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3rd Quarter 2023 Market Commentary

Markets Fail to Climb Wall of Worry in the 3rd Quarter

For our mid-year report we talked about conflicting factors, focusing on differences in how the economy and markets were reacting to the Federal Reserve's mission to cool inflation. Markets for the 1st half of the year were carried forward by a small group of large cap U.S. (primarily technology focused) stocks. These "MegaCap 8" stocks largely sustained the return load for the entire S&P 500. Likewise, the S&P 500 led markets overall, substantially outperforming most other major asset classes. Citing historically high valuation levels for large cap U.S. stocks, particularly the MegaCap 8, we questioned how long this trend could continue in our June commentary.

As the 3rd quarter played out, it seemed the load got too heavy for the MegaCap 8 and a few more bricks on the wall of worry toppled stocks and bonds to produce negative results for the quarter. In the downturn through quarter end, there were not many places to hide as most major stock and bond asset classes we cover retreated.

In capital markets we are not always blessed with the opportunity to manage portfolios in "75 degrees and sunny" environments. This year, we were able to provide sizable returns through the first six months, despite the consistent wall of worry. As markets pivoted in the 3rd quarter, our portfolios retreated as well. Despite the pullback, we are holding onto respectable results near the +2-6% range YTD, depending on risk tolerance. With many scenarios for investors to be flat (or down) for the year with other strategies, we are pleased with the results so far and hope to hold onto gains through what promises to be an eventful 4th quarter. Looking out further, however, we remain confident in the opportunity for our portfolios to deliver meaningful results to our investors over the long term.

After discussing Q3 2023 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) Conflicting Factors Confuse Markets
2) The Federal Reserve turns Hawkish at a Critical Point
3) Earnings, the US Dollar & Oil Prices Come into Focus

Third Quarter and Year-To-Date Markets Review

Most equity indexes saw negative returns in the third quarter. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning -2.6% and -4.1%, respectively. Midcap (S&P 400, -4.2%) outperformed small cap equities (S&P 600, -4.9%). Emerging markets (MSCI Emerging Markets) returned -2.9%, outpacing developed international (MSCI EAFE), which returned -4.1%. Real estate (MSCI World Real Estate, -7.1%) was down in the third quarter, while natural resources (S&P GSSI NA Natural Resources, +8.1%) were the only equity asset class that saw positive returns.

Although most equities saw negative returns in the third quarter, most remain positive for the year. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning +18.1% and +7.6%, respectively. Midcap (S&P 400, +4.3%) is outperforming small cap equities (S&P 600, +0.8%). Developed international (MSCI EAFE) returned +7.1% and is outpacing emerging markets (MSCI

Emerging Markets) for the year, which have returned +1.8%. Natural resources (S&P GSSI NA Natural Resources) are up +4.9% for the year and the laggard for the year is real estate (MSCI World Real Estate), down -6.2%.

Fixed income returns were a little bit more of a mixed bag in the third quarter. The Barclay's US TIPS Index had a -2.6% return for the quarter, while the Barclay's US Aggregate Bond Index was down -3.2%. Credit (ICE BofA US Corporate Index, -2.7%) outperformed government (ICE BofA US Treasury Index, -3.3%). In the third quarter, high yield (Solactive USD High Yield Corporates, +0.4%) was positive, while international bond indexes (Bloomberg Global Aggregate ex-USD, -1.3%) and investment grade corporates (iBoxx USD Liquid Investment Grade Index, -4.3%) were negative. The 10-year US Treasury yield increased from 3.81% to 4.59% in the third quarter.

For the year, the Barclay's US TIPS Index has returned -0.8%, outpacing the Barclay's US Aggregate Bond Index, down -1.2%. Credit (ICE BofA US Corporate Index, +0.4%) has outperformed government (ICE BofA US Treasury Index, -1.8%). High yield (Solactive USD High Yield Corporates, +5.6%) and international bond indexes (Bloomberg Global Aggregate ex-USD, +2.2%) are both positive year-to-date, while investment grade corporates (iBoxx USD Liquid Investment Grade Index, -0.4%) are down for the year. The 10-year US Treasury yield increased from 3.88% to 4.59% so far this year.

Conflicting Factors Confuse Markets?

As we often say, there are thousands of variables affecting index values throughout the day. As we look at the conflicting factors currently affecting markets, there are multiple areas where these factors which are typically positively correlated are going in opposite directions. Let's look at a few examples.

Consumer confidence numbers are dropping, but consumer spending is still strong. Oil prices are rising like there is no recession in sight, yet small cap stock valuations look like a recession has been priced in. Interest rates are rising like inflation is approaching double digits, yet we are starting to see Personal Consumption Expenditures (PCE) inflation numbers come down. Housing prices are rising like rates are falling and mortgages are attractive, yet rates are rising overall and 30-year mortgage rates are in the 8% range (Bankrate). Commercial real estate is experiencing what could be argued to be the biggest pullback since 2008, yet real estate overall is not softening to the same degree. The Federal Reserve is tightening with monetary policy, while Congress continues a stimulative fiscal policy. These are just a few examples of the conflicting issues affecting market values.

Amidst all this confliction was the artificial intelligence (AI) driven large cap growth stock rally. Not exactly a textbook rally for such an environment, especially given the already elevated valuations of those stocks before the rally and appreciation they had in the face of rising interest rates. Higher interest rates typically create headwinds for growth stocks, as investors weigh the opportunity for shorter-term surety in bonds and borrowing costs go up. As mentioned above, these growth stocks did retreat in September. While not a welcome development for investors, it was at least a potential dose of reality for markets.

As we will discuss in the closing "TOPS Portfolio Strategies" section, our team has made several strategic changes in this cycle. While our timeline for strategic viewpoints is typically at least 12-36 months, our recent string of strategic changes have paid off handsomely in the shorter term as well.

The Federal Reserve Turns Hawkish at Critical Point

How many more times will the Federal Reserve raise interest rates? How long will they keep rates elevated? To say these are trillion-dollar questions would be an understatement. The focus on the Federal Reserve has reached rockstar levels. The Fed has even joined Instagram, posting their first video

this quarter with a message from Jerome Powell, going by “Jay”, promoting economic education. Presumably, it would be a better world if the average American did not know the name “Jay Powell”, as that would likely mean things are going smoothly. As we all know though, prices are not normal. We are living in a time where prices from housing to oil to used cars are interestingly high. As portfolio managers, we overwhelmingly prefer boring yet recognize many times we are required to navigate choppy waters.

A year ago, the Fed Funds Rate was at a range of 2.25%-2.5%. At the end of the 3rd quarter, it was 3% higher at 5.25%-5.50%. As we discussed last quarter, all this water thrown on the inflation fire has yet to get the blaze under control. With a goal of getting inflation cut in half once more to a 2% sustained level, the Fed is battling a strong consumer, GDP, labor market and housing market. So far, even the significant increase in rates has played out like pushing on a loose string.

In August, stocks and bonds began to slide. Despite a pause in rates, markets reacted to a renewed hawkish tone from the Fed’s August meeting. It is obvious the Fed is concerned that markets are overpowering their restrictive policies. In the post meeting interview, Chairman Powell stated, “The heat that we see in GDP, is it really a threat to our ability to get back to 2% inflation? That's going to be the question.” It seems the Fed is concerned robust economic growth may reinvigorate inflation over time, counteracting the impact of the economic brakes they are applying. We must think they had expected a more significant impact on economic activity than we have experienced. As proof of the sober reality, the Fed revised its GDP projections higher for the year. It was 1% and now it’s 2.1%. And even next year, when officials forecast growth to slow substantially, the latest outlook is higher too, rising to 1.5% from 1.1%

Cleveland Fed President Loretta Mester followed August comments in September stating, “At this point, I suspect we may well need to raise the Fed Funds rate once more this year and then hold it there for some time as we accumulate more information on economic developments and assess the effects of the tightening in financial conditions that has already occurred.” We expect the market results to be quite different in a scenario where the Fed raises rates further versus a scenario where they would pause and provide dovish guidance regarding the length of time they will keep rates elevated. At this point, no one knows which scenario will occur. We believe rates are likely to stay elevated until at least the midpoint of 2024, but we are positioning the portfolios for multiple scenarios which may play out.

One important recent development, which gives us some encouragement regarding a looser monetary policy ahead, is the fresh change in the yield of long-term government bonds. The yield on 30-year government bonds has risen from about 3.8% in July to a recent mark of 4.92%. As Dr. Jeremy Siegel recently highlighted, “0.25% of tightening at the long end of the curve has much more impact than a 0.25% increase at the short end of the curve.” This 1% increase in long rates may give the Fed some confidence in holding steady at their upcoming Halloween meeting. Only time will tell though, and 30 days in this Fed cycle has proven to be enough time for sentiment to change multiple times.

Earnings, the US Dollar & Oil Prices Come into Focus

Three of our favorite topics will be focus areas through year end. The US Dollar (USD) and oil prices have had significant recent appreciation, while the upcoming earnings season promises to be an important barometer of how companies are digesting the conflicting factors.

As the 10-Year U.S. Treasury touched yields not seen since 2007 (Bloomberg), the USD rallied. USD values are now approaching October 2022 levels, which were the highest since just prior to the burst of the tech bubble 20 years ago. As a reminder, a strengthening USD results in a direct reduction in returns of any non-USD denominated investments. However, a strong USD can also hurt exports, as US goods become more expensive for trading partners. While there are hundreds of other implications of USD

strength, these two are very important. In the short term, USD valuations have likely been pushed ahead by the US' higher relative interest rates.

With important allocations to some non-USD denominated investments in the TOPS portfolios, we stand to benefit should the USD fall from its elevated perch. As the USD weakens, international returns are directly boosted dollar for dollar. While it is very difficult to predict short-term changes in currency values, we feel the strong current level of the USD bodes well for international investments in the longer term.

Amidst the currency rally, oil prices have jumped as well. Crude prices rose from about $68 a barrel in May to nearly $90 a barrel at quarter end. As we know, oil is an essential component of the global economy. Therefore, significant changes in value have ripple effects.

A key driver of rising oil prices is a reduction in production by Russia and Saudi Arabia. Both countries want higher prices. According to Yardeni Research, Saudi Arabia wants to invest $40 Billion a year on their domestic economy and are currently building a $500 billion futuristic city in the desert; they need higher oil prices to afford these things. In addition to being a nuisance to central bankers, a major risk of higher oil prices is their ability to cause a global recession.

Higher prices are not a positive for U.S. defense either. According to Reuters, the US has only about 17 days of supply left in the Strategic Petroleum Reserves, about half of the normal level. Additionally, government officials have failed to time oil prices well as they are now over 30% above the target buying price the U.S. set for refilling the reserves (Kobeissi Research). Along with an overall tough stance against domestic oil production in the U.S. currently, this leaves the U.S. vulnerable.

This brings us to earnings, where rubber meets the road. We believe the stock market follows earnings and profits over the long term. Q3 earnings will be released during October. With Q3 real GDP numbers beating consensus forecasts, we are optimistic earnings will follow suit. To use a baseball analogy, we have read several research pieces pitching the case of why Q3 could be a double or triple instead of a single on the earnings front. For Q4, analysts are predicting that S&P 500 operating earnings per share will be at a record high (Yardeni). The biggest risk to earnings, in our opinion, may be a credit crisis. While far from definitive, there is some concern credit markets will tighten quickly in the coming months given economic factors and high rates.

We would like to have the USD soften and the price of oil weaken into year end. As always, we would love to see earnings outperform. This is really one of the better scenarios, to have an economic soft landing while earnings continue to grow. We will position for this optimal result; however, we will maintain diversification as a measure to reduce our assumed risk should the scenario fall short of optimal. Along with a potential credit crisis, we are watching a sub-optimal potential scenario of persistent wage pressures and surging oil prices pushing inflation (and expectations) higher and central bank policy rates to a new level.

TOPS Portfolio Strategies

Our portfolios are designed with the goal of providing appropriate long-term results. We believe we have accomplished this goal over the last 20 years and are encouraged by the opportunity to do so going forward. Of positive note, we continue to provide positive returns in our fixed income allocations despite negative results YTD for the Bloomberg Aggregate Bond Index.

Adding to over 6% outperformance on the fixed income side for many of our investors in 2022, many investors have added about another 3%+ of fixed income outperformance in 2023 YTD. This recent strong run of fixed income outperformance has pushed many investors towards further fixed income

outperformance since the inception of their accounts. We are pleased to be able to provide these strong results in one of the most tumultuous periods ever for bond investments. Instead of taking significant principal losses, our investors have been able to sustain meaningful fixed income principal and are able to focus on the benefits of higher income now available.

On the equity side of the portfolios, large cap U.S. stocks continue to be the clear leader, with the S&P 500 Growth index far outperforming every other major global asset class we track on our primary reports. The S&P 500 Growth index posted its best first-half performance since 1998 (up 21.2%), through June 30th (S&P). As a reminder, large cap U.S. stocks remain the largest equity allocation in the TOPS portfolios. Therefore, we have placed the most chips on the asset class which has won in 2023. However, with a goal of providing appropriate risk adjusted returns for investors over time, through a diversified portfolio, our portfolios continue to trail the large cap S&P 500 YTD.

Importantly, with a diversified portfolio, it is mathematically impossible to outperform your top performing asset class. As we have discussed, we feel it would be imprudent to increase exposure to large cap U.S. stocks at this time, with heavy credence given to the reality large cap U.S. stocks have been trading near their highest valuation levels in 20 years. This decision is further clarified by research showing many of the other asset classes we hold are trading near their lowest valuations in 20 years. While valuations can be poor predictors of short-term results, they have historically been strong predictors of longer-term relative performance (JP Morgan GTM) and continue to be given focus across the institutional investing community.

Lastly, a few follow-ups regarding some recent trades. In January, we added portfolio position EMXC, which provides exposure to emerging markets stocks, yet excludes Chinese securities. The addition of EMXC has proven to be a success YTD, as EMXC has nearly tripled the return of the reduced VWO broad emerging markets ETF. Likewise, trades completed in May for most portfolios to reduce the exposure to REITs towards our program minimum levels have benefitted investors, with REITs continuing to be a laggard in performance. Further, the replacement of VNQ and VNQI for REIT exposure in May with REET has benefited most of our investors as well.

Thank you for the continued opportunity to serve you. We feel confident in the tools available to us, as we navigate changing market conditions with over 50 years of combined professional experience on our team.

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