Making Sense of Finance

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Third Quarter 2023 Review

STOCK MARKET

The rally in stocks this year came to an abrupt halt in the latter half of the third quarter. All three major indexes posted declines. The S&P 500 declined 3.6% last quarter. The Nasdaq lost nearly 5% yet is still having a big year due to price increases in a small group of stocks as mentioned in our last newsletter. These seven stocks have contributed largely to the S&P 500's 11.7% year-to-date rise (but also were the main reason for the large decline last year) since they have a 27% weighting in the index. The Dow Jones Industrial Average index that is less skewed to technology stocks, declined the least with a loss of 2.6%. The big news in the stock market is the bond market, as yields continue to rise and offer an alternative investment choice to stocks. Stock market valuations have increased this year. The forward price-earnings multiple on the S&P 500 index is currently 17.7, which is slightly above its 10-year average (started the year at 16.8x). Earnings are expected to grow over 12% in 2024, which can justify current stock valuations in a rising yield environment as stock prices over the long term typically follow earnings growth.

In a miserable quarter, only two stock sectors had positive returns – communication services and energy. The latter was aided by the 29% increase in the price of oil last quarter. The worst performing stock sectors in the third quarter, as they have been all year, were utilities and REITs (real estate investment trusts). Higher interest rates not only negatively affect their cash flow due to their typical debt laden balance sheets but also diminish the attractiveness of these type of companies' dividend yields as enticing alternatives are attainable in fixed income securities.

Foreign markets in general performed awfully last quarter. The MSCI EAFE index of developed markets had a loss of 4.7% in the third quarter when measured in US dollar terms. The Japanese market however did manage to continue to show positive returns as it has done all year. The Bank of Japan is the only major central bank to maintain easy monetary policy with very low interest rates. The British stock market although still showing a loss, fared better than its peers. However, any gains in the foreign stock markets were muted and losses magnified

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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when translated into US dollars. The dollar rose for 11 straight weeks last quarter, its second longest appreciating streak in over 50 years. Emerging markets as measured by the MSCI Emerging Market Index also declined in the third quarter both in local currency and US dollar terms. Exceptions to the losses in emerging markets were in India and Turkey.

BOND MARKET

Bonds were not the place to hide in the third quarter as they posted losses comparable to stocks, as measured by the Bloomberg Barclays US Aggregate Bond Index total return of a negative 3.2%. The yield curve while still inverted became less so as long-term yields rose faster than short term yields. The 30 Year Treasury had its largest quarterly increase in yield in more than 14 years (as yields rise, bond prices decline). The yield on a Ten-Year Treasury ended the quarter at 4.59%, up from 3.81% at the end of June. The One Year Treasury yield rose to 5.46% from 5.40%. The Federal Reserve increased the Fed Fund target rate by 25 basis points in July. However, the Fed chose to pause its raising of interest rates at the September meeting. “Higher for longer” appears to be the mantra that may be causing the stock market to worry. However, this is just the bond market normalizing. The Fed has been suppressing interest rates for years. We have been living through an extended period of not receiving an inflation adjusted positive return on our money and this is finally ending. Historically the median “real”, meaning inflation adjusted, return is around 2.0%-2.5% (as measured against the Ten-Year Treasury). This has not been the case since post the Great Financial Crisis in 2008-2009.

The lower interest rate sensitivity of low-grade high yield bonds helped them eke out positive returns for the third quarter and year to date. These riskier high yield bonds were the only positive bond sector last quarter. Investment grade corporate bonds performed better than Treasuries and short-term bonds did better than long-term bonds in the third quarter. Municipal bonds have recently reacted to rising Treasury yields with a price decline (rise in yields). Volatility in the bond market is almost twice its historical level and has been for more than the past six quarters. The typical appeal of stability in bonds has not been evident to investors in the past couple of years.

OUTLOOK

We have two primary messages; predicting and timing the markets are futile, and speculating in the newest shiny object often leads to poor results.

Who would have thought that after the attacks on Israel, that on the three following trading days that the major stock indices would all be positive? Still, this is not an indication of what will happen in the following weeks.

We have waited nearly a decade for the Fed to raise rates meaningfully and while market prices benefited for many years, this difficult adjustment to higher rates in the past year is probably for the better. Free money (historically low interest rates), as we call it, can often lead to dangerous bubbles. We saw some signs in the real estate market, and it persists even now. However, as discussed last quarter, the amount of real estate activity seems to have softened. Most pundits had forecast a recession in 2023, and with just a couple months to go, it seems unlikely. Actually, by definition, it’s nearly impossible given the definition of a recession being two straight quarters of economic contraction. Most estimates are for the third quarter of GDP growth to be in the 2% range. And with the flattening of the yield curve, it looks like that reality is becoming the consensus. Past inverted yield curves (long-term bonds yielding less than short term bonds) have historically been a good indicator of a future recession, but nothing is a given.

Regarding shiny new objects, some recent examples being marijuana legalization, crypto currency, and now AI (artificial intelligence). These are all growth sectors, for sure, but the question is, how do you make money from it. A quick survey of publicly traded “pot stocks” shows declines of 60% to 90% plus declines in share price from their all-time highs. Bitcoin, the most popular crypto currency, is still down almost 60% from its 2021 peak, although its price does seem to have stabilized. And now AI is in the limelight.

We aren’t sure what the ramifications are for AI, but it will likely have a major transformative effect on our society. What is murky to us is how AI will make money for investors. The chip makers are the early beneficiaries of this demand. It seems like it will be a way to eliminate human jobs, therefore, cost cutting will be the largest initial impact. At Karagosian Financial, we will likely take more of a wait-and-see approach and invest in the sector when it’s more proven.

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