withum WEALTH MANAGEMENT

Fall, 2023

Investment Commentary

While the contents of our Fall letter do not acknowledge the tragedies going on in the Middle East, we take a moment to offer support to anyone affected. Withum Wealth does not stand for any form of hatred, racism, antisemitism or terrorism and our thoughts and prayers are for health and safety of innocent citizens in the area.

What Happened in Q3?

Major US equity indices retreated in Q3, with the S&P 500 hitting a year-to-date high at the end of July but falling thereafter, closing the quarter -3.7% lower, with most of the decline taking place during September. Still, the benchmark sits at +12.1% year-to-date at quarter-end.

Big tech names were mixed but still offered some cushion, as the equal-weight S&P continued to lag the cap-weighted index. Energy was by far the best-performing sector as WTI crude rose around +29%, its strongest quarter since the Ukraine invasion in Q1'22. Meanwhile, the yield curve steepened as the 10Y yield touched its highest level since 2007, rising faster than shorter term bonds.

The Fed's policy trajectory continues to be the dominant force in the market narrative. While the FOMC's 25 basis points hike in July and pause in September were both as-expected, growing acceptance of the Fed's higher-for-longer mantra (as we highlighted here) feels at least partially responsible for the interruption to the market's AI-assisted upward momentum in the first half of the year. The market has been seeking assurances that we've reached the top of this rate cycle, and while analysts are skeptical, policymakers' projections still lean toward one more hike in 2023.

Strength in equities early in the quarter seemed to represent a continuation of themes from the second quarter, including expectations for a soft landing underpinned by disinflation traction, a still-tight labor market, a resilient consumer, and improving corporate earnings. While these themes remained at the fore for much of the third quarter, they were increasingly counteracted by mounting concerns including slowing mega cap momentum, a likely government shutdown (which has been averted for now), union labor unrest, a restart of student loan payments, anemic growth in China, disinflationary pressures on corporate earnings, and negative September seasonality.

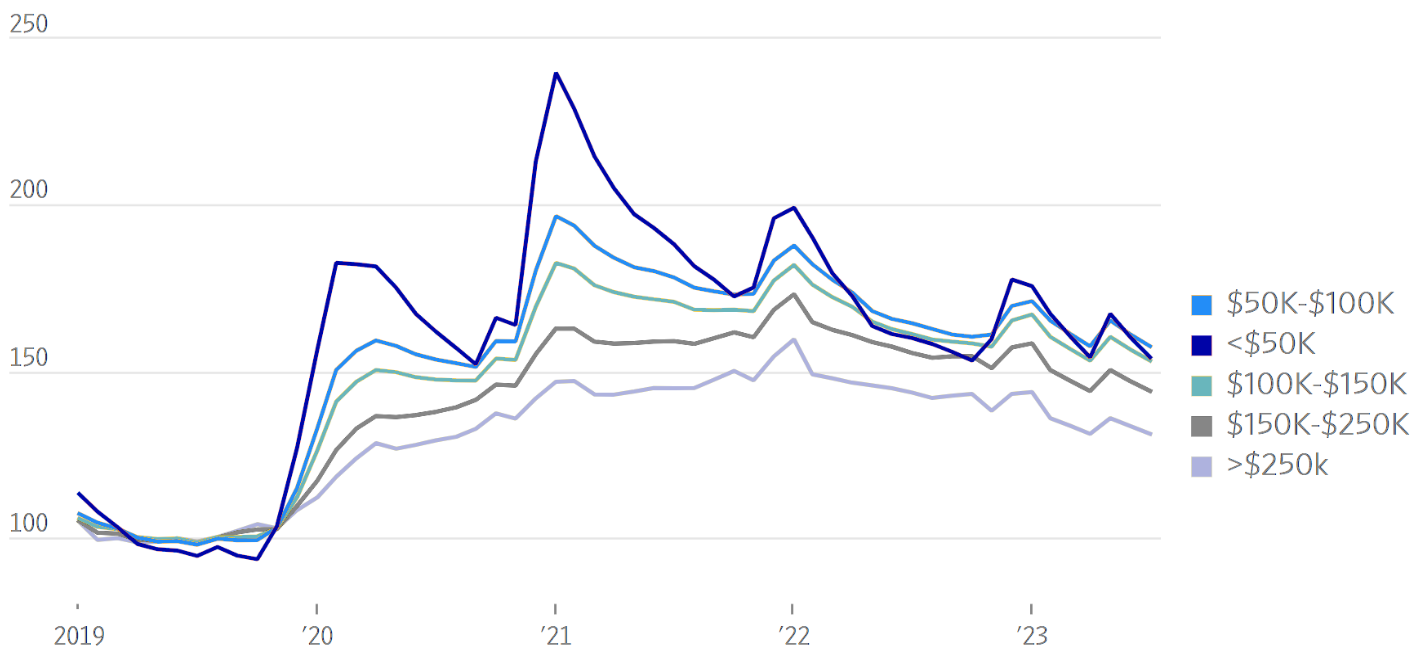
See important disclosures on last page

Trouble Ahead for the Consumer?

Topping that list, however, is the fear that consumer resilience may be starting to falter. The recent spike in energy prices (gasoline rose +10.6% in August alone), is a significant burden on wallets and a threat to the disinflationary narrative. There are also worries about the impact of the coming resumption of student-loan payments in October, which could divert up to $100B from consumers' pockets over the next year. High interest rates have made big-ticket purchases that require loans particularly onerous for consumers and small businesses – loan rates that are approximately +4% higher than they were a few years ago have resulted in monthly mortgage and car payments that are +60-70% higher in many cases. Recall that consumers entered this tightening cycle with a very large cash cushion thanks to the pandemic – folks spent less while stuck at home while simultaneously receiving stimulus payments. Those excess savings are now largely gone, particularly for the lower end consumer. A recent sharp uptick in credit card delinquencies is evidence of this.

Median household savings and checking balances by income

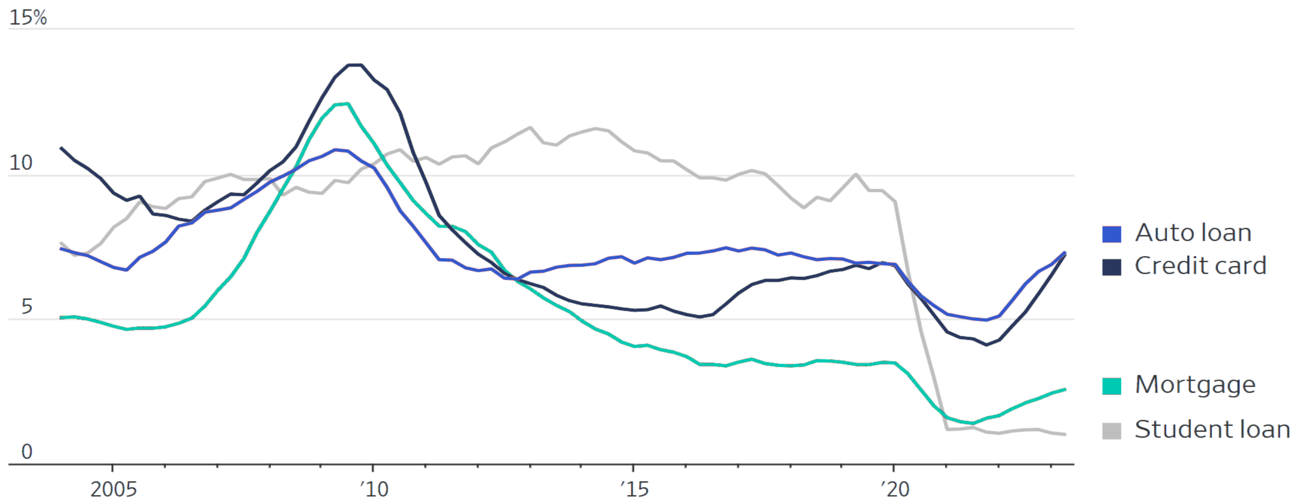
Indexed to 2019 average at 100, for a fixed group of households



Source: Bank of America Institute

Percentage of U.S. consumer balances moving from current to 30-days-plus delinquent during quarter

By loan type



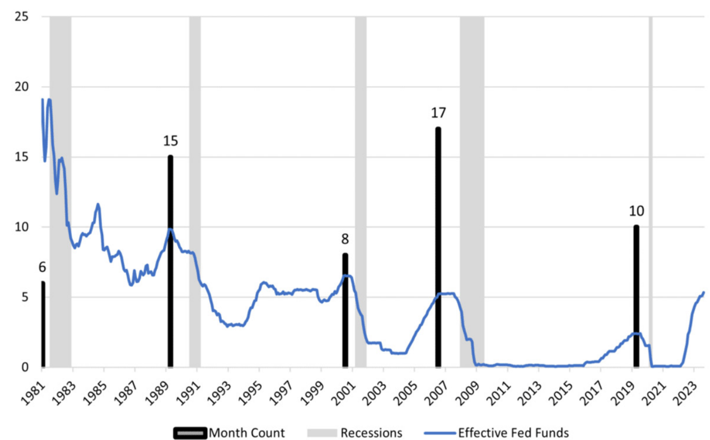
Note: Annualized by four-quarter sum.
Source: Federal Reserve Bank of New York's Quarterly Report on Household Debt and Credit

Inflation across all goods and services, more expensive gas, the student loan repayment resumption, much pricier loan repayments, etc. begin to add up. One or two of these forces operating simultaneously may not be enough to significantly hamper consumer spending and derail the economy, but all of them acting in concert could prove a material headwind for corporate earnings. This could precipitate a recession, particularly if any unforeseen exogenous shock occurs.

Mind the Lag

Much of the perceived resilience of the consumer and corporate earnings in the face of higher rates to this point can be attributed to the lag effect – simply put, it takes time for higher rates to cool the economy and markets. On average, recessions begin 11 months after the final rate increase. Depending on whether the Fed has another hike in store for us, this means we may start to see more obvious signs of trouble (i.e., notably higher unemployment) sometime late next year, perhaps just in time to have a meaningful impact on election season.

Fed funds and the lag effect



Source: RIA SimpleVisor

It is worth pointing out that lags could be longer than usual this time, for several straightforward reasons. As mentioned previously, consumer cash balances going into this tightening cycle were higher, likely lengthening the lag. Corporations also locked in long-dated financing at low rates, which lengthens the lag, at least until a wave of maturities necessitates refinancing at higher rates. Mortgages that were broadly refinanced at lower rates function similarly. Finally, pent up demand for services post-pandemic likely acted as a boost to the global economy and delayed the negative impact of higher rates.

So, No Soft Landing?

Uncertainty remains about the timing and magnitude of a potential recession in the near term. However, there's still hope that we remain on what Chicago Fed President Goolsbee recently called the "golden path" to a soft landing. First, realize and accept that a cooling economy is precisely what the Fed has been trying to achieve all along as it sought to bring inflation under control, and we've known for a while that the "last mile" of this journey would be the toughest. The upshot is that the Fed is at or at least very near peak rates, and has baked some loosening into 2024 forecasts, a welcome signal of data-dependent flexibility.

Beyond an appropriately-positioned Fed we find several other positive talking points intact. Core inflation (ex-food and energy) should continue ticking lower, especially the shelter component. The labor market has shown signs of gradual softening without a spike in unemployment (thus far). Recent data from China finally showed improving growth after months of stimulus. Credit card data shows consumer spending is still solid, despite some deceleration and debt burdens are no more onerous as a percent of spending than in the past decade. On the corporate side, messaging from CEOs has remained upbeat ahead of Q3 earnings season, and there have been several notable positive earnings estimate revisions of late. Despite some dampening of mega cap momentum, optimism around AI remains robust. While the S&P 500 is trading at a high valuation, vast swaths of the index trade at multiples far below the headline price-to-earnings ratio. Finally, while September and October are historically the market's worst months, Q4 has tended to be strong in recent years.

Ultimately, whether the Fed can "stick the landing" or gets derailed will have little impact on how we invest. Cash may seem safe and attractive with a recession somewhere on the horizon, but history shows us that sitting on the sidelines never leads to outperformance over the long term. So, we continue to identify and invest in companies across multiple sectors that have proven track records in a range of economic environments. On the fixed income side, we are extending duration somewhat across portfolios to reflect our view that rates are near their peak.

As always, if you would like to discuss the market's prospects or review your portfolio and investment goals, please reach out to your advisor. We wish everyone a happy holiday season.

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QUARTERLY PORTFOLIO & ECONOMIC COMMENTARY

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