

Thoughts from the Holy City – October 2023

“The gap between knowing what you want and going after it is where fear thrives. You don’t need enough courage for the entire journey, you only need courage for the next step.”

~ L.G.W.

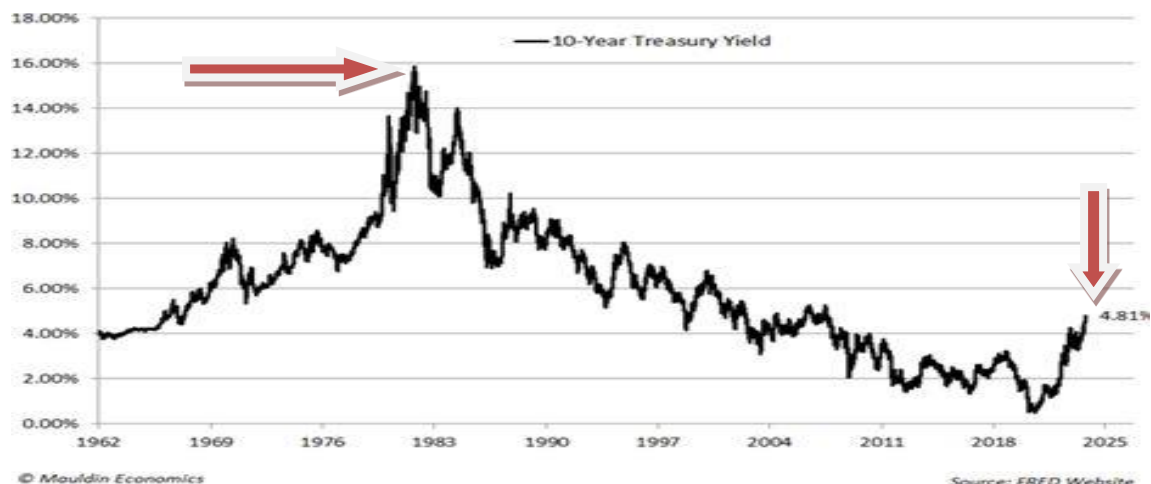
As we enter the final quarter of 2023 both the equity and fixed income markets are in flux. Going into this year, the consensus was that the domestic economy was heading for a recession by mid to late 2023. So far, that has been proven wrong as the data continues to support a robust economy with unemployment at 3.8%. The equity markets are positive for the year, but down in the last month. The Fed continues fighting inflation through its rate raising program, yet the equity markets have remained resilient on the heels of economic growth, a strong labor market, and healthy consumer spending. The S&P 500 has had its best start to the year since 1997 and was due for a pullback. As investors, we must remind ourselves that intra year pullbacks are normal with an average pullback of roughly 5%.

After said start to the year, the DJIA is down almost 7.5% in just the past nine weeks (as of 10/06/23). Much of that drop (-6% of the -7.5%) has come in just the last three weeks. Realistically, a -5% - 7% pullback is perfectly normal in any given year, and sometimes much more. Despite the uptick in volatility in both the stock and bond markets, the domestic indices remain in positive territory for the year with the DJIA positive 1.09%, the S&P 500 up 11.68%, and the tech heavy NASDAQ positive 26.30% year to date. The international markets, as measured by the MSCI EAFE, are positive 6.79% for the year. The bond market, as measured by the Bloomberg Aggregate Bond Index, is down 1.21% as it continues to face headwinds of rising rates and actions of the Federal Reserve.

The bond market, yield curve, and the Fed have been at the forefront of news throughout this year and last year as the Fed most likely concludes one of the most aggressive rate hiking cycles in history. The 10-year US Treasury has been hovering around 4.81%, which is up 24% this year and a shockingly 825% since August 2020. As seen on in the following chart, we have not seen bond yields at these levels since 2007. However, we must keep this in perspective from a historical standpoint - rates peaked at 15.59% in 1981.

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For decades, we as investors have been conditioned to think that stocks always outperform fixed income, which has been the case as the S&P 500 has, on average, returned 10%+ annually for 100 years. However, we are now in a new market regime with bond yields nearing 5% and the risk/reward between stocks and bonds having changed. Consideration for how portfolios and capital is managed needs to be reassessed due to this new era. As legendary investor Howard Marks puts it, “we never know where we are going, but we should know where we are.” We are no longer in an easy money environment and portfolios will most likely look different going forward.

Of course, this is all dependent on the individual investor, their own needs, time horizons, etc. If you came into the investment business or have been an investor since the 1980s, then you have only seen declining interest rates or ultra-low interest rates. Thus, one’s views are shaped by that environment of the past four decades. However, we are now in, and most likely will be in, a much different environment going forward. That is, one in which you can get equity like returns with certain fixed income investments and potentially less risk. This is going to drive portfolio allocations to look different than they have, and risk management will look different. The decisions that we make today are done so with careful consideration and the management of risks, not the management of returns.

Be Well,

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The S&P 500 is an unmanaged index of 500 widely held stocks. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. The MSCI EAFE (Europe, Australia, Far East) index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. An investment cannot be made in these indexes. It is not possible to invest directly in an index. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Bond prices and yields are subject to change based upon market conditions and availability. If bonds are sold prior to maturity, you may receive more or less than your initial investment. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

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