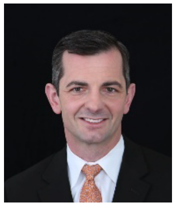


"In the foggy seas of investing, it's not the absence of risk but the compass of wisdom that guides us to treasures."

~ Unknown

Navigating foggy seas: Imagine you're the captain of a sailboat on a vast ocean. Your goal is to sail to a distant island where treasures await. Under normal conditions, you use a combination of your map, compass, and clear skies to guide your way.

One day as you're sailing, a thick fog descends upon the water, reducing visibility. It's harder to see where you're going, other boats, and potential obstacles like rocks or shallow waters. You might still have a general sense of direction from your map and compass, but the clear landmarks and the distant view of the island are now obscured.

As you continue cautiously, you suddenly hear the sound of waves crashing against rocks. It's a sign that there are hazards nearby, but it's not necessarily a sign that your ship is about to be wrecked. You must be more attentive, make more frequent checks with your navigation tools, and possibly even slow down or adjust the course.

During this time, some sailors might choose to drop anchor and wait for the fog to lift—they prefer to avoid risk, even if it means their journey to the island might take longer. Others continue forward but at a slower pace, while some may use the fog as an opportunity, believing their knowledge of the seas will give them a navigational advantage.

However, it's essential to understand that while the fog and waves increase the level of difficulty and risk, they do not necessarily mean there is an imminent storm or that the boat will never reach its destination. It is a time for caution, informed decision-making, and possibly patience, but it's not a full-blown crisis (yet).

Just like a sailor navigating through difficult waters, investors navigating through high uncertainty and emerging risks require a balanced approach—keeping a close eye on indicators, adjusting strategies as needed, and remembering the long-term goals. But it also serves as a reminder that when risks are present, opportunities can also be found for those willing to navigate the challenges carefully.

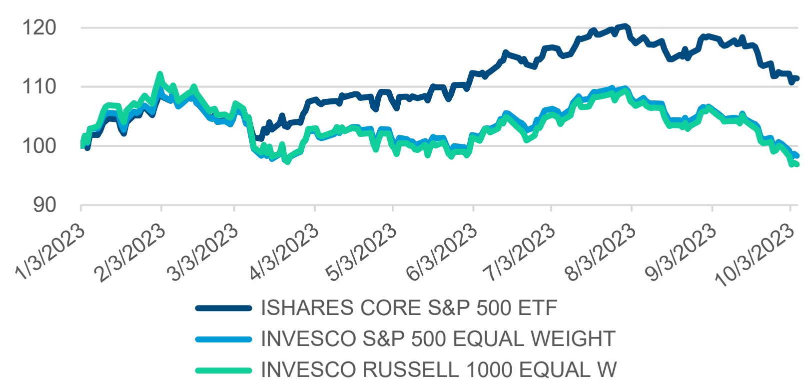
A CIO's View

Here are my summaries on several topics affecting markets, all monitored daily by our models. We regularly cover these topics in our monthly Navigator and quarterly Fixed Income Commentary.

Market Return: Historical Narrow Rally for Cap-Weighted Indices Only

We had mentioned in a previous newsletter the magnitude of the distortion of index returns caused by the top 10 stocks in the S&P500 representing 32% of the weight in the S&P500, a new high, while contributing to just 22% of the earnings. With the recent pull-back the distortion is more glaring: both the S&P500 Equal-weighted index and the Russell 1000 Equal-weighted index are below their levels from the beginning of the year, while the S&P500 Cap-weighted is still more than 10% above its 2023 starting level (Exhibit 1). That gap has increased during the Q3 pullback, with the S&P500 down 6.3% from the 7/31/2023 high, while the S&P500 Equal-weighted is down 8.1% over that same time period.

Exhibit 1: Cap-weighted vs. equal-weighted indices: a narrow rally eclipsing the broader reality



Source: Bloomberg

Recession: Slightly lower likelihood, with clouds on the horizon

Recession risks have continued to be pushed back for several months, forcing some with bearish positioning to adjust their stance. Looking at the short covering of bearish positions on the S&P500 puts the recent S&P500 pull back in perspective: at the end of September the non-commercial positioning in S&P500 E-mini futures contracts (overall net bets on the future direction of the market) was cut in half from its end of June level, as participants unwound half of their positions by buying back some of their contracts (Exhibit 2). This means traders were betting on a future decline in the market, but less so than the previous quarter. This activity had a net support effect for the market, leaving little support left from these participants.

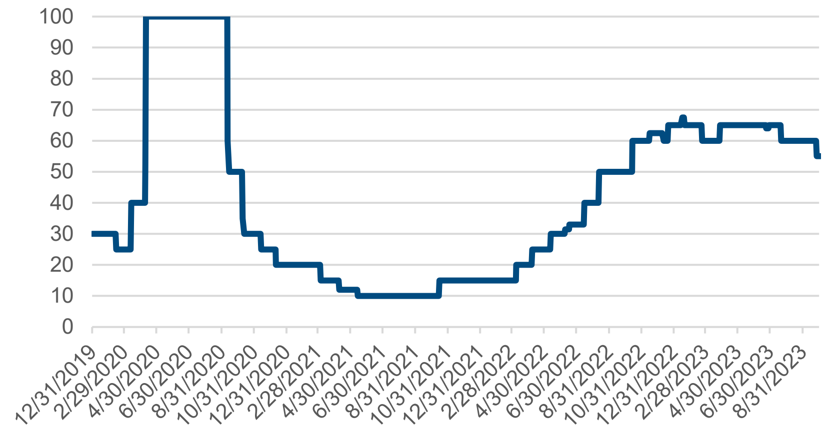
Exhibit 2: S&P 500 E-Mini Futures Contracts (50% reduction from June to September 2023)

Source: Bloomberg.

On the positive side, the probability of a recession has improved slightly at an elevated 55% (Exhibit 3), since the economy has shown some resilience, and maybe emboldening the FOMC to continue its restrictive actions.

The risk-reward ratio still remains high for the remainder of 2023: the stock market continues to display expanded multiples despite a rise in policy rates and real rates with cash yielding 5%, and a decelerating economy due to the Fed's action along with softening consumer trends and other sources of uncertainty. The summer strikes contributed to a loss of more than 4 million work days, the excess savings from fiscal stimulus have mostly been spent, student loan repayments are restarting (with rising consumer delinquencies), oil prices hit a new high, and a strong dollar are all seen as drags on growth. The government shutdown has been temporarily averted, but at the price of the U.S. House losing its speaker and bringing more political uncertainty to an incoming election year. Additionally, the rising topic of reckless fiscal policies could lead to the necessary removal of some stimulating fiscal policies. This all contributes to lowering the potential for further appreciation.

Exhibit 3: Probability of a U.S. Recession (remains at 55%)



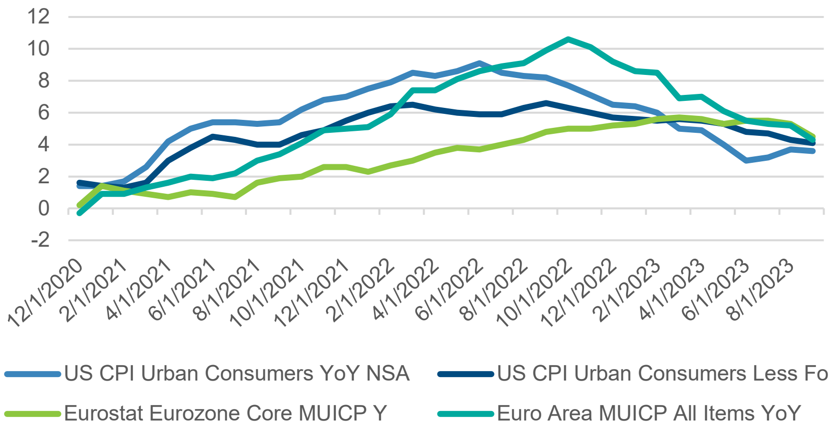
Source: Bloomberg.

Inflation: Improvements so far but resilience ahead

Updating our inputs from last quarter, while we continue to see the same pattern: core inflation is slowly coming down but still above 4%, while headline inflation has temporarily worsened to 3.6% due to an upward trend in energy prices which could continue over the next few months (Exhibit 4).

Core inflation above 3% for the remainder of 2023 and 2024 is a scenario which would trigger hawkish actions from the Federal Reserve and an additional rate hike.

Exhibit 4: U.S./Europe Core Inflation Rates

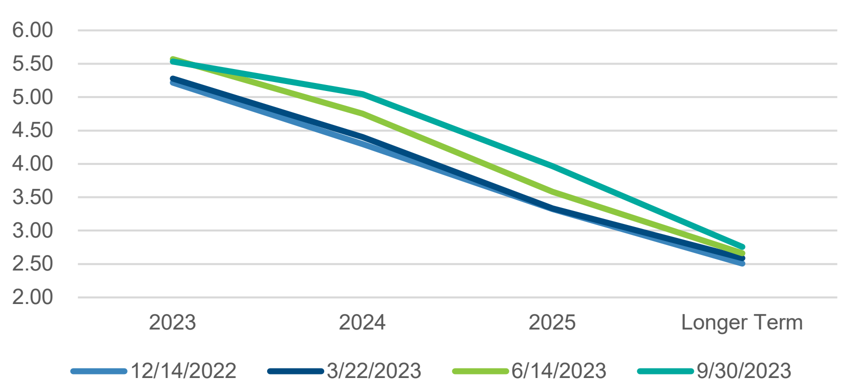


Source: Bloomberg.

Federal Reserve actions: Pause but another hike signaled

In September, the FOMC decided to pause, with additional context of higher real GDP growth for 2023, lower unemployment rates forecasts (from 4.1% to 3.8% in 2023 and from 4.5% to 4.1% in 2024), core inflation forecasts were lowered from 3.9% to 3.7% which was a positive sign. But the dot plots showed that most of the participants are still projecting another rate hike for 2023, with rates 50bps higher in 2024 and 2025, and a postponing of the first rate cut (Exhibit 5).

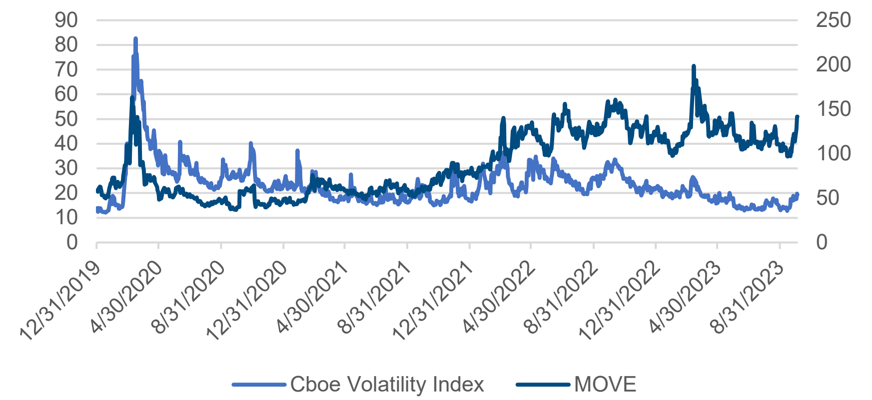
Exhibit 5: FOMC Dot plots signaling higher rates for a longer period



Source: Bloomberg.

The interest rate uncertainty has ticked up with the recent FOMC meeting, as can be seen in Exhibit 6: the MOVE Index (implied volatility of a basket of OTC options on US interest rate swaps) illustrates the foggy environment we are in.

Exhibit 6: The VIX Volatility Index and the MOVE Index indicate greater uncertainty in fixed income and higher interest rates

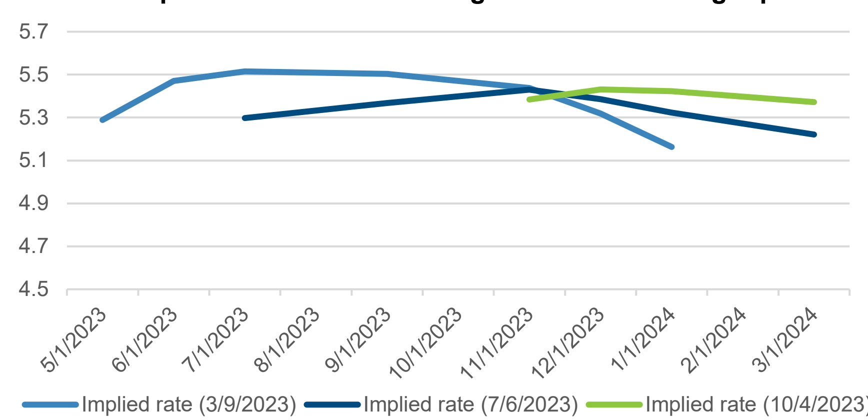


Source: Bloomberg.

The market has reacted to this information and incorporated most but not all of it (Exhibit 7): "Higher rates for longer."

The potential consequences would be twofold: more rate hikes down the road and later rate cuts as inflation could be more persistent than predicted.

Exhibit 7: Implied Rates now show higher rates for a longer period



Source: Bloomberg.

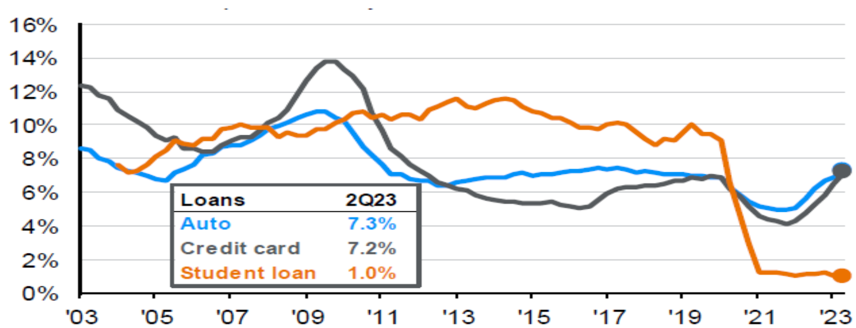
Economy: Resilient with some cracks

The persistent and surging higher bond yields are an adverse current for economic activity, which could lower financing activity, increase corporate debt burden, federal budget problems and have a negative impact on earnings which could reset market valuations.

Another impact is the rise of bankruptcies and delinquencies. We are seeing some of these effects manifesting themselves in the recent data (Exhibit 8).

Student loan repayments are restarting which will likely start showing an uptick in delinquencies within a few months.

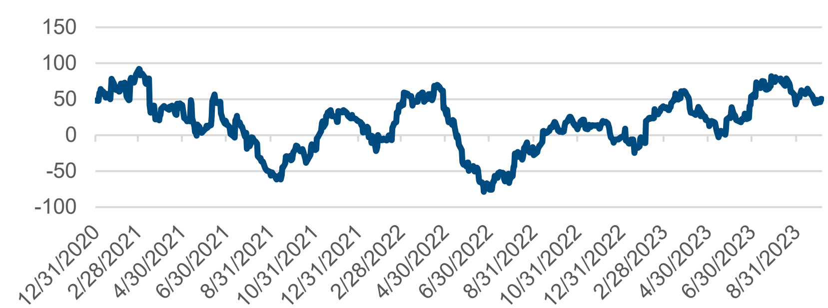
Exhibit 8: Debt delinquencies starting to rise (% of balance delinquent 30+ days)



Source: FactSet, JRB, J.P. Morgan Asset Management, BEA.

The Citigroup economic surprise index illustrates the resilience of the US economy: beating expectations, and almost as high as the end of 2020, but with a recent downtick (Exhibit 9).

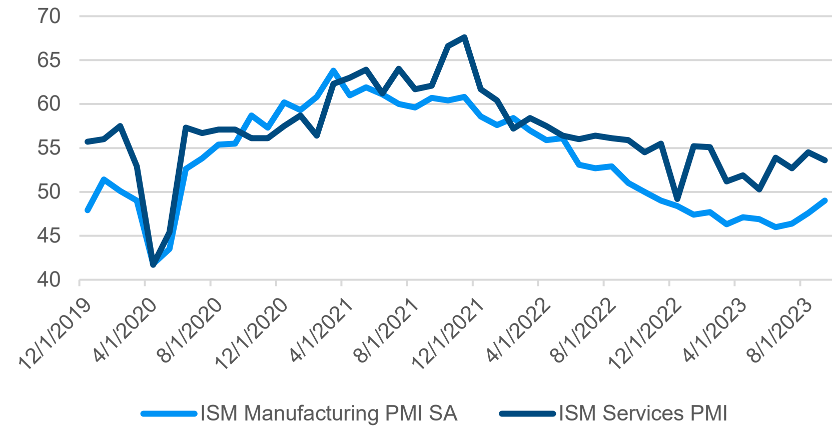
Exhibit 9: The Citigroup Economic Surprise Index indicates how economic data compares with consensus estimates



Source: Citigroup.

Similarly, the more restrictive monetary policies continue to show results: the ISM indices are still at a low (Exhibit 10), and the conference board leading indicators are in a recessionary phase.

Exhibit 10: ISM Manufacturing and Services Indices are still at a low



Source: Bloomberg.

Looking forward, we anticipate more weakness in the economy from the lagging effects of the Federal Reserve's tightening policy, combined with banks restricting credit. While we are not in a full-blown crisis like 2008, there are enough signs that invite us to caution and trim our sails.

Investment Implications

In summary, I have a few considerations for your portfolio given market conditions:

- Remain cautious in the current environment.
- Diversify your investments.
- Focus on active risk management and equal-weighted approaches.
- Consider getting paid to be on the sidelines with 5% cash yields.

Remember when you sail in the fog, trimming your sails and resisting the sirens' song will more likely lead you safely to your journey's destination. Thoughtful, measured consideration and diversity in your investment allocations according to your risk tolerance should be made with your advisor.

I hope this letter finds you and your family happy, healthy, and enjoying the last month of warm weather. If you have any questions about your portfolio or would like to discuss your current positioning, please contact your advisor at any time. Our team always has your interest at heart and stands ready to help you meet your goals with the proper allocations and financial planning. As always, we thank you for your business.

Enjoy the fall season and Happy Halloween!

Warm regards,

Patrick Jamin
President & CIO

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