CENTURION COUNSEL
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Third Quarter Recap

The S&P 500 started the third quarter largely the same way it ended the second quarter – with gains. Stocks rose broadly in July thanks primarily to "Goldilocks" economic data, meaning the data showed solid economic growth but not to the extent that would have implied the Federal Reserve needed to hike rates further than investors expected. The Federal Reserve, meanwhile, increased interest rates in late July but also signaled that could be the last rate hike of the cycle. This tone further fueled optimism that one of the most aggressive rate hike cycles in history was soon coming to an end.

That market dynamic changed on the first day of August, however, when Fitch Ratings, one of the larger U.S. credit rating agencies, downgraded U.S. sovereign debt. Fitch cited long-term risks of the current U.S. fiscal trajectory as the main reason for the downgrade, but while that lacked any near-term specific justification for the downgrade, the action itself put immediate downward pressure on U.S. Treasuries, sending their yields meaningfully higher. The Fitch downgrade kickstarted a rise in Treasury yields that lasted the entire month, as the downgrade--combined with a rebound in anecdotal inflation indicators and a large increase in Treasury sales stemming from the debt ceiling drama--pushed yields sharply higher. The 10-year Treasury yield rose from 4.05% on August 1st to a high of 4.34% on August 21st -- the highest level since mid-2007. That rapid rise in yields weighed on stock prices throughout August and the S&P 500 posted its first negative monthly return since February--finishing the month of August down 1.59%.

That August volatility subsided as solid economic data and a pause in the rise in Treasury yields allowed the S&P 500 to stabilize in early September. Volatility returned, however, as the FOMC[1] delivered markets a "hawkish" surprise. Despite not increasing interest rates, the majority of FOMC members reiterated that they anticipated the need for an additional rate hike before the end of the year and forecasted only two rate cuts for all of 2024 (down from four rate cuts forecasted at the June meeting).

[1] The Federal Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the eleven Reserve Bank presidents who serve one-year terms on a rotating basis. The FOMC reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth. Changes in the federal funds rate trigger a chain of events that affect interest rates, foreign exchange rates, and, ultimately, a range of economic variables, including employment, output, and prices of goods and services.

Then, late in September, two additional developments weighed further on both stocks and bonds. First, the United Auto Workers labor union began a general strike -- a move that would disrupt automobile production and temporarily weigh on economic growth. Second, the U.S. careened towards another government shutdown as Republicans and Democrats failed to agree on a "Continuing Resolution" to fund the government. Shutdown was avoided at the last minute, but the funding extension only lasts until November 17th -- meaning there will likely be another budget battle in the coming months. The S&P 500 declined towards the end of the month to hit a fresh three-month low, ending September down modestly.

In sum, all markets were weak in the third quarter in response to U.S. budget deficits and Federal Reserve interest rate setting policies. As rising bond yields pressured stock valuations, and some inflation indicators pointed to a bounce back in inflation, we saw considerable volatility throughout the third quarter.

Third Quarter Market Sector Performance

All markets were weak this quarter in response to U.S. budget deficits and Federal Reserve interest rate setting policies. Rising bond yields were the main driver of the markets in the third quarter as high Treasury yields caused reversals in performance on both a sector and an index basis.

Starting with market capitalization, large caps once again outperformed small caps--as they did in the first two quarters of 2023--although both posted negative returns. That relative outperformance by large caps is consistent with rising Treasury yields (because smaller companies are typically more reliant on debt financing to sustain operations, and rising interest rates create stronger financial headwinds for smaller companies when compared to their larger peers).

From an investment style standpoint, Value outperformed Growth in the third quarter, although both investment styles finished with a negative quarterly return. Because rising bond yields tend to weigh more heavily on companies with higher valuations, and most growth funds are overweighted with higher price/earnings tech stocks, those funds lagged in the third quarter. Value funds that include stocks with lower price-to-earnings ratios are less sensitive to higher yields, and as such, they outperformed in the third quarter.
Although the S&P 500 rose to its highest level since March 2022, rising global bond yields, fears of a rebound in inflation, and concerns about a future economic slowdown weighed on the major indices in August and September, causing the S&P 500 to finish the third quarter with a modest loss. Looking deeper into the raw data, it is interesting to note that just seven stocks (Apple, Microsoft, Alphabet, Amazon, Tesla, NVIDA and Meta) represent 30% of the weighted S&P 500 performance rate, with the other 493 stocks in the S&P 500 representing the remaining 70%.

On a sector level, nine of the eleven S&P 500 sectors finished the third quarter with a negative return, which is a stark reversal from the broad gains of the second quarter. Energy was, by far, the best performing S&P 500 sector in the third quarter thanks to a surge in oil prices. Communications Services also finished Q3 with a slightly positive quarterly return based on hopes that integration of advanced artificial intelligence would boost search and social media companies' future advertising revenues.

The worst-performing sectors in the third quarter were consumer staples, utilities, and real estate. Those sectors offer some of the highest dividend yields in the market, but with bond yields quickly rising, those dividend yields become less attractive -- causing investors to rotate out of the high-dividend sectors and into less-volatile bond funds.

Internationally, foreign markets saw moderate declines and again lagged in the third quarter as disappointing economic data in Europe and China bolstered regional recession fears. Emerging markets outperformed developed markets owing to the announcement of larger-scale Chinese economic stimulus late in the quarter.

Commodities saw substantial gains and were the best performing major asset class in the third quarter thanks to a significant rally in the energy complex. Oil rose throughout the quarter with continued supply concerns as Saudi Arabia and Russia extended voluntary supply cuts to the end of the year. Meanwhile, demand estimates rose late in the third quarter following the announcement of large-scale Chinese stimulus plans -- causing prices to rise sharply late in the quarter. Gold, meanwhile, declined moderately, thanks primarily to the stronger U.S. dollar--which rallied steadily over the course of the third quarter--hitting a fresh 2023 high in September.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) declined moderately for a second consecutive quarter as hawkish Fed rhetoric and hints of a rebound in inflation weighed broadly on fixed income markets.

Looking deeper into the bond markets, shorter-duration debt securities posted a positive quarterly return and outperformed those with longer durations in the third quarter, as the Fed signaled it would not raise interest rates any higher than previously expected. Longer-duration bonds, however, were pressured by the combination of a rebound in some inflation indicators and a "higher for longer" interest rate expectation.

Turning to the corporate bond market, lower-quality but higher-yielding "junk" bonds rose slightly, while higher-rated, investment-grade debt declined moderately in Q3. The large performance gap reflected continued optimism from investors regarding future economic growth, as investors "reached" for the higher yields offered by riskier companies amidst broadly-rising bond yields.

Fourth Quarter Market Outlook

Markets begin the fourth quarter decidedly more anxious than they started the third quarter, but it's important to realize that while the S&P 500 did hit multi-month lows in September and there are legitimate risks to the outlook, underlying fundamentals remain generally strong.

First, while there are reasonable concerns about a future economic slowdown, the latest economic data remains solid. Employment, consumer spending, and business investment were all resilient in the third quarter. There simply isn't much actual economic data that points to an imminent economic slowdown. So, while a future economic slowdown is certainly possible given higher interest rates, amidst the resumption of student loan payments and declining U.S. savings, the actual economic data is clear: It isn't happening yet.

Second, fears that inflation may bounce back are also legitimate, given the rally in oil prices in the third quarter. But the Federal Reserve and other central banks typically look past commodity-driven inflation, and instead focus on "core" inflation; that metric continued to decline throughout the third quarter. Additionally, declines in housing prices from the recent peak are only now beginning to work into the official inflation statistics; that should see core inflation continue to move lower in the months and quarters ahead.
Finally, regarding monetary policy, the Federal Reserve's historic rate hike campaign is nearing an end. And while we should expect the Fed to keep rates "higher for longer," high interest rates do not automatically result in an economic slowdown. Interest rates have merely returned to levels that were typical in the 1990s and early 2000s (before the financial crisis), and the economy performed well during those periods. Yes, the risk of higher rates causing an economic slowdown is one that must be monitored closely, but for now, higher rates are not causing a material loss of economic momentum. We believe the next move will be a *decrease* in interest rates because The Fed wants to create an economic soft landing. If rates keep going up, the economy will be thrown into recession—which, of course, we all want to avoid.

In sum, there are real risks to both the markets and the economy as we begin the final three months of the year. These are largely the same risks that markets have faced throughout 2023, and over that period the economy and markets have remained impressively resilient. So, while these risks and others must be monitored closely, they don't present any new significant headwinds on stocks that haven't existed for much of the year.

That said -- as we begin the final quarter of 2023 -- we remain vigilant towards economic and market risks and are focused on managing both risk and return potential. We remain firm believers that a well-prepared, long-term-focused, and diversified financial plan can withstand virtually any market surprise and related bout of volatility, including "higher for longer" interest rates, stubbornly high inflation, geopolitical tensions, and recession risks.

At Centurion, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. We monitor and analyze the market continually, adjusting your specific investment portfolio as appropriate. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it is critical for you to stay invested, remain patient, and stick to the unique, personal allocation target we previously established for you based on your financial position, risk tolerance, and investment timeline.