

# Quarterly Economic Commentary

*October 2023*

## Market Returns

	12/31/2022	9/30/2023	% Gain/Loss
Dow	33,147	33,508	2.70%*
S&P 500	3,840	4,288	13.10%*
NASDAQ	10,466	13,219	27.10%*

*\*Total Return Including Dividends*

*By Jim Watts, KS Trust Senior Portfolio Manager*

As we head into the fourth quarter, the home stretch for 2023, if you look at the S&P and the NASDAQ, it seems like it has been a great year in the stock market. However, just as we discussed in the last Economic Commentary, the “surging seven,” Apple, Microsoft, Nvidia, Amazon, Meta, Tesla, and Alphabet, have been the drivers of the “great year” in the stock market for both the S&P and the NASDAQ. Likewise, if you look at the current yields on fixed income, you get excited. However, if you purchased longer-term securities early this year, you are showing a principal loss because with rising yields/interest rates come lower prices on the securities themselves.

#### **UBS Daily House View: Thursday, September 28th**

“Higher for longer weighs on markets. Equity and fixed-income markets were under pressure on Wednesday (September 27th). This reflected a growing conviction among investors that the Federal Reserve will maintain restrictive monetary policy well into next year and concerns over the impact on bond yields of the increased level of Treasury issuance. The yield on the 10-year US Treasury climbed seven basis points to 4.61%, a fresh 16-year high. The real 10-year yield rose to 2.26%, the highest level since the global financial crisis. The S&P 500 recovered from an intraday loss to end virtually flat on the day, but the index is still down 1% on the week, 5.2% this month, and 4% for the third quarter overall.

**Our view:** Recent developments support our view that markets had become overly confident in pricing a rapid easing of monetary policy from the Fed. While we expect stocks to advance by the end of the year, there are more significant downside risks to stocks than bonds. As a result, we have a neutral overall stance on equities. We see the best risk-adjusted return potential from parts of the market that have lagged global indexes this year. But overall, we prefer fixed income to equities under current conditions, with a focus on high-quality bonds. Regardless of whether the landing is ultimately hard or soft, US and global economic activity is set to slow over the next year. Falling inflation should bolster the real return on fixed income despite the recent rebound in energy prices. Finally, yields remain well above long-term equilibrium levels, providing investors a cushion against adverse developments.”

As the markets wrestle with the changing economic and political environment, stocks and fixed income suffer. The stock and fixed-income markets lost ground during September, and so far, the first couple of days of October are continuing that trend. With another government shutdown narrowly avoided last week by a 45-day extension, nothing is certain but uncertainty. Now, the House is in turmoil with the removal of the Speaker. It appears that uncertainty will prevail over the immediate future.

The FOMC meeting in mid-September put a damper on the “equity party” when they indicated that they may raise rates one more time. In addition, they have now finally convinced the investment community that rates will be higher for longer. The expectations are for just two potential rate cuts in 2024. Concerns that rates may stay higher for longer were intensified on Tuesday by the release of the Job Openings and Labor Turnover Survey (JOLTS) for August. This survey showed a 690,000 increase in job openings for the month to 9.61 million, while vacancies for July were also revised higher. Demand for personnel was particularly strong in professional and business services. This pushed rates on Treasuries to rates not seen since 2007. The 10-year interest rate is 4.76%, and the 30-year is 4.89%, down from 5.01% earlier today. As part of this interest rate escalation, 30-year mortgage rates are approaching 8.0%.

What has caused this sudden increase in rates? Not inflation! While inflation is still stubbornly high, it has been trending down and remains pretty stable. It is a culmination of the work done by the FOMC. They have been raising rates, as we all know, but they have yet to be in the business of buying bonds, which they were doing during the pandemic. As such, the demand has fallen while rates have risen, and with the lack of demand, prices tend to fall and interest rates rise. This is particularly a problem with the increased issuance from the Treasury, and we “create cash” to fund the government and the increasing budget deficit.

How do we invest in this type of environment? The one-word answer is carefully! We don’t expect the stock market to descend into a bear market but expect some negativity. While several tech stocks have been priced for perfection, other sectors and companies present exciting opportunities. For now,

the economy is still pretty strong and growing. Typically, the fourth quarter is the best quarter for equity performance. Being selective and patient, we think the fourth quarter will prove true to the trend. These are my thoughts. Let's look at what the **UBS Daily House View, October 4th, 2023**, has to say:

#### **How do we invest?**

Uncertainty around the outlook for Fed policy is likely to weigh on equity markets for now. With near-term risks elevated for broader markets, we are neutral on equities and favor adding exposure mostly to parts of the market that have lagged so far in 2023—including the equal-weighted S&P 500, value, and emerging markets.

Against the current backdrop, we see a better risk-reward profile for fixed income, and we recommend that investors consider buying high-quality bonds in the 5–10-year maturity range. We foresee further cooling in inflation and slower global growth. Our 12-month forecast for the 10-year US Treasury yield is 3.5% in a base case, 4% in an upside scenario, and 2.75% in a downside scenario, which includes a US recession.

We also believe this is an opportunity to add to diversified, balanced portfolios. Despite near-term headwinds for stocks, we're at a rare time when, in our base case, we expect cash, bonds, stocks, and alternatives to all deliver reasonable returns over the next six to 12 months and the longer term. In our view, investors can tap into an attractive opportunity set across asset classes, position for durable returns for years to come, and mitigate the effect of potential risks.

Kevin McCarthy was ousted from his US House Speaker leadership role in a 216–210 vote on Tuesday, with Republican dissidents taking action to depose McCarthy following his compromise continuing resolution (CR) with Democrats to avoid a government shutdown.

Absent a new House speaker, no action can be taken on bills, from routine matters to federal government funding. The removal of McCarthy throws a wrench into the timing of budget negotiations as the Republican side of the aisle will need to focus first on leadership elections. Policy differences regarding border protection and military assistance to Ukraine remain persistent policy obstacles. We believe the

ouster of McCarthy increases the probability of further delays in reaching a bipartisan compromise with the Senate over these and other issues and increases the risk of a government shutdown in late November.

In summary, the past 30 days have added to the uncertainty in the economy and the markets. While this is nothing new, it is a new spin on an old problem. I believe the Speakership will be resolved relatively quickly, and it will delay some necessary actions. I think the potential government shutdown will again be averted by “kicking the can down the road.” I believe that the next 30 days, including the next FOMC meeting, will be volatile but will provide some opportunities in equities and fixed income. This will allow us to position for closing out 2023 and setting up for 2024.

As we outlined earlier this year, I believed oil prices would top \$100 a barrel before year-end. While we have not done that yet, we have been close over the past few weeks. Since then, oil has dropped below \$90 per barrel, but strong demand, short supply, and the need to fill the Strategic Petroleum Reserves will stabilize prices and most likely increase prices. The prospects for a cold winter here and internationally will also affect price moves.





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Roger Thomas  
Chief Wealth Officer  
[rthomas@ksbankinc.com](mailto:rthomas@ksbankinc.com)



Heidi Watkins  
Trust Operations Manager  
[hwatkins@ksbankinc.com](mailto:hwatkins@ksbankinc.com)



Shannon Austin  
Wealth Consultant  
[saustin@ksbankinc.com](mailto:saustin@ksbankinc.com)



Jim Watts  
Senior Portfolio Manager  
[jwatts@ksbankinc.com](mailto:jwatts@ksbankinc.com)

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