

Stegent Equity Advisors, Inc. Investment Letter

Market Review

October 2023

The S&P 500 rose to the highest level since March 2022 early in the third quarter but rising global bond yields, fears of a rebound in inflation and concerns about a future economic slowdown weighed on the major indices in August and September and the S&P 500 finished the third quarter with a modest loss.

The S&P 500 started the third quarter largely the same way it ended the second quarter – with gains. Stocks rose broadly in July thanks primarily to “Goldilocks” economic data, meaning the data showed solid economic growth but not to the extent that would have implied the Federal Reserve needed to hike rates further than investors expected. That solid economic data combined with a decline in inflation metrics to further boost stock prices, as investors embraced reduced near-term recession risks and steadily declining inflation. The Federal Reserve, meanwhile, increased interest rates in late July but also signaled that could be the last rate hike of the cycle. That tone and commentary further fueled optimism that one of the most aggressive rate hike cycles in history was soon coming to an end. Finally, Q2 earnings season was better-than-feared with mostly favorable corporate guidance which supported expectations for strong earnings growth into 2024. The S&P 500 rose to the highest level since March 2022 and the index finished with a strong monthly gain of more than 3%.

The market dynamic changed on the first day of August, however, when Fitch Ratings, one of the larger U.S. credit rating agencies, downgraded U.S. sovereign debt. Fitch cited long-term risks of the current U.S. fiscal trajectory as the main reason for the downgrade, but while that lacked any near-term specific justification for the downgrade, the action itself put immediate downward pressure on U.S. Treasuries, sending their yields meaningfully higher. The Fitch downgrade kickstarted a rise in Treasury yields that lasted the entire month, as the downgrade combined with a rebound in anecdotal inflation indicators and a large increase in Treasury sales stemming from the debt ceiling drama pushed yields sharply higher. The 10-year Treasury yield rose from 4.05% on August 1st to a high of 4.34% on August 21st, the highest level since mid-2007. That rapid rise in yields weighed on stock prices throughout August and the S&P 500 posted its first negative monthly return since February, as higher rates pressured equity valuations and raised concerns about a future economic slowdown. The S&P 500 finished August down 1.59%.

The August volatility subsided in early September, however, as solid economic data and a pause in the rise in Treasury yields allowed the S&P 500 to stabilize through the first half of the month. But volatility returned following the September Fed decision as the FOMC delivered markets a “hawkish” surprise, despite not increasing interest rates. Specifically, the majority of Fed members reiterated that they anticipated the need for an additional rate hike before the end of the year and forecasted only two rate cuts for all of 2024, down from four rate cuts forecasted at the June meeting. Then, late in the month, two additional developments weighed further on both stocks and bonds. First, the United Auto Workers labor union began a general strike, a move that would disrupt automobile production and temporarily weigh on economic growth. Second, the U.S. careened towards another government shutdown as Republicans and Democrats failed to agree on a “Continuing Resolution” to fund the government. The shutdown was avoided at the last minute, but the funding extension only lasts until November 17th meaning there will likely be another budget battle in the coming months. The S&P 500 declined towards the end of the month to hit a fresh three-month low, ending September down modestly.

In sum, volatility returned to markets during the third quarter, as rising bond yields pressured stock valuations, some inflation indicators pointed to a bounce back in inflation and the Fed reiterated a “higher for longer” interest rate outlook.

Third Quarter Performance Review

Rising bond yields were the main driver of the markets in the third quarter as high Treasury yields caused reversals in performance on a sector and index basis, relative to the first and second quarters.

Starting with market capitalization, large caps once again outperformed small caps, as they did in the first two quarters of 2023, although both posted negative returns. That relative outperformance by large caps is consistent with rising Treasury yields, as smaller companies are typically more reliant on debt financing to sustain operations and rising interest rates create stronger financial headwinds for smaller companies when compared to their larger peers.

From an investment style standpoint, however, we did see a performance reversal from the first two quarters of the year as value relatively outperformed growth in the third quarter, although both investment styles finished with a negative quarterly return. Rising bond yields tend to weigh more heavily on companies with higher valuations and since most growth funds overweight higher P/E tech stocks, those funds lagged last quarter. Value funds that include stocks with lower P/E ratios are less sensitive to higher yields, and as such, they outperformed in the third quarter.

On a sector level, nine of the 11 S&P 500 sectors finished the third quarter with a negative return, which is a stark reversal from the broad gains of the second quarter. Energy was, by far, the best performing S&P 500 sector in the third quarter thanks to a surge in oil prices. Communications Services also finished Q3 with a slightly positive quarterly return on hopes integration of advanced artificial intelligence would boost search and social media companies’ future advertising revenues.

Looking at sector laggards, the impact of rising bond yields was again clearly visible as consumer staples, utilities and real estate were the worst performing sectors in the third quarter. Those sectors offer some of the highest dividend yields in the market, but with bond yields quickly rising those dividend yields become less attractive and investors rotated out of the high-dividend sectors and into less-volatile bond funds as a result.

US Equity Indexes	Q3 Return	YTD
S&P 500	-2.08%	13.07%
DJ Industrial Average	-1.28%	2.73%
NASDAQ 100	-1.30%	35.37%
S&P MidCap 400	-3.57%	4.27%
Russell 2000	-4.76%	2.54%

Source: YCharts

Internationally, foreign markets saw moderate declines and again lagged the S&P 500 in the third quarter as disappointing economic data in Europe and China bolstered regional recession fears. Emerging markets did relatively outperform developed markets, however, thanks to the announcement of larger-scale Chinese economic stimulus late in the quarter.

International Equity Indexes	Q3 Return	YTD
MSCI EAFE TR USD (Foreign Developed)	-3.22%	7.59%
MSCI EM TR USD (Emerging Markets)	-2.48%	2.16%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	-2.96%	5.82%

Source: YCharts

Commodities saw substantial gains and were the best performing major asset class in the third quarter thanks to a significant rally in the energy complex. Oil rose throughout the quarter on continued supply concerns as Saudi Arabia and Russia extended voluntary supply cuts to the end of the year. Meanwhile, demand estimates rose late in the third quarter following the aforementioned announcement of the large-scale Chinese stimulus plans, causing prices to rise sharply late in the quarter. Gold, meanwhile, declined moderately thanks primarily to the stronger U.S. dollar, which rallied steadily over the course of the third quarter, hitting a fresh 2023 high in September.

Commodity Indexes	Q3 Return	YTD
S&P GSCI (Broad-Based Commodities)	17.06%	7.24%
S&P GSCI Crude Oil	29.85%	12.73%
GLD Gold Price	-3.10%	1.40%

Source: YCharts/Koyfin.com

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) declined moderately for a second consecutive quarter as hawkish Fed rhetoric and hints of a rebound in inflation weighed broadly on fixed income markets.

Looking deeper into the bond markets, shorter-duration debt securities posted a positive quarterly return and outperformed those with longer durations in the third quarter, as the Fed did not signal it intended to raise interest rates any higher than previously expected. Longer-duration bonds, however, were pressured by the combination of a rebound in some inflation indicators and as investors digested that the Fed may well delay any rate cuts in 2024, keeping rates “higher for longer.”

Turning to the corporate bond market, lower-quality but higher-yielding “junk” bonds rose slightly while higher-rated, investment-grade debt declined moderately in Q3. The large performance gap reflected continued

optimism from investors regarding future economic growth, as investors “reached” for higher yields offered by riskier companies amidst broadly rising bond yields.

US Bond Indexes	Q3 Return	YTD
BBgBarc US Agg Bond	-2.94%	-1.21%
BbgBarc US T-Bill 1-3 Mon	1.36%	3.71%
ICE US T-Bond 7-10 Year	-4.20%	-2.86%
BbgBarc US MBS (Mortgage-backed)	-3.84%	-2.26%
BbgBarc Municipal	-3.95%	-1.38%
BbgBarc US Corporate Invest Grade	-2.59%	0.02%
BbgBarc US Corporate High Yield	0.80%	5.86%

Source: Ycharts

Year End and 2024 Positioning Update

We anticipate a significant US large-cap growth equity sell-off to come catalyzed by a new structurally higher-for-longer interest rate and inflation environment. The road map is 1973-74 and 2001-02. History does not repeat, but it rhymes. These were times when the combination of late-cycle Fed tightening and Treasury bond market selloffs morphed into the bursting of large-cap growth stock bubbles. These were also economies with geopolitical and wartime features not dissimilar to today. For instance, in October 1973, Arab countries attacked Israel leading to the Yom Kippur War and an oil embargo. At the same time, the US was embroiled in a costly and politically divided war in Vietnam.

In our other comparable timeframe, September 2001 was the attack on the World Trade Center, a direct act of war on the US at a time of deep partisan divide. We mention the idea of these wartime parallels because some market pundits may be postulating that a war would be bullish for US stocks and the economy. That was certainly not the case during these two periods which were marked by both real economic downturns and stock-market meltdowns.

It is also very important to note that both these windows coincided with major macro regime shifts where scarce commodities and natural resource stocks rose during the recessions after a period of long-term suppression and then continued with major secular bull markets in the ensuing recoveries. These are macroeconomic parallels today that we think are most relevant for the road ahead in equity and commodity markets.

Looking for the proper forward-thinking macro analog from history is critical today because a stagflationary recession playbook is much different than the deflationary one where commodities get slaughtered and Treasury bonds are among the few securities that go up.

While further severe downside in US Treasury bonds from today's levels may indeed be less of a risk, significant upside remains highly questionable. More importantly, we envision substantial equity market value destruction directly ahead. The rise in long-term rates is most likely to hit overvalued and over-leveraged large-cap consumer and financial sectors next along with highly popular and bloated mega-cap technology stocks. We remain steadfast in our underweighted allocations to these areas, even though our 2023 performance has suffered thus far.

With respect to our overweighted positions, we are not only fans of precious metals for an upcoming stagflationary recession but look favorably at commodities for the entire next economic expansion cycle.

We expect the inevitable recovery to be led by value-oriented cyclical growth industries on the back of massive government fiscal stimulus focused on rebuilding US resources, infrastructure, and manufacturing. In this regard, the US already has already approved three bi-partisan spending acts that are ripe to be expanded. Deficit-and-inflation-conscious political posturing ahead of the 2024 elections should be putting the brakes on these spending programs for now which only increases the risk of a not-so-soft landing. We think Washington elites must now wait for the green light of an economic and financial crisis, God-forbid a provoked entry into direct military conflict, to ramp them up.

In the meantime, we have never been more excited about the opportunity to put money to work in the wrongfully distressed metals and mining industry.

At *Stegent Equity Advisors*, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

We remain focused on both opportunities and risks in the markets, and we thank you for your ongoing confidence and trust. Please rest assured that we will remain dedicated to helping you successfully navigate this market environment.



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