The US economy experienced a strong rebound in the third quarter, with real gross domestic product growing at an annual rate of 4.9%. This robust performance suggests the US economy is on a solid footing, even if temporarily, despite ongoing concerns about inflation and restrictive interest rates.

Inflation remains a focal point in the US, and in most parts of the world, with consumer spending being the main driver of this continued growth. However, cracks are emerging in larger swaths of economic data.

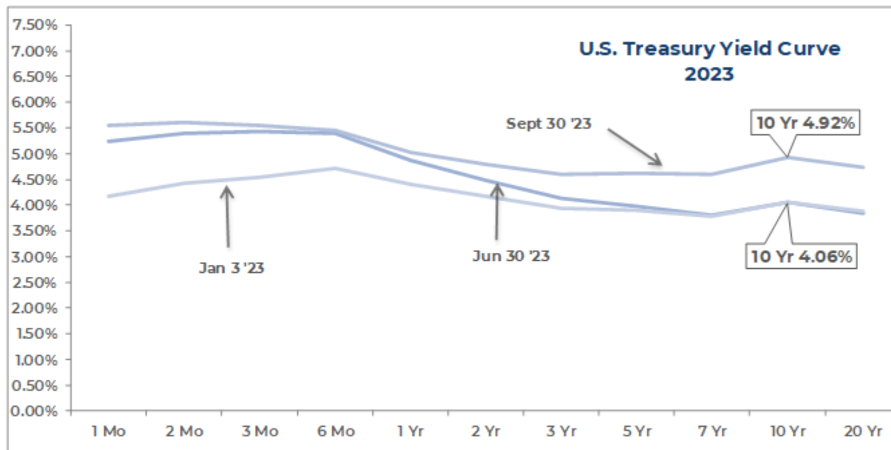
Recap: Third Quarter 2023

The focus remained firmly on the Federal Reserve ("Fed") and the trajectory of interest rates during the quarter. The first two months of the quarter were relatively benign as most of Wall Street took their final vacations to close out the summer.

However, things shifted dramatically at the end of August. The US Treasury, which is unrelated to the Federal Reserve, announced a much higher bond issuance amount than originally expected. This higher issuance amount stems from the need to fund a record, and growing, spending deficit by the Biden administration. Expectations were in the $700 billion range with the actual issuance announcement coming in at over $1 trillion.

In addition, the market saw an uptick in government bond supply due to the Fed's unwinding of its balance sheet, i.e., slowing and reversing its massive purchases of US Treasury notes and mortgage-backed securities since the pandemic and the Global Financial Crisis.

These two major influences, combined with a seasonally thin trading market, caused interest rates to move dramatically higher in September. The yield on the 10-year US Treasury note increased 1.0% during the month alone to hit highs not seen since 2007.

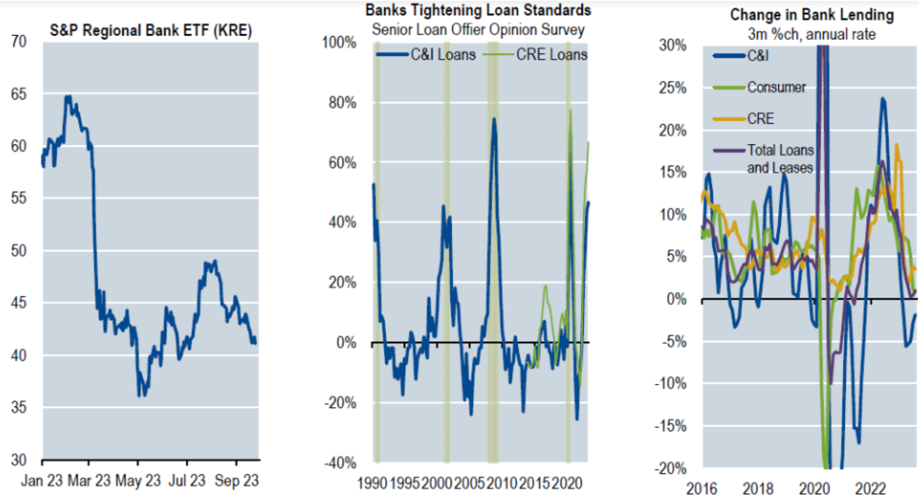


Source: U.S. Dept of The Treasury

Macroeconomic

As investors look for something to break as to allow the Fed to ease back on rates, data confirms there are definitely cracks forming in the system. For instance, the rate of borrowers falling behind on their auto loan payments has reached an all-time high. In September, Fitch Ratings reported 6.1% of subprime auto loan borrowers were at least 60 days overdue on their loans, the highest level in data dating back to 1994.

This is certainly impacting lending activity across the board. Community banks and credit unions are scaling back, while captive lenders and other financial institutions are gaining a larger share of the market. This shift has several implications for financial institutions and the economy as a whole.

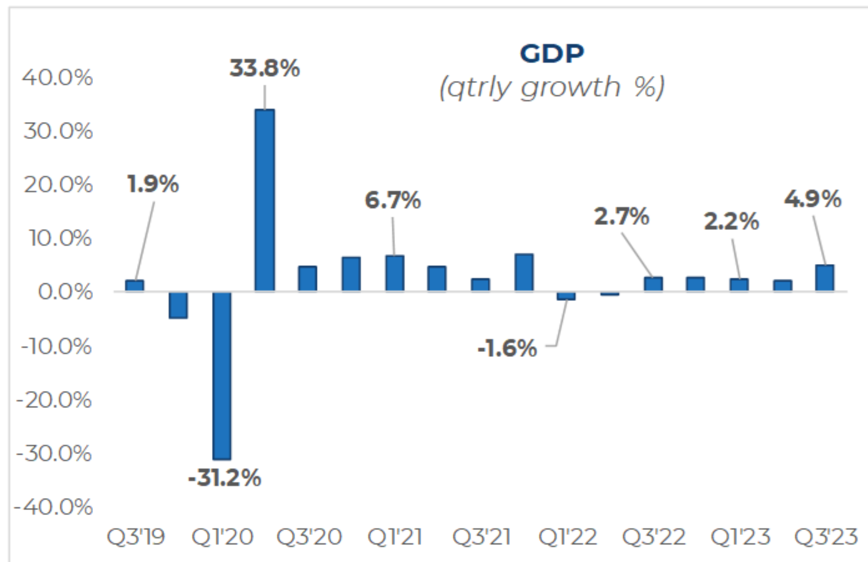


Source: Bloomberg, Federal Reserve, Haver Analytics. As of 25 Aug 23

GDP

The US economy grew at an annualized rate of 4.9% during the quarter, down from 2.1% in Q2'23. The consequences of Fed tightening are starting to emerge but the full effects remain to be seen. On average, it takes 12-18 months for one rate hike to make its way through the economy.

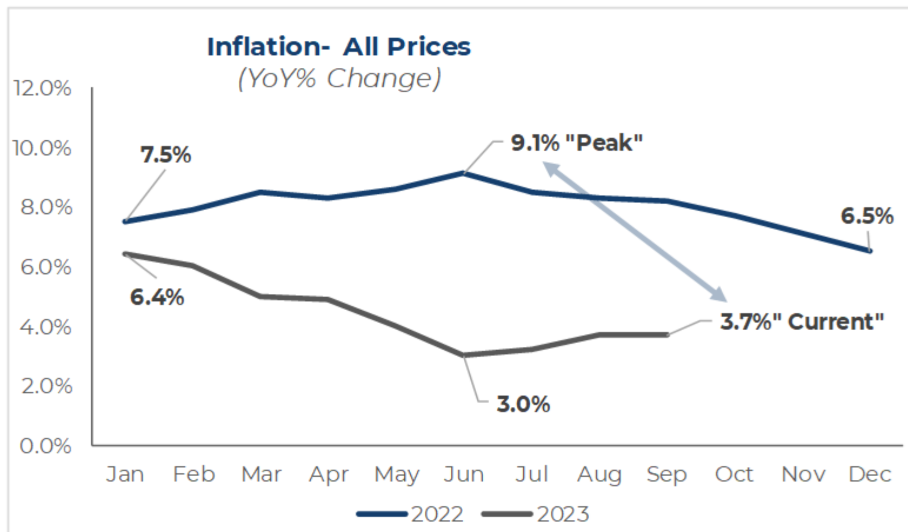
The strength was a result of increases in consumer spending, private inventory investment, exports and residential fixed investment spending. Personal consumption, which makes up more than two-thirds of GDP, saw an increase of 4.0% from the prior quarter and an annual increase of 2.4%. Consumers have remained resilient and continue to spend money on nondurable goods, recreational goods and vehicles. As 2023 draws to a close, the holiday season will be the next gauge on the overall health of the consumer.



Soure: FRB St. Louis, FRED

Inflation
The path back to declining inflation has been a painful one with the economy holding up better than most expected especially after the aggressive monetary policy tightening from the Fed. However, inflation still remains a major concern for policymakers and households around the world. In the US, inflation reached 3.7% in September 2023 after dropping to 3.0% in June 2023. Fortunately, this is a far distance from the 9.1% seen in June 2022.

Overall, prices have declined sharply in the last year without the help of an economy in recession. This is a clear indication of how important supply-side improvements have been to the softening inflation trend. By the same token, the fact inflation jumped sharply in 2021-2022, without the coincidence of an economic boom, underlines the importance of supply-side factors in that run-up.



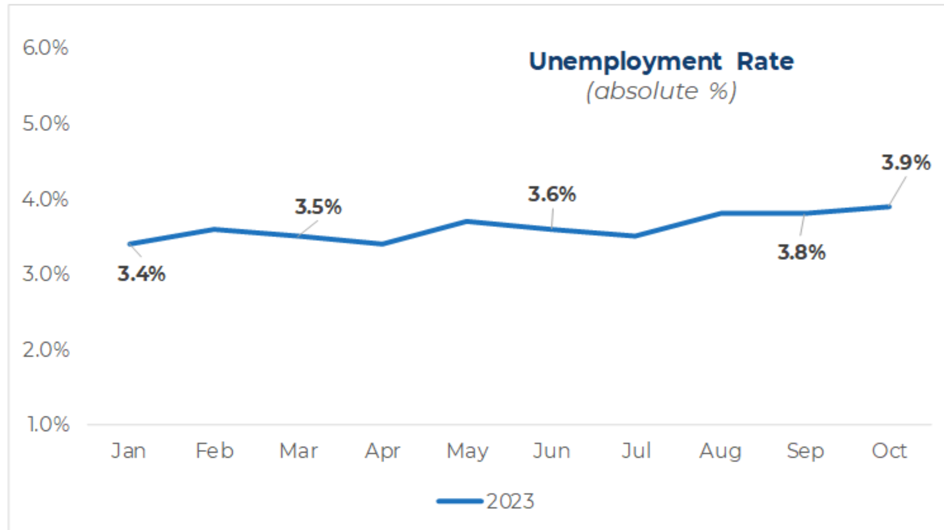
Source: BLS

Labor Market

The labor market started the year at historically tight levels on the heels of a significant labor shortage following the supply shock of the pandemic. The unemployment rate in the US started 2023 at 3.4%, the lowest level since 1969, only to hit 3.9% by October 2023. In the eurozone, the unemployment rate is near 6.5%, the lowest level tracking back to 2008, after seeing highs near 8.5% during the pandemic.

As many industries returned to pre-pandemic staffing levels, and grinded through order backlogs, hiring plateaued and began to fall as seen by the last few labor reports.

Strong labor markets have supported, and continue to support, consumer spending and economic growth making taming inflation that much harder. For the foreseeable future, bad news for the labor market will be good news for the inflation fight.



Source: BLS

Markets

Returns (%) as of 9.30.23				Trailing (Annualized)		
	June	**QTD**	**YTD**	**1-Yr**	**3-Yrs**	**5-Yrs**
U.S. Equity						
S&P 500 Index	-4.8	-3.3	13.1	21.6	10.2	9.9
DJ Industrial Average Index	-3.4	-2.1	2.7	19.2	8.6	7.1
Russell 1000 Index	-4.7	-3.1	13.0	21.2	9.5	9.6
Russell Mid Cap Index	-5.0	-4.7	3.9	13.4	8.1	6.4
Russell 2000 Index	-5.9	-5.1	2.5	8.9	7.2	2.4
Non-U.S. Equity						
MSCI EAFE Index	-3.4	-4.1	7.1	25.6	5.8	3.2
MSCI Emerging Markets Index	-2.6	-2.9	1.8	11.7	-1.7	0.6
Fixed Income						
Bloomberg US Agg. Bond Index	-2.5	-3.2	-1.2	0.6	-5.2	0.1
Bloomberg US Int. Corporate Index	-1.3	-0.9	1.3	3.8	-2.6	1.5
ICE BofA US High Yield Corp Index	-1.2	0.5	6.0	10.2	1.8	2.8

[1] Source: Morningstar

Equities
As bond yields hit multi-year highs, and correlations once again moved closer to +1, US equities closed out September firmly in the red, with Energy as the lone positive sector gainer. The overarching theme for Q3 was “volatility” as all major

indices experienced a negative return. The S&P 500 Index declined -3.3%, the Nasdaq Composite fell -3.9%, and the Dow Jones Industrial Average lost -2.1%.

Despite the decline during the quarter , US equities are still up for the year. The S&P 500 Index is up +13.1% year-to-date, and the Nasdaq Composite is up +27.1%. However, this performance continues to be led by a small subset of technology companies with exorbitant valuations. When adjusting for those companies, the performance is much different as shown by the S&P 500 Equal Weight Index +1.8%. This implies the broader market is not necessarily growing fundamentally and this small pocket of outperformance from tech is speculative in nature.

It seems the market is focusing on subjective short-term factors that are providing support for equity market prices and this FOMO behavior could extend into the coming quarters. The US labor market seems strong, but is clearly softening, and consumer spending continues to hold up well, supported by the savings accumulated during the pandemic. But, many argue including us here at Eamon, with consumer debt levels north of $1 trillion carrying +30.0% average interest rates, it is just a matter of time before consumers feel the pain.

Non-US equities provided modest hedging, albeit turning negative during September as shown MSCI ACWI ex US Index falling -3.1%. A bright spot, and lone positive performer for the quarter, was the MSCI EAFE Value Index up +0.6%. Emerging markets performed in line to its developed counterparts as shown by the MSCI Emerging Markets Index falling -2.9% versus the MSCI EAFE Index down -3.4%.

On a global basis, by far the most unique economy has been China this year. After a year of disappointing retail sales and industrial output, official data for August pointed to signs of stabilization. Fixed asset investment failed to grow during August as China deals with a steep decline in property investment. The MSCI China Index fell -2.9% during August (in USD terms) and is down -6.8% year-to-date (in USD terms.)

Fixed Income

The fixed income market struggled during the quarter with a majority of the bond indices experiencing negative returns. The Bloomberg US Aggregate Bond Index lost -3.2%, the worst quarterly performance since the same quarter in 2022. The yield curve inversion (10 year US Treasury rate minus 2 year US Treasury rate) declined from -1.05% to -0.48%. The more negative the number the more inverted the yield curve.

The first part of the quarter was relatively benign until the market was shocked by the US Treasury issuance announcement. In addition, the Fed's rapid wind down of its balance sheet continues to bring new supply of US government bonds to the

market. Since January 2022, the Fed has reduced its balance sheet from $9.0 trillion to around $7.8 trillion by selling an average of $30 billion in securities per month. Both of activities by the Treasury and the Fed have caused a deluge of bond supply and in turn have depressed bond prices. Bond prices move inversely to rates so as prices fall interest rates move higher.

These two major factors sent the US Treasury yield curve into a performance nosedive as longer maturity yields moved 1% higher by the end of September. To put this into perspective, the Federal Reserve increased its policy rate from near zero to 5.25% over the last year and we experienced a 1.0% move in one month.

There were two bright spots as the shorter duration and less interest rate sensitive US Gov't/Credit 1-3 Yr. Index +0.7% and BofA U.S. High Yield Corp Index +0.5% both ended in positive territory. Longer duration indices, i.e., more interest rate sensitive, were hit the hardest as shown by the Bloomberg US Long Corporate Index down -7.2% for the quarter.

From a policy perspective, the Fed, led by Jerome Powell, kept the policy rate unchanged at the September meeting, despite low unemployment, strong job gains, and elevated inflation. Overall, the fixed income market is beginning to settle into a "higher for longer" scenario with expectations for any potential rate cuts looking more likely in mid-2024. This is in line with the expectations of the potential slowdown in economic growth. With only one meeting left this year, a rate hike is not looking likely as the Fed instead adopts a "wait and see" approach while monitoring for signs of economic weakness.

Outlook: The Beat Goes On

We are beginning to see the light on the horizon as inflation trends lower and expectations for interest rates level off as we head into the final quarter of 2023. As of this commentary, the Fed has now paused its rate hiking cycle for two consecutive meetings, pointing to the yet unseen effects of its historic policy tightening cycle over the last year or so.

While inflation remains above the long-term target of 2.0%, it has declined significantly from the peaks seen last year. Further, as of late, the labor market is beginning to lose steam as the unemployment rate increased by 0.4% to 3.9% with the most recent release in October.

From a positioning standpoint, we continue to favor bonds over equities in this environment. The equity market continues to push higher in the face of economic weakness, major retailers warning of a consumer spending slowdown, and a

decline in corporate business investment. By some measures, e.g., the equity risk premium, the equity market is overvalued somewhere in the 20-30% range given current interest rate levels. This shown in the black boxed area in the graph from Wilshire below:

Equity Valuations: Stocks are Expensive, Even if You Assume EPS of $248 in 2024

US 10 Year Treasury Yield (%)

US Equity 2024 EPS ($)	2.00	2.25	2.50	2.75	3.00	3.25	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50
275	28%	21%	16%	11%	6%	2%	-2%	-6%	-9%	-12%	-15%	-18%	-20%	-23%	-25%
270	25%	19%	14%	9%	4%	0%	-4%	-7%	-11%	-14%	-17%	-19%	-22%	-24%	-26%
265	23%	17%	12%	7%	2%	-2%	-5%	-9%	-12%	-15%	-18%	-21%	-23%	-26%	-28%
260	21%	15%	10%	5%	0%	-4%	-7%	-11%	-14%	-17%	-20%	-22%	-25%	-27%	-29%
250	16%	10%	5%	1%	-3%	-7%	-11%	-14%	-17%	-20%	-23%	-25%	-28%	-30%	-32%
245	14%	8%	3%	-1%	-5%	-9%	-13%	-16%	-19%	-22%	-24%	-27%	-29%	-31%	-33%
240	11%	6%	1%	-3%	-7%	-11%	-14%	-18%	-21%	-23%	-26%	-28%	-30%	-33%	-35%
235	9%	4%	-1%	-5%	-9%	-13%	-16%	-19%	-22%	-25%	-27%	-30%	-32%	-34%	-36%
230	7%	2%	-3%	-7%	-11%	-15%	-18%	-21%	-24%	-26%	-29%	-31%	-33%	-35%	-37%
225	4%	-1%	-5%	-9%	-13%	-17%	-20%	-23%	-25%	-28%	-30%	-33%	-35%	-37%	-39%
220	2%	-3%	-7%	-11%	-15%	-18%	-22%	-24%	-27%	-30%	-32%	-34%	-36%	-38%	-40%
215	0%	-5%	-9%	-13%	-17%	-20%	-23%	-26%	-29%	-31%	-34%	-36%	-38%	-40%	-41%
210	-3%	-7%	-11%	-15%	-19%	-22%	-25%	-28%	-30%	-33%	-35%	-37%	-39%	-41%	-43%
205	-5%	-9%	-14%	-17%	-21%	-24%	-27%	-30%	-32%	-34%	-37%	-39%	-41%	-42%	-44%
200	-7%	-12%	-16%	-19%	-23%	-26%	-29%	-31%	-34%	-36%	-38%	-40%	-42%	-44%	-45%
195	-10%	-14%	-18%	-21%	-25%	-28%	-30%	-33%	-35%	-38%	-40%	-42%	-43%	-45%	-47%
190	-12%	-16%	-20%	-23%	-27%	-30%	-32%	-35%	-37%	-39%	-41%	-43%	-45%	-47%	-48%
185	-14%	-18%	-22%	-25%	-29%	-31%	-34%	-36%	-39%	-41%	-43%	-45%	-46%	-48%	-50%
180	-17%	-21%	-24%	-27%	-30%	-33%	-36%	-38%	-40%	-42%	-44%	-46%	-48%	-49%	-51%

Data Source: Wilshire, Bloomberg

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Now, this is not indicative of an imminent decline of this magnitude in the price of equities, however, it points to fundamentals not necessarily supporting prices at these levels. Many cannot justify equity prices going much higher from here for maybe the next two years. So, on a relative basis, given the selloff in bonds over the last two years, the asset class shows much more value when compared to equities. Put simply, bonds have not looked this attractive in decades and present the opportunity for equity like returns, with much less risk, in the near-term.

Looking Ahead & Positioning

As has been our theme for most of 2023, we are waiting patiently for a better entry point back into equities and are willing to forgo buying into this recent rally. We would likely rotate back into more balanced portfolio allocations, i.e., closer to normal asset class weights between equities and bonds, after a sustained decline in equity prices in the range of 10-20% from current levels.

We appreciate your continued support and partnership. In the meantime, stay disciplined- stay invested.

If you have any questions or want to discuss and of these topics further, please reach out at info@eamoncap.com

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