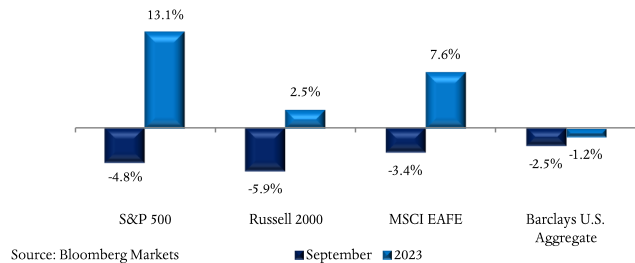




## MARKETS

Following a robust rally for stocks in the first half of 2023, Q3 saw profit taking on the back of rising interest rates and a fourth consecutive quarter of declining corporate earnings. The S&P 500 index pulled-back -4.8% in September and -3.3% in Q3 (+13.1% ytd). Driving the index are the “Magnificent 7” mega cap technology stocks, which command a 27% weighting and have gained approximately +84% in 2023. The equally weighted S&P 500 index has only risen +1.8% in 2023, indicating a lack of broad participation. In other signs that equities are still digesting elevated valuations, the Dow Jones Industrial Average is on track for another lackluster year (-3.4% in September; -2.1% in Q3; +2.7% ytd), while the Russell Microcap index (-6.7% in September; -8.0% in Q3; -6.3% ytd) showed its fragility. Overseas the situation is similar, with the exception of Japan which was the best performing major equity market in local currency terms, returning 2.5% in Q3 (+24.5% ytd) with Yen weakness continuing.

In fixed income markets, long-dated US Treasury bond yields posted their biggest quarterly advance since 2009. The 10-year yield rose 74bps in Q3 to a peak of 4.69%, marking a 16-year high. There are various theories as to why long rates are moving higher: tightening liquidity from the Fed including QT, sales of US Treasuries by China, much greater government bond issuance to fund multi-trillion dollar annual federal budget deficits, as well as the recent US sovereign rating downgrade. With the Fed approaching the end of its rate hike cycle, the shorter-end 2-year Treasury yield rose a relatively modest 15bps. The US Aggregate bond index declined -2.5% in September (-3.2% in Q3; -1.2% ytd). High yield bonds remain the top performing fixed income segment, with year-to-date returns of +6.0%, aided by short maturities and stable credit spreads.



Commodities have outperformed of late, returning +3.1% in September (+12.8% in Q3; -0.07% ytd), echoing the market dynamics of 2022. Energy prices surged, led by a 29% quarterly gain in WTI crude, catalyzed by the announcement that Saudi Arabia and Russia will extend voluntary oil output cuts through year-end. During the quarter, gas and heating oil rose 41% and 37%, respectively, while EU natural gas rose 13%. Precious metals were soft, with gold and silver declining -4% and -2%, respectively, while industrial metals were mixed. Higher commodity prices threaten to slow the global economy, curtail consumer spending and re-accelerate inflation, putting central bankers on alert.

## GEOPOLITICS

September 30 marked the end of the US federal government's fiscal year. Leading up to the eve of this date, Congress had not passed the twelve appropriations bills required to form the new fiscal budget to fund the American government. Barring a deal or “continuing resolution” a government shutdown was possible. Finally, three hours before the deadline, the Senate passed a last-minute stopgap funding measure which allowed the government to operate through November 17. Importantly, a government shutdown would not equate to a default, like the recent debt ceiling standoff could have, and not every federal agency would be affected. Treasury auctions would continue, interest payments would be made, Social Security and Medicare benefits would be paid and essential federal workers like air

traffic controllers and law enforcement would still continue to work. The longest government shutdown in history was 35 days from December 2018 to January 2019, which the CBO estimates cost \$11 billion, reducing real GDP by 0.3%, but about \$8 billion was recovered once activity resumed. Roughly 800,000 federal workers were furloughed or worked without pay. However, impacted workers did receive backpay once the government reopened. The US budget deficit remains large at 6% of GDP, an unsustainable level that requires increased fiscal discipline.

### UNITED STATES

US manufacturing took a further step towards recovery in September as production picked up and employment rebounded. Data also showed that prices paid for inputs by factories fell considerably, a confirmation that inflation remains in a downward trend on the back of a supply chain recovery. The latest employment data showed that the US labor market is still hot with the creation of 336,000 new jobs for the back-to-school period, above both expectations and pre-pandemic averages. The unemployment rate was unchanged at 3.8%, and average hourly earnings rose 4.2% year-over-year. Firms in leisure and hospitality stepped up their hiring, with employment at restaurants and bars returning to normalized levels. Unfortunately, housing affordability has reached 30+ year lows as high mortgage rates and still elevated home prices have outweighed modest income growth. This is corroborated by the index of home-purchase applications which fell to the lowest level since 1995 (when the population was 70 million less). Comments from Federal Reserve policymakers suggest a further rate hike is to come before the end of the year, to which the market ascribes a one-third chance, while their dot plot now illustrates a higher median rate for 2024 (5.1% vs 4.6%).

The post-pandemic inflationary environment and worker shortage has ushered a balance of power shift from corporations to labor, reversing a multi-decade long trend. September 15 marked the start of a United

### September 2023 Economic Statistics

	Sep-23	Dec-22	Dec-21
Federal Funds Target Rate	5.25 - 5.50%	4.25 - 4.50%	0 - 0.25%
Consumer Confidence Index	103.0	108.3	115.8
Manufacturing PMI Index	49.0%	48.4%	58.7%
Unemployment Rate	3.8%	3.5%	3.9%
JPY / USD	149.35	131.11	115.08
USD / EUR	1.0570	1.0702	1.1368
Gold / oz.	\$1,848.31	\$1,824.40	\$1,828.39
Oil (WTI) / bbl	\$90.79	\$80.26	\$75.21

Sources: see disclosure \*

Auto Workers (UAW) strike, the largest of many currently underway nationwide. The UAW represents nearly 150,000 employees at the so-called “Big Three” auto makers (Ford, General Motors, and Stellantis) that account for roughly 50% of US annual vehicle production and roughly 1.5% of GDP. The scope of the strike was initially limited to 18,600 participants and has since expanded by an additional 5,600 workers, with a potential to grow and persist. A confluence of events are at work. The Big Three, which have higher production costs than the competition, are heavily-indebted and investing billions into the transition to electric vehicles. Meanwhile, inflationary forces are curtailing the purchasing power of workers.

### EUROPE

The eurozone economy likely shrank last quarter, on the back of a slack in demand as indebted consumers reined in spending in the face of rising borrowing costs and higher prices. Regional manufacturing activity remained mired in a deep downturn as evidenced by an extremely contractionary reading of 43.4%. Further, both the composite and services PMI's of 47.2% and 48.7%, respectively, were indicative of a broad based decline in output. In one bright spot, services firms increased headcount, filling outstanding job gaps, as workers reenter the workforce. The Euro-19 unemployment rate rests at a record low of 6.4%.

Data showed that eurozone inflation slowed to a two-year low of 4.3% in September, down from 5.2% in August, still crimping consumers' disposable income.

This could potentially pave the way for the European Central Bank to put an end to interest rate increases (which were ratcheted up by 75bps over the past quarter) amid tepid economic growth.

### ASIA

China's economic recovery continues to disappoint, with both investment and consumption momentum remaining weak. Authorities have cut policy rates, as well as relaxed mortgage restrictions, with more likely to come in order to materially revive the economy, which is being heavily weighed on by the troubled real estate sector.

Japan's central bank kept the nation's main interest-rate targets unchanged, in negative territory, citing deflationary risks should monetary policy tighten too soon. The BoJ's action seems surreal given that the local CPI increased 3.1% in August from a year earlier, with the core reading rising 4.3%. Both metrics have been well above the Bank of Japan's 2% inflation target for the past 17 consecutive months. It's no wonder then that the value of the yen has weakened 12% relative to the US dollar.

### OUTLOOK

Recent economic data points towards a deterioration in economic growth, with services activity starting to follow the already weak manufacturing sector. Coupled with a continued moderation in inflationary pressures, investors are increasingly confident we are near a peaking in the global hiking cycle. The focus has thus shifted to how long central banks will hold rates at restrictive levels, what criteria they are focusing on, and how preemptive they might be. Fiscal sustainability is another area of concern for investors after long US Treasury yields rocketed higher, stemming partly from concerns over the significantly larger amount of debt issuance that will be required to sustain multi-trillion dollar annual deficits. Despite resilient economic activity thus far in 2023, recession risks remain elevated and not all market segments appear appropriately priced for such a scenario. Our research indicates that for the foreseeable future the US Treasury market will be the leading indicator for other asset classes.

With regard to equities, according to FactSet, Q3 earnings for the S&P 500 declined 0.2%, the fourth straight quarter of negative momentum. For Q4 2023, analysts are projecting a recovery of earnings and revenue growth of 8.2% and 3.8% respectively. The trend is expected to continue into 2024, with estimated earnings growth of 12.2%. Should that come to pass, the S&P 500's forward 12-month PE ratio is 18.0, which is below the five-year average of 18.7 but above the ten-year average of 17.5. This should provide reasonable valuation support. The smaller capitalization segment of the US equity market does, however, offer seemingly more compelling value. "The Russell 2000 finished September 2023 with a 2.4% 5-year annualized return—a performance nearly identical to its year-to-date result through the end of 3Q23 and evidence of just how underwhelming recent returns have been for the small-cap index. ... Yet the average price to earnings ratio for the Russell 2000 five years ago on 9/30/18 was 18.4x—close to its long-term average of 18.1x—versus 12.5x at 9/30/23. While returns have stalled, multiples have compressed, creating a considerable number of buying opportunities." (Credit: Royce Investment Partners). There has been a tremendous, decade-long, capital concentration in the US Dollar and large capitalization domestic stocks, leaving US small-caps, as well as foreign developed and emerging market equities on sale.

The positive correlation between stocks and bonds in the third quarter (as well as 2022) is a timely reminder of the importance of alternative assets. Such exposure should provide ballast to traditional portfolios through diversification and non-market correlation. Short-term government bonds and certain credit opportunities finally offer investors reasonable risk-adjusted returns. Commodities, especially agricultural related ones, stand to benefit from cyclical tailwinds stemming from underinvestment and the potential for scarcity and supply shortages, amid geopolitical instability. In the real estate sector, we are seeing interesting special situations due to scarcity and secular regional growth. Finally, we are seeking to benefit from disruptive technology trends in the defense, edu-tech and cybersecurity sectors.

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\*Sources: Reuters, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Institute for Supply Management, MSCI, Russell, Standard & Poor's, Financial Times and the Wall Street Journal.