46 PEAKS
INVESTMENT ADVISORY GROUP

The Red Zone

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Following year-to-date gains in nearly every asset class, investors were likely pleased at the end of June. The good times extended through July when the S&P 500 advanced another 3.2%. And then suddenly, like the cops showing up to a raging party, it was over. August and September saw declines across most stock and bond categories; the only broad asset class that was up in the third quarter was commodities.

The consistency of declines across major stock market categories and core bonds in the quarter is evidenced in this table. You can say virtually all markets were in the **Red Zone** in the third quarter. But that's not the whole story. At the year's ¾ mark, there has only been one pocket of strong returns all year – Large Cap U.S. Stocks.

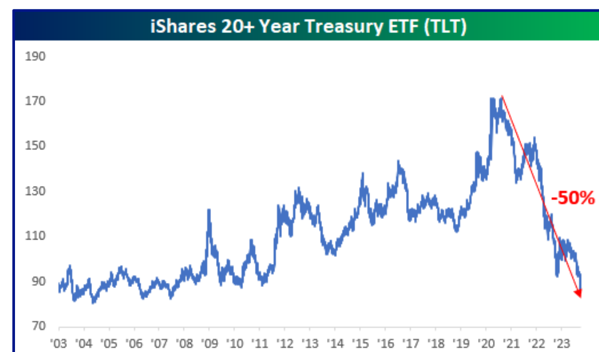
	3rd Qtr	Year-to-Date	Last 5 Years
U.S. Large Cap Stocks	-2.1%	13.0%	9.9%
U.S. Mid Cap Stocks	-4.1%	3.3%	6.5%
U.S. Small Cap Stocks	-4.8%	2.6%	2.5%
Non-U.S. Stocks	-3.1%	5.1%	2.9%
Emerging Market Stocks	-4.1%	0.9%	-0.3%
Core Bonds - U.S.	-2.9%	-1.1%	0.1%

Furthermore, what you can't see in these figures is how concentrated the Large Cap U.S. stocks' performance has been - The ten largest U.S. stocks are up an average of 69.6% this year. The remaining 490 stocks in the S&P 500 are up only 1.7%! We will come back to this topic later.

We included five-year performance for these asset classes as well to illustrate how this year's Large Cap U.S. dominance is not just a current event. Few classes of stocks have provided average returns greater than a piddly 3% while Core Bonds have made little money for *five years*! A **frustrating period** for diversified investors, especially those with conservative portfolios.

We cautioned in July that we would not be surprised to see a stock market correction. Following the bear market of 2022 that ended in October of last year, markets had been strong for three consecutive quarters. Volatility is a part of investing. A breather was warranted. Also, seasonality was not in the market's favor as the August – September period has been, on average, challenging for the stock market. What we did not expect to see, however, was the carnage in the Bond market - in response to the yield on 10-year Treasuries spiking 0.80%, the Core Bond index dropped 3.1% in August and September alone.

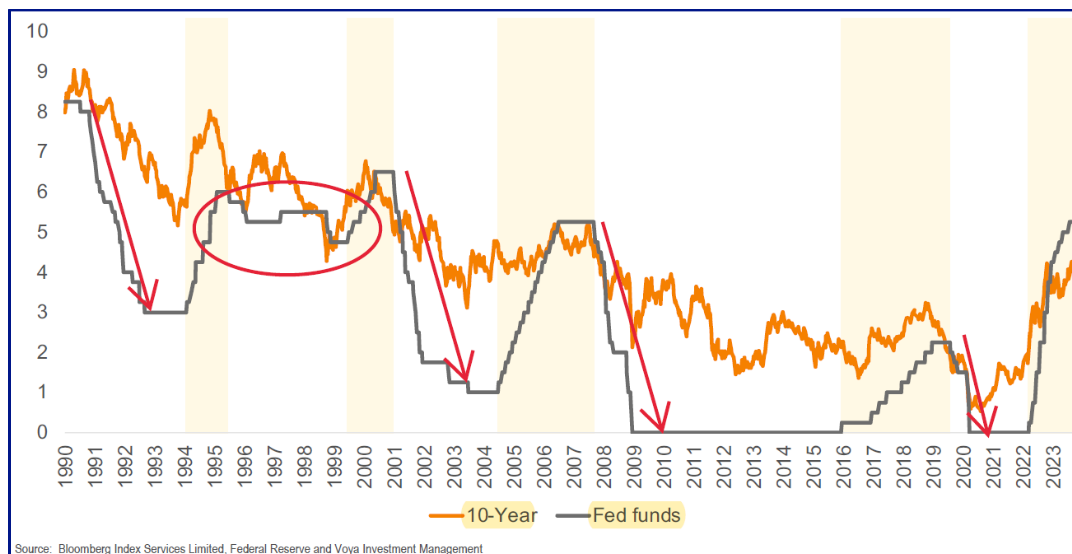
It's hard to appreciate the extent of the bear market that we're experiencing in the bond market, which declined in 2021 and 2022, and which is heading toward another negative year in 2023. A picture may help. Here is a chart of the share price of an ETF that invests in Long-Term Treasury Bonds.



This is the type of chart that you would expect to see for a tech stock or aggressive growth ETF, not "safe" investments like Long-Term Treasury Bonds.

So, what led to the sudden spike in rates that ruined the festivities this summer? Several factors. Perhaps already forgotten, but the rating agency Fitch downgraded the U.S. credit rating over the summer. This may not have meant much, as S&P downgraded the U.S. all the way back in 2011, but it certainly doesn't help. Our increasing deficits may be scaring some sovereign and institutional investors away. Excess supply has also been an issue, as Treasury bond issuance has spiked in recent months. Then there's the Fed themselves – while they have softened their language about further rate hikes, they have emphasized a commitment and expectation to keep short-term rates near current (5%) levels until 2025.

Since this cycle has the Fed's fingerprints all over it, a review of previous cycles seems important. This chart, going back to 1990, shows the Fed Funds (short-term) rate in grey and the yield on the 10 Year U.S. Treasure in Orange.



The sharp rise in both short-term and long-term rates over the past two years jumps off the far-right part of the chart. Also notable - except for the (circled in red) mid-90's, which included an economic "soft landing", the other four cycles saw the Fed **cut rates quickly** and significantly soon after they stopped raising them (in response to recessionary economic conditions).

Is the Fed done raising rates this cycle? Nobody knows. They have not declared so yet, but several Fed officials are starting to verbally admit that current conditions might call for an extended pause. What if they are finished? Well, by definition, if the Fed is done, then the next step is a pause, followed by rate cuts. But we're getting ahead of ourselves, as the Fed is unlikely to cut rates until they are convinced that inflation has been tamed.

Did somebody say inflation? As we all know by now, the tension in the markets and the volatility caused by higher interest rates has been driven by inflation for almost two years now. Inflation peaked at about 9% in July 2022, clearly in the bright red zone, and has been steadily dropping. But its **too soon to declare victory**. While some prices fell in September, shelter and energy prices rose. Core CPI inflation eased to 4.1% from 4.3% in August - in what we might call the yellow zone.

Importantly, when the day comes that inflation is down to a more comfortable level, it's not like everything will be cheaper then. Inflation is cumulative - if inflation were eradicated and went to 0% and stayed there, prices on average would still be 20% higher today than they were three years ago. Without deflation, which sounds good in theory, but which is economically undesirable, goods, services, and housing will simply stay much more "expensive" compared to only three years ago.

Although some forecasters that we trust think it will happen by the end of next year, we think it will be difficult to get inflation all the way down to the Fed's target of 2.0%. It might take longer than one more year. It might require a recession. The topic of a pending recession has been front and center for about a year now. Yet, in 2023 economic growth has remained good, surprising so many of the experts.

We think one of the most important topics of the day that has been overlooked by many, is simply "why have the Fed's rate hikes been **ineffective** so far?" While the army of Wall Street economists should have been talking about this twelve months ago, they weren't. They are now and in hindsight, it's obvious how these factors have helped us avoid a recession despite the Fed's actions:

1. Following the Pandemic and the various, enormous relief packages, there was an estimated $2.3 Trillion of excess savings at American Households that fueled consumer spending the last three years.
2. Only 11% of U.S. Household debt is adjustable rate. Thus, the interest rate on 89% of U.S. household debt has been unaffected by the Fed's hikes.
3. 37% of U.S. Homeowners have no mortgage. Of those with a mortgage, 71% of home mortgages in the U.S. have an interest rate below 4.0%.
4. Most CEOs and CFOs are not stupid. When interest rates were low, many public companies opportunistically issued long-term debt at interest rates under 4%. To wit, only 2% of S&P 500 debt is maturing this year and over 45% of S&P 500 debt will not mature until after 2030.

Even with that said, looking into next year, it is hard to be confident about the economy. For one, so-called "soft landings" whereby the Fed succeeds at cooling the economy without triggering a recession, are exceptionally rare. Looking beyond interest rates, much of the excess savings built by households during the Covid crisis has been spent. Today's higher oil and gas prices will not help. Consumer confidence is low. And while headline employment numbers are still impressively strong, a deeper look behind the curtain shows building evidence that **the job market is clearly starting to weaken**. And then there's the presidential cycle – we think the uncertainty and anxiety surrounding the election could easily pressure corporate and consumer spending.

In the end, we remain conflicted about the economic outlook. Several indicators suggest we have only delayed a recession and will not avoid one. We hate to look historical precedent in the eye and say this time is different. But on the other hand, this time **really is different**, with trillions of dollars having been printed, households and corporations taking on debt at rates as low as 2.5% - 3.5%, and with different parts of the economy having already experienced their own recessions at different times over the past three years, leaving them potentially less likely to experience another downturn so soon thereafter.

Along with our conflicted view of the economy, we have a similarly conflicted view of the markets, largely due to the significant tension between stocks and bonds right now. Conservative investors should be much more optimistic going forward thanks to higher yields, but we think it is challenging to build a bullish case for stocks. With a still inverted yield curve, bonds are acting like a recession is unavoidable. If bonds are "right" and the economy slows sharply or enters a recession soon, then lower stock prices are warranted.

On the other hand, if we avoid a recession, then interest rates should stay at currently elevated levels for longer, a phenomenon that would also call for lower stock prices. This chart (from the Apollo Group) highlights how the inverse relationship between interest rates (the 10-year Treasury yield in grey) and Growth Stocks (the Nasdaq 100 in green) has broken down after being closely linked for a long time. These lines can converge only if yields drop, stock prices

drop, or some combination of the two.

Thus, to be excited about stocks, you really need to feel confident that we will have a rarely-seen "**soft landing**" whereby inflation subsides, the economy cools just a little, and unemployment rises just the right amount to give the Fed some comfort to lower rates, all while avoiding a recession

These tensions leave us for the first time in what feels like forever **enthusiastic** about Bonds. In a complex and unpredictable world, we think the bond decision is quite simple - bonds offer good return opportunities with reduced and reasonable risks. This table shows the 9/30/23 yield on Core Bonds (5.39%) as well as hypothetical performance of the index if interest rates fall 1.0% over the next twelve months, remain unchanged, or rise another 1.0%

	9/30/23	Hypothetical 12 Month Return if Yields		
	Yield	Fall 1%	Stay the Same	Rise 1%
Core Bonds	5.39%	11.47%	5.39%	-0.69%

As you can see, with today's yields, there are multiple ways for bonds to win, and even if rates somehow rise another 1.0%, the twelve-month returns will be barely negative – a nice tradeoff in our minds.

Our mixed feelings about stocks are also affected by valuations. Those massive year-to-date and five-year performance disparities highlighted in the earlier table have resulted in **significant valuation disparities** within the stock market, namely between Large U.S. Growth Companies (Apple, Microsoft, Amazon, Google, etc.) and everything else.

	Current P/E Ratio	% of it's 20 Yr Average	Discount to U.S. Large Growth
U.S. Large Growth	24.4	130%	
U.S. Large Value	13.7	100%	44%
U.S. Mid Cap	15.2	93%	38%
U.S. Small Cap	19.2	90%	21%
Non-U.S.	12.4	95%	49%

This table shows the current Price/Earnings (P/E) Ratio for five categories of stocks, how the current ratio compares to its own 20-year average (middle column), and how the other sectors compare to U.S. Large Growth Stocks (far right column).

While the other four categories are valued near their own 20-year averages or 5-10% *cheaper*, Large Growth stocks currently sport a P/E ratio 30% *higher* than their two-decade average. Except for Small Cap stocks, the other categories are priced at 38-49% *discounts* to U.S. Big Tech. Now some of these differences are certainly justified, as Large Growth stocks are dominant businesses that have grown revenues and earnings over time. But at some point, these disparities become extreme – For example, the almost 50% difference in valuation between U.S. and non-U.S. large cap stocks is at a level seen fewer than 5% of the time. Consequently, one major Wall Street bank is currently forecasting that non-U.S. stocks will outperform U.S. Large Caps by 2.2% annually over the next decade.

The performance and valuation gaps surrounding growth stocks have us thinking about trimming our exposure. It's not an easy decision. But we're old and we think wise enough to remember how poorly expensive Tech stocks like Cisco, Intel, Lucent, and AOL performed in the early 2000's after reaching similar valuation extremes.

As if all the above wasn't enough to consider, we now have another war in the Middle East. Like much of the world, we are saddened and horrified by the unspeakable atrocities that sparked the current conflict. And we dread the bloodshed that likely lies ahead. We're uncomfortable speaking about how this may or may not affect financial markets, as that seems irrelevant in the face of loss of life. Yet, we'll simply remind investors that while markets sometimes experience short-term volatility around such events, they often remain mostly unaffected.

So, in the face of elevated uncertainty, unprecedented economic developments, severe valuation disparities across stocks, political tensions at home, conflicts around the world, and an unusually wide range of potential outcomes, what's an investor to do? We think one of the answers lies with the suddenly-back-in-the-spotlight football coach of Colorado University – Deione Sanders. Mr. **Prime Time**. No, Mr. Sanders is not giving investment advice. But the relevance is

that he was not only a two sport (Football and Baseball) athlete, but he also excelled at both offense and defense. Broadly speaking, in an environment which feels so uncomfortably unpredictable, and where we continue to think the next 20% move in stocks could be either up or down, we believe it is more important than ever to populate portfolios with strong **two-way players** – strategies that can play both offense and defense.

Now that their yields are near 5%, we think U.S. Treasuries fit that bill. If rates do not move, we earn an acceptable yield (that's the offense). If the economy softens, their yields should decline, pushing up prices and helping to 'defend' the equity exposure in portfolios. We added some U.S. Treasuries in June and are looking to add more prior to year-end.

We also think having Trend-Following strategies on your team is essential in this environment. These Alternative strategies can play either offense or defense, going long or short a wide variety of exposures. They do not rely on intellect, prediction, or solving any economic riddles. They simply rely on the durability of cycles and patterns. We are maintaining our meaningful allocation to these strategies across most portfolios.

Other yield sensitive categories can also emulate Mr. Sanders' versatility. Alternative exposures like Reinsurance and Private Credit are benefiting from higher interest rates. The strong return opportunities in these categories may help portfolios play offense, while their non-correlation to traditional markets helps defend against volatility in stocks and bonds.

Then there's Gold, an asset class that we have only dabbled in and out of once over the years. To us, Gold has renewed appeal in light of the U.S.'s large fiscal deficits, potential increased demand from other Central Banks, concerns about the U.S. Dollar, heightened geopolitical uncertainty, and a simple lack of attention from the investment community that could translate to an opportunity for increased demand in the future. We are considering adding exposure.

Beyond specific or complex investment strategies, we also think that three fundamentals – patience, adaptability, and robust diversification have rarely been more important. From an investing perspective, the most comfortable thing to do right now would be to try to time the market by moving to cash or staying in stocks but embracing the popular U.S. Tech stocks. But in investing, that which is **comfortable is often not very profitable** and that which is profitable is often not very comfortable. In football, like investing, it's hard to come back from a fumble in the Red Zone. We are building portfolios to try to make sure that doesn't happen.

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