POWER
WEALTH MANAGEMENT

# QUARTERLY MARKET UPDATE

PLAN WITH PURPOSE.
INVEST WITH CONFIDENCE.

**OCTOBER 2023**

*"My ventures are not in one bottom trusted,*
*Nor to one place; nor is my whole estate*
*Upon the fortune of this present year;*
*Therefore, my merchandise makes me not sad."*

**William Shakespeare, The Merchant of Venice, Act I, Scene 1**

# Investment Principles

- We believe clients should understand and be compensated for the financial risks they take.
- We believe portfolio diversification is an active process that requires more than just traditional stocks and bonds.
- We believe a tax-sensitive approach is key to enhancing real returns.
- We believe each client's portfolio should be customized to best help them achieve their financial goals.

# Third Quarter 2023 Market Performance, Key Drivers & Outlook

Financial markets in Q3'23 were somewhat weaker than the prior quarter, though year-to-date results, particularly for U.S. equities, continue to be strong. On a year-to-date basis, U.S. equities were up 12.4%, international developed equities were up 6.7%, and emerging market equities were up 2.3%. Fixed income was down 1.2%. Encouragingly, our equity allocations are most heavily weighted to the United States. See **Figure 1.**

**Figure 1. Market Performance, Total Returns**

| | Q3'23 | Year-to-Date |
|---|---|---|
| Equities | | |
| US Total Market[1] | -3.3% | 12.4% |
| International Developed[2] | -3.9% | 6.7% |
| Emerging Markets[3] | -1.5% | 2.3% |
| Fixed Income | | |
| Aggregate[4] | -3.2% | -1.2% |

*1. S&P Total Market Index, 2. FTSE Developed ex US Index, 3. FTSE Emerging Index, 4. Bloomberg US Aggregate*

In Q3'23, the modest decline in the U.S. equity market wasn't a matter of lower earnings power for businesses. In fact, corporate earnings are expected to be higher relative to the prior quarter. The decline was entirely a result of multiple contraction. As a matter of background, an 'earnings multiple' refers to the price of a stock relative to its earnings per share. This 'multiple' can be thought of as a proxy for investor enthusiasm, which in our view, was impacted by comments from the Federal Reserve, and an increasing realization that rates will be 'higher for longer', as well as a number of other factors. Higher rates negatively impact the economy and reflexively impact share prices based on valuation math. Intuitively, higher rates also make bonds more attractive relative to stocks. The risk of a federal government shut-down also lingered through the end of the quarter before being resolved, at least temporarily, the following day.

In fixed income, after an unusually challenging 2022, bonds continued to face headwinds and modestly drifted lower, driven by higher interest rates. This is in part due to additional rate hikes, resilience in the U.S. economy, worsening budget deficits, and quantitative tightening (i.e., the Fed unwinding COVID era asset purchases). Encouragingly, we believe that we're nearing the end of the rate hiking cycle, and rates now more fully reflect fiscal and monetary policy, which should provide a positive backdrop for go-forward returns in fixed income.

# U.S. Economic Trends

The U.S. economy continues to be surprisingly resilient. Corporate earnings are expected to continue growing this quarter while the unemployment rate remains near all-time lows. At the same time, inflation is subsiding, consumers are continuing to spend, and economists, as well as market prognosticators, are discussing the possibility of a 'soft landing', referring to the Fed's ability to squash inflation without creating a recession.

That said, our economic outlook is based on a 'mosaic' approach, where we combine a variety of quantitative and qualitative factors to inform our view. One particularly important data point is The Leading Economic Index (LEI), published by The Conference Board. The LEI is a 'mosaic' in its own right, and is a composite of ten economic indicators. Components include average weekly hours worked in manufacturing, weekly initial claims for unemployment insurance, new residential building permits, manufacturers' new orders for consumer goods and materials, among others. Importantly, the LEI has historically led changes in economic activity. The LEI continues to trend negatively and is one of the reasons we remain cautious on our economic outlook. See **Figure 2**. Additionally, the yield curve continues to be inverted, which means short-term rates are higher than long-term rates. Inverted yield curves have also historically preceded recessions.

In the late 16th century, when William Shakespeare wrote the Merchant of Venice, he recognized the importance of diversification. Like 'The Bard', we strive to build portfolios that will be resilient in a number of different scenarios, including upside and downside surprises to economic growth, interest rates, and commodity prices, with the continuous goal of our merchandise making us 'not sad'.

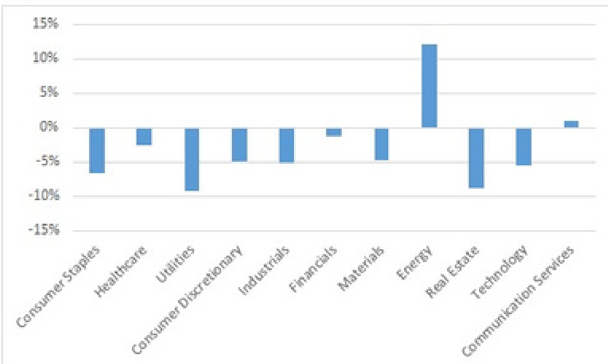
**Figure 2. US Leading Economic Index, Year-Over-Year % Change**


*Source: The Conference Board, Bloomberg*

# Domestic Stock Market

In Q3'23, the U.S. Total Market was down a modest 3.3%. The performance of mega-cap tech-focused companies, otherwise known as 'The Magnificent Seven', faded in the quarter, with only Alphabet, NVIDIA, and Meta generating positive returns. Looking at performance across industry groups, or sectors, there was a significant divergence. Within the S&P 500, the best performing sector beat the worst performing sector by more than 20 percentage points. 9 of the 11 GICS sectors generated losses, with Energy being the stand-out performer on the heels of higher energy prices. See **Figure 3**. Security selection also continued to be a meaningful driver of results, underscoring the need for active management. Importantly, we believe that the dispersion of stock returns will continue to be elevated going forward, particularly given higher interest rates, which should drive greater valuation discipline among investors.

**Figure 3. Q3'23 Returns By Sector**



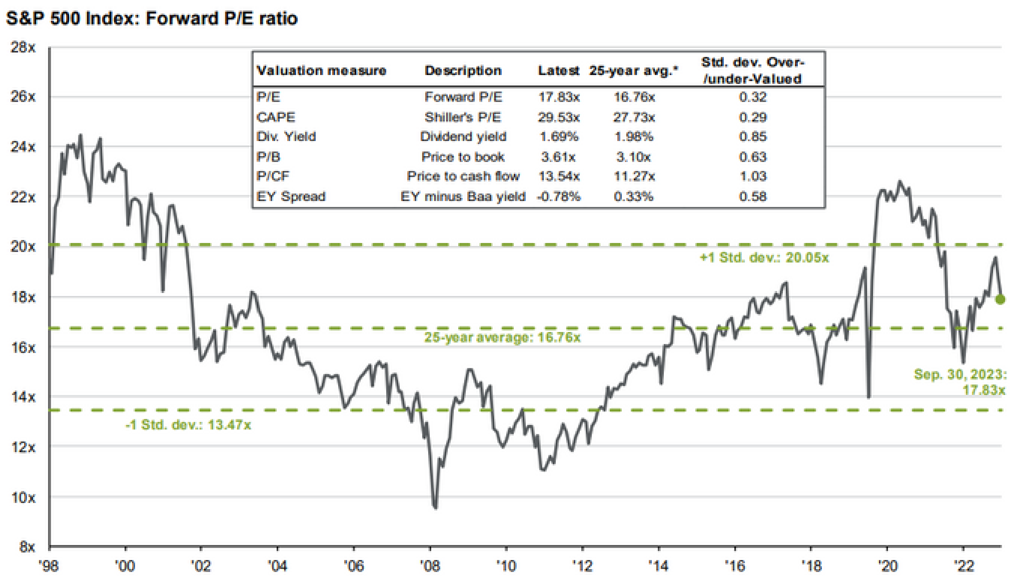

*Source: Bloomberg, sectors defined by SPDR funds*

Our conservative economic outlook influences our equity allocations in several ways. First, we place less emphasis on cyclical stocks (i.e. stocks that are reliant on economic growth), and greater emphasis on stocks with secular trends in place. Additionally, as we think about our allocation across sectors, we have a greater preference for 'defensive' industries, like utilities. Note that utilities have become meaningfully cheaper in recent weeks, which we believe may offer an attractive entry point. We also have higher conviction on funds that benefit from volatility, like covered-call writing strategies.

During the quarter, the price of Brent Crude increased 27.2%, but energy stocks, as defined by the Energy Select Sector SPDR (XLE), increased only 12.2%. While consumers may be having 'sticker shock' at the gas pump, oil prices have been meaningfully higher in the past, particularly after adjusting for inflation. In addition to geopolitical issues, a lack of capital investment in the energy industry has led to a meaningful supply shortage, that we expect to continue for the longer-term. As a caveat, we recognize that commodity prices are notoriously difficult to predict. That said, in the spirit of diversification, we think that real assets, including exposure to commodities, play a meaningful role in portfolios. As we go about 'scenario planning', higher commodity prices can be a cause of economic slow-down, and exposure to those same commodities may provide a partial offset in portfolios.

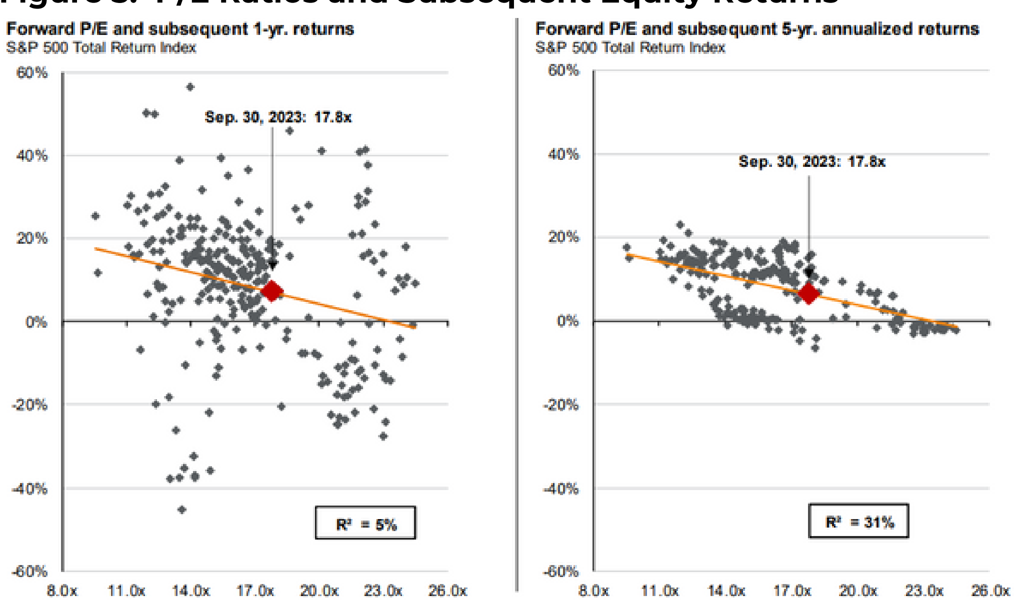
As always, our longer-term outlook for equities is largely based on valuation. Encouragingly, the combination of a modest decline in stock prices and continued earnings growth, has made valuations somewhat more attractive. At the end of Q3'23, the S&P 500 was trading at ~17.8x next twelve months earnings vs. a 25-year average of ~16.7x next twelve months earnings. This means that stocks are modestly more expensive than the historical average, but reasonable valuations, in our view, still set-up positively for go-forward returns. See **Figures 4 and 5**.

### Figure 4. S&P 500 Valuation Measures




*Source: J.P. Morgan Asset Management*

### Figure 5. P/E Ratios and Subsequent Equity Returns




*Source: J.P. Morgan Asset Management*

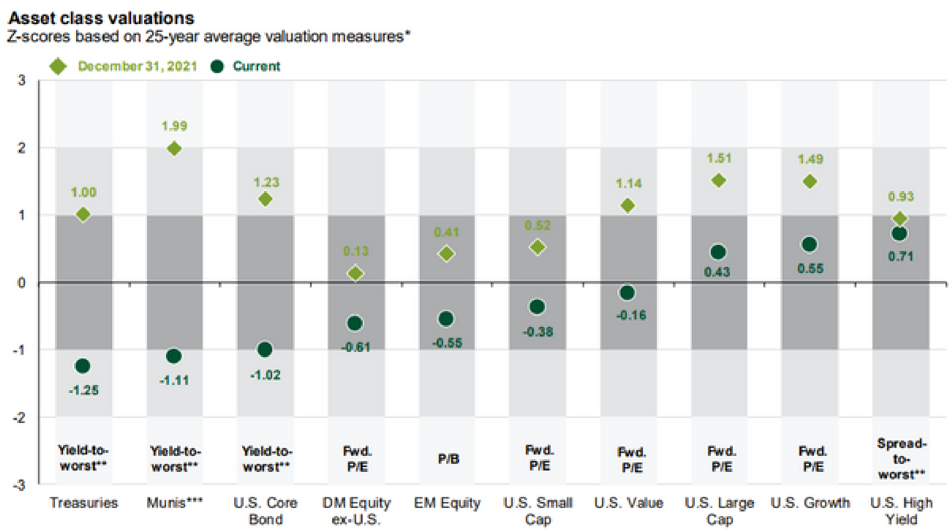
# International Stocks

In Q3'23, international developed and emerging market stocks were down 3.9% and 1.5%, respectively. The strongest contributors within international markets were India, Turkey, Norway, and Denmark. The biggest detractors were France, Germany, the Netherlands, and Switzerland.

Encouragingly, Japan, the largest international developed country, is seeing meaningful inflation for the first time since the 1980's. Additionally, wages are improving, which may contribute to the end of a long period of stagnation. At the same time, Japanese firms have improved their corporate governance, are more focused on profitability, and are increasingly returning cash to shareholders. To be sure, Europe continues to have its own unique economic challenges, and Germany has slipped into recession, after a number of policy missteps, including its well-publicized reliance on Russian natural gas and its exposure to a slower Chinese economy as an export market.

Valuations in international markets remain attractive. See **Figure 6**, for 'z-scores' based on 25 years of data. Z-scores refer to the number of standard deviations away from the historical average for each category. Green circles below '0' are cheap relative to history, and green circles above '0' are expensive relative to history. As you can see, Developed Markets ex-US and Emerging Markets are meaningfully cheaper than US Large Cap.

**Figure 6 Valuations Monitor**




*Source: J.P. Morgan Asset Management*

Additionally, to the extent that foreign currencies strengthen relative to the U.S. Dollar, there is additional upside for international equities. In our view, stickier inflation in Europe may lead to rates staying higher for longer vs. the U.S., and contribute to such an outcome over the medium-term. Note that currency moves tend to occur over long cycles. We'd also point out that environments with higher commodity prices tend to be favorable for emerging markets, since many of these countries rely on commodity exports.

# Fixed Income

Albert Einstein once said that 'everything should be made as simple as possible, but no simpler'. While we recognize the elevated complexity level surrounding fixed income markets, we attempt to lay out several core concepts and relate them to our investment decision-making process.

In Q3'23, the U.S. Aggregate Bond Index , which represents the investment grade bond universe in the United States, was down 3.2%. As a reminder, there is an inverse relationship between bonds and yields. As yields rise, bond prices fall, and vice versa. Intuitively, as rates rise, older bonds with lower fixed coupon payments become less valuable. Conversely, as rates decline, older bonds with higher fixed coupon payments become more valuable.

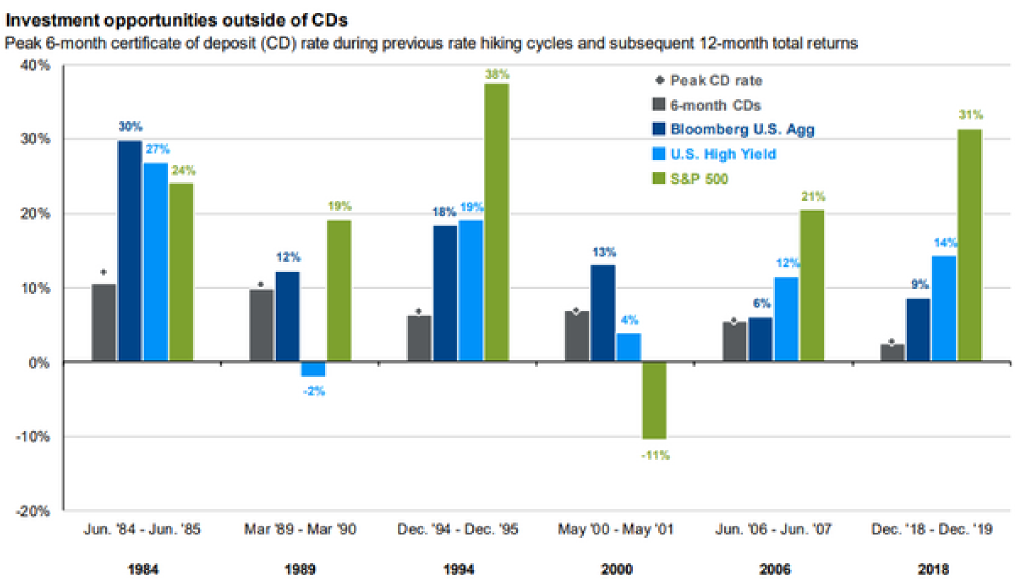
To quickly review recent history, the 10-Year U.S. Treasury rate bottomed at the unprecedented low-level of 0.52% in August 2020, and through the end of 2022, increased dramatically to 3.87%. As a result, the U.S. Aggregate Bond Index was down 13.0% in 2022, which was the worst year on record. During the 2023 year-to-date period, the ''Agg' was down an additional 1.2%, as rates continued to drift higher. The 10-Year U.S. Treasury finished the quarter at 4.57%. Higher rates have been the result of actions at the Federal Reserve (e.g., a rapid rise in the Fed Funds rate and quantitative tightening to unwind COVID era asset purchases), budget deficits at the federal government, as well as the resilient economy to date. Behavioral economics suggests that humans have a tendency to extrapolate the recent past into perpetuity. That said, the Fed appears to be reaching the end of its hiking cycle and rates now more fully reflect fiscal policy.

Another key driver of fixed income returns is 'credit spreads'. Credit spreads should be thought of as the additional yield received for investing in riskier fixed income securities (i.e., comparing a high-yield bond to a U.S. Treasury). Importantly, credit spreads should be wider (higher) in weaker economic environments and tighter (lower) in stronger economic environments. High-yield credit spreads are currently lower than their historical averages and have actually declined year-to-date. This implies that confidence is relatively high and fixed income markets are not yet pricing in a recession.

So how does this influence our fixed income asset allocation? Given our conservative economic outlook, and relatively tight credit spreads, we have a preference for higher quality, less risky fixed income securities. We also have an incrementally greater preference for longer duration securities, which benefit more when rates decline, since rates usually fall in a weaker economic environment. However, as a caveat, we'd also point out that to the extent clients see duration extended in their portfolios, durations are still below benchmark (i.e., the U.S. Aggregate Bond Index), in most accounts. Lower duration positioning year-to-date has been a contributor to relative performance. Risks to our thesis include stickier inflation and further interest rate hikes, among other things.

Separately, we've had a number of clients particularly focused on the high-rates on offer for CDs and money markets. While cash alternatives and short-term fixed income securities play an important role in portfolios, we would advocate for a more balanced approach. See **Figure 7.** for prior instances of peak CD rates during previous rate hiking cycles and subsequent 12-month returns across asset classes. Core bonds, as defined by the U.S. Agg, has regularly outperformed CDs, in part due to locking in higher yields before short-term rates roll-over. The S&P 500 has also tended to outperform by a wide margin.

### Figure 7. Peak CD Rate and 12-Month Subsequent Returns




*Source: J.P. Morgan Asset Management*

# Conclusion


As always, we continue to invest on your behalf, consistent with the PWM investment philosophy, and with a focus on the long-term. As the Federal Reserve nears the end of its rate hiking cycle, and markets evolve, we are working to diversify portfolios and identify new opportunities for growth. We consider it a privilege to help our valued clients reach their financial goals. Thank you for your continued trust and, as always, we remain available to address any questions or concerns.

Sincerely,

**Power Wealth Management**