November 2023

MONTHLY MARKET INSIGHTS

Key takeaways:

- The S&P 500 and Nasdaq entered into correction territory as long-term yields continued their push higher.
- Despite very strong Q3 GDP, the third quarter earnings season has proven to be a disappointment. Consensus estimates for Q4 and 2024 are coming down due to cautious commentary from companies.
- The horrific terrorist attack against Israel and the ensuing war reflects rising geopolitical tensions that may weigh on equity sentiment if it spills over into a broader conflict.

US equities suffered their third consecutive monthly decline in October, with the S&P 500 and Nasdaq entering correction territory after dropping more than 10% from their July highs. Despite respectively falling -2.2% and -2.8% in October, the S&P and Nasdaq both remain in positive territory for the year. However, the top-heavy nature of these indices has masked much broader weakness under the surface. After a challenging October, other widely followed US indices show losses for the year. For example, the S&P 500 Equal Weight Index has a year-to-date loss of -2.37%, the S&P 400 MidCap Index has a year-to-date loss of -1.33%, and the Russell 2000 Index has a year-to-date loss of -4.48%.[1] For most of the year, the performance of equities outside of the Magnificent Seven has been mixed and reinforces our ongoing cautious stance towards equities.[2] Of particular concern for equities going forward, the Russell 2000 Index undercut its 2022 low in October, and the KBW Banking Index ended the month near the lows established during the regional banking crisis earlier this year, suggesting the health of the banking sector remains a concern.

Bonds, as measured by the widely-followed Bloomberg US Aggregate Bond Index (Agg), were no help to diversified portfolios. The Agg declined -1.78% in October and is on pace for its third consecutive yearly decline, for the first time in the index's history.[3] As we have highlighted in previous communications, higher rates increase recession odds and gradually pressure equity multiples. The sharp upward move in long-term yields that began in July continued in October, with the US 10-year yield rising 33 basis points (bps) and the US 30-year yield rising 36 bps. During the month, the US 10-year yield reached 5% for the first time in 16 years, and 30-year mortgage rates made a 23-year high near 8%.

One of the reasons for the sharp move up in long-term yields since July has been the resilient strength of the US economy, which has lent credence to the idea that rates will stay "higher for longer." On October 26, the government reported that US GDP grew 4.9% annualized in the third quarter. This figure widely exceeded consensus expectations coming into the quarter and is remarkable given the Fed's actions over the last 18 months. Growth in the quarter was largely driven by resilient consumer spending alongside strong government spending bolstered by an 8% increase in defense spending. While robust government spending has been a key driver of economic growth throughout the year, excessive government deficits have been a renewed source of angst among investors since Fitch downgraded the US's debt rating in August. Political dysfunction, as evidenced by the debt ceiling standoff earlier this year and October's Republican House revolt against former Speaker McCarthy, is also undermining investor confidence in US treasuries.

1. Bloomberg, data as of October 31, 2023.
2. The Magnificent Seven include Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.
3. Bloomberg.

Meanwhile, price-insensitive buyers like the Fed, China, and Japan have all stepped away from buying treasuries at a time of elevated issuance, resulting in a supply/demand mismatch requiring higher yields to attract new discerning buyers. The good news is that the Fed appears to have reached the end of its rate-hiking campaign, and there appears to be strong demand for treasuries when yields are near 5%. If yields can stabilize in this area or decline, the equity market should find its footing and recover some of the losses from the prior three months. However, absent a significant economic slowing, we continue to believe that long-term yields are biased upward, so any equity rally is likely to be short-lived.

Coming into the third quarter earnings season, investors had high hopes that earnings outperformance would be a positive catalyst for a stock market rally, as it was in the previous two quarters. Strong economic growth in the quarter made a third-quarter earnings outperformance a reasonable assumption. However, with third-quarter earnings season more than halfway complete, those expectations have yet to materialize. Investor confidence has been shaken as the market has been punishing earnings misses severely and rarely rewarding earnings beats. The results for this quarter have been satisfactory, but companies have issued disappointing guidance for the fourth quarter and the year ahead. These underwhelming earnings reports lead us to believe that the third quarter's robust GDP growth is likely an aberration. We find it likely that the US economy will slow significantly in the months ahead as the cumulative effect of Fed rate hikes finally takes its toll on economic growth.

Finally, we would be remiss if we did not mention the horrific events of October 7, when Hamas, an undisputed terrorist organization, massacred over 1,400 Israeli citizens. The ensuing war in the Middle East has once again brought geopolitics into the forefront. Stocks have a history of looking past such events, but this conflict has the potential to spill over into a broader conflict that could upend energy markets at a time of elevated inflation. Oil prices spiked after the initial Hamas attack, but have since retreated and are now lower than they were before the attack. So far, it is hard to attribute any equity market weakness to the conflict, but the terrorist attack and its aftermath are a stark reminder that the de-globalization trend that began last decade brings with it heightened geopolitical risks.

In summary, we believe equities are poised for a short-term bounce if bond yields stabilize near current levels. However, despite correcting over the last three months, we still believe that equities remain overvalued given today's interest rate environment, elevated odds of a recession over the next twelve months, and a geopolitical environment that rivals the Cold War period. As we have done all year, we continue to prioritize capital preservation, and we believe that credit markets offer more favorable risk/reward than equities at present time.

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