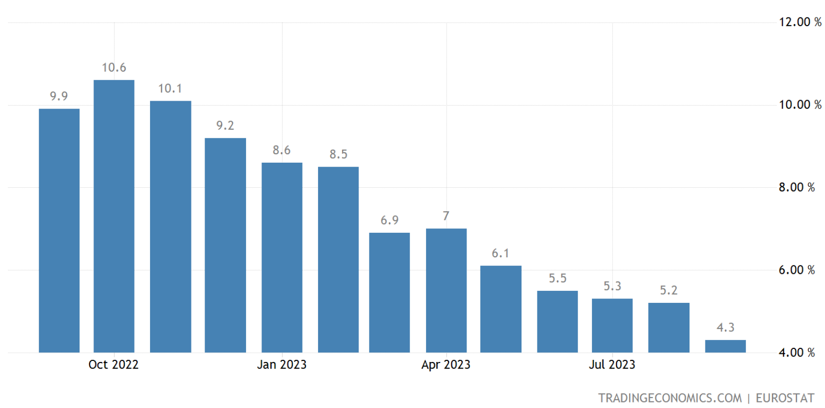
Source: [Trading Economics]

The downward trend in inflation is apparent across the globe. The chart below shows the annual percentage change in consumer prices in the UK, the Eurozone (and France in particular), Japan and the US.



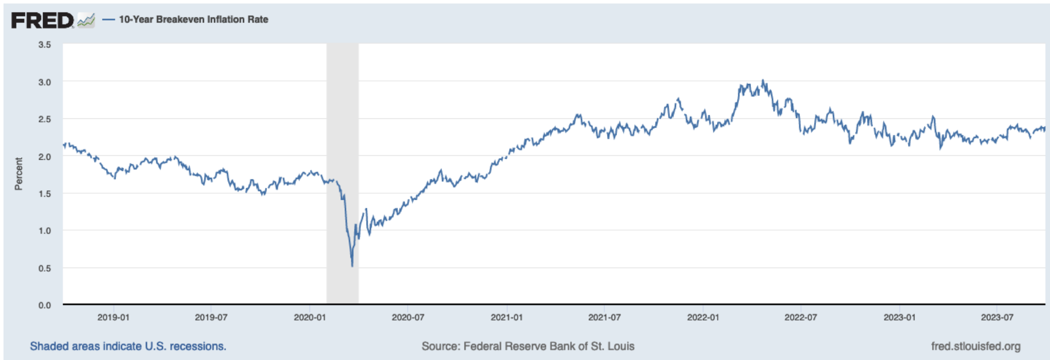
Source: Financial Times

In the Eurozone, the inflation rate fell to 4.3% year-on-year in September 2023, its lowest level since October 2021 and below the market's consensus of 4.5%.



Source: Trading Economics

The markets are still anticipating that the Fed will succeed in getting domestic inflation down close to its long-term target of 2% per year, with the 10-year breakeven inflation rate hovering around 2.3% for several months.



Source: [Federal Reserve]

With the labor market remaining very tight (see more below) and the economy proving to be resilient to the unprecedented series of interest rate increases by the Fed, there is a growing consensus that interest rates are likely to remain "higher for longer".

Just a few weeks ago, many economists and market observers thought that the Fed would turn to cutting rates in late 2023 or early 2024. However, with fears of a rate hike-driven recession receding, and the Fed lowering its forecast for unemployment and raising its growth projections, we could well see interest rates staying at or near their current level well into next year.

Mortgage Rates

The average rate on a 30-year fixed mortgage was 7.31% as of Friday. This is the highest rate since 2000, and is up slightly from last week's 7.19%. A year ago, the average mortgage rate was at 6.70%.

The chart below shows the benchmark 30-year fixed mortgage rate over the past five years.

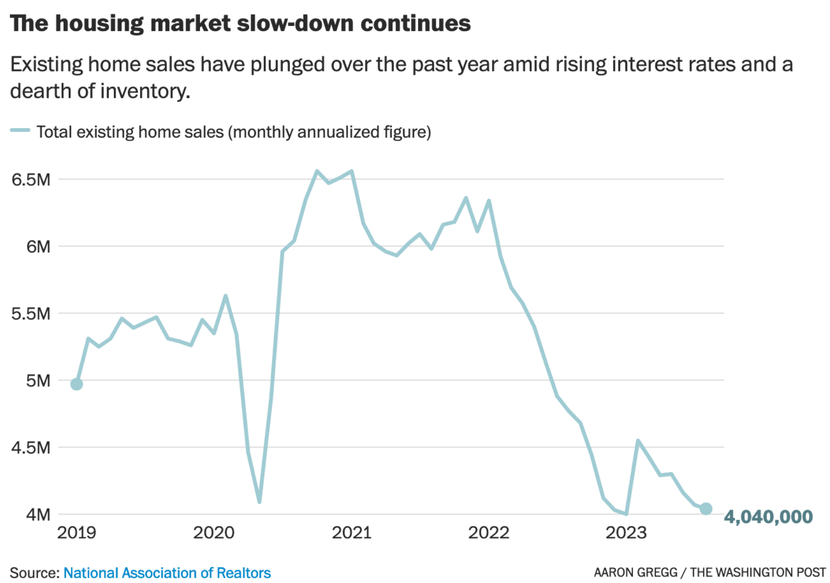
Source: [Trading Economics]

The Housing Market

The housing market has broadly slowed over the past year, as the Federal Reserve has increased interest rates as part of its campaign to bring down inflation. Higher interest rates have made it more expensive for home buyers to finance their home purchases, increasing the costs for everyone except all-cash buyers.

The number of previously occupied homes sold in the United States dropped by 21% over the past year, according to new data from the National Association of Realtors (NAR) released last week.

That's on top of an 18% annual decline the year before, indicating the housing market has continued to slow down in the face of rising interest rates.

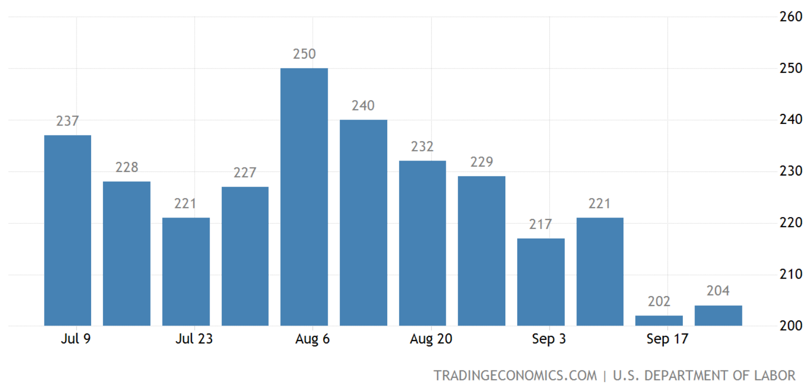


Source: Washington Post

However, prices continued to rise, with the median sales price climbing 3.9% from a year ago to reach $407,100.

The Labor Market

The number of Americans filing for unemployment benefits rose slightly to 204,000 for the week ended September 23. The figure represents a small increase of 2,000 from the prior week, and is well below the market's expectation of 215,000. The labor market's continued tightness provides the Federal Reserve with support to continue tightening monetary policy and points to a potential interest rate increase next month.



Source: [Trading Economics](#)

The Markets

US Stocks

Stocks ended the third quarter on a mixed note, with the prospect of a US government shutdown and the possibility of interest rates remaining "higher for longer" weighing on investors.

The benchmark S&P 500 index - a proxy for large US companies - closed down 0.3% on Friday. Over the past month the index is down 4.8%, and over the past year it's up 15.6%.

The chart below shows the performance of the S&P 500 index over the past year.

Source: [Trading Economics](#)

The tech-heavy Nasdaq closed up 0.1% on Friday. Over the past month the index is up 4.7%, and over the past year it's up 34.4%.

The chart below shows the performance of the Nasdaq index over the past year.

Source: [Trading Economics]

<u>International Stocks</u>
The Stoxx 600 index - a proxy for large European companies - closed up 0.4% on Friday. Over the past month the index is up 1.9%, and over the past year it's up 16.1%.

The chart below shows the performance of the Stoxx 600 index over the past year.

Source: [Trading Economics]

The Bond Market

The yield on the benchmark US 10-year Treasury note closed at around 4.5% on Friday, down from a 16-year high of 4.68% reached earlier in the week. Investors are looking at macroeconomic data for a guide to the Fed's policy outlook. Inflation continues to trend down toward the Fed's long-term goal of 2%. But the relatively strong performance of the economy and the tight labor market have pushed bond yields higher.

The chart below shows the yield on the benchmark 10-year US Treasury note over the past year.

Source: [Trading Economics]

<u>Oil</u>

Prices for the benchmark West Texas Intermediate futures contract closed at about $92 per barrel on Friday, as tightening global supplies offset concerns about demand. Saudi Arabia and Russia extended their supply reductions to the end of the year. Prices were up 10% in September and nearly 30% in the third quarter.

The chart below shows the performance of the benchmark WTI contract over the past year.

Source: [Trading Economics]

Gasoline

Prices for gasoline futures contracts rose to $2.60 per gallon on Friday, tracking the rise in oil prices. Prices remain well below the record levels of $4.00 per gallon seen in the summer of 2022.

Source: [Trading Economics]

Benchmark Returns

For comparative purposes, the S&P 500 index (a proxy for large US stocks) rose 15.6% for the twelve months to September 30, but declined -3.4% in the third quarter.

The Russell 2000 (a proxy for small US stocks) rose 8.9% for the twelve months to September 30, but fell -5.1% in the third quarter.

The Wilshire 5000 index (a proxy for the broad US stock market) rose 20.5% for the twelve months to September 30, but declined -3.3% in the third quarter.

The MCSI EAFE index (a proxy for large international stocks) rose 22.3% for the twelve months to September 30, but fell -4.7% in the third quarter, as measured in USD. Because the USD strengthened during the quarter versus the EUR, the picture was different when measured in the local currency, with the index gaining 13.1% for the 12 months to September 30, but falling -1.8% for the third quarter.

Finally, the MSCI Emerging Markets index rose8.8% for the twelve months to September 30, but declined -3.7% in the third quarter.

In the fixed income segment, the Bloomberg Barclays US Aggregate Bond Index returned 0.3% for the twelve months to September 30.

Looking Forward

News about the US economy is generally good, with inflation trending down and unemployment remaining low. America's economic growth rate is the highest of the G-7 nations. So, at first glance, the concerns of a recession – even a mild one - seem to be fading.

However, there are also a number of potential headwinds that could prove challenging. Interest rates are likely to stay higher for longer. Elevated rates are already impacting the housing market, and may impact the corporate credit markets. The commitment by OPEC+ and Russia to restrict oil supplies to keep prices high may also end up negatively impacting global economic growth. And federal student loan repayments are scheduled to resume in October for nearly 30 million borrowers, who have benefitted from a pandemic-triggered pause of more than three years. Many economists expect the economy to struggle in the fourth quarter as a result.

Finally, we remind you that Springwater's investment philosophy is based on decades of robust, peer-reviewed academic research. One of the principles of that philosophy is that, over time, investors can expect to generate higher returns if they tilt their portfolio's equity allocation toward small stocks (the "size" factor) and value stocks (the "value" factor). The important caveat is that these tilts don't consistently deliver higher returns, day in and day out, just as stocks don't always out-perform bonds and cash.

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