

## 2023 Third Quarter Investment Market Report

After a strong first half continuing into July, the markets seemed to hit a wall heading into August, and our 18-month roller coaster of volatility continued! In the last 2 months of the quarter, the S&P 500 declined ~8% as long-term interest rates climbed, making future earnings of growth companies less valuable in today's dollars. Last quarter, we wrote about the increasing concentration of the top 7 stocks in the S&P 500, and the associated risk implications, so it is no great surprise that the aggregate value of those select companies fell significantly over the same 2 months – for example, Apple, which began the quarter as 7.7% of the entire index, declined 12% in Q3. For now, those stocks do still have healthy gains from the “A.I.” rally this year though, and they still account for an astronomical 97% of the S&P 500's total return year to date – implying the other 490 companies in the index are essentially flat for the year.

INDEX	Q3 2023	YTD 2023
S&P 500	- 3.3%	13.1%
Dow Jones Industrial Average	- 2.1%	2.7%
Nasdaq Composite	- 3.9%	27.1%

Source: Schwab Center for Financial Research

The strong upward trend in longer-term U.S. interest rates in the third quarter caused a sharp spike in the U.S. dollar, which interrupted what we view as a multi-year, secular decline. This hurt the return from international markets, as did a sputtering economy and ongoing real estate crisis in China. Between inflation and high government borrowing in the U.S., we expect to see the dollar structurally weaker in the coming years, which, combined with the historic valuation discounts in international markets, leads us to believe that international markets will strongly outperform over the next several years.

INDEX	Q3 2023	YTD 2023
MSCI EAFE (Developed Markets)	-4.1%	7.1%
MSCI Emerging Markets	-2.9%	1.8%

Source: Morningstar Direct; See disclosures for important benchmark information

## REALITY FINALLY SETTLING IN FOR LONGER-TERM INTEREST RATES

Throughout 2023, the largest disparity in the markets has been between expectations the Federal Reserve has been trying to set regarding interest rate policy and the market's perspective regarding the Fed's implementation of that policy. In fact, the Fed's attempts to slow the economy were likely hindered by lower long-term rates that never fully bounced back after the bank failures of the Spring. Fed Chairman Powell has been speaking very aggressively for the last 18 months about implementing a restrictive monetary policy to cool the economy and, thus, inflation, yet the market has maintained expectations for a rapid course reversal with interest rate cuts to follow soon after. At the beginning of the year, the market was pricing in Fed rate cuts to begin by this past June despite the Fed clearly signaling that cuts should not be expected this year! The market had also expected a recession to begin by now and did not seem to believe that the Fed had the will to continue to restrain the economy to fight inflation in the face of a recession. Chairman Powell has been very clear that, even if it were to cause a recession, the economic priority was to implement a restrictive monetary policy until inflation was back under control and back at the Fed's target of 2%. The rationale is inflation, once imbedded in the economy, is far more damaging than the recession itself. There are already signs that some inflation has become imbedded; for example, strikes by organized labor unions are becoming commonplace, and they are succeeding at extracting very large pay increases from employers over the next several years.

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## OUR OUTLOOK FOR INVESTORS

Our biggest theme with most clients this year has been diversification. Increasing diversification in response to the radically different investment environment that we find ourselves in post-2022. The near-zero interest rate policies that existed from 2008-2022 are a historical aberration, and that is not the rate regime to which investors should expect us to return. For several structural reasons, inflation is going to be difficult to contain initially, and it will likely prove extremely difficult to keep contained. For at least the next several years, several contributors to inflation are unlikely to disappear:

- Shortage of labor
- Under-supply of housing
- Vulnerability of supply chains to disruption
- Energy prices

Therefore, inflation may well be a battle that the Fed will need to continue waging, off-and-on, for years to come. This means the Fed will need to be vigilant with monetary policy, which has implications for both borrowers via a continuation of higher rates than those they have grown accustomed to over the previous 15 years, as well as for investors in terms of yields and returns. However, it also has impacts on risk management as during market movements driven by inflationary concerns, stocks and bonds become correlated, which is why 2022 was so damaging. Last year was the worst performing year ever for the oft-cited “60/40 portfolio” made up of 60% equities and 40% fixed income.

Therefore, our focus is on keeping clients and their portfolios prepared for more volatility ahead, which for many has included keeping healthy cash positions because earning a risk-free return of over 5% has been a fantastic risk/reward opportunity in this volatile environment. Inflation, economic uncertainty, geopolitical conflict, and a likely government shutdown are just a few pending sources of volatility. Clients have seen us make some significant changes to their portfolios this year to increase diversification to address these risks and the how they impact portfolio performance, and we will continue to introduce different asset classes in the coming quarters to keep improving diversification.

There is an old adage, “Don’t fight the Fed,” which market participants would do well to remember. After the last Fed meeting, Chairman Powell voiced very strongly that the market should not expect any rate cuts until well into 2024 at the earliest. The reality of this seems to be finally settling in on market participants, and we have seen a rapid adjustment in longer-term interest rates, which are now at 16-year highs. A recession beginning this year is becoming very unlikely as Q3 GDP is expected to be stronger than Q2, although 2024 may well be a different story. Regardless, with the economy performing well despite the higher interest rates, the Fed seems to be finally getting its message across that, recession or not, any rate cuts are probably closer to a year away, and even then, we may not be back to the inflation target of 2%. As a result, the yield on the 10-year U.S. Treasury Bond rose from 3.8% to 4.6% in Q3, one of the biggest quarterly jumps in the last 20 years.

This realization seems to have brought recognition of another reality that is not new – the extent of U.S. government fiscal deficit spending and its impact on inflation and interest rates. Federal deficits have exploded in the last 20 years, and the government’s total public debt has almost doubled in just the past eight years. With the government planning to borrow a record \$2.7 trillion in the coming year through treasury auctions and with the traditional foreign buyers cutting back significantly on US treasury holdings, the heavy supply will likely need to offer more yield to be absorbed by largely domestic buyers. Adding to the upward pressure on yields, the associated government spending could also add further inflationary pressure. Therefore, despite the rapid climb in longer-term interest rates, the structural reasons for the higher rates will not be changing until at least sometime next year, so this seems like an adjustment that was overdue.

INDEX	Q3 2023	YTD 2023
Bloomberg Global Aggregate Bond Index	-3.3%	1.3%
Bloomberg US Aggregate Bond Index	-3.2%	1.2%

Source: Morningstar Direct; See disclosures for important benchmark information

## Financial Planning News:

A topic that we will likely be hearing a lot about as we get closer to the 2024 elections is the fact that the tax provisions in the Tax Cuts and Jobs Act of 2017 are due to sunset, or expire, at the end of 2025 and revert back to what they had been in 2017—just 26 months from now. But if and when that threshold is crossed, it could be a rude awakening for a number of taxpayers.

For example? One of the most dramatic shifts would be the estate tax rates. The federal estate tax exemption in 2017 was \$5.49 million; meaning, the first \$5.49 million that a taxpayer passed on to heirs would pass estate-tax free. Today, that exemption is \$12.92 million; for married couples, the combined exemption is \$25.84 million. Post-sunset, the exemption will be approximately \$7 million for individuals and \$14 million for married couples.

The Tax Cuts and Jobs Act also doubled the standard deduction on federal income tax returns, which led to fewer people going through the hassle of itemizing deductions. The standard deductions for the 2017 tax year were \$6,350 for single filers; \$12,700 for people married filing jointly. Today, the standard deduction is \$13,850 for single filers; \$27,700 for those filing jointly.

As for income tax brackets, the Tax Cut and Jobs Act restructured the brackets in a taxpayer-friendly fashion and lowered the rates for most brackets. Reverting to the 2017 brackets would mean most Americans would pay 1-4 percent more in personal income taxes than they are currently.

While we still have more than two years to prepare for this, anyone whose estate plans are impacted by these changes should consider planning for it now. Of course, Congress may pass a new tax bill by then and completely change the equation!

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## MONTIS COMPANY NEWS:



### MEET MELISSA HAGANEV

We are thrilled to announce that Melissa Haganev has joined Montis Financial as a Senior Operations Analyst! Prior to joining Montis, she served as a Relationship Manager with Beacon Pointe as well as Senior Operations Associate with Adviser Investments. In her role, Melissa helps prioritize, develop, and execute processes and procedures so commercial operations run effectively and efficiently to ensure client satisfaction. To learn more, please see Melissa's full bio on our website. Welcome to the Montis Family, Melissa!

### Important Disclosure Information

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