MANAGED ASSET PORTFOLIOS

# MAP VIEWS

MAP QUARTERLY COMMENTARY | OCTOBER 2023

Stock prices moved lower during the third quarter of 2023 as progress on the inflation front slowed, and investors began to digest the likelihood of more interest rate hikes. As we have noted in previous MAP Views, we believe it will be challenging for the Federal Reserve (the Fed) to guide inflation back to its desired two percent target without causing a recession.

Earlier this year, there was optimism that the Fed could navigate a successful soft landing. Headline inflation, which peaked at 9.1 percent in June 2022, trended steadily lower until this summer, when it picked up a bit, primarily due to a stout increase in energy prices over the last few months. Many oil analysts and executives at energy companies are reviving calls for triple-digit oil prices following a strong summer rally. Saudi Arabia and Russia have curtailed production, while demand remains relatively strong. U.S. production has eased a bit over the past few months, as U.S. producers are reluctant to ramp up production in an uncertain environment. Calling it capital discipline, oil companies are more likely today to buy back shares and increase dividends than plow money back into drilling, given the uncertain political environment.

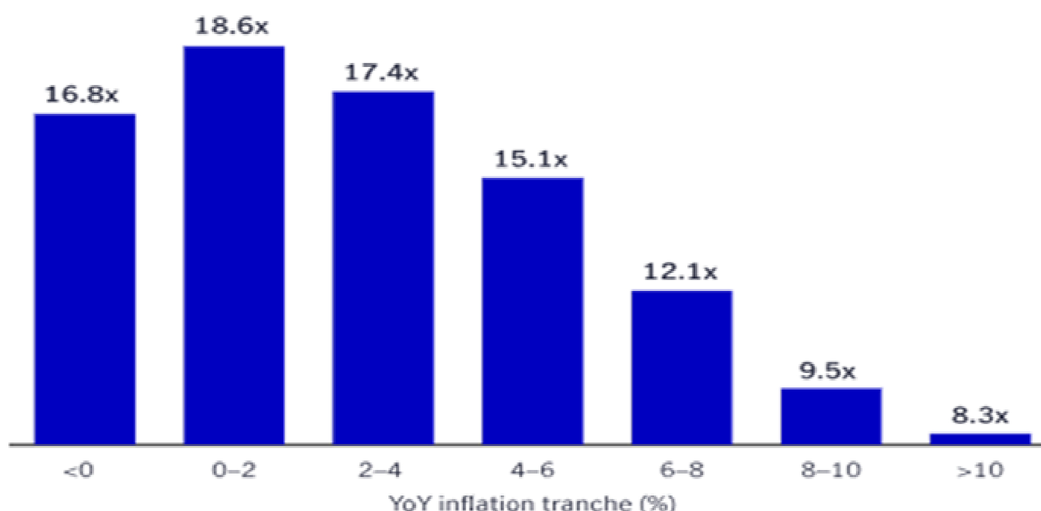
Higher labor costs will also challenge the Fed's objective of its two percent inflation target. Labor has been flexing its muscles more this year than ever in recent memory as President Biden offers the most public support for unions in decades. Markets appear to be taking notice. During the 48 hours following Joe Biden becoming the first sitting president to join a picket line, yields on the 10-year Treasury have risen 19 basis points. We find this to be a little too much of a coincidence.

Sticky inflation levels have led to interest rates rising to their highest levels since 2007. Given our views on the stickiness of inflation, it should not be surprising that we are in the 'higher for longer' camp regarding interest rates. Chairman Powell recently said the Fed may increase rates again to reduce inflation to the two percent target. We are not convinced that "one more hike" would do the trick. The optimists are calling for rate cuts to begin next year. We caution that one should be careful what they wish for, as lower rates will likely only occur if the economy heads south. Such an environment would also negatively affect corporate earnings and the stock market.

Stock market valuations have increased this year, with the 2024 price-to-earnings multiple for the S&P 500 currently standing at 19.6x versus 18.2x at the start of the year. While that valuation number is not unrealistic, given the current level of interest rates, it is lofty. To put this in perspective, stock values today are on par with where they were pre-COVID, and when interest rates were almost 300 basis points lower on the 10-year Treasury.

We believe our forecasts for elevated inflation and higher for longer interest rates will pose headwinds for stocks with lofty valuations. Recall that such stocks suffered significantly in 2022 as the market digested higher inflation and interest rates. For the first few months of 2023, investors threw caution to the wind, seemingly ignoring economic challenges by buying shares of stock that were plays on Artificial Intelligence. However, the past two months have felt more like the first few quarters of 2022 than the first quarter of 2023. In fact, as of September 27, 2023, The Equal Weighted S&P 500 is officially negative for the YTD period, highlighting the excessive contribution of the Magnificent Seven to the S&P 500's 11.7 percent return year-to-date. We believe sticky inflation and higher interest rates seem to be the driving forces behind this reversal. The likelihood of sticky inflation's persistency should bode well for value investors. The chart below shows that stocks command the highest valuations when inflation is between zero and two percent. As inflation moves higher, valuations move lower.

S&P 500 Index average P/E ratio trailing 12 months, CPI YoY tranche, 1950–2021




Source: Strategas, as of 3/31/22. For illustrative purposes only, not reflective of any fund. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. The Consumer Price Index (CPI) tracks the average change of prices over time by urban consumers for a market basket of goods and services. It is not possible to invest directly in an index. Price-to-earnings (P/E) is a valuation measure comparing the ratio of a stock's price with its earnings per share. YoY refers to year over year. Past performance does not guarantee future results.

# MAP Views
# Third Quarter 2023

As we have penned in previous issues of MAP Views, we are keeping maturities short for our portfolios with a fixed income mandate, as we believe that the risk versus reward set-up does not favor having a portfolio long on duration. Bond market bulls point to the fact that, with data going back to 1974, the Bloomberg U.S. Aggregate Bond Index had two consecutive calendar years of negative returns for the first time in 2021–2022; before 2021, the index had only been negative four times in 46 years. To that, we respond: “Many times, history repeats itself, but there are times when we make history.” We believe the latter to be true in this case. The bond market tends to have very long cycles. Remember that the bond bull market ran from 1980-2021, over four decades! It is not unrealistic to expect longer-dated bonds to be an underperforming asset for the foreseeable future. Accordingly, our weighted average maturity is approximately 1.5 years.

As we write this, Congress passed a last-minute agreement to keep the federal government funded through November 17th, avoiding a government shutdown. Considering the contentious environment in Washington these days, we would not be surprised to see talk of a shutdown retake front and center stage in a month and a half. Shutdowns have occurred before and will likely happen again. The frequency with which Washington struggles with its finances is becoming increasingly problematic. In August, rating agency Fitch downgraded their rating on U.S. debt, citing expected fiscal deterioration, a high government debt burden, and the erosion of governance related to ‘AA’ and ‘AAA’-rated peers. A few days ago, Moody’s, the sole holdout giving the U.S. a ‘AAA’ rating, expressed that a U.S. government shutdown would harm the country's credit. Historically, the market has shrugged off such events. However, at some point, the government’s lack of fiscal responsibility will become an issue for investors. Running fiscal deficits greater than GDP growth is only sustainable for so long.

As we begin the fourth quarter of 2023, we want to take this opportunity to thank you for your continued trust and patronage. We are grateful for the opportunity to work with you and strive to provide you with the best risk-adjusted returns while delivering the highest level of service and support.

Happy Autumn!

**Managed Asset Portfolios Investment Team**

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