The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets October 2023

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***Inflation Numbers Continue to Worry the Investment Community.*** *While reports show improvement, core prices remain ahead of the Federal Reserve's 2% inflation target.*
- ***Jobs Numbers and Wage Growth Remain Large Concerns of the Fed.*** *Most recently, however, while hiring numbers have been rising, wage growth has been moderate.*
- ***Global Stocks Declined, Pressured by Rising Interest Rates and Slowing Growth.*** *Indications that central banks will keep monetary policy tight weighed on global stock and bond markets.*

THE ECONOMY

The strength of the economy so far this year has surprised everyone, from casual observers to most economists. Even the Federal Reserve is taking a more optimistic view and is not forecasting a recession in 2023. The perceived odds are for a soft landing where the economy avoids a recession while inflation decelerates towards the Fed's two percent target. The Personal Consumption Expenditure Index, which the Central Bank uses to define its two percent inflation goal, rose slightly more quickly last month as gas prices gave it a boost. But after stripping out food and fuel costs, both of which are volatile, the "core" inflation measure that the Fed watches closely is beginning to cool notably.

As mentioned in our bullet points above, the jobs numbers report is one report that worries the Fed. Hiring is up, meaning demand is up, and thus prices rise to contain supply. All of this bothers the Fed, but we think they have become more comfortable understanding we are still getting back to pre-pandemic relationships.

Global markets are rattled by rising interest rates and oil prices. Dollar strength creates pressure on other currencies. Central banks continued to remove accommodative policy by shrinking their balance sheets during the third quarter. Global earnings growth, which has been decelerating since 2021, showed some signs of stabilizing in the quarter. Earnings growth should remain positive for the next 12 months across the world markets.

FINANCIAL MARKETS

EQUITIES

Stocks struggled under the weight of rising Treasury yields and the concern that the Federal Reserve will keep rates higher next year than it had earlier expected. Higher yields undercut stock prices by pulling investment dollars away from stocks and into bonds. They also crimp corporate profits by making borrowing more expensive.

As reflected in the chart below, the market declined in the third quarter as the S&P 500 decreased by 3.27% after increasing by 16.89% in the first half of 2023. Of particular note is the performance of the Nasdaq throughout the course of the year. Information Technology, at 27.5% of the S&P 500, is far and away the largest component of the broad index. Artificial intelligence, demand for advanced semiconductors, cloud-related companies involved with such important services as security, are exciting new investment vehicles that have bid this sector to price levels not seen before.

	Equity Returns*			
Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	-3.27%	8.74%	7.50%	13.07%
Dow	-2.10%	3.97%	0.93%	2.73%
Nasdaq	-4.12%	12.81%	16.77%	26.30%
Russell 2000	-5.13%	5.21%	2.74%	2.54%

*Total: price change + reinvested dividends

As somewhat covered in the discussion of the index table, the various sector weights below are quite easy to understand given where we go from one quarter to the next in the economic reports and outlooks provided by the Fed in their interpretation of the reported data. Health Care provides a fairly consistent weight in the S&P sectors, with Financials, Consumer Discretionary and Utilities carrying more of a defensive posture. Industrials and Materials await clearer evidence of a sustainable growth of business in the economy.

	S&P 500	Returns*			
Sector	**Weight**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	4.7%	12.22%	-0.89%	-4.67%	6.03%
• Materials	2.4%	-4.76%	3.31%	4.29%	2.61%
• Industrials	8.3%	-5.16%	6.49%	3.47%	4.50%
• Cons. Discretionary	10.7%	-4.80%	14.58%	16.13%	26.67%
• Consumer Staples	6.6%	-5.97%	0.45%	0.83%	-4.76%
• Health Care	13.4%	-2.65%	2.95%	-4.31%	-4.09%
• Financials	12.8%	-1.13%	5.33%	-5.56%	-1.65%
• Info Technology	27.5%	-5.64%	17.20%	21.82%	34.72%
• Commun. Svcs	8.9%	3.07%	13.06%	20.50%	40.43%
• Utilities	2.4%	-9.25%	-2.53%	-3.24%	-14.41%
• Real Estate	2.4%	-8.90%	1.81%	1.95%	-5.45%

09/30/23
*Price + income
Source: S&P Dow Jones

S&P 500 earnings have stabilized over the past several weeks as the first and second quarter earnings both came in better than expected. Third quarter earnings reports, which kick off in mid-October, will provide valuable insight into how corporations are navigating the current environment. Once again, we go back to jobs numbers and how the Fed will continue to react to the announcements. An unexpected drop in initial U.S. jobless claims is one example of reports that the Fed would characterize as a labor market too tight, putting upward pressure on wages. These reports, as well as others, are considered by many to be quite hawkish.

FIXED INCOME

September was a difficult month for U.S. Treasuries as falling prices pushed yields higher across the curve. The most notable moves were on the long end of the curve. Maintaining higher interest rates for longer is one of the major headwinds for bonds. How long rates stay elevated will ultimately be a function of how quickly inflation growth declines. It is doubtful the Fed will be ready to think about cutting interest rates from present levels until core inflation, now at 3.9%, decelerates further.

On a third quarter and year-to-date basis, long bonds performed the worst in comparison with other maturity lengths, as shown in the table below. Municipal bonds experienced a similar pattern. Interestingly, lower quality issues had the better returns simply because of their higher current yields. This phenomenon held true for municipals as well as corporate bonds.

Fixed Income Returns

Index	3rd Qtr	2nd Qtr	1st Qtr	YTD
Corporate/Govt.	-3.03%	-0.93%	3.17%	-0.88%
Int. Corporate/Govt	-0.74%	-0.77%	2.30%	0.77%
Long Corporate/Govt	-9.32%	-1.39%	5.69%	-5.49%
U.S. Treasury	-3.33%	-1.41%	3.08%	-1.76%
- Intermediate	-0.77%	-1.13%	2.24%	0.30%
- Long	-11.41%	-2.31%	6.01%	-8.25%
Corporate	-2.70%	-0.21%	3.45%	0.45%
- Intermediate	-0.72%	-0.08%	2.50%	1.68%
- Long	-6.91%	-0.50%	5.47%	-2.31%
- Quality				
- AAA	-5.18%	-0.91%	4.54%	-1.79%
- AA	-3.40%	-0.65%	3.59%	-0.58%
- A	-2.86%	-0.37%	3.26%	-0.06%
- BBB	-2.37%	0.02%	3.56%	1.12%
Municipal	-3.78%	0.02%	2.82%	-1.04%
- Intermediate	-1.87%	-0.53%	1.80%	-0.63%
- Long	-5.13%	0.41%	3.58%	-1.34%

Source: ICE BofA

Interest rates and bond yields have soared in 2023 while prices have retreated. The yield on the benchmark 10-year U.S. Treasury ended the third quarter at 4.57% with an increase of 73 basis points from the end of the second quarter and 69 basis points for the year to date. Like in June, the Fed paused again in its tightening by keeping rates unchanged in September but retained its “higher for longer” stance and kept on the table the possibility of one more rate hike in 2023. Fed Chair Powell stressed in his September press conference that policy will be dependent on economic data showing that inflation is continuing to moderate towards its two percent target, as discussed above.

It is our opinion that high quality corporate, government and municipal bonds remain attractive with upside potential, and we will focus on the short-to-intermediate maturity range for client accounts.

****

In our view, investors with a diversified portfolio should continue to be optimistic. The markets will adjust to the mean at some future point. The unusual moves we are seeing today in both the stock and bond markets will smooth out, and well-structured portfolios will reap the rewards of carefully positioned investments.

Philadelphia Investment Management Group does not guarantee the accuracy of any statement contained herein. This report is for informational purposes only and does not constitute an offer or recommendation to buy or sell any security. For more information on Philadelphia Investment Management Group, please contact us at **(800) 935-PIMG [7464]**.

Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851