# October 2023

## Market Update

We have now had two consecutive months (August and September) of market declines for the first time since last August and September. The reason for both sets of declines-- interest rates. Last year the Fed began raising rates at the quickest pace ever, and the markets reacted by sending the most interest-rate-sensitive assets sharply lower. These included growth stocks, REITs, and intermediate-to-longer-term bonds. But entering 2023, investors were very hopeful that the Fed would soon reverse course and begin lowering rates. Not only has the Fed not lowered rates, but longer-term rates have risen, especially over the last two months. This again has affected those same assets the most.

Growth stocks are still strongly positive for the year but were down the most in September. For the month the S&P 500 was down -4.8%, small caps lost -5.90%, and international stocks were also lower (-3.4% developed and -2.6% emerging). The dollar continued to strengthen, but even so, internationals held up slightly better. Commodities (+2.1%) were the only positive broad asset for the month. REITs (-7.0) were negative as was gold (-4.7%). Bonds were down -2.5%, but short-term bonds, floating rate notes, and higher yield bonds were flat to slightly positive.

Despite the fact that asset prices have been falling due to interest rates, fundamentals continue to be doing well. Earnings estimates for the third quarter are improving, and GDP indicators look strong as well. The recession that so many were concerned about does not appear to be materializing, at least not yet. However, the risk continues to be that high interest rates will begin to cause problems such as slowed growth and increased default on debt. Consumer and car loan debt are already showing higher default rates.

Many asset prices have cooled over the last two years, making them attractive as investments. Bonds are probably the best example. An investor can now earn between 5 and 6 % on a high-quality bond. In addition, many stocks are trading at or below their long-term valuation average, making them relatively attractive as well. However, some growth stocks remain expensive which means that we should be cautious about our buying decisions in this area. The market cap weighted indexes such as the S&P 500 have become heavily concentrated in these same growth stocks. Historically, following periods of concentration, the indexes have struggled, underperforming other weighting strategies.

Our base case is now updated so that GDP and earnings growth will be slightly positive in 2023. Household net worth, boosted by portfolio and home price gains over the last 5 years, and continued demand for workers should keep households in a position to take up some of the slack from companies that begin cutting spending in an attempt to focus on profitability and productivity. Inflation should continue receding through the year but may not get to the 2% target. The Fed may end up slowing rate increases and accepting a lower but still elevated (3% to 5%) level of inflation as they did in the 1950s following WWII.

## Performance Summary

The S&P 500 is up 13.1% while small caps are up 2.5%. Developed International markets are up 7.1%. Bonds are down -1.2%.

# Fixed Income Strategy

During the 3rd quarter 2023, the Fed's hiking cadence slowed from 10 sequential meeting hikes to a pause in June, hike of 25 basis points in July, and a pause in September bringing the upper bound of the Fed Funds Target Rate to 5.50%, a cumulative increase of 525 basis points since March 2022. The September quarterly Summary of Economic Projections (SEP) reduced future projected rate cuts by 50 basis points, conveying an expectation the Fed Funds rate will be "higher for longer". Where the Fed goes from here was best described by Chair Powell's September comment, that the Fed is 'guided by stars in a cloudy sky'.

On average, the lagged economic influence of rate hikes and tighter monetary policy takes approximately 2 years. The end of the 3rd quarter 2023 marks 18 months since the Federal Reserve began hiking interest rates, which means the 4th quarter will be a litmus test of the impact of higher rates on the real economy. Will unemployment be able to sustain historically low levels, or will companies begin reducing head count in order to protect margins and possibly tip the economy into recession? We believe that higher rates will result in future slower growth and could result in a recession.

Through August, the market's 'the recession is near' narrative kept rates in a trading range. However, enduring economic resilience changed that narrative to 'no recession' in early September, leading to higher rates as fixed income investors became 'tired' and lacked interest in buying dips. During September alone, the benchmark 10-year Treasury rate rose 46 basis points out of the quarterly change of +73 basis points and ended the quarter at 4.57%. The oft cited 2's/10's curve began to reverse much of the inversion that began July 2022. The curve began the quarter at -105 basis points and ended at -47 basis points, a re-steepening of +58 basis points as longer rates demanded more compensation and rose more than shorter rates.

Investment grade corporate spreads remained behaved both quarterly and year-to-date as spreads barely moved, -2 basis points for the quarter and -6 year-to-date to +121 basis points. We consider this level as average to slightly tight and indicates the market is not yet concerned about corporate credit fundamentals in investment grade credits. High yield corporate spreads were also behaved and only widened 4 basis points in Q3 2023, totaling tighter spreads by 75 basis points year-to-date to 394 basis points.

We continue to strongly believe that an increase of 525 basis points in the Fed Funds Target Rate, and higher yields along the curve are tightening financial conditions, which will eventually lead to an increase in labor force slack and result in declining economic growth. Therefore, we are maintaining our increased government exposure in the form of Treasuries in anticipation of wider corporate spreads and have also moved to a balanced maturity stance along the curve, locking in higher yields out to 10 years. As yields reach highs not seen in 15+ years, we are wary of unanticipated consequences and believe US fixed income will retain flight to quality status in times of stress.

## Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation.

Overall, traditionally defensive sectors like Utilities, Real Estate, and Healthcare (which make up most of the portfolio allocation) have underperformed year-to-date as this market rally has been entirely driven by the Technology, and Consumer Discretionary sectors. Additionally, we have seen the Energy sector go from best to last over the past 2 quarters.

As such, the strategy hasn't been able to fully participate in this rally.

We remain skeptical that this is the dawn of a new bull market, and as such we will pursue a balanced strategy till, we get more clarity on the economic front.

In the quarter we had no trades to report.

As always, we continue to look for opportunities to upgrade the quality of the portfolio while staying true to our disciplined valuation process.

## Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with stable operating results and reduced stock price volatility in the broader market.

Similarly, to other strategies we are positioned in a more defensive posture waiting for further clarity. We remain overweight high-quality stocks remain underweight recession sensitive sectors like financials, and materials.

Additionally, we hold cash and have a small position in gold.

We exited our position in Broadcom in the quarter as it benefited from good earnings and the AI market theme.

As always, we continue to look for opportunities to upgrade the quality of the portfolio while staying true to our disciplined valuation process.

## Core Equity Strategy

For the third quarter, we saw a pause in the global market rally as most equity markets were down between 3-5% for this time period.  For the most part, this market weakness can be attributed to a sharp rise in interest rates, reaching new multi-decade highs, and a 25%+ increase in oil prices. This combination reignited concerns about the health of the U.S. consumer and the possibility of an upcoming recession.

At this point, we need to examine what has driven this sharp rally for the first half of 2023. In our opinion, the two major contributors have been relief and belief. Relief that inflation has been tamed, and of course, belief that that we (Fed) managed to achieve said taming without breaking the economy. This is in stark contrast to investor sentiment in 2022, when we were counting the days till the next recession. As such, the longer things don't break, the closer we get to a soft-landing scenario, and of course, the more bullish investors become. It remains to be seen if the market reaction in Q3 was a short-term correction, or a more meaningful price check as the equity and bond markets keep signaling different things.

Overall, we remain defensive in our positioning as we wait for better opportunities to deploy capital. It is our view that as long as the FED remains steadfast on keeping rates "higher for longer", the markets will remain volatile as they are trying to discount the severity of the upcoming economic slowdown. Along similar lines, we will rely on leading economic indicators for clues regarding the depth and duration of the economic slowdown.

In times of economic uncertainty, we believe that a balanced approach is the best move forward. As such, we have a higher level of cash than normal, but we also have an eye on the longer term as all recessions and bear markets give way to the next cycle.

From a portfolio perspective, we came into the year with a tilt to growth.  As the market has rewarded growth we have trimmed and exited positions into that strength as the markets continues to price an "immaculate" soft landing scenario in which the Fed threads the needle of fighting inflation while simultaneously not killing economic growth. In the quarter we exited one position, Eaton Corp.

Overall, we continue to favor high quality companies with strong balance sheets and strong management teams. In Q3 we added a few new names: Resmed, Quest Diagnostics and Wabtec.

While we cannot predict near-term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the Core Equity portfolio.

## International Equity Strategy

In Q3 the global recession has so far been kept at bay. Nonetheless, there are issues that give us pause for concern. Firstly, the rapid rise in global interest rates in September could have a negative impact on the European and global economies. Secondly, China continues to struggle to sustain an economic rebound post Covid and their property sector is once again a concern as it has too much leverage. As far as Europe goes, rising energy costs are a concern as we are entering the fall and winter season.

From a stock allocation standpoint, we added one new position in FMC Corp. We exited positions in NXPI Semiconductor.

The Strategy has a higher level of cash than normal, and our positioning is more defensive as we traded into market strength for our industrial, technology and consumer-related stocks. We are seeing value in the healthcare sector and consumer staples sector where we added to positions throughout the quarter.

Our goal is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established moats often expand market share and strengthen their business during a downturn. These are the types of companies that we continue to look for in the International Equity strategy.
While we cannot predict near-term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the International Equity portfolio.

## Value Strategy

Value and growth indices performed very similarly in Q3. Some traditional value sectors such as financials are still unattractive to us given the pressure on the balance sheet from the rise in interest rates. We are also struggling to find compelling value in the retail sector as consumer spending is starting to show signs of weakness, especially at the lower income level.

As always, valuation opportunities drive the over and underweight positioning. Currently, we see value in Healthcare, Staples and some areas of technology. We have a higher cash level than normal.

We remain defensively positioned in the Value strategy as we see more headwinds for the economy and markets in the 2nd half of 2023.

In the quarter we added new positions in: Anheuser Bush InBev, Lamb Wesson and FMC corp. We exited positions in Westrock and Williams Sonoma.

## Thematic Equity Strategy

Over the past year, we used some of the cash "dry-powder" and invested in themes that offered an attractive risk/reward proposition.

Over this past quarter, we took advantage of the AI driven outperformance in the semiconductor space and took some money off the table.

As ever, we remain vigilant in our efforts to identify new themes of secular growth that would benefit the strategy.

## Covered Call Strategy

The primary goal of the Big Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation. Should the broad US equity market continue to rise, but at a slower pace, or become range-bound, constrained by high valuations on the upside but buoyed by strong earnings on the downside, this may continue to be a fruitful period for the Covered Call strategy.

Equities pulled back towards the end of the quarter as interest rates began to rise rapidly, from around 3.8% at the end of June to nearly 4.6% by the end of September. More importantly, the rise in yields was driven by a repricing of the term premium (the extra compensation investors demand to buy longer dated bonds rather than rolling shorter term bonds) and the real yield, the after-expected-inflation return that bond buyers are paid. The added risk premium and demand for higher returns in bond markets coincided with rising deficits and political dysfunction that have led to a surge in US Treasury issuance to fund the nation's spending spree and downgrades of the nation's credit worthiness by major ratings agencies. Additionally, the Fed's quantitative tightening (QT) program, whereby they slowly unwind their massive holdings of government debt, may finally be having some impact. Finally, the Fed's "higher for longer" message has begun to sink in, after 18 months where investors constantly tried to front-run the peak in rates and eventual shift to rate cuts, continually second-guessing the Fed.

Economic data have remained firm for much longer than most economists and strategists expected. In December of 2022, many believed we would see a recession in the first half of this year, and that has clearly not panned out. Consumers dipped into pandemic savings and added credit card debt to keep on spending. The labor market remains tight, so there's no immediate pressure to cut back. A steady stream of new government spending initiatives have contributed to higher than-expected growth and worsening deficits. Rather than a hard landing, the consensus view shifted to "no landing" in the second quarter. That is unrealistic, as we are now entering the window where economic data may begin to deteriorate more rapidly as the impact of higher rates flows through. There's always a "long and variable lag" between rate hikes and their economic impact, typically 12-24 months. Due to the uncertainty of the lags, the period between a rate hiking cycle and the onset of recession can be very volatile, and that's exactly what we have seen.

The economic uncertainty has led to rapid swings in flows between asset classes and factors, as investors have tended to overreact to short-term peaks and troughs in data that reflect noise rather than a true signal. This is not recommended, given that the quality of the data itself has deteriorated. Response rates to surveys have fallen, political polarization has impacted sentiment surveys, the range of economist estimates has widened markedly, seasonal adjustment factors have been rendered obsolete by the pandemic era's shifts, and post-hoc revisions to data have grown more impactful. In 2023 to date, we have seen wild swings in sentiment driving flows between cyclical / defensive, value / growth, international and domestic stocks. These swings have tended to reverse themselves over the following weeks and months, resulting in losses for those who chased the short-term trend or adjusted portfolios based on news headlines.

Rather than reacting to individual datapoints of dubious validity, investors should keep an eye on the overall trend of economic data. The Conference Board's index of leading economic data and the ISM Manufacturing Purchasing Managers' Index, excellent tools for assessing the economic cycle, have been declining since mid-2021. Economists believe that consumers have nearly exhausted their excess savings from pandemic stimulus and consensus odds of recession are elevated. As such, it seems premature to assume that we will avoid recession, merely because it has not yet occurred. Recessions represent a nonlinear process, with a slow deterioration culminating in a rapid "unexpected" breakdown, and this type of process is notoriously challenging to forecast.
Timing when the final straw will break the camel's back is impossible- rather than chasing headlines and guessing at catalysts, investors would be better off accepting that conditions are consistent with historical periods that have seen higher volatility, lower returns, and larger drawdowns than normal. We don't know if there will be a crash- a soft landing remains possible. We do know that these sorts of market conditions have historically been unfavorable and should be navigated with caution.

In the meantime, as we wait for clarity and the resolution of the hard vs soft landing debate, portfolio management techniques and strategies that provide the market with much-needed liquidity by betting against these wild swings (mean-reversion) are likely to outperform strategies that take more of the market's limited liquidity by chasing short-lived trends (momentum). Nobody knows if this period of uncertainty will end in a soft or hard landing, but continuing to bet on the outcome amounts to gambling in a casino and losing over and over. Maintaining a diversified portfolio and rebalancing diligently, waiting for the smoke to clear and accepting that there will be performance swings is likely the best course. Investors with appropriate asset allocations and sufficient liquidity to weather a downturn do not need to play in the casino.

A point that has drawn an unusual degree of discussion in recent months is the outperformance of the largest megacap tech stocks and the resulting degree of concentration risk in major indices. At present, the weight of the so-called "magnificent 7" in the S&P500 has grown to an unhealthy ~28%, and an absurd ~44% in the Nasdaq 100. While these stocks are profitable and have enjoyed rapid growth in the last few years, they are also trading at an elevated valuation premium to the rest of the market. The combination of a high concentration in a small number of stocks and their high valuations is creating significant risk potential for investors in "passive" indices or other funds that closely track these benchmarks.

Fiduciaries who push their clients' dollars into these vehicles every month are buying more and more of the same stocks at ever higher prices with each new dollar, arguably an abdication of responsibility. Those taking the responsible course of building better-diversified portfolios have been punished for it, as the median stock is barely up year-to-date while the magnificent 7 have enjoyed a strong rebound from their 2022 travails. Historically, the market's largest stocks at any given moment have gone on to underperform the broader market in subsequent years; betting on the largest companies to keep on winning indefinitely is a not a bet with favorable odds.

Fueling the outperformance of megacap tech has been the enthusiasm for AI-related investments, which surged after the media hype around the release of ChatGPT 4 in March. It is worth noting that "artificial intelligence" is a grossly misleading label, as the current generation natural language models represent a probabilistic inference from large datasets, NOT "intelligence" in the sense of ability to problem-solve creatively. Further, this type of tool has been in use for many years already, so it is not new. The latest versions are certainly impressive, but not without issues, as those who have experimented with these tools will attest. It is likely that machine-learning will continue to be a factor driving productivity in coming decades, but making large bets today on specific companies on this basis is gambling. The sheer frenzy recalls the dotcom mania and should raise red flags for prudent investors. Remember that nobody will call you at home with a truly amazing investment opportunity- if something is in the news, it's likely that the money has already been made and someone is trying to sell you their previously purchased asset at an inflated price.

It's worth noting that monthly visits to OpenAi's site have fallen from their peak, reports suggest that the accuracy of ChatGPT's results has declined, and most of the users were outside the USA, possibly reflecting possible use as a glorified translation tool for non-English speakers rather than widespread domestic adoption. Investors should always be skeptical of the hottest trends in markets- latecomers to the party seldom have a good time.

Options premia fell below the average levels of the post-Covid period from the end of May through mid-Sep before rebounding as the market declined. However, the VIX (Volatility Index) has so far failed to crack the 20 level that divides calm markets from choppier periods. The realized volatility of the S&P500 over the last 100 trading days is below 12. Interestingly, the market has exhibited higher volatility during its sharp rallies than during its declines, which have been relatively orderly. The correlation between the VIX and the S&P500 fell sharply from June into August, with options markets exhibiting little reaction to share price movement. These unusual patterns may in part reflect investor psychology.

The fear of missing out on potential upside gains has overridden the fear of downside losses in the last few years. The incredible V-rebound to new highs following the 2020 Covid crash has reinforced the lessons of a decade of endless central bank intervention and zero interest rates. Investors have been taught very dangerous lessons- ignore risk and double-down on any dips. Hedging or risk-management only cost money, so don't bother. There are periods in markets where these bad ideas become a reality, but in the long run they lead to losses. In fact, the "martingale" strategy of doubling bet size in response to losses is mathematically guaranteed to lead to "ruin" (total capital loss) over the long-term. Gamblers executing this strategy are akin to investors repeatedly "buying the dip" -

eventually a second order decline of larger magnitude will wipe them out.

If the central bankers pivot again in response to market disorder, they may put the final nail in the coffin of any remaining responsible money managers. I would also argue that in that case markets will no longer be free, and the expected real return will converge to zero over time. Why would markets reward investors with returns if there is no risk? On the other hand, if central banks react more slowly to market turmoil than in past years, the lessons taught to speculators may be incredibly painful and have spillover effects that impact innocent bystanders, like working Americans. It's likely that central bankers are aware of this dilemma but unlikely that they have a good strategy to resolve it. While we are rewarding the inventors and popularizers of QE-infinity / ZIRP with Nobel prizes, there has never been a clear exit strategy other than continuing to "kick the can" and hope that some deus ex machina (AI?) will lead to a burst of productivity that clears the massive pile of debt without pain. Treasury markets are showing early signs that they won't tolerate much more, but a sharp decline in equities and explosion of credit spreads will likely see a "flight to safety" anyway, with inflows to Treasuries eventually. These are certainly interesting times!

Over the prior few quarters, I have slowly eliminated our position in the Nasdaq 100, to which we allocated approximately 25% of assets back in 2019-21. This quarter, I shifted approximately 25% of our exposure in the strategy into the Russell 2000 via the IWM ETF. While small caps are more vulnerable during recession, the relative price of the Russell compared to the S&P 500 is already below the lows of 2020, so a significant decline in earnings relative to large cap stocks is already "priced in." A recession will see pain, but on a relative basis the upside looks more favorable. Additionally, allocating a portion of assets to the Russell 2000 helps to lower the concentration risk in megacap tech developing in the S&P. Finally, option prices in IWM are higher, offering greater return potential. This shift has not borne much fruit to date, as the underperformance of small caps has offset the benefit of higher options prices. Looking ahead, I remain satisfied with the position. Additionally, option prices have begun to rise from their summer lows, which is an additional benefit. I've maintained a high cash level (above 10% on average across accounts), which has been a minor drag year-to-date but gives us a little flexibility in the event of a market dislocation. We did not add downside protection despite the summer sale, as economic data to date remain strong and the risk of recession remains "pending" rather than realized. Managing volatility via cash level and strike price selection for our call sales has outperformed put option purchases so far and remains the risk-management plan, barring a more substantive decline in options prices.

Investors in the growth and accumulation phase of their investing life cycle or those with a strong bullish outlook may wish to look at other strategies while those in the distribution phase or with a more neutral market outlook may find Covered Call an attractive complement to their traditional portfolios.

# Disclosures

*There is a risk of loss from an investment in securities, including the risk of total loss of principal, which an investor will need to be prepared to bear. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. These Investment Strategies are not a recommendation to buy or sell any specific security. The comments made are opinions of Exencial Wealth Advisors portfolio managers at the time of this summary's distribution. No representation is made as to the accuracy or completeness of this information. Exencial Wealth Advisors, LLC ("EWA") is an investment adviser registered with the Securities & Exchange Commission (SEC). However, such registration does not imply a certain level of skill or training and no inference to the contrary should be made. EWA may only transact business in those states in which it is registered, notice filed, or qualifies for an exemption or exclusion from registration or notice filing requirements.*

*All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 9/30/2023. Asset class performance numbers come from Morningstar as of 9/30/2023.*

*The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.*

*The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

*The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks. These non-financial sectors include retail, biotechnology, industrial, technology, health care, and others.*

*The Russell 1000® Growth Index measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).*

*GDP is the final value of the goods and services produced within the geographic boundaries of a country during a specified period of time, normally a year. GDP growth rate is an important indicator of the economic performance of a country.*

*The Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.*
*The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options. On a global basis, it is one of the most recognized measures of volatility -- widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.*

*The ISM Manufacturing Index is a monthly gauge on the level of economic activity in the U.S. manufacturing sector versus the previous month.*