

Quarter-In-Review – It was a difficult quarter for investors across almost the entire risk spectrum. Fixed income investors were faced with surging bond yields, making it tough to preserve capital. Intermediate-term Treasuries lost -4.5% for the quarter as the yield on the 10-year soared from 3.81% to 4.58%. Those unfortunate enough to own long-term bonds experienced double-digit losses. The only safe haven were short-term Treasury bonds (which gained +0.6% for the quarter) and cash (where money market yields are now roughly 5.25%). Short-term bonds made money in 3Q despite the increase in the 2-year yield. For the first time in years absolute yields at the short end of the curve are generous enough to compensate for any price fluctuations. We will circle back to this shortly.

What happened in the bond market fed back into the equity markets. Stocks corrected across the board as investors priced in the idea that yields are likely to stay higher for longer. All the major equity indexes lost between -2% and -5% for the quarter, with small-cap stocks suffering the worst (they are barely hanging on to their gains for the year). Interest rate sensitive sectors of the stock market struggled the most. For example, REIT stocks lost -8.6% for the quarter, bringing the YTD loss to -5.4%. Similarly, utility stocks declined -9.4% for the quarter, and are now down -14.7% for the year.

Returns this year for REITS, utilities, and small-caps highlight another feature of the market in 2023. Performance for the S&P 500 is being driven by the seven largest stocks (the so-called magnificent seven). The average large-cap stock this year is only up +1.7%, while the average small-cap stock is currently in the red. Anyone without large positions in Amazon, Apple, NVIDIA, etc. (which means almost everyone) are almost certainly lagging the S&P 500 index this year.

The Bond Market Dilemma –

Last quarter we speculated that the second half of 2023 was going to be much trickier than the first half of the year. This view was based on the fact that we thought the market was pricing in three somewhat mutually exclusive scenarios at the end of June. Namely, 1) global central banks cutting rates in the second half of 2023, 2)

Market Benchmarks			
Market Indices	3Q23	YTD	3-Yr An
S&P 500 Index	-3.3%	+13.0%	+10.0%
Russell 2000	-5.2%	+2.5%	+7.0%
Global Equities	-3.5%	+9.7%	+7.1%
Int'l Index (EAFE)	-4.9%	+6.9%	+5.7%
Emerging Mkts	-2.2%	+2.4%	-0.4%
Other Indicators			
	9/30/23	6/30/23	12/31/22
Fed Funds Rate	5.25%-5.5%	5%-5.25%	4.25%-4.50%
2-Year Treasury	5.06%	4.87%	4.43%
10-Year Treasury	4.58%	3.81%	3.88%
S&P 500 P/E Ratio*	17.8	19.1	16.7
Crude Oil	\$90.90	\$70.56	\$80.35
Core Inflation	3.9%	4.6%	4.7%
*Forward 12-month operating earnings per S&P			

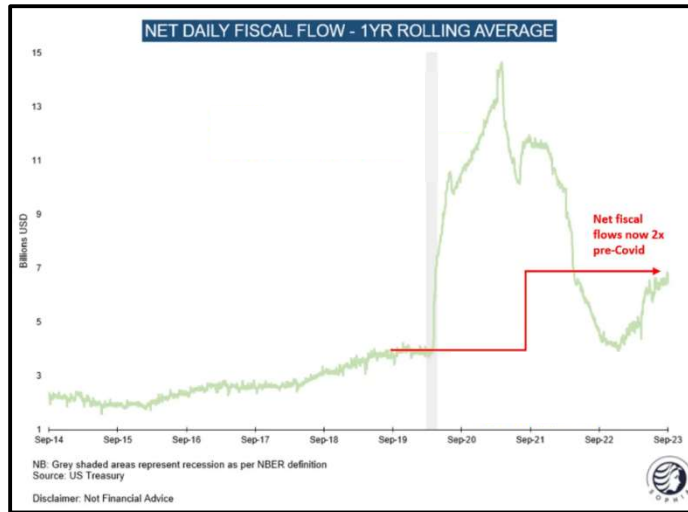
inflationary pressures moderating, and 3) a continued global economic expansion. At the time we thought that at best only two of these three macro trends could coexist simultaneously. And specifically, we thought the odds of lower rates in the back half of the year were remote. That’s certainly proved to be the case as both short-term and long-term interest rates have moved higher over the last three months. How big of a problem are rising rates, both for the economy and the markets? To answer that question we have to talk about why the economy has proved to be more resilient than expected.

What’s Different This Time – The chart at the bottom of the page is worth studying as it captures our species herd like mentality, at least when it comes to the markets. Back in November of last year only 10% of investors surveyed thought a recession was **unlikely** over the next twelve months. If you think back to late last year, stocks were mired in a bear market, the yield on the 10-year Treasury was sub-4%, and Fed Funds futures were pointing towards rate cuts in the back half of 2023. But growth in the first and second quarters of this year was +2% or better, and the

third quarter is tracking at close to +5%. So much for consensus thinking!! While we covered in our last letter why the U.S. economy is outperforming, it’s worth touching on the topic again while keeping in mind how these factors might change in a world of significantly higher interest rates and energy costs.



No Fiscal Brake – One of the most startling features of the post-COVID world is simply how pro-cyclical fiscal policy has become. What we mean by this is that despite the positive growth surprises of the last few quarters, fiscal spending has soared. The chart to the right shows daily fiscal spending going back to 2014 in billions of dollars. There's the now all too familiar surge during COVID followed by a quick retrenchment as things got back to normal. However, since the end of last year spending has soared to roughly 2X the pre-COVID levels, and neither the debt ceiling standoff nor the threatened government shutdown has done anything to stop the growth. There are a number of reasons for this spike. A few key spending plans like the CHIPS and Science Act, the Inflation Reduction Act, and the Infrastructure Act are kicking into gear, and the debt ceiling compromise basically removed any debt limit until 2025.



An often-overlooked feature of a higher rate regime is how much the government is spending on interest payments. The chart below shows that this is currently running at a little over \$900bn a year, but given today's rates and maturity schedule, should hit close to \$1.2tn next year. This is income for someone, be it a college endowment, insurance company, or individual investor. In a strange way a large government debt load can be pro-cyclical in a rising rate environment if interest payments are financed rather than paid for through higher taxes (which is the case today).

Private Sector Balance Sheets – One underappreciated factor of the last three years is simply how much personal and corporate debt was refinanced into longer-term loans at low rates. Think of your mortgage, if you have one. Almost certainly you've refinanced into a fifteen or thirty-year fixed rate loan at 3.5% or less. It's the same in the corporate world. So much so that net corporate interest expense is lower today than it was in 2020 despite the increase in rates. Part of this is due to debt refinancing, but the other part is due to increased interest income on cash balances. Again, this is true for consumers. Who is going to pay down a mortgage today when cash yields over



5% and your thirty-year mortgage costs 3%? Both the consumer and corporate sector are proving to be largely immune to rate increases so far, but this should moderate over time. Consumer loans for such things as cars are harder to come by, and lending to apartment and real estate ventures is getting tight.

Re-Industrialization – We touched on this topic last quarter, but this is going to be a long running theme.

Corporate spending on plant and equipment is growing rapidly and is tied to four major trends – 1) efforts to improve efficiency to offset rising labor costs, 2) building U.S. based manufacturing facilities to harden supply chains, 3) renewable energy investments, and 4) manufacturing semiconductors in the U.S. This new investment is showing up in the data in a meaningful way. Manufacturing and construction spending has basically doubled as a percent of GDP over the last couple years. Now admittedly, it's coming off a low base, but what matters for growth and inflation are changes at the margin.

Now how sensitive is this trend to interest rates? We noted earlier that fiscal spending and private sector balance sheets might actually be geared positively to higher rates. By that we mean that spending increases as rates increase, within certain boundaries. This isn't the case for capital expenditures. They are likely to prove sensitive to rate increases at some point.

The Energy Wildcard – No discussion of the economy would be complete without touching on the main topic during dinner time conversations – what's happening with gasoline prices?? Much of the problem is a supply story, with the group called OPEC+ doing little to increase production despite tight inventory levels. Furthermore, the benefit from releasing crude from the Strategic Petroleum

Reserve has probably run its course, and if anything might reverse if the administration starts to refill the tanks (unlikely in an election year). But there's no easy solution to higher energy costs. What's interesting from a macro perspective, though, is that today's gasoline costs relative to wages are roughly in line with the long-term average (see the chart at the top of the next page). Now this doesn't make anyone excited about

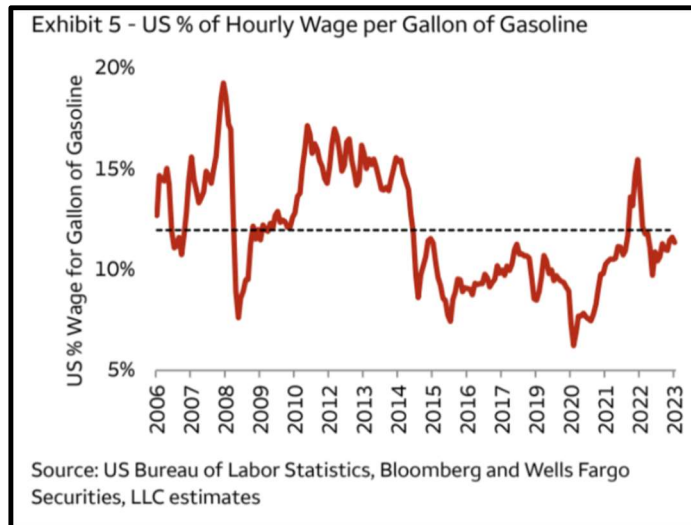
spending \$6 on a gallon of gas, but for the economy as a whole it means pump prices are unlikely to be a recession trigger (although they should be a headwind in the coming months).

Inflation and Energy - Higher energy costs are far more problematic when it comes to the outlook for inflation. For most of this year inflation has been on a downward trajectory, largely as economists expected. Moderating supply chain inflation combined with slower

rent growth have all helped pull core inflation down to below 4%. But in recent weeks the markets have started to worry that we've seen the easy gains. Energy costs are obviously a factor. \$90 crude and \$6 gasoline and diesel prices means that headline inflation ticked higher in August, and further increases can't be ruled out. The market was also unnerved a couple weeks ago when the Fed released their projections for inflation and said they don't see inflation getting down to their 2% target until 2026. And there are plenty of analysts willing to take 'the over' on this bet as long as fiscal spending is running hot. Another inflation wildcard remains the labor market. A continued tight market combined with rising prices is leading to more and more labor unrest. United Airline pilots just received a large pay increase, and while the outcome of the auto strike is anyone's guess, it's hard not to think that a material pay increase is in the works. Don't get us wrong, we are not arguing against such moves, we are just noting that all of this plays into a hotter for longer inflation story.

Central Banks Higher for Longer – So why did rates go up in the third quarter and stocks lose ground? The headline answer is that the market started to price in higher neutral central bank rates around the world. For example, at the beginning of this year, investors in the U.S. were thinking the Fed would hike rates to roughly 4.9% by June 2023 before cutting them to 4.5% by the end of the year. Now investors bet that the Fed hikes one more time to 5.5% and keeps rates essentially at that level through all of 2024. This is a big change, and as a result the entire yield curve moved higher in the third quarter and equities sold off as multiples contracted. But the \$64 trillion question is how far into the future should such a scenario be extrapolated? Will the Fed keep tightening until something cracks, or can they achieve the fabled soft landing whereby both growth and inflation moderate without a big increase in unemployment?

Two Possible Paths Forward – Forecasting the future is fraught with uncertainty even at the best of times. Humans



seem naturally programed to extrapolate recent trends and be overly confident in their views of the future, despite numerous examples of our fallibility. And trying to guess what the future holds in the post-COVID world is doubly hard. But let us lay out two possible paths forward then speculate about which is most probable, or at least which path appears to be the consensus view.

Turning Up The Heat This is the overheating scenario. Fiscal spending continues to pump untold billions into the economy. Consumers and corporations, largely insulated from rising interest rates, continue to spend, and corporate investment booms. The good news is that wage growth accelerates and unemployment stays low. The bad news is that inflation hooks higher. Throw in \$100 oil and \$7 gasoline prices and, as 2024 unfolds, it becomes clear that a series of hikes is needed. Under this scenario the Fed's number one goal will be battling inflation. Both stocks and bonds would struggle as rates go higher. Maybe more worrisome is that the Fed risks overshooting on the high side, and the negative feedback loop from weaker financial assets would probably increase the odds of a recession in the second half of 2024.

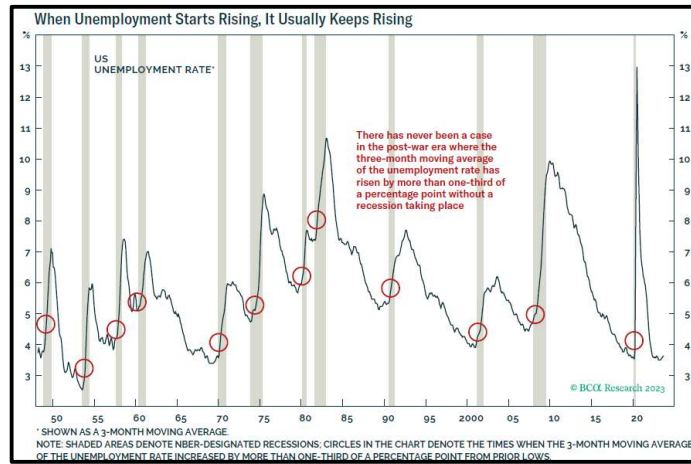
A Slowdown Comes Into View This scenario is all about the lags between a certain action or price movement and when they have an impact on the real economy. For example, it takes some time for higher crude prices to filter through all the channels into economic activity. It's not like a price spike on day one will pull down consumer spending in a week, or even a month. It's the same with rate hikes. Studies suggest that at the best of times it can take nine to eighteen months for a rate move to have a measurable economic impact. After all, it takes time for loans to refinance at higher rates and for tighter lending standards to crimp credit creation. If you buy into this idea, we are probably on the cusp of an economic slowdown simply due to the increase in interest rates and the run in oil prices the last few months. It probably won't show up in the third quarter growth data, but early projections for the fourth quarter show a noticeable slowdown. The bad news is that slower growth translates into less of an earnings tailwind for the stock market. But the good news is that the current fears about an inflationary spiral leading to much higher interest rates are misplaced. If anything, the recent spike in longer-term yields might be it for the fixed income bear market of 2021 to 2023. Now the Fed isn't going to be cutting rates in the first half of next year, but policymakers would go from being an adversary to at

least a neutral party. This scenario would also be supportive for the equity market. Yes earnings growth could slow, but the Damocles sword hanging over the market has been monetary policy. Take this away and stocks could stage a rally, at least over the short-term.

Weighing the Risk and Reward

It's all well and good to lay out two theoretical scenarios, but how do you pick between the two? But maybe a better question (or a more answerable question) is what scenario is priced into the markets today? As we noted earlier, if you think back to the end of 2022, the consensus view was recession in 2023. Market pricing reflected this view and in retrospect it would have been tough to make money even if the consensus scenario had played out. Today the tables have turned somewhat. We aren't at the extremes we saw late last year, but we'd say that investors are betting on the overheating scenario. Bond yields seem to be increasing every trading day, oil prices are on a tear, and stocks are struggling despite a better-than-expected earnings backdrop. We suspect this market narrative is too one-sided for the world we live in. After all, feedback loops are critical in any complex system. You can't see the yield on the 10-year Treasury, probably the most important financial price in the world, go through the repricing it did in the third quarter without consequences. And we think that fallout will be slower growth in the next couple quarters that takes the air out of the inflation trade.

Does this mean yields are likely to fall? Maybe not. But we could be in for a period of stability. If so, there are finally some interesting values in the fixed income market. Both cash and short-term bonds offer yields above inflation, and even the risk in the longer-term bonds is less than many think. For example, if you bought a 10-year Treasury today with a yield of 4.75% and interest rates went to 5.5%, your total return over the next year would be just -1.8% (price change plus income). However, if yields fell to 3% your total return would be over +16%. This doesn't mean you should flock into long-term bonds at this



point, but the risk/return equation in fixed income is starting to look interesting for a lot of investors.

If bond yields are set to stabilize, stocks could be in for something of a reprieve after a tricky third quarter. A couple of softish inflation or jobs reports would do the trick to spark a bounce back because it would mean investors start to price out a more hawkish Fed scenario.

But beyond the short-term, equities are likely to be sensitive to recession risks next year. Historically, stocks have peaked roughly six months before the beginning of a recession. And what has been the most reliable harbinger of recession? The labor market. As you can see above, there's never been an instance when the unemployment rate has increased by a third of a percentage point without a recession taking place. As we said, we don't think anyone should take a firm view on the risk of recession over the coming year, but this will be a key indicator.

Final Thoughts – We saw a sea change in the markets during the third quarter as investors started to price in a higher for longer scenario. Granted, the economic and earnings backdrop in the U.S. remained robust, but the markets took their cue from the changing outlook for monetary policy. As the final quarter begins, we suspect the narrative could once again shift. The lagged impact from higher rates and soaring energy costs is likely to trickle through to the real economy, and we wouldn't be shocked that we are talking about an economic slowdown by early next year. This may provide some relief for the beleaguered fixed income markets, and at a minimum, the risk/return equation in U.S. government bonds looks much more intriguing than it did at the end of 2022. It's been costly to doubt the U.S. economy the last few quarters, and it's quite possible optimism will continue to be the name of the game in 2024. But we think it will be important to be sensitive to changes in the labor market next year to gauge the lagged impact of rates and energy on the real economy.

Charles Blankley, CFA
Chief Investment Officer

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