MARKET UPDATE

Fiduciary Financial Group

What We Said In Our Q2 / June 30, 2023 Newsletter

The data from the first half of 2023 suggest that the overwhelming consensus among market participants is that interest rates will fall materially in the near-term. This is reflected in the recent outperformance of more interest-rate sensitive growth stocks (vs. value stocks), the inverted yield curve, and the resilient domestic real estate market. We believe that investing under this assumption of 'near-term rate declines' exposes investors to significant risk of loss in stocks, bonds, AND real estate. Focusing on strategies that would outperform in an ongoing climate of elevated rates is more prudent, especially because the market doesn't appear to be pricing in any material probability of this happening. This strategy is characterized by **(a)** an overweight to value stocks, **(b)** stock hedging strategies, **(c)** mitigating credit and duration risk in bonds, and **(d)** overemphasizing liquidity to leave room for more opportunistic investments in asset classes that will face distress if rates do not drop imminently as the market currently anticipates.

Has This Played Out, and Has Our Stance Changed?

(a) Value stocks outperformed growth in Q3, but both stock styles were down for the full quarter (2.31% and 3.63% respectively)

- Our stance here has not changed. We expect value stocks to significantly outperform over the next decade given starting valuations, higher interest rates (which favor value stocks), and general historical outperformance in value stocks over 10 year or longer holding periods.

(b) Stock hedging added value in Q3. For instance, the Innovator ETF "PJUL" that hedges the S&P 500 was down 1.52% for the quarter vs. 3.22% for the S&P 500.

- Hedging has become more expensive heading into the last quarter of 2023. That said, we still view the S&P 500 as an index that is better held with put option protect vs. a pure long strategy given elevated valuations.

(c) Short-duration bonds significantly outperformed long duration bonds. For instance, iShares 1-3 year treasuries "SHY" were up +1.26% vs. 20+ year treasuries "TLT" down 13.1%. So far, investors in junk bonds have *not* been punished with "JNK" (Junk bond index) flat for the quarter and up 4.2% for the year.

- *Duration Risk:* We are not yet ready to take on the interest rate risk associated with owning 20+ year treasuries. That said, with the 10 year yield above 4.7%, we do view "extending duration" heading into Q4'23 as a reasonable move within client bond portfolios. This is still not recommended for clients' funds that are needed in the very near term (next 1-2 years).
- *Credit Risk:* With leading economic indicators signaling the weakest economy since 2007, and with spreads (i.e. incremental / extra interest earned) on high yield bonds vs. investment grade bonds being very low, we remain defensive with high yield bonds excluded from our core portfolios.

(d) Overemphasizing liquidity with short-term treasuries proved wise in Q3 as all other "major" asset classes were negative for the quarter including US Stocks, Foreign Stocks, Real Estate Indexes, US Aggregate Bonds, and International Bonds. This was in anticipation of ongoing / worsening distress in many industries which are dependent on rates "coming back down" such as venture capital, private equity, real estate development, and banking.

- The greatest distress in the market exists within long-dated treasury bonds (down 10.5% YTD and 45.8% since the peak in Aug'20). While some banks have failed (SVB, Signature, Credit Suisse, First Republic), we expect additional failures over the next 12-24 months. There are 3 separate (although related) factors that suggest bank duress is anything but over:
    - (1) *Deposits continue to decline* as banking assets continue to shift into money markets and short-term treasury bills.
    - (2) *Bank deposits are generally backed by longer duration loans* (mortgages, business loans, and longer-term treasury bonds) which as noted above, have become severely devalued. When bank deposits decline, banks must sell their longer date loans at these lower prices as compared to what they were purchased for when interest rates were lower. These losses are an example of "interest rate risk".
    - (3) *Banks are the largest holders of commercial real estate loans* which, in many cases are under extreme duress (particularly development/construction loans and office loans) and defaults are accelerating (credit risk).
        - *Conclusions:* So long as 0-2 year treasuries are paying > 5%, we view them as very attractive assets to be earmarked for "opportunistic capital". Short-dated treasuries have historically been the most liquid assets on earth and also tend to appreciate during times of stress. Recession indicators lead us to expect continued volatility, particularly if the FED stays the course in 2024 with hawkish monetary / interest rate policy.

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Asset Class Snapshot	9/30/23
Asset Class	**YTD Return**
U.S. Stock	12.39%
Global Stock Ex U.S.	5.34%
U.S. Bond	-1.21%
Global Bond	-2.21%
U.S. Real Estate	-4.86%

Region Snapshot	9/30/23
Region	**YTD Return**
Latin America Stock	12.89%
U.S. Stock	12.39%
Europe Stock	7.96%
Global Stock Ex U.S.	5.34%
Asia Pacific Stock	3.23%
Emerging Markets	1.82%

Equity Style Snapshot			9/30/23
YTD	Value	Blend	Growth
Large	0.15%	13.69%	28.35%
Mid	-1.56%	3.30%	8.91%
Small	2.01%	4.12%	7.21%

Asset Class Summary							9/30/23
Asset Class	**1 Week**	**1 Month**	**3 Month**	**YTD**	**1 Year**	**3 Year**	**5 Year**
U.S. Stock	-0.52%	-4.76%	-3.25%	12.39%	20.46%	9.38%	9.14%
Global Stock Ex U.S.	-1.34%	-3.16%	-3.77%	5.34%	20.39%	3.74%	2.58%
U.S. Bond	-0.96%	-2.54%	-3.23%	-1.21%	0.64%	-5.21%	0.10%
Global Bond	-0.93%	-2.92%	-3.59%	-2.21%	2.24%	-6.93%	-1.62%
U.S. Real Estate	-1.43%	-7.28%	-8.56%	-4.86%	-0.64%	2.15%	2.58%

Region Summary							9/30/23
Region	**1 Week**	**1 Month**	**3 Month**	**YTD**	**1 Year**	**3 Year**	**5 Year**
U.S. Stock	-0.52%	-4.76%	-3.25%	12.39%	20.46%	9.38%	9.14%
Global Stock Ex U.S.	-1.34%	-3.16%	-3.77%	5.34%	20.39%	3.74%	2.58%
Emerging Markets	-1.14%	-2.62%	-2.93%	1.82%	11.70%	-1.73%	0.55%
Europe Stock	-1.31%	-3.97%	-4.96%	7.96%	28.85%	7.23%	3.96%
Asia Pacific Stock	-1.44%	-2.50%	-2.77%	3.23%	16.09%	-0.27%	1.38%
Latin America Stock	-1.56%	-2.30%	-4.75%	12.89%	19.37%	15.07%	2.81%

Equity Style Summary							9/30/23
Region	**1 Week**	**1 Month**	**3 Month**	**YTD**	**1 Year**	**3 Year**	**5 Year**
Large Growth	-0.17%	-5.76%	-3.68%	28.35%	28.16%	6.79%	11.98%
Large Blend	-0.66%	-4.65%	-3.07%	13.69%	21.75%	9.39%	9.82%
Large Value	-1.24%	-3.28%	-2.33%	0.15%	14.85%	12.45%	7.32%
Mid Growth	0.52%	-5.19%	-5.27%	8.91%	15.12%	3.27%	7.22%
Mid Blend	-0.35%	-4.89%	-5.06%	3.30%	12.63%	7.28%	6.51%
Mid Value	-1.14%	-4.59%	-4.85%	-1.56%	10.37%	11.36%	5.44%
Small Growth	0.64%	-6.57%	-6.63%	7.21%	10.43%	0.37%	3.30%
Small Blend	0.48%	-5.63%	-4.64%	4.12%	12.40%	8.66%	4.57%
Small Value	0.35%	-4.90%	-3.09%	2.01%	13.86%	15.32%	4.90%

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Sector Snapshot	9/30/23
Sector	YTD Return
Comm. Services	37.57%
Technology	32.58%
Consumer Cyclical	25.49%
Energy	6.11%
Industrials	4.49%
Materials	2.55%
Financials	-1.66%
Health Care	-4.08%
Real Estate	-5.44%
Consumer Defensive	-5.97%
Utilities	-14.43%

S&P 500 Sector Weights*	9/28/23
Sector	Weight
Technology	27.93%
Health Care	13.47%
Financials	12.44%
Consumer Cyclical	10.77%
Comm. Services	8.91%
Industrials	8.19%
Consumer Defensive	6.52%
Energy	4.80%
Utilities	2.40%
Real Estate	2.36%
Materials	2.21%

Sector Summary							9/30/23
Sector	1 Week	1 Month	3 Month	YTD	1 Year	3 Year	5 Year
Cyclical							
Consumer Cyclical	0.03%	-5.53%	-5.03%	25.49%	14.10%	3.89%	7.63%
Financials	-1.46%	-3.09%	-1.16%	-1.66%	11.48%	13.43%	5.96%
Materials	0.23%	-4.78%	-4.75%	2.55%	17.90%	9.42%	8.52%
Real Estate	-1.45%	-7.23%	-8.88%	-5.44%	-1.91%	2.28%	4.30%
Sensitive							
Comm. Services	-0.08%	-2.95%	1.00%	37.57%	38.20%	4.23%	6.94%
Energy	1.21%	2.40%	12.17%	6.11%	30.20%	50.75%	9.01%
Industrials	-0.40%	-5.95%	-5.15%	4.49%	24.47%	11.33%	7.18%
Technology	-0.29%	-6.48%	-5.51%	32.58%	39.31%	12.97%	18.09%
Defensive							
Consumer Defensive	-1.90%	-4.79%	-6.60%	-5.97%	5.81%	5.06%	7.83%
Health Care	-1.08%	-2.96%	-2.61%	-4.08%	8.03%	8.53%	8.10%
Utilities	-6.89%	-5.64%	-9.22%	-14.43%	-7.15%	2.84%	5.57%

Market Indicators							
Name	As of	Last Month**	1 Month Ago	1 Mo. % Change	1 Year Ago	1 Year % Change	Freq.
Key Interest Rates							
1 Month Treasury	9/29/23	5.55%	5.54%	0.2%	2.78%	99.6%	Daily
2 Year Treasury	9/29/23	5.03%	4.87%	3.3%	4.16%	20.9%	Daily
10 Year Treasury	9/29/23	4.59%	4.12%	11.4%	3.76%	22.1%	Daily
30 Year Mortgage	9/28/23	7.31%	7.23%	1.1%	6.29%	16.2%	Weekly
US Corporate AAA	9/30/23	5.30%	4.88%	8.6%	4.76%	11.3%	Daily
US Corporate BBB	9/30/23	6.33%	5.94%	6.6%	6.10%	3.8%	Daily
US Corporate CCC	9/30/23	14.03%	13.38%	4.9%	16.84%	-16.7%	Daily
Effective Federal Funds	9/29/23	5.33%	5.33%	0.0%	3.08%	73.1%	Daily
U.S. Economy							
Consumer Sentiment	9/30/23	68.10	71.60	-4.9%	58.60	16.2%	Monthly
Unemployment Rate	8/31/23	3.80%	3.50%	8.6%	3.70%	2.7%	Monthly
Inflation Rate	8/31/23	3.67%	3.18%	15.3%	8.26%	-55.6%	Monthly
Manufacturing PMI	9/30/23	49.00	46.40	5.6%	50.90	-3.7%	Monthly
Non Manufacturing PMI	8/31/23	54.50	52.70	3.4%	56.90	-4.2%	Monthly
Retail Sales	8/31/23	606,791	603,141	0.6%	597,069	1.6%	Monthly
Building Permits	8/31/23	1,543	1,443	6.9%	1,586	-2.7%	Monthly

For additional economic data & commentary, please reference supplemental chart pack accompanying this newsletter.

Disclosures