Wealth Management Newsletter

Fall Issue 2023

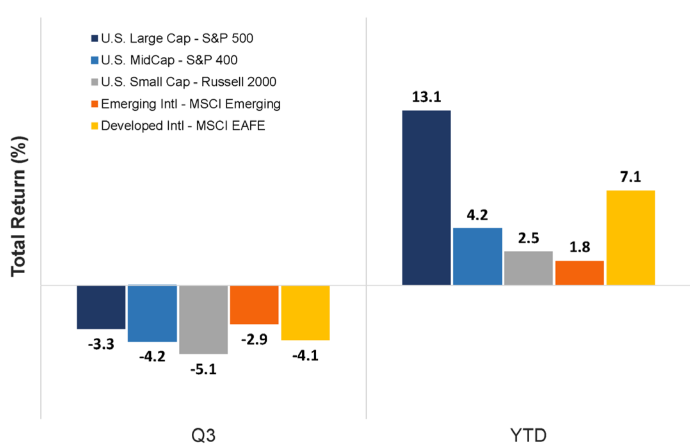
KEY POINTS

- Smooth sailing in capital markets during the first half of the year gave way to a challenging third quarter as global interest rates rose substantially, and investor sentiment turned sour
- While the Federal Reserve is likely at (or near) the end of their hiking cycle, they remain committed to keeping interest rates higher for longer to quell inflation
- Cash and bond yields are at 15-year highs and offer attractive diversification attributes
- The economic environment and financial markets remain challenging and therefore, we remain vigilant with respect to the current risks and continue to maintain a defensive investment posture

Q3 2023: BY THE NUMBERS

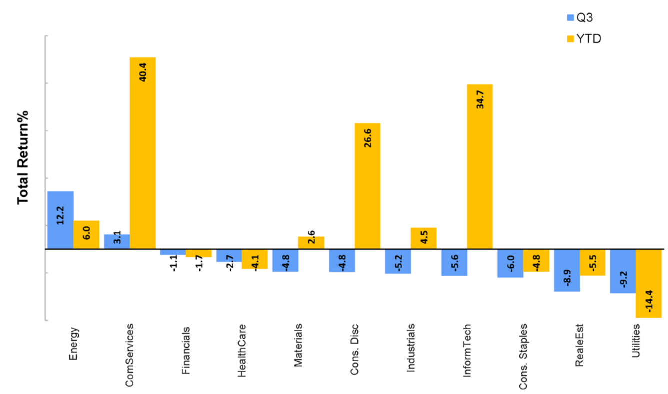
2023's market rally stalled during the third quarter as investors grappled with the prospects of a higher-for-longer interest rate environment, surging oil prices, the resumption of student loan payments, the United Auto Workers (UAW) strike, and sluggish growth in China. In addition, September, which has historically been a challenging month for investing markets, proved to be just that once again.

Against this backdrop, most asset classes finished the quarter in negative territory. Although equity returns across the board remain positive year-to-date, performance declined meaningfully from the summer highs. U.S. Large Cap equities finished the quarter -3.3%, while U.S. Mid Cap and Small Cap companies declined -4.2% and -5.1%, respectively. Developed international fell -4.1% and Emerging Market stocks outperformed their counterparts, falling -2.9% (See figure 1).



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

At the sector level, energy stocks surged as oil prices (WTI) rose from around $70 at the beginning of July, to over $90 at the end of September following the announcement that Saudi Arabia and Russia will extend voluntary oil output cuts through the end of the year. The S&P 500 Energy Sector rose +12.2% during the quarter and +2.6% during September. In contrast, interest rate-sensitive sectors fared the worst as the 10-year Treasury yield hit a 15-year high. The S&P 500 Utilities and Real Estate sectors finished the quarter down -9.2% and -8.9%, respectively. Performance moderated for the high-flying Communication Services, Consumer Discretionary, and Information Technology sectors as the artificial intelligence (AI) driven rally faded and higher interest rates weighed on lofty valuations (See figure 2).



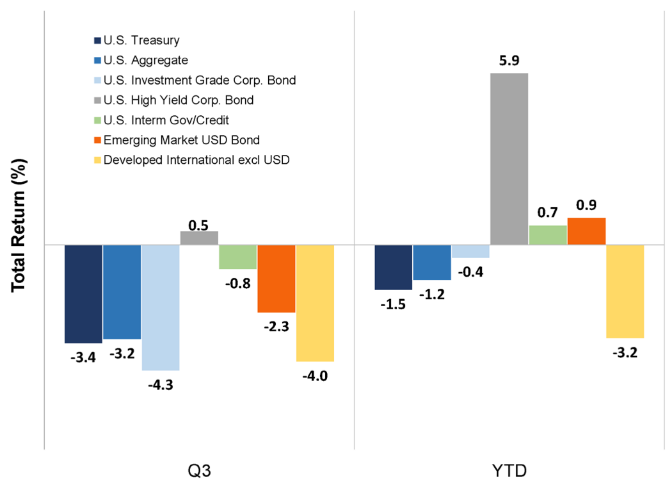
Data Sources: Bloomberg Financial LP, Bangor Savings Bank

From a style perspective, value stocks proved relatively resilient during the quarter as investors favored more defensive investment characteristics. Value stocks fell -1.7% during the quarter in comparison to -4.9% for growth stocks. Year-to-date, however, the dispersion between the two factors remains wide, with growth stocks outperforming value by more than 18% in 2023, despite the rise in interest rates.

BOND MARKET SELLOFF CONTINUES – LONG BONDS UNDERPERFORMFED

After an orderly selloff in the bond market throughout the first half of the year in response to the ongoing Fed tightening program, Q3 saw long-dated US Treasuries suffer their worst quarterly loss since 2009 as markets began pricing in higher rates for a longer duration. Thirty-year Treasury yields moved nearly 1% higher back to levels not seen since before the financial crisis, steepening the yield curve, and pushing year-to-date US Treasury returns into negative territory (See figure 3) for the third consecutive year. Short maturity bonds outperformed on the yield curve and are now pricing in roughly a 50% chance of one more rate hike this year. Inflation-linked bond yields moved in lockstep with their nominal counterparts leaving market-based inflation expectations largely unchanged and providing little investor protection despite the inflationary environment we're currently navigating. Lower-rated high-yield bonds were the lone positive returning sector in the fixed income universe in the quarter and continued their year-to-date outperformance despite increased investment market volatility.

Looking forward the substantial repricing of the bond market is largely behind us. The Fed has raised rates from zero to over 5% in a historically rapid fashion and will likely be on hold heading into the new year to allow the cumulative effect of interest rate increases to work their way through the economy. Historically, the bond market rallies once the Fed pauses interest rate hikes as their next policy action is likely to lower rates in response to a slowing economy. Furthermore, given current market pricing, this would be the first time on record when the US Treasury market had 3 consecutive negative investment return years. The bond market offers the highest yields we have seen in fifteen years and the potential for capital appreciation if the economy falters.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

THE ECONOMY – MIXED SIGNALS

Economic data was mixed in the third quarter and most economists have shifted from forecasting a 2nd half recession to now expecting more of a soft landing. The U.S. economy grew just north of 2% for the first half of 2023 and is forecast to slow marginally for the second half of the year and into 2024. Core PCE inflation came in below 4% for the first time in over 2 years, but the disinflationary pace has slowed recently due to the rapid increase in commodity prices – especially energy. Manufacturing activity remains in contractionary territory though the service industry expansion has persisted. The labor market remained strong as the unemployment rate hovered near all-time low levels and the economy produced an average of 260k new jobs per month in Q3.

MARKET VIEW AND PORTFOLIO CHANGES

Throughout the year we have highlighted the importance of investor patience as the economic environment and financial markets are at a challenging juncture. Many market participants entered the year with the view that a recession would unfold in the back half of 2023. This view proved to be wildly off the mark as economic data came in stronger than many anticipated. With fears of a recession pushed further down the road, market expectations during the early summer months moved squarely in favor of a soft-landing scenario with equities pricing in a rapid recovery in profits, credit markets pricing little concern over rising defaults, and rates pricing a less restrictive monetary policy stance from the Fed. However, the smooth sailing for risk assets that we experienced in the first half of the year was abruptly interrupted in the third quarter given the meaningful rise in interest rates and energy prices.

Looking forward, we are hopeful that the third quarter's market performance is a healthy pause and that improved market conditions will resume as the outlook for corporate profits and the economy in 2024 begins to crystalize. A pause in the rise in both oil prices and yields should provide some temporary relief into the seasonally strong year-end performance period. That said, we remain vigilant with respect to the risks the economy and financial markets face in the months ahead. Higher energy prices are not only problematic for central banks working diligently to tame inflationary pressures, but it could also pressure consumer spending and reignite recessionary fears. Furthermore, the resumption of student loan payments, various labor strikes taking place, government budgeting and shutdown challenges, heightened geopolitical tensions, and headwinds from the lagged effects of the Fed rate hiking cycle all pose threats to financial markets and the economy. Currently, the uncertainty around market fundamentals and economic risks remains quite high. As such, we continue to maintain our overall defensive investing posture, focusing on high-quality companies with durable cash flows. Furthermore, given the narrow breadth of this year's equity market rally there is a wide dispersion in individual stock valuations, which means that while some stocks look expensive, there are plenty of other stocks trading at attractive valuations relative to the broader market. This creates appealing active management investment opportunities in the equity market. Additionally, fixed income yields are at the highest levels we have seen in 15 years and shorter-dated maturities continue to look attractive on both an actual and relative basis.

In closing, history has shown repeatedly that the best defense against an uncertain investing landscape is having – and sticking with – a long-term financial plan. Therefore, please don't hesitate to reach out to our wealth management team to review your investment goals, and to ensure that your portfolio is properly aligned with your risk tolerance and time horizon.