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Market Update

Q3 2023 Market Review: When Good News Was Bad News

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Market Recap

There is an old saw in the investment business that “the market is not the economy.” This past quarter proved once again it might just be true. While the U.S. economy continued showing strength --- good news, right? --- This was *bad* news for stocks and bonds, both.

The U.S.’s economic resilience surprised many. In fact, many doomsday prognosticators officially threw in the towel during the quarter, conceding the Fed might actually be able to pull off an unlikely “soft landing.” See the chart below from Citigroup, which publishes an Economic Surprise Index. When the line is above zero, it means the economy is doing better than what a collective group of economists expected, while below the line means worse than expected. All through 2023, and especially all through Q3, the economy kept surprising to the upside.

Source: Bloomberg, Citigroup. The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median).

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Until July, this resilience was viewed favorably by the markets. Unfortunately, this *continued* strength was ultimately interpreted by the financial markets as bad news, too much of a good thing. It meant the Fed would likely keep rates "higher for longer" - crimping the consumer, slowing home purchases and home construction, and hurting growth companies whose future earnings are hurt by higher interest rates. It also meant that the Fed might be forced to apply even more tightening, risking a recession.

Through the lens of this logic, August and September saw sizable selloffs. For the quarter, the S&P 500 recorded a -3.6% loss. The fear was felt globally, as developed international stocks (MSCI EAFE) dropped -4.1%. Emerging markets (MSCI Emerging Markets) were down -2.9%. On a year-to-date basis, global equities are still up over 10%; so while the quarter's give-back is uncomfortable, equity portfolios have still delivered quite healthy returns so far in 2023.

Bond yields rose notably during the quarter, breaking decade-plus records. The yield on the 10-year treasury moved from 3.85% to over 4.5% (and has moved closer to 4.8% in the past few days). These are levels not seen since 2007. Mortgage rates, the same. While higher rates are good for savers, the move in rates caused some pain for current bondholders, as the Bloomberg Barclays Aggregate bond index lost 3.2% during the quarter, and muni bonds lost 2.2%.

Outlook and Strategy

We have maintained for some time that a recession, should it occur, would likely be shorter and shallower than past recessions. Our base case has not changed. We still believe that at some point, the dramatic rate hikes over the past year - historic in their speed - will tamp down spending and economic growth enough, reassuring the Fed that we are on a healthy path toward lower inflation. The data certainly paints that picture. But we also knew it would never be a straight line; economic data always move in a herky-jerky fashion. And that is what triggered the second-guessing and uncertainty, and, ultimately, volatility of the third quarter.

But our base case also has to contemplate some uncomfortable realities. Home prices have remained stubbornly high, wages appear sticky, labor has found a new assertiveness, and oil prices have materially surged in the past few weeks. This will put continued pressure on CPI and other inflation indicators, possibly forcing the Fed to do even more. The benign "soft landing" or even our own slightly more conservative "short and shallow" base case is far from a sure bet. The Fed could overreach. It would not be the first time.

From a positioning standpoint, we remain largely in line with client target allocations to equities. We've maintained an overweight allocation to U.S. stocks along with a modest underweight to developed international equities and a neutral view of emerging markets. Our U.S. equity allocation also reflects a slight tilt toward small-cap stocks, which have lagged in this year's rally but appear quite inexpensive in relative terms. We are in the midst of a research project exploring whether to allocate even more to this "cheap" asset class; by many metrics, small and mid-cap stocks are the cheapest they've been in over 20 years. In real assets, we are biased toward infrastructure stocks, and an underweight in real estate. Further, we are watching rates with great interest and investigating whether it might be time to move out our maturities and duration, given the sizable moves in yields. Last quarter, we trimmed our High Yield overweight, mostly as a defensive move in the event our base case proved wrong. We maintain this position; credit spreads are paying you a "normal" amount against a backdrop of above-normal risk, and our belief is that credit risk should command additional compensation.

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About Pete Chiappinelli, CFA, CAIA, Chief Investment Officer

Pete is Chief Investment Officer at the firm. He is focused primarily on Asset Allocation in setting strategic direction for client portfolios. Pete has 30 years of experience in research, investment strategy, and thought leadership regarding the management of multi-asset class portfolios, inclusive of equities, fixed income, and alternatives. His work has been featured in leading financial publications such as *The Wall Street Journal*, *The New York Times*, *Barron's*, and others in Canada, Europe, and Asia. His market commentaries have been featured at major industry conferences, in TV documentaries on capital markets history, and on social media outlets. Prior to joining Ballentine Partners in 2022, he was a Senior Portfolio Strategist on GMO's Asset Allocation team. Prior to that, he was an Institutional Portfolio Manager at a specialized unit within Fidelity Investments and was the Managing Director of Institutional Investment Strategy & Research at Putnam Investments. He is a graduate of Carleton College and holds his MBA from The Wharton School at the University of Pennsylvania. Pete holds the Chartered Financial Analyst (CFA) designation, is a member of the CFA Institute and CFA Society Boston, and he holds the CFA Institute Certificate in ESG Investing. He also holds the Chartered Alternative Investment Analyst (CAIA) designation and was the founding President of CAIA Boston. Pete lives in Hingham, MA with his wife, Cheryl, and enjoys travel, cooking (definitely not a "foodie," but a "foodie wannabe"), sourdough breadmaking, and conjuring up ways to embarrass his three children.

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