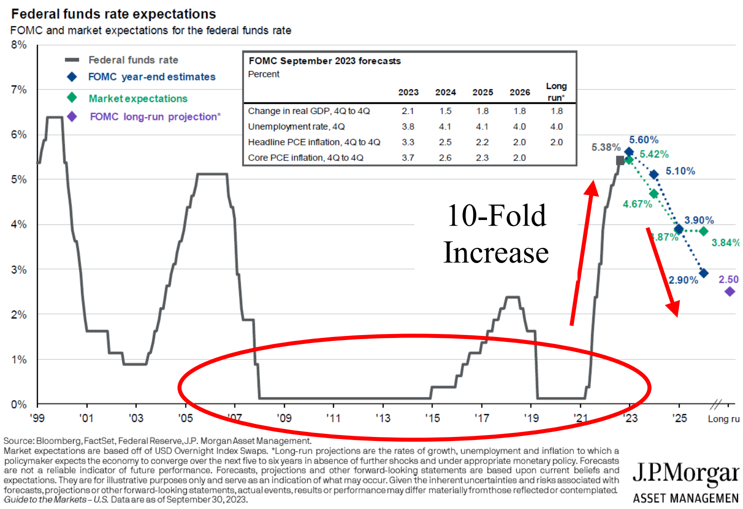
A Double-Edged Sword

Q3 2023 Commentary

We have been witnessing and discussing in our webcasts, commentaries, and client meetings that the persistant inflation would result in higher interest rates for a longer time. The Federal Reserve, and many economic pundits, wrapped the unprecedented rise in interest rates by 10-fold in 18 months, as a temporary disruption in what was considered the status-quo of low interest rates since the great-recession of 2008. The hope was that the rise in interest rates would cool off the economy, inflation, and the employment shortage quickly. The far right of the chart below shows the Federal Reserve and market expectations of a rapid and precipitous decline in Federal Funds Rates into 2024-2025.



As we have been communicating, the deep-rooted inflationary pressures are sticky in many key components, particularly wages.

The continued rise in interest rates across the yield curve have created more pressure on bond valuations (prices) and the equities markets indirectly. When interest rates rise, there is now competition for dollars going out of equities. The days of TINA (There Is No Alternative) other than stocks is gone! Additionally, the pricing mechanism for stocks and their future earnings makes them worth less, as those dollars are discounted to present value. Last quarter, we mentioned that the market has been very narrow, with the Magnificent 7 mega-cap stocks being the only drivers in the Standard and Poor's 500 index.

Through the 3rd quarter of 2023, the S&P 500 was up 12.1%, but gained less than 1.8% after removing these 7 mega-cap technology stocks. The valuation of the large-cap growth style is stretched in relation to the other areas, compared to their 20-year average. The grid below shows the current price-to-earnings ratio of the various equity styles.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	13.7 / 13.7	17.8 / 15.6	24.4 / 18.8
Mid	13.3 / 14.5	15.2 / 16.4	23.7 / 20.5
Small	14.1 / 16.8	19.2 / 21.4	31.1 / 33.1

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YTD

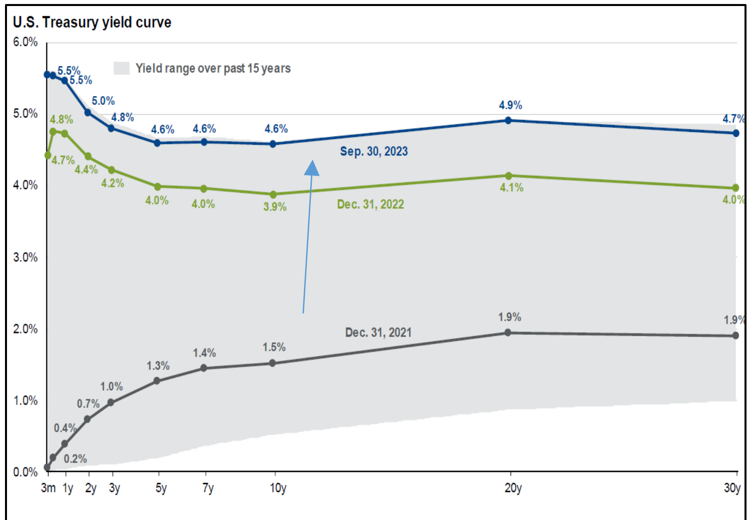
	Value	Blend	Growth
Large	1.8%	13.1%	25.0%
Mid	0.5%	3.9%	9.9%
Small	-0.5%	2.5%	5.2%

Source: FactSet, Refinitiv Datastream, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.
All calculations are cumulative total return, including dividends reinvested for the stated period. Since market peak represents period from 2/19/2020 to 9/30/2023. Since market low represents period from 3/23/2020 to 9/30/2023. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell style indices except for the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. The price-to-earnings is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM) and is provided by FactSet Market Aggregates and J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of September 30, 2023.

2023's market focus on artificial intelligence (AI) appears to be the driver of growth, particularly large cap tech. We do agree that AI is a bold new frontier, but similar to past bubbles in tech, crypto, etc, we feel a reversion to the normal averages is likely. At the end of the third quarter, the valuation comparison and year-to-date contrast in returns above illustrates the dichotomy.

The Brechnitz Group always attempts to be forward-looking and balanced in our portfolio construction. In the near-term, diversification may seem unpopular when compared to owning the latest hot sector, but over an entire market cycle, the prudent spreading out of risk is generally advantageous.

This quarter, many of our tactical adjustments were focused on our team's attempts to take advantage of lengthening the duration of fixed income in portfolios as interest rates moved up nearly one whole percent in the quarter. We also attempted to strengthen the credit quality in cash alternatives, due to concerns over the exaggerated demand for money market funds and potential worst-case liquidity issues (that have not yet come to fruition).



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.

The double-edged sword countering all of the negative effects of higher interest rates is the ability for fixed income to actually contribute to performance within a portfolio allocation. With the ten-year U.S. Treasury Note yielding above 4.75%, and short-term rates above 5% (inverted yield curve), there is definitely a silver lining to the cloud in the near-term.

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IMPORTANT DISCLOSURES:
All investments are subject to risk, including loss. There is no assurance that any investment strategy will be successful. Asset allocation and diversification does not ensure a profit or protect against a loss. It is important to review the investment objectives, risk tolerance, tax objectives and liquidity needs before choosing an investment style or manager.

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The information contained in this report has been obtained from sources deemed to be reliable; however, we do not guarantee the accuracy and completeness of such information.

ASSET CLASS RISK CONSIDERATIONS
Equities: Investors should be willing and able to assume the risks of equity investing. The value of a client's portfolio changes daily and can be affected by changes in interest rates, general market conditions and other political, social and economic developments, as well as specific matters relating to the companies in which the portfolio has invested. Companies paying dividends can reduce or cut payouts at any time.

Fixed Income: All fixed income securities are subject to market risk and interest rate risk. If fixed income securities are sold in the secondary market before maturity, an investor may experience a gain or loss depending on the level of interest rates, market conditions and the credit quality of the issuer. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices generally rise. Please note these portfolios may be subject to state, local, and/or alternative minimum taxes. You should discuss any tax or legal matters with the appropriate professional.

International investing involves additional risks over developed countries and is greater in emerging markets. Additional information is available upon request. The S&P 500 is an unmanaged index of 500 widely held stocks. You cannot invest directly in an index.

Companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification. Biotechnology companies are affected by patent considerations, intense competition, rapid technology change and obsolescence, and regulatory requirements. Investing in the energy sector involves special risks, including the potential adverse effects of state and federal regulation and may not be suitable for all investors. 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.

Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. Price Earnings Ratio (P/E) is the price of the stock divided by its earnings per shares

You cannot invest directly into any index and past performance doesn’t guarantee future results.

This is not a recommendation to purchase or sell the stocks of the companies pictures/mentioned.

The Dow Jones Industrial Average (DJIA), commonly known as “The Dow,” is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal. The S&P SmallCap 600 Index is a stock market index established by Standard & Poor’s. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index. To be included in the index, a stock must have a total market capitalization that ranges from $850 million to $5.2 billion.

Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance.

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