Market Review Commentary

Third Quarter 2023

Kayne Anderson Rudnick Investment Management

MARKET PERFORMANCE

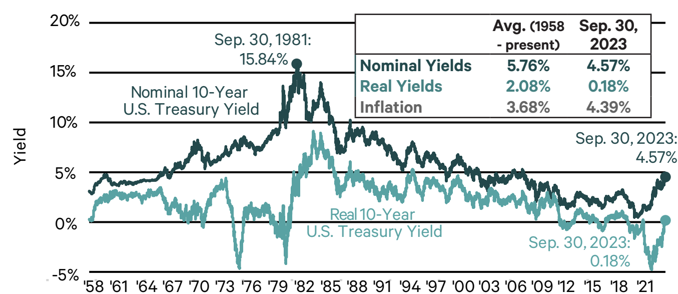
Stocks pulled back modestly in the third quarter with the S&P 500 Index declining 3.27%, bringing the year-to-date return to a solid 13.07%. Large capitalization growth and value returns were nearly identical for the quarter with the Russell 1000 Growth Index falling 3.13% and the Russell 1000 Value Index declining 3.16%. Year-to-date, large cap growth stocks continued to dominate returning 24.98% compared to 1.79% for large cap value stocks. Small capitalization stocks continued to underperform larger capitalization stocks with the Russell 2000 Index declining 5.13% for the quarter and up 2.54% for the year so far. International and emerging market stocks also declined during the quarter with the MSCI EAFE Index down 4.11% and the MSCI Emerging Markets Index down 2.93%. For the year-to-date, returns remained positive with the MSCI EAFE Index up 7.08% and the MSCI Emerging Markets Index up 1.82%.

Fixed income declined in line with equity markets with the 10-year U.S. Treasury yield rising substantially during the quarter from 3.81% to 4.57%. Two-year U.S. Treasury yields increased as well but not as much as long-term yields (4.87% to 5.04%). This increase in yields resulted in the Bloomberg U.S. Aggregate Bond Index declining 3.23% for the quarter and falling 1.21% for the year-to-date. The credit-sensitive high yield index performed better with the ICE BofA U.S. High Yield Index returning 0.53% for the quarter and 5.97% for the year-to-date. On the other hand, municipal bonds, as measured by the Bloomberg U.S. Municipal Bond Index, were hit hard declining 3.95% for the quarter and turning year-to-date returns from positive to negative down 1.38%.

WHY THE WEAKNESS IN STOCKS?

We believe the principal cause of the pullback in stock prices has been the backup in long-term interest rates. As long duration assets, equities are sensitive to shifts in longer-term interest rates. So, the obvious question is what is causing longer-term yields to rise?

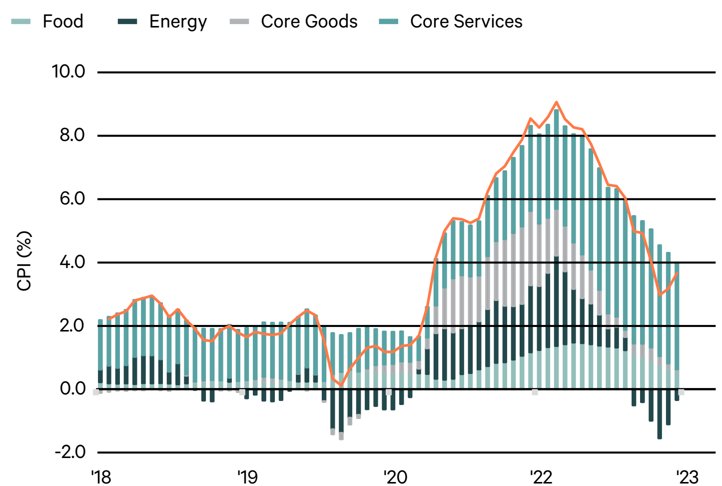
FIGURE 1: NOMINAL AND REAL U.S. 10-YEAR TREASURY YIELDS



Data presented is as of September 30, 2023, is obtained from BLS, FactSet, Federal Reserve and J.P. Morgan Asset Management and is assumed to be reliable. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month. For the current month, J.P. Morgan uses the prior month's core CPI figures until the latest data is available. ***Past performance is no guarantee of future results.***

We believe it is a combination of factors, but a primary driving factor is the recent strength in the price of oil ($74.90 to $95.31 in Brent crude oil over the last three months). Oil is an important commodity, and it is difficult to predict its price, but it affects transportation costs, raw material prices, and the cost of goods sold for many businesses outside of the energy sector. This recent strength in oil prices adds to longer-term concerns of where inflation will settle and makes it more difficult for the Fed to reach its inflation goals.

FIGURE 2: ENERGY HAS BEEN A BIG SWING FACTOR IN HEADLINE CPI | U.S. Year-Over-Year CPI Breakdown



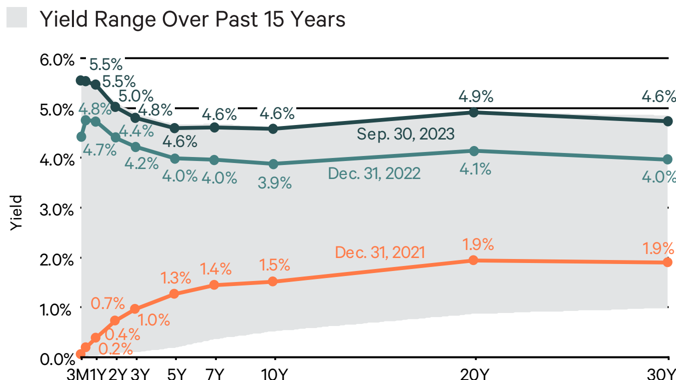
Data presented is as of October 2, 2023, is obtained from U.S. BLS and Strategas and is assumed to be reliable. ***Past performance is no guarantee of future results.***

Another factor driving long-term yields higher is the ongoing resilience of the economy which continues to grow modestly despite the enormous increase in interest rates engineered by the Fed. The labor market continues to soften somewhat but clearly not as much as expected given the hawkish Fed environment of the last couple of years. Despite continued progress on heading toward the Fed's goal of 2% inflation, the market has become more convinced that the Fed may have to hold interest rates higher for longer than previously expected due to these factors. It is important to remember the Fed does not directly control long-term interest rates like it does short-term rates.

MIXED NEWS ON THE YIELD CURVE INVERSION

Many investors are still fearing the recession that just has not shown up yet. In our opinion, the yield curve being inverted for over 14 months now is their strongest argument for an impending recession.

FIGURE 3: U.S. TREASURY YIELD CURVE



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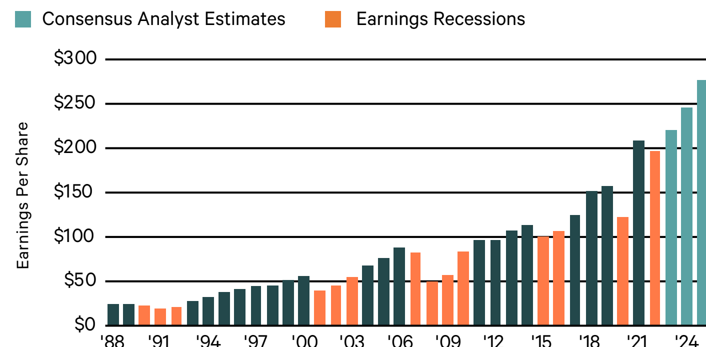
If the yield curve were to at least flatten, this future risk would be strongly mitigated. The good news is that the 2/10-year Treasury yield spread started to flatten in the third quarter. The spread was 106 basis points at the end of the second quarter and ended the quarter at 47 basis points. However, the spread narrowed by long-term interest rates rising much more than short-term rates which is a less desirable way to flatten the curve for equity prices. If the price of oil were to stabilize (or even better decline) over the next 12-to-18 months, the pressure on long-term rates may abate and allow the inflation data to continue to head to the Fed target of 2% on a more consistent basis. Short-term rates would then have significant room to decline from the 5% plus level recently. The yield curve inversion would likely move from negative to at least positively sloped which would dissipate most of the impending recession fears of investors. It should also be noted that high-yield spreads have not widened at all which would not be happening if the economy was showing signs of an impending recession.

MARKET OUTLOOK

Despite the pullback in equities this quarter, we believe many stocks are attractively positioned for future growth at reasonable prices. The magnificent seven is justifiably priced at a premium to the market (given their artificial intelligence position and initial ability to benefit from large data pools and enormous financial resources). This has created a "market of stocks" versus "a stock market" and , in our view, has provided opportunities for many of the other 493 stocks in the S&P 500 Index. Investors in the short run have continued to pour money into money market accounts yielding over 5% but we believe this is likely to be a short-term opportunity as inflation eases over the next 12 months. Despite the slowing economy over the last two years, corporate earnings have been barely dented, even with COVID dislocations and dramatic interest rate increases.

FIGURE 4: S&P 500® EARNINGS PER SHARE

Index Annual Operating Earnings, USD



Data presented is as of September 30, 2023, is obtained from Compustat, FactSet, Standard & Poor's and J.P. Morgan Asset Management and is assumed to be reliable. ***Past performance is no guarantee of future results.***

Therefore, we continue to believe the S&P 500 bottomed last October, which, in our view, should incentivize investors to stay put in these more uncertain and controversial times.

As always, thank you for your trust and confidence in managing your assets. Our focus will continue to be owning quality companies that can prosper in good and bad times given their competitive moats.

Douglas S. Foreman, CFA
Co-Chief Investment Officer

Douglas S. Foreman, CFA is Co-Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 37 years of investment experience.

Large-capitalization stocks are represented by the S&P 500® Index which is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. Growth stocks are represented by the Russell 1000® Growth Index which is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Value stocks are represented by the Russell 1000® Value Index which is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Small-capitalization stocks are represented by the Russell 2000® Index which is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. Emerging markets are represented by the MSCI® Emerging Markets (EM) Index which is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. The Bloomberg U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prefunded bonds. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. ***Past performance is no guarantee of future results.***

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