# Market Commentary

September 30, 2023

DAVIDSON
INVESTMENT ADVISORS

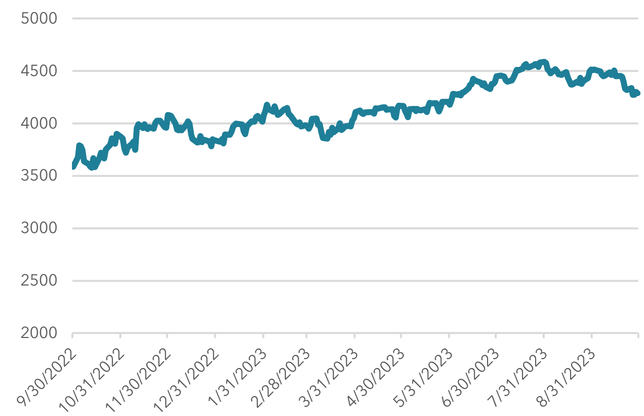
## U.S. Equities Market

*Rate Moves*

Rising interest rates finally began to impact equity markets as the S&P 500® Index returned its first negative quarter of the year, falling -3.2%. Interest-rate sensitive sectors were the worst performers with Utilities and Real Estate posting -9% returns. Consumer Staples, Technology and Industrial stocks also performed poorly, all posting -5% returns or worse. Energy stocks performed best, gaining 12% for the quarter, as oil prices rallied with OPEC, led by Saudi Arabia, cutting production and U.S. energy companies focusing on capital return instead of growing production. Communication Services was the only other sector in the black, as rebounding digital advertising and cable stocks performed well despite traditional media companies lagging badly due to the Hollywood strikes negatively impacting production of new shows and movies. Smaller company stocks, as measured by the Russell 2000® Index, continued to lag their larger counterparts, losing -5.2% for the quarter. Value and Growth performed roughly equally as higher interest rates dented multiples on expensive stocks, but also impacted the attractiveness of dividend-paying stocks. With cash rates above 5%, many investors are now simply preferring to stay with less risky cash assets, causing headwinds to equity markets.

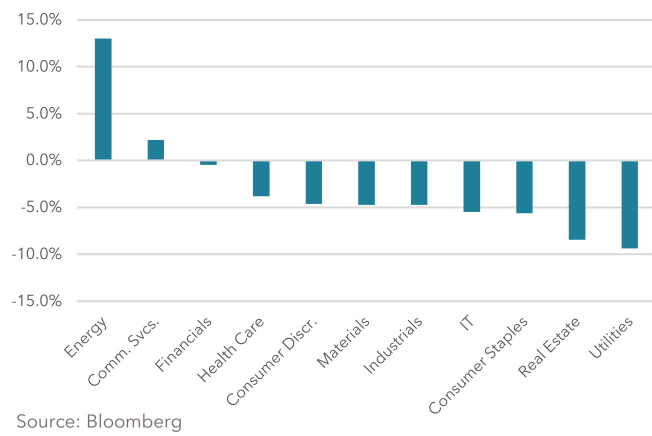
As noted in our previous quarterly commentary, the market's strong performance in the first half of 2023 seemed difficult to replicate in the second half as interest rates marched higher and the narrowness of market breadth became more so, such that a new term was coined: The Magnificent Seven. Not long ago, it was FANG, then FAANG – once Apple resurrected itself – but those of us that have studied the history of markets perhaps remember best the Nifty Fifty in the late 1960s and early 1970s. At the time, it was believed that one only had to buy these high-quality growth stocks – valuation agnostic – and be rewarded with handsome returns. In some ways, today's market backdrop is similar: long-lasting wars and expensive social programs causing large government deficit spending, leading to higher inflation and rising interest rates. Despite such an environment, steadfast optimism and determination that all will be okay kept the market going – that is, until 1973, when energy prices rose dramatically and what was a strong bull market became a lost decade for those Nifty Fifty stocks. Active managers began to outperform, as valuation and stock selection mattered again. As Bob Seger sang in 1976, "I remember, I remember," we remember, too, as that time was not particularly enjoyable for those investors wedded to past winners. History rarely repeats itself, but the resemblance is usually remarkably similar.

S&P 500 Index



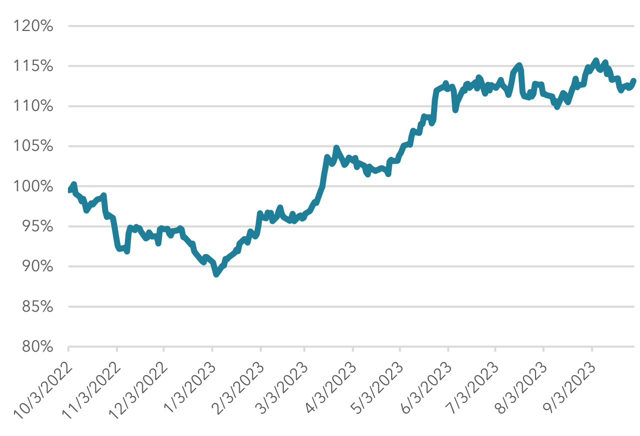

Source: Bloomberg

Q3 2023 Russell 3000 Returns by Sector




Source: Bloomberg

Russell 1000 Growth / Russell 1000 Value




Source: Bloomberg

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## U.S. Taxable Fixed Income Market

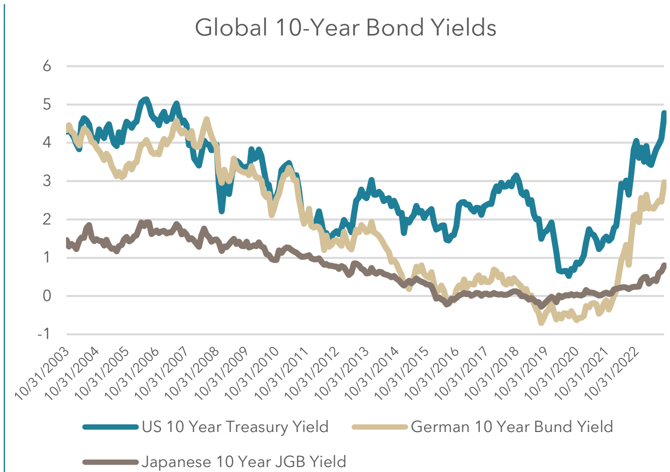
*Higher, but also Longer*

The third quarter of 2023 saw a resurgence of global interest rates; the U.S. 10-Year Treasury yield finished the quarter at 4.58%, up from 3.84% in the 2nd quarter, marking a 16-year high. The 10-Year German Bund made it to 2.83% – a 12-year high – and even the Japanese 10-Year Bond rose to 0.76%, a 10-year high. Several factors have been pushing rates higher, but items we would highlight are: 1) better than expected economic performance in terms of GDP growth, 2) declining but still elevated inflation, 3) a realization central banks will likely need to keep policy rates higher for an extended time frame, and 4) government financing requirements will be outsized in the years to come. For example, we believe, the U.S. Treasury will need to issue more than $10 trillion of bonds and bills in the next 15 months. There will be buyers, but at what yield?

If these higher rates generally persist, we expect the economy to continue to slow, given the higher debt service requirements. A slower economy should help the Fed in lowering inflation back to their 2% target, but it is likely to weigh on the labor market, bringing the 2nd leg of the Federal Reserve's mandate (full employment) back into play. We think the Fed would likely reverse course on rates with unemployment above 4.5%, but not with an inflation rate still above 3%.

Credit markets and spreads have thus far taken higher rates in stride, with credit spreads remaining at or below average levels. In this environment, being more cautious on credit is beneficial to a point, but only to a point; while higher interest rates can be challenging for borrowers, they can be welcome news to savers and investors. A well-diversified investment grade portfolio can generate yields in excess of 5% in the current environment. Yields of this magnitude serve as a cushion, should rates move even higher. This income stream will offset potential price declines in fixed-rate bonds in the scenario of higher rates. In our view, the risk/reward for investment grade fixed income is very favorable.

In the current environment, emphasizing credit quality, knowing the companies you own, and locking in higher rates as they become available are all ways to preserve capital and earn income. The longer rates remain at these levels, the more likely it is that a growing number of companies and consumers will have to rollover their debt at a much higher cost. That is why *longer* matters as much as *higher*.

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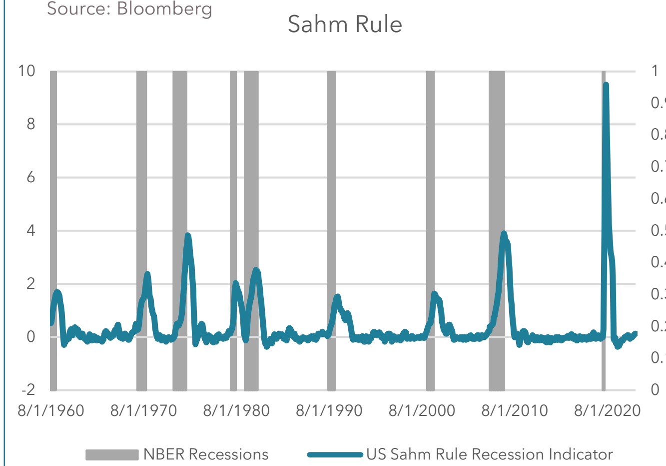


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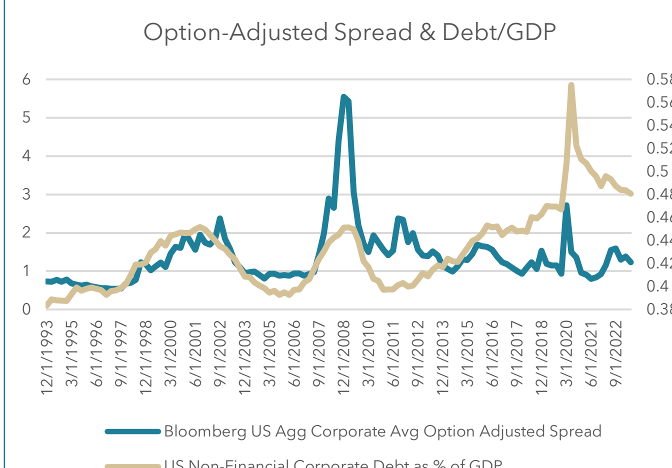


Source: Bloomberg

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## U.S. Municipal Fixed Income Market

*Muni Yields Reach New Highs*

Municipal yields moved higher during the third quarter, in sympathy with Treasury yields. Front-end muni yields rose around 100 basis points, while longer-dated tenors rose approximately 86 basis points over the quarter. The inverted shape of the yield curve remained intact, as the rise in muni yields was effectively parallel over the course of the quarter. Total return on the Bloomberg Municipal 1-10 Year Blend Index was -2.2% for the quarter, while the year-to-date and trailing 12-month returns were -0.8%, and 2.3%, respectively. Option-adjusted duration remained just shy of 4 years, with an average maturity of 5.98 years. Five percent coupon bonds make up the majority of the index, with 4.61% being the resultant average. Longer-dated bonds moderately underperformed shorter-dated bonds. Their higher starting yield was not enough to offset their price decline due to the overall rise in yields.

Regarding the breakdown between purpose types, last quarter both General Obligation (GO) and Revenue bonds produced similar returns. However, over the past 12 months, Revenue bonds have outperformed GOs by 89 basis points, 2.10% versus 2.99%. The primary driver of outperformance is the moderately longer option-adjusted duration of revenue bonds compared to GO bonds, 6.69 versus 6.10, and a slightly higher yield to worst, 4.10% versus 4.44%.

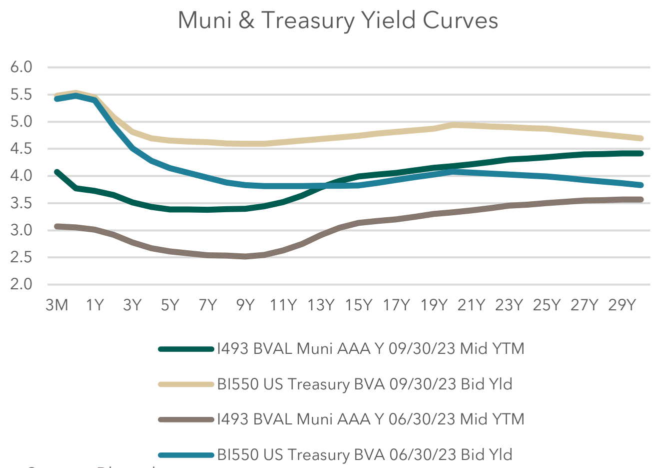
In terms of credit quality, spreads between AAA and A-rated bonds have recently narrowed by 15 basis points, to a new 12-month low of 51 basis points. The trend of narrowing credit spreads could continue until we see signs of a credit deterioration, perhaps due to a recession or a drop in federal support funding. Until then we expect investors will continue to reach for yield.

We remain focused on adding more duration exposure to our existing portfolios via maturity reinvestment and tax loss swaps. Wide window callable bonds still have a place in the short end of the portfolio, but locking in longer exposure at tax-exempt yields north of 4% seems prudent given our longer-term view of interest rates. Tax-exempt yields of 4% are equivalent to taxable yields of 6.75%, assuming a 40.8% tax rate. Yields could move higher from here depending on how long the Fed keeps rates elevated, but by beginning to average into the market at current levels, investors can lock in attractive yields without having to exactly time the market.

Bloomberg Index Statistical Comparison

| Index | Q3 | YTD | 12 Months | OAD | Avg. Maturity Years |
|---|---|---|---|---|---|
| 1-10 Year Blend | -2.23 | -0.81 | 2.29 | 3.88 | 5.98 |
| 1-15 Year Muni | -2.85 | -1.05 | 2.50 | 4.72 | 7.93 |
| GO Bond Index | -4.10 | -2.01 | 2.10 | 6.10 | 11.37 |
| Revenue Bond Index | -4.04 | -1.16 | 2.99 | 6.69 | 14.16 |

Source: Bloomberg

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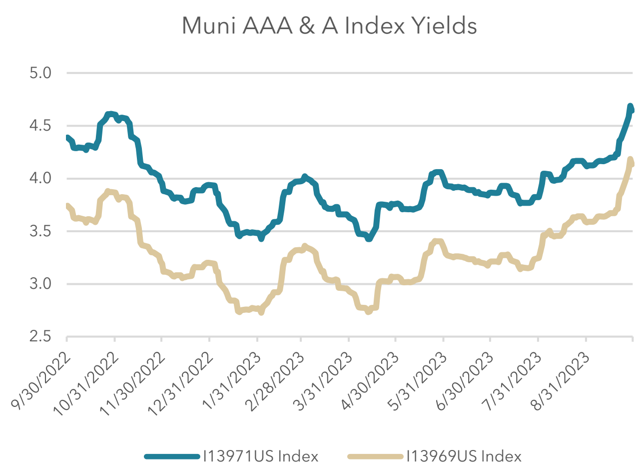


Source: Bloomberg


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## International Equities Market

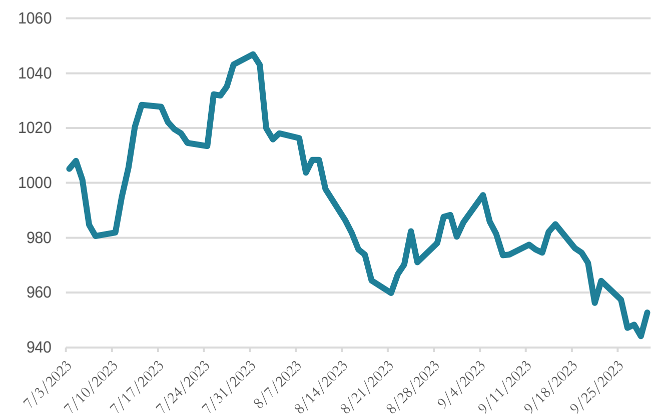
*Higher Rates Everywhere*

Emerging markets outperformed both developed international and domestic equities; however, the performance for the MSCI Emerging Markets Index was negative, down 2.9% for the third quarter. Developed international markets, represented by the MSCI EAFE Index, was the greatest laggard with quarterly performance down 4.1%. The dollar was a larger headwind to investment performance this quarter than it was during the second.

Interest rates are climbing around the globe not just here in the United States. Rates on average in Europe increased 43.6 basis points versus a 73.4 basis point increase in the U.S. In Asia, rates increased on average 42.1 basis points. The only major economy where rates aren't rising at such rates is China, where they increased modestly, up 3.3 basis points. Inflation rates are decelerating, like they are domestically, but they remain stubbornly above most central banks' targets. China is the only major economy not suffering from high inflation; in contrast, it's suffering from borderline deflation. In terms of economic growth, the United States, Japan and India are reporting robust numbers but growth in both Europe and China is slower than hoped.

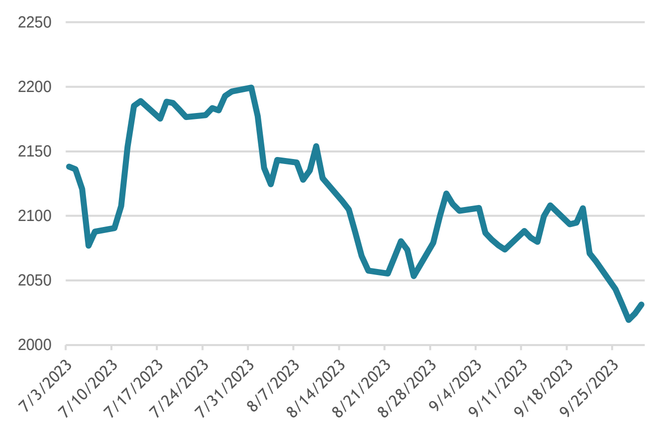
So, what's going to change the narrative? So far, it's been dictated by macroeconomics – Central Bank policies and the interplay between inflation, interest rates and growth. Therefore, the change is going to have to come from bottom-up fundamentals. Today, consensus estimates have the U.S. and emerging markets returning to profit growth in 2024; however, for developed international equities, expectations are modest, in the low single-digit range. International valuations are at their historical averages or slightly below, depending on the market; so, we are not at a trough in sentiment. Therefore, it will be important to pay attention to company performance and their confidence in the economic environment to invest in their business.

MSCI Emerging Markets Index



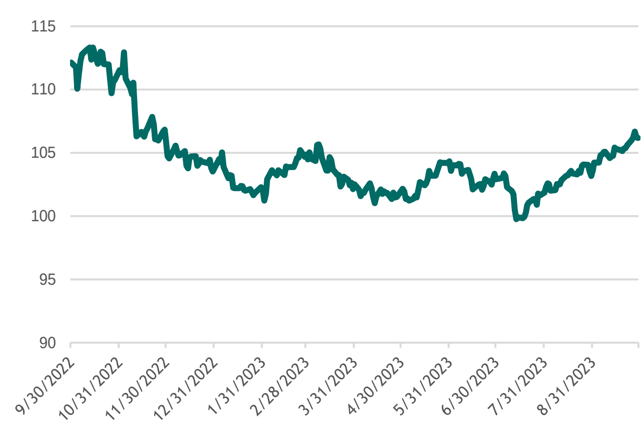

Source: Bloomberg

MSCI EAFE Index




Source: Bloomberg

Dollar Index Spot




Source: Bloomberg

## Disclosures

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The information contained in this presentation has been taken from trade and statistical services and other sources, which we believe to be reliable. We do not guarantee that this information is accurate or complete and it should not be relied upon as such.

This presentation is for informational and illustrative purposes only, and is not intended to meet the objectives or requirements of any specific individual or account. Past performance is not an indicator of future results. Indices provide a general source of information on how various market segments and types of investments have performed in the past. An investor should assess his/her own investment needs based on his/her own financial circumstances and investment objectives.

The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Sahm Rule identifies signals related to the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to its low during the previous 12 months. It has been right about every recession dating back to 1960.

Option-Adjusted Spread (OAS) is the yield spread which as to be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

## Disclosures

The Bloomberg Municipal 1-10 Year Blend Index measures the performance of short and intermediate components of the Municipal Bond Index – an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market.

The Bloomberg Municipal 1-15 Year Index measures the performance of the U.S. dollar-denominated long-term, tax-exempt bond market with maturities of 1-15 years, including state and local general obligation (GO) bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Bloomberg Municipal Bond: GO Bond Index represents the General Obligation (GO) sector of the Bloomberg Municipal Bond Index, which covers the U.S. dollar-denominated long-term tax-exempt bond market. A general obligation bond is a municipal bond backed solely by the credit and taxing power of the issuing jurisdiction.

The Bloomberg Municipal Bond: Revenue Bond Index represents the Revenue Bond sector of the Bloomberg Municipal Bond Index, which covers the U.S. dollar-denominated long-term tax-exempt bond market. A revenue bond is a municipal bond supported by the revenue from a specific project, such as a toll bridge, highway, or stadium.

The BVAL Muni AAA curve is the baseline curve for BVAL tax-exempt munis. It is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P. The yield curve is built using non-parametric fit of market data obtained from the Municipal Securities Rulemaking Board, new issues calendars and other proprietary contributed prices.

The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.