Q3 2023 Commentary

October 2023

Market Trivia:
What fixed income asset class has a similar risk profile to the S&P 500 over the past 10 years?

Q3 Market Recap

Global stocks declined in the quarter despite better-than-expected economic data and corporate earnings. Large cap stocks outperformed small caps in the U.S., while foreign equities outperformed their U.S. counterparts. The Federal Reserve maintained a hawkish stance leaving one additional rate hike on the table this year. More notably, Fed officials increased their inflation expectations for next year and reduced rate cut forecasts, shifting long-term interest rates higher. Economic growth in the Eurozone continues to sputter, particularly in German manufacturing. Economists have been downgrading growth estimates for China, but these numbers remain above developed market economies. India and Japan continue to be bright spots for economic growth in the region.

High yield bonds outperformed both taxable and municipal bonds as credit spreads remained stable. Rising real yields hindered other portfolio diversifiers like REITs and gold. Energy stocks, along with select alternative strategies and cash, provided positive returns.

Asset Class	Benchmark	September	Q3 2023	2023	Since all-time high for S&P 500
U.S. Large Cap Stocks	S&P 500 TR USD	-4.8	-3.3	13.1	-9.2
U.S. Small & Micro Cap	Russell 2000 TR USD	-5.9	-5.1	2.5	-22.0
Intl Dev Stocks	MSCI EAFE NR USD	-3.4	-4.1	7.1	-10.7
Emerging Mkt Stocks	MSCI EM NR USD	-2.6	-2.9	1.8	-19.9
Global Stocks	MSCI ACWI NR USD	-4.1	-3.4	10.1	-12.0
U.S. Municipal Bonds	Bloomberg Municipal TR USD	-2.9	-3.9	-1.4	-10.1
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-2.5	-3.2	-1.2	-14.6
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	-1.2	0.5	5.9	-7.2
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-4.1	-5.5	-4.3	-25.7
U.S. REITs	MSCI US REIT NR USD	-7.0	-7.3	-2.9	-29.8
Broad Commodity Futures	Bloomberg Commodity TR USD	-0.7	4.7	-3.4	10.4
Energy Partnerships	Alerian MLP TR USD	3.2	9.9	20.6	49.0
Gold	DJ Cmmdty Gold TR USD	-4.7	-3.9	1.3	0.9

Data from Morningstar as of 09/30/2023. All-time high for S&P 500 TR set 1/3/2022.

Consensus shifted towards a ‘no-landing’ economic scenario as investors observed stronger-than-expected economic growth and declining headline inflation. Fixed income investors remain discouraged as the drawdown in bonds may enter its third year this coming quarter. In hindsight, the increase in interest rates may appear obvious, but recall there was a large disconnect between Fed rate projections and market expectations. We are skeptical of a ‘no-landing’ scenario as history shows inflation can be sticky and it usually takes longer than expected to reach policymaker’s targets.

Recession Risk Rising Again

The risk of a near-term recession is once again on the radar. Various economic indicators suggest that the U.S. economy likely continued to grow during the quarter but may be slowing down at the margin. September employment data showed a 336,000 increase in non-farm payrolls with no meaningful change to labor force participation or the unemployment rate at 3.8%. Average hourly earnings grew by 0.2% for the month and 4.2% year-over-year, unchanged from last quarter. Wage growth has been steadily declining since Q1 2023. In short, no signs in the labor market that a recession is around the corner.

Economists expect slowing global growth in the quarter led by services while manufacturing contracted at a slower rate. The J.P Morgan Global Composite Output Index fell to 50.6 in August, its lowest reading since January 2023.[1] Discretionary spending on experiences appears to be waning as post pandemic savings are largely exhausted for the bottom 80% of U.S. households.[2] Other headwinds include median mortgage payments reaching all-time highs leading to reduced purchasing power and difficult conditions for first time buyers.[3] Fortunately, existing home-owners have dramatically deleveraged mortgage debt since the 2008 GFC.[4] As seen on the chart to the left, there were no new recession signals triggered during the quarter. Third quarter corporate earnings should provide much needed insight into the health of the consumer and aggregate demand.

	Indicator	Latest Data	Date	Q3 2023 Recession Signal	Q2 2023 Recession Signal
Leading Economic Indicators	Interest Rate Spreads (2Y - 10Y Trsy Yield)	-0.44%	September-23	Yes	Yes
	Stock Market Performance (S&P 500)	13.07% YTD	September-23	No	No
	Quit Rate	2.3%	August-23	No	No
	U.S. Consumer Spending (MoM)	0.4%	August-23	No	No
Lagging Economic Indicators	US Manufacturing PMI	49.8	September-23	Yes	Yes
	US Services PMI	50.1	September-23	No	No
	Global PMI	50.6	August-23	No	No
	Unemployment Rate (U3)	3.8%	August-23	No	No
	Inflation (CPI)	0.6% (MoM) / 3.7% (YoY)	August-23	Yes	Yes
	Index of Consumer Sentiment	69.5	August-23	No	No
	Real GDP Growth (Quarter over Quarter)	2.1%	June-23	No	No
	Corporate Earnings Growth (S&P 500 - YoY)	-0.1%	September-23	Trending yes	Trending yes
	Housing Prices (YoY)	0.1%	July-23	No	No
	Residential Building Permits (National - YoY)	-2.7%	August-23	Trending yes	Trending yes

Sources (in descending order): Federal Reserve Bank of St. Louis, Morningstar Advisor Workstation, U.S. Bureau of Labor Statistics (BLS), U.S. Bureau of Economic Analysis (BEA), S&P Global and JP Morgan, BLS, BLS, University of Michigan, BEA, Factset (Q2 2023 data is an estimate), S&P Case-Shiller U.S. National Home Price Index, U.S. Census Bureau

Bond Market Blues

September marked the fifth consecutive month of declines for bonds.[5] Starting in July 2020, the drawdown on high-quality bonds has been the worst on record.[6] Making investment decisions based solely on recent investor behavior can be detrimental to long-term wealth accumulation. This tendency can be caused by a behavioral finance principle called recency bias. Recency bias causes

Estimated 1-Year Total Return for Given Change in Yields

Change in Yields (%)	Tenor: 3-Mnth	1-Yr	3-Yr	4-Yr	5-Yr	7-Yr	10-Yr
3.0%	4.7%	2.8%	-3.2%	-6.0%	-8.5%	-12.9%	-19.2%
2.5%	4.9%	3.3%	-1.9%	-4.2%	-6.3%	-10.0%	-15.2%
2.0%	5.0%	3.7%	-0.5%	-2.4%	-4.1%	-7.0%	-11.2%
1.5%	5.1%	4.2%	0.8%	-0.6%	-1.9%	-4.1%	-7.2%
1.0%	5.2%	4.6%	2.2%	1.2%	0.3%	-1.1%	-3.3%
0.5%	5.4%	5.1%	3.5%	3.0%	2.5%	1.8%	0.7%
0.0%	5.5%	5.5%	4.9%	4.8%	4.7%	4.8%	4.7%
-0.5%	5.6%	5.9%	6.3%	6.6%	7.0%	7.7%	8.7%
-1.0%	5.7%	6.4%	7.6%	8.5%	9.2%	10.7%	12.7%
-1.5%	5.9%	6.8%	9.0%	10.3%	11.4%	13.6%	16.7%
-2.0%	6.0%	7.3%	10.3%	12.1%	13.6%	16.6%	20.7%
-2.5%	6.1%	7.7%	11.7%	13.9%	15.8%	19.5%	24.7%
-3.0%	6.2%	8.2%	13.1%	15.7%	18.0%	22.5%	28.7%
Duration (Yrs)	0.2	0.9	2.7	3.6	4.4	5.9	8.0
Yield YTM	5.5	5.5	4.9	4.8	4.7	4.8	4.7
Convexity	*0.0*	*0.0*	*0.1*	*0.2*	*0.2*	*0.4*	*0.8*

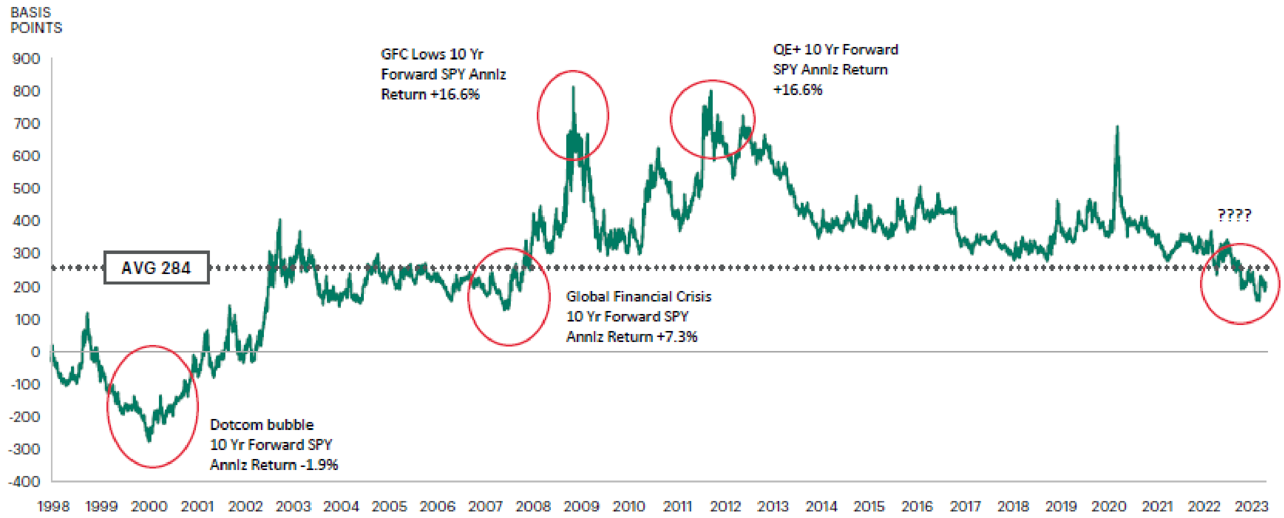
Source: Bloomberg and Springtide Partners

[1] J.P Morgan Global Composite PMI, retrieved from https://www.pmi.spglobal.com/Public/Release/PressReleases?language=en, October 4, 2023
[2] https://www.bloomberg.com/news/articles/2023-09-30/us-consumer-spending-is-signaling-pain-ahead-credit-weekly, retrieved October 4, 2023
[3] Housing Market Update: New Listings Hold Up As Mortgage Rates Soar Toward 8% (redfin.com), retrieved October 5, 2023
[4] BofA Global Research, Federal Reserve Board, via Daily Chartbook #295, retrieved October 5, 2023
[5] Bloomberg Aggregate Bond Index -2.54% in September 2023. Data from Morningstar
[6] Measured using the Bloomberg Aggregate Bond Index as of September 30, 2023. Data from Morningstar

investors to overemphasize the importance of recent events or information, such as the trend of rising interest rates or falling stock prices, to make future choices. This psychological impulse tempts bond investors (professionals included!) to sell bonds and rotate to cash anticipating yields will continue to rise. However, as economic indicators point to a slowing economy, now is the time investors may want to rebalance to, or increase, fixed income target allocations. As illustrated on the previous chart, bonds offer compelling expected returns and are trading at yields that provide a fair amount of safety should rates continue to move higher. For example, if interest rates increase 1%, 7-year Treasurys should deliver a -1.1% return over a one-year period. Conversely, if interest rates decline by 1%, this same Treasury should produce a +10.7% return. Furthermore, bond yields are higher than earnings yields on U.S. equities which may attract additional investors focusing on near-term risk adjusted returns.

Equity Risk Premium

There are many methods used to value stocks, both on a relative and absolute basis. One metric is called the equity risk premium (ERP). The equity risk premium measures the additional return required by investors for



Source: Bloomberg, Apollo Chief Economist; as of April 2023.Morgan Stanley Equity Risk Premium (MSRPSPX) shows a market-based measure of equity-risk premium for the S&P 500, where equity-risk premium is calculated as the spread (in basis points) between the index's next 12-month consensus earnings yield and the 10-year Treasury yield. Sector level data has not been adjusted for GICS reclassifications. SPDR S&P 500 ETF used for 10 year forward return calculations.

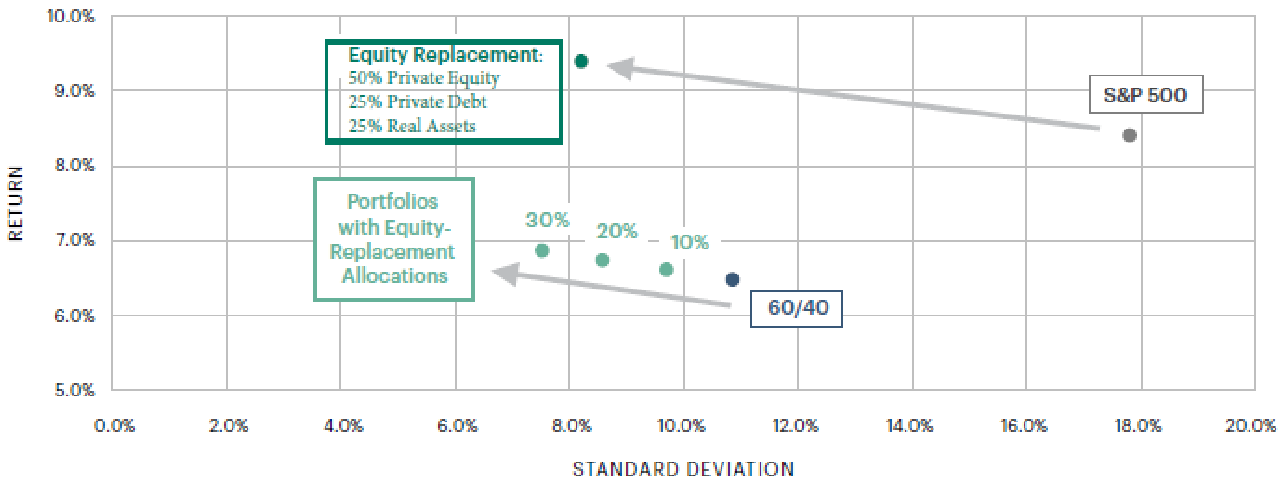
holding stocks rather than risk-free assets. As risk-free rates have skyrocketed and earnings yields have declined, ERP estimates have fallen to below average levels, suggesting the future for equity returns may be muted on a risk-adjusted basis relative to other assets. While the ERP is only knowable in hindsight, we can look at historical charts (see above) and observe that low or negative ERPs commonly precede below average 10-year equity returns and vice versa. We are not suggesting equity investors liquidate their portfolio, rather be mindful of relative valuations and ensure they have exposure to other diversified assets.

Diversification Has Been Elusive

On a monthly basis, nearly every time U.S. stocks have declined in this post-pandemic, high inflationary environment, so too have bonds.[7] Traditional investors remain challenged due to the positive correlation between stocks and bonds at a time when risk assets have struggled. As discussed above, investors may be tempted by high short-term yields to mitigate interest rate risk. While this rebalance might feel good now, it does not solve for what may be a longer-term diversification problem. At PCM, we have spent extensive time researching alternative strategies to provide a diversification benefit for times like these. Our belief is that

[7] November 2021 was the exception. SPY -.8% and AGG +.27%

PORTFOLIO IMPACT OF ALLOCATIONS TO A PUBLIC EQUITY-REPLACEMENT PORTFOLIO



Source: Bloomberg, Apollo, Preqin. Investments include S&P 500 equity Index (total return) for stocks, Bloomberg US Aggregate Total Return Value Unhedged USD and bonds/fixed income, Preqin Private Equity, and Preqin Private Debt. Real assets equally weight three indices: Preqin Natural Resources, Preqin Infrastructure, NCREIF NPI. Public equity-replacement portfolio is 50% Private Equity, 25% Private Debt, 25% Real Assets. 60/40 Portfolio is 60% Stocks, 40% Bonds. Equity-replacement allocations listed are funded by stock allocation. For example, '10%' portfolio is 10% equity-replacement, 50% Stocks, 40% Bonds, Q1 2008-Q3 2022. "Illiquid portfolio" was not rebalanced. Past performance not necessarily indicative of future results.

combining private market strategies with select low correlation public market strategies in a diversified portfolio has the potential to deliver returns similar to public stocks, but with less volatility, and more inflation protection. Researchers at Apollo reached the same conclusion when modeling the impact of adding private equity, private credit, and real assets as replacements for part of an investor's equity allocation. As the chart above shows, incremental additions of private market assets would have increased return and decreased risk compared to owning large cap stocks over the last fifteen years.

Parting Thoughts

Times like these require investors to stick to a long-term plan. Persistently high correlations among major asset classes have made diversification more challenging, but not impossible. Our dedication to helping you reach your financial goals has not wavered. To that end, we encourage you to reach out to your PCM advisor to address any planning questions you may have. Now is also a great time to get a head start on calendar year deadlines such as required minimum distributions, qualified charitable distributions, funding or establishing donor advised funds, and charitable gifts, among other items.

Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

Market Trivia Answer: Long-Term US Government Bonds, as measured by the Bloomberg Long-Term US Treasury TR USD Index. Data as of 9/30/2023