Investment Commentary

HANOVER ADVISORS

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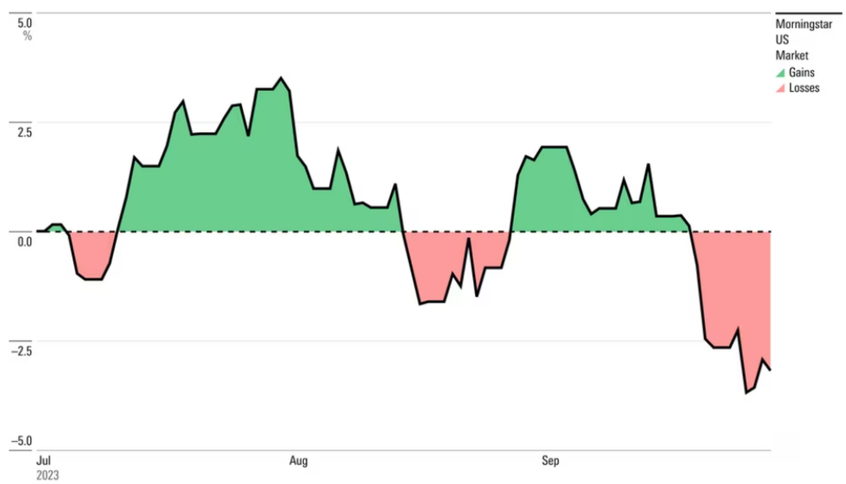
Q3 Review: No Boom, No Bust

As we head into the final quarter of the year, the prevailing theme regarding the economy has become "no boom, no bust." Inflation is trending down, the economy is expected to see moderate growth, and it appears the Federal Reserve may be on track to engineer something of a "Goldilocks" scenario, slowing the economy enough to bring down inflation, but without tipping the economy into a recession. Uncertainty remains elevated, and there are still potential risks on the horizon, but we enter the final quarter of the year with a sense of cautious optimism.

U.S. Stock Market Performance



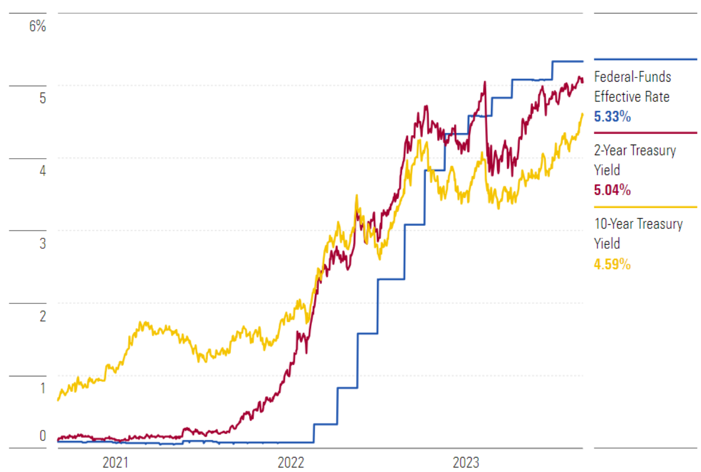
Source: Morningstar Direct. Data as of Sept. 30, 2023.

The first seven months of the year saw a strong rally in the markets that lifted stock prices from the heavy losses seen in 2022. By the end of July, the S&P 500 had recovered all but 4.4% of the 25.4% decline seen during the bear market of 2022. Unfortunately, the markets entered choppy territory in the late summer. The S&P 500 ended the quarter down 3.7% and has returned 10.16% year-to-date. The tech-heavy Nasdaq index has had a more impressive rebound this year, returning 24.7% year-to-date, but the index entered correction territory during the later part of the summer as investors reconsidered the impact that higher interest rates would have on the tech sector, which is more sensitive to rate changes. The Fed's recent messaging that rates will be higher for longer has also sent Treasury yields higher, leading to volatility and losses in the bond market. The broad-based Morningstar US Core Bond Index lost just over 3%, the largest quarterly loss since the third quarter of 2022, when many bond funds posted their worst losses ever. Historically, bonds have had a negative correlation to stocks, meaning that losses in the stock market are offset by gains in the bond market. Investors have had a challenging few years with both stocks and bonds seeing downward pressure.

It should be noted that much of the year's gains in the stock market have been highly concentrated among a handful of mega-cap tech stocks like Apple, Amazon, and Nvidia. As of early September, the top seven contributors to the U.S. stock market had returned a collective 66.3%. When these stocks are excluded, the Russell 3000's (a broader measure of the stock market than the S&P 500) year-to-date returns fall from 20.3% to just 10.8%. This handful of large-cap tech and communication stocks were also the hardest hit during last year's selloff, so much of this year's rally was making up for last year's losses. These stocks are also extremely expensive compared to the rest of the market's valuations. One of the best ways to analyze stock valuations is by looking at the ratio of price to earnings. Historically, the average ratio is 14. Today's mega-cap stocks are trading at levels far above this. Apple is trading at 28.77 times earnings, Tesla is at 70.88 times earnings, and Nvidia is trading at a staggering 99.5 times earnings. By comparison, Exxon Mobil is trading at just 9.3 times earnings and has gained more than 30% in the past 52 weeks. The dominance of just a handful of stocks in a singular sector introduces a great deal of concentration risk to the market, and we would like to see a broadening out of the market rally to other sectors of the market.

As has been the case since the central bank began its rate hike cycle, the Fed continues to drive much of the market. After raising interest rates from basically zero in early 2022 to their current level of 5.25%, the general consensus is that the hikes are likely nearing their end. The Fed left rates unchanged at the two most recent meetings of the Federal Open Markets Committee (FOMC), the collective of Fed chairs who determine the key Fed funds interest rate. We may see one more rate increase this year. Traders put the current odds at about 30%, but the forward-looking markets are already looking past another potential rate hike, and the question for investors has shifted from “how high will rates go?” to “how long will they stay elevated?” as investors try to assess a potentially lengthy period of high rates.

Treasury Yield and Federal-Funds Rate



Source: Federal Reserve Economic Database..

Projections from the latest FOMC meeting indicate that the Fed, having potentially achieved a rare soft landing (which has occurred just once out of the past 11 rate hike cycles), is attempting something even more rare: a gradual decline in interest rates. The Fed indicated no rate cuts until at least the second half of next year, and once they do begin coming down, the Fed intends a series of gradual decreases spread over several years. History suggests this is unlikely to come to fruition. There is a saying in finance that goes “rates take the stairs up and the elevator down.” Rate cuts historically come down quickly, usually in response to an economic downturn or financial shock, such as the financial crisis of 2007 or the Covid pandemic. Even during the one previous soft landing in the early 1990s, the Fed abandoned their rate cut plans as the economy picked up steam and inflation resurged. Still, the markets seem to have taken the Fed at face value and reacted to the prospects of a lengthy era of higher rates. Treasury yields surged and the markets were somewhat roiled, adding to the increased volatility we have seen in recent weeks. The key questions facing both investors and the Fed are whether rates are high enough to truly beat inflation and whether the economy has enough steam to power through a period of elevated rates. The impact of tighter monetary policy has been said to have a “variable and lagging” impact on the economy, meaning that it can take some time for higher rates to work through the economy before slowing growth and inflation.

On the inflation front, meaningful progress has been made. After peaking at an annual rate of 9.1% in June 2022, inflation, as measured by the consumer price index (CPI), had dropped to just 3.0% in June of 2023. Inflation reaccelerated in the end of the summer, and August’s annual CPI reading came in at 3.7%, highlighting the uneven path inflation is likely to take, even as it continues to trend down over time. More than half of August’s inflationary gains were due to higher energy prices. Energy prices surged 5.6% on a month-to-month basis, led by a 10.6% jump in gasoline prices as oil crested above $90 per barrel. The global energy supply is likely to remain constrained as geopolitical factors like the war in Ukraine and OPEC’s production cuts further exacerbate existing inefficiencies caused by governmental policies around the world that seek to move away from fossil fuels. This supports our stance that inflation is likely to remain “sticky” in the coming

months and years, not as high as recent peaks, but likely higher than the Fed's 2% target.

Another factor likely to keep inflation elevated is the housing market. After a red-hot run in the years following the pandemic, the highest mortgage rates in more than 20 years have brought the market to a virtual standstill. Existing owners who are locked into low mortgages are reticent to sell, resulting in historically low inventory on the market. The ultra-tight market has pushed prices higher, but mortgage demand has cratered, and many prospective buyers are being priced out. The good news is that rents have seen a substantial decline in recent months, and real time data regarding housing costs have shown a marked improvement. The bad news, however, is that the method CPI uses to calculate housing inflation is arcane and subject to significant lag, and housing costs account for roughly 40% of the total CPI reading. The severity of the lag and the sizable impact of the sector means that CPI is not a particularly accurate reflection of the prices consumers are facing.

Economists have begun to sound the alarm about this potentially skewed data and how it is misleading the Fed. Professor of Economics at Duke University, Campbell Harvey, best known for pioneering the idea that an inverted yield curve acts as a recessionary signal, argues that the Fed's reliance on lagging data "makes no sense whatsoever" and is totally "disconnected from market conditions." When shelter is excluded, inflation was up just 1.9% on a year-over-year basis in August, according to the Labor Department. In the professor's estimation, the Fed has already achieved its goal of taming inflation and is now at risk of driving the U.S. economy into a recession. It should also be noted, historically, that there is a lag between the initial yield curve inversion and a recession of about 14 months, which further supports Professor Harvey's view that we could be heading for a recession in the coming months.

Presently, recessionary risks appear subdued. Economic activity remains unexpectedly strong. Retail sales in August came in higher than expected, though the bulk of the increase was due to Americans paying more at the pump. Still, even when gas sales are excluded, retail sales increased 0.2% for the month. There are some signs that household budgets are being stretched by inflation. When adjusted for inflation, wages in August fell 0.5%. Reliance on credit cards has picked up, with the nation's collective credit card bill topping $1 trillion for the first time. Delinquencies have also ticked higher, as have credit card "losses," meaning the amount of debt that banks are writing off as uncollectible. Much has also been made of the declining household savings rate, which has plummeted from the levels seen when Americans were stashing away the government's generous stimulus checks. A large portion of that excess savings has been spent down, particularly in households at the lower end of the income spectrum, and the monthly savings rate is lower than pre-pandemic levels. Much of this is offset, however, by the increased wages Americans are receiving. The savings rate, as a percentage of income, has fallen, but that is largely because incomes have increased, so even if the amount saved has not significantly changed, it represents a smaller piece of a relatively larger pie. All things considered, household finances in the U.S. are strong.

The ultra-tight labor market—which has given workers additional leverage to push for higher wages, driving inflation higher—has shown initial signs of cooling. August's 187,000 new jobs were slightly above expectations but represent a slowdown from numbers seen in the post-pandemic era. Previous months also saw a sizable downward revision, with 110,000 fewer jobs created than initially reported. The unemployment rate saw a marked increase to 3.8%, up from 3.5% the month prior. This is potentially a welcome sign, however, as the increase represents an increase in the labor participation rate, which tracks the portion of the population who are either employed or actively looking for work. Some 736,000 Americans joined the workforce in August, bringing the participation rate to 62.8%, its highest level since February 2020, just before the pandemic began. This may be sign that more Americans are confident in the economy and the infusion of new workers means there is more slack in the labor market and wage gains should continue to slow, which is good news for inflation's trajectory. It may also be a sign that Americans are exhausting their savings and feel compelled to re-enter the workforce, which could mean weaker consumer spending in the coming months.

While the Fed and its efforts to combat inflation will continue to drive the markets, they may be relegated to background noise in the coming months as investors focus more on how strong the economy and corporate profits will be over the next 3 to 6 months. The recent resilience of the economy is likely to withstand another 25 or 50 basis point increase in interest rates. Analysts have shown surprising optimism in the coming months. Estimated S&P 500 profits for the S&P 500 are higher now than they were a month ago. Usually, estimates made months ahead of time are overly optimistic and get whittled down as time goes on. Seeing the opposite take place is quite rare and speaks to the market's confidence in the economy.

This is not to say that we are out of the woods entirely. The U.S. economy and indeed the entire global economy is in a very fragile place, and while it appears that we are successfully waling a tightrope between resurgent inflation and economic slowdown, the markets are very susceptible to external shocks. The country is facing a wave of strikes, with the latest being the autoworkers union. Most analysts feel the strike will have a muted impact on the economy, especially if it is resolved quickly and the union and automakers can reach an agreement that satisfies workers without making the companies less efficient or competitive. A similar bit of gamesmanship is taking place in D.C., as the government deals with a looming shutdown. Again, the markets expect the impact of the shutdown on the economy to be limited and investors are largely looking past Congress's performative antics. Still, there is a fog of uncertainty around the next 3 to 6 months and we may not have a clearer sense of the economy's momentum and inflation's winding path until early next year. In the meantime, investors should be aware of their risk tolerances, maintain a diversified approach, and focus on their long-term investing goals.

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