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3Q 2023 Commentary

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At the time of this writing, war has again broken out in the Middle East and the scope of the conflict is not yet clear. The atrocities endured by our fellow human beings and wantonly displayed for global consumption are incomprehensible. Our hearts and prayers are with those who have been most impacted.

The impact on financial markets has been muted thus far. The situation is fluid and we are monitoring it closely. The commentary that follows summarizes what took place in the third quarter, though events in the Middle East introduce further uncertainty.

EQUITIES

All major equity indices declined in the 3rd quarter; growth still outperforming in 2023.

Quarterly Returns: As can be seen from ***Table 1*** (below), all broad market styles were down in the quarter. The S&P 500 was down 3.3% and the NASDAQ was down 3.9%. The small cap value index was down the least (-3.0%), while the generally more speculative small cap growth performed worst (-7.3%). Developed international and emerging market stocks were down 4.1% and 2.8%, respectively. Gold fell 3% while Bitcoin fell 10%. Hedge fund results were mixed with health care focused funds the weakest.

All equity market styles were down in the quarter; growth still outperformed YTD.

2023 YTD Returns: Through September 30, the NASDAQ was the best performer, up 27%. The S&P 500 was up 13%, while small-cap stocks were up 2.5%. Large-cap growth significantly outperformed all other categories. Developed international stocks were up 7.5% and emerging markets were up 2%. Gold was up 3%, while Bitcoin was up 64%. Hedge fund indices were mixed but generally up less than the S&P 500 and outperformed the broad bond index[1].

Table 1[2]

3Q 2023	Value	Core	Growth
Large Cap	(3.2%)	(3.3%)	(3.1%)
Mid Cap	(4.5%)	(4.7%)	(5.2%)
Small Cap	(3.0%)	(5.1%)	(7.3%)

[1] Bloomberg Barclays Aggregate Bond Index

[2] Large cap growth = Russell 1000 Growth Index; Large cap core = S&P 500; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap Core = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap core = Russell 2000 Index; Small cap growth = Russell 2000 Value Index; Developed international = MSCI EAFE Index; Emerging markets = MSCI Emerging Market Index.

YTD Thru 9/30/2023	Value	Core	Growth
Large Cap	1.8%	13.1%	25.0%
Mid Cap	0.5%	3.9%	9.9%
Small Cap	(0.5%)	2.5%	5.2%

FIXED INCOME

Bond prices were down in the 3rd quarter as interest rates continued to rise despite lower inflation.

All interest rates moved higher; long bond rates went up the most.

Quarterly Returns: Corporate and municipal bond returns were down in the quarter. Short term rates were higher as the Federal Reserve (Fed) increased interest rates by 0.25% in July. Longer-term rates rose significantly, discussed in more detail below. The yield curve continued to be inverted (short term rates higher than long term rates), though less so than in prior months. The quarterly changes in Treasury yields are highlighted in blue in ***Table 2*** below. Federal Reserve holdings of Treasury Notes and Bonds fell $159 billion in the quarter and have fallen $738 billion since the April 2022 peak.[3]

2023 YTD Returns: Municipal, corporate, and government bond returns were mixed, with short-term bonds flat to up slightly, and medium to longer term bonds generally down.

Table 2

Maturity*	12/31/22	6/30/23	9/30/23	3Q23 Yield Change
3 Month	4.41%	5.32%	5.46%	**+0.14%**
2 Year	4.42%	4.87%	5.04%	**+0.17%**
5 Year	4.00%	4.13%	4.61%	**+0.48%**
10 Year	3.88%	3.81%	4.57%	**+0.76%**
30 Year	3.97%	3.85%	4.70%	**+0.85%**

**Source: FactSet*

Inflation: Inflation readings decelerated further in the third quarter, including headline Consumer Price Index (CPI), core CPI, and the Personal Consumption Expenditure (PCE) "deflator," which is the inflation reading the Fed is focused on. That said, all inflation readings continue to exceed any reading from 2012-2020, though some price pressures are easing. The Fed did not raise interest rates in September but said they intend to leave interest rates higher for longer to ensure inflation is on a path to its 2% target.

ECONOMIC AND MARKET ENVIRONMENTS

Higher rates impacted almost all assets; other assets must be repriced to compete with Treasuries.

Higher Interest Rates Pressured All Markets: There were only two pockets of strength in the markets during the 3rd quarter: energy (because of higher oil prices) and the US dollar. Almost all stocks, bonds, commodities, and other assets were down in price, whether in the US or abroad. The common factor was higher interest rates. Interest rates are the starting point for any investment, as they set the floor for what needs to be earned for a "good investment." If one can earn 4%, 5%, or more on a 2yr, 5yr, or 10yr Treasury security (considered a "risk free" return), all other investments must provide a higher potential return to account for additional risk. Interest rates are higher than they have been in many

[3] Source: Federal Reserve and PSG; the Fed owned $4.2 trillion of Treasury Notes and Bonds as of 9/27/2023.

years, increasing competition when compared with other asset classes. This normally leads to lower valuations for other assets.

Interest rates are determined by growth, inflation, default risk, and supply/ demand.

Factors Driving Interest Rates: Given slowing inflation, it may seem counterintuitive that interest rates continue to rise and are at the highest levels since 2007. Short-term rates are driven primarily by the Fed, while longer term bond yields are influenced by several factors.[4] Economists and most market participants believe there are three embedded assumptions that add up to the yield in medium to long term Treasuries:

- Growth Expectations
- Inflation Expectations
- Default Risk Expectations

Growth Expectations: Economic growth is generally determined by population and productivity growth and is relatively easy to predict. Both have slowed over the last decade.[5] However, if artificial intelligence triggers a boost to productivity, growth can accelerate. Treasury yields would move higher with those expectations. It would also imply higher profits and stock prices (particularly for growth stocks).

Inflation expectations tend to have large impacts on bond yields.

Inflation Expectations: Investors expect to be compensated for the negative effect inflation has on the value of money over time. From 2009-2020, core inflation (excluding energy and food prices) was consistently below 2%.[6] Inflation soared to multidecade highs in the summer of 2022 before decelerating back to lower but still elevated levels. The deceleration in inflation does not mean it will return to the low levels of the prior 30 years. Oil prices were up over 30% in the 3rd quarter, which often flows through the economy in higher prices. More broadly, inflation over the last two years was toughest on the working class. Many workers and particularly unions are demanding higher wages and benefits. The success of the recent airline and entertainment industry strikes, and current auto and nursing strikes, indicates more power may be shifting to labor. If workers continue to make significant gains, wage inflation may persist for the next few years.

Default Risk: The possibility of default factors into Treasury interest rates. During much of the post WWII era, a US government default was considered almost impossible. Over the last few years, a group in Congress has made the idea of a default possible. US federal government debt is $28 trillion, 55% higher today than it was at the end of 2018. While the US government is far from being insolvent, the cost of servicing debt is up significantly.

In theory, these three components add up to the yield of a longer-term US Treasury. In reality, market dynamics often have an outsized influence on interest rates:

- Supply and Demand

The market has absorbed $3.2 trillion of new Treasury supply since April 2022.

Supply and demand influence interest rates (and Treasury bond prices) over the short term. The Fed was a large buyer of Treasuries through the 2009-2020 period sited above, buying regardless of the yield: it was a price insensitive buyer. During the pandemic the Fed bought trillions more US Treasuries, both to thaw frozen credit markets and support the massive Treasury issuance which funded COVID relief. It is hard to tell how much influence the Fed had on prices and yields.

[4] The terms “interest rates,” “rates,” and “yields” are all used interchangeably. When yields move higher, bond prices fall, and when yields move lower, bond prices rise.

[5] Source: Charles I Jones; https://www.kansascityfed.org/Jackson%20Hole/documents/9744/Jones-handout.pdf)

[6] Core PCE Deflator; source Bureau of Economic Analysis (BEA)

The Fed is not buying as many Treasuries as it had been. It owned $738 billion fewer Treasuries at the end of September than in April 2022. Over the same 18 months supply from the US government ballooned an additional $2.5 trillion to fund the Federal deficit. The result is $3.2 trillion more in Treasury supply than just a year and a half ago. In recent years both China and Japan have also stepped back from owning as many Treasuries as in the past.

We believe supply/demand has moved rates and are cautious about inflation moving forward.

Summary: We think interest rates are rising mainly because of both supply/demand and inflation expectations. We have been writing for years that the long-term impacts of the Fed unwinding its very large balance sheets are unknown: no one has seen this before. Higher interest rates are impacting the US government budget and Treasury supply. We believe rates are not likely to decline for a while and may continue to rise until either the Fed steps back into the market, the Federal government reins in the deficit, or other market dynamics create conditions such that demand outpaces supply (such as geopolitical risk).

CONCLUSIONS

Bond yields are the most attractive in years.

Bonds: Individual bond yields are attractive. Yields on both corporate and municipals are the highest they have been in at least a decade. We have often written that bonds, particularly individual bonds purchased here, are a source of stability and income, though for many years they acted more as a source of stability given the low rates. Now that yields are higher, bonds look more attractive regardless of the direction of interest rates in the near term. We are in favor of using cash and liquidity from maturing bonds to lock in higher interest rates for longer, and all other investments should be compared to bonds' currently attractive rates when making investment allocation decisions. This is particularly true for intermediate and longer-term municipal bonds which, on a tax equivalent basis, offer competitive returns relative to both taxable bonds and even equities.

Growth still outperforming; value looks better since 1/1/22.

Stocks: After a strong start to the year, rising interest rates triggered widespread declines. Growth continued to outperform for the year. Value indices have been plagued by poor performance from banks early in the year and, more recently, from sharp declines in utilities, telecommunication, and consumer staples stocks. Despite these headwinds, large cap value (-5.9%) has outperformed large cap growth (-11.4%) since the start of 2022. Higher interest rates and further quantitative tightening keep us cautious. They both serve as a stark reminders that bonds and carefully vetted alternatives can enhance returns and reduce risk.

Private Investments: We continue to believe there are attractive opportunities in the alternative space. Distressed credit investing has been an area of focus for some time and should provide attractive opportunities over the next few years, though patience will be key.

PSG'S NEWEST ADDITIONS

We are excited to announce the addition of Jay Koehler to the PSG family as Senior Vice President. Jay joins us with 20+ years of institutional equity sales experience at Barclays/Lehman, most recently co-running the New York equity sales team. He started his career at Price Waterhouse where he was a CPA. He graduated from the Kelly School at Indiana University. Jay will head up our business development efforts as we continue to grow and expand our firm.

We are also excited to announce the addition of Stephanie DiMartino to the PSG family as a Administrative Assistant. Stefanie joins us with 10+ years of client service and operational experience in finance and real estate industries. Stefanie graduated from Pace University with BA and MS degree. We are excited to support her development and provide opportunities for her to gain experience and thrive in her new role.

DISCLOSURE

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