Thomas Rozman, CFA, CAIA | Partner & Chief Investment Officer
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Quarter In Review

Financial Market Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q3 2023	**STOCKS**				**BONDS**	
	-3.25%	**-4.10%**	**-2.93%**	**-6.49%**	**-3.23%**	**-0.78%**
Since Jan. 2001						
Average Quarterly Return	2.2%	1.5%	2.4%	2.1%	0.9%	0.9%
Best Quarter	22.0%	25.9%	34.7%	32.3%	4.6%	4.6%
	2020 Q2	**2009 Q2**	**2009 Q2**	**2009 Q3**	**2001 Q3**	**2008 Q4**
Worst Quarter	-22.8%	-23.3%	-27.6%	-36.1%	-5.9%	-4.1%
	2008 Q4	**2020 Q1**	**2008 Q4**	**2008 Q4**	**2022 Q1**	**2022 Q1**

The third quarter saw a reversal of the performance from the previous two quarters, as all major global stock categories gave back previously hard won gains. In particular, the optimism that had driven the powerful upward momentum and increased valuation in the U.S. equity markets year-to-date vanished as it became clear that several presumptions that were the basis for the appreciation may have been misguided or premature. The progress made fighting inflation during the first half of the year stalled and the CPI even reversed course to finish the quarter at a 3.7% level, nearly twice the Federal Reserve's 2% stated target. In response to the data, the Federal Reserve's monetary policy continued down a restrictive path, with an increase of 25 basis points in the benchmark fed funds rate in July. That move and the belief that the Fed's battle with inflation was not over served as the catalyst for a spectacular increase in interest rates across all bond maturities in the US Treasury market for the quarter.

With the headwinds of higher for longer interest rates, a price-earnings multiple for the S&P 500 that began the quarter far above its 25-year historical average ended the quarter just 8% "overvalued." While the 10 largest market cap stocks gave back some gains as well, a 31.9% weighting in the S&P 500 index and a price-earnings multiple that still places those stocks 28% above the historical average leaves plenty of room for additional downside surprises.[1]

A defensive approach to portfolio selection continues to have merit given historically low equity risk premiums. Consequently, actively managed model portfolios with a higher bond composition continue to be attractive at this time. For investors looking for equity exposure, defined outcome ("buffered") ETF's that provide some downside protection also appear to have favorable terms.

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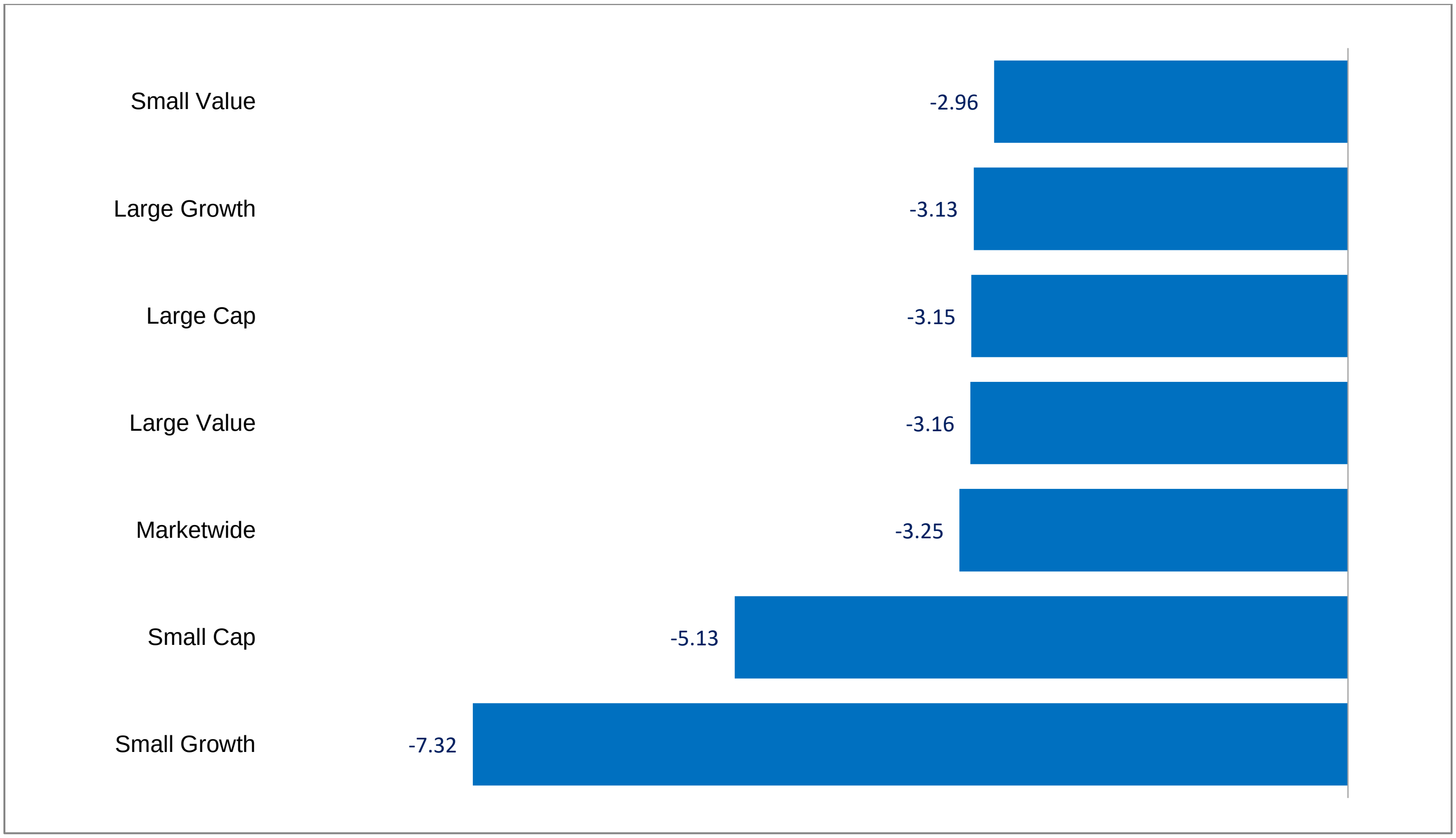
US Equity Style Box Ranked Returns %



With the S&P 500 earnings yield converging with six-month T-bill and intermediate corporate bond yields last quarter, we ended the previous commentary wondering if the US equity markets would be susceptible to some level of profit taking in the third quarter. Unfortunately, this is exactly what happened. US equities suffered broad declines across all equity style boxes, courtesy of a bond market selloff and rising interest rates. Persistent inflation, resilient economic growth, and an ever-expanding budget deficit were the primary culprits, as this meant the one-two punch of future Fed rate hikes and increasing US Treasury debt issuance were highly probable. For all intents and purposes, while the Federal Reserve narrative spoke to monetary policy remaining data dependent, forward guidance seemed preordained - rate hikes were most likely not coming to an end in 2023. Consequently, the lower equity risk premium due to higher rates demanded a valuation reset. This quarter's performance has potentially brought broad equity indices much more in line with their long-term secular trend, but some styles may still be in danger of further retracement.

In terms of style performance, five "long duration" large cap growth stocks that are the perceived artificial intelligence innovators drove 110% of the S&P 500 index gains year-to-date. Those stocks returned +14.5%, meaning the rest of the S&P 500 delivered a dismal -1.4%.[2] Large growth stocks still suffered a downdraft, but were buoyed by the technolog sector. Small cap growth stocks, with no dividend cushion, experienced the most drammatic downturn. Nonetheless, all cap growth stocks still remain above the average price-earnings multiple premium to value. Model portfolios that tilt towards rising dividend paying value stocks that are recession reslient may have merit in a low growth environment, with income generation helping to mitigate further equity sell-off.

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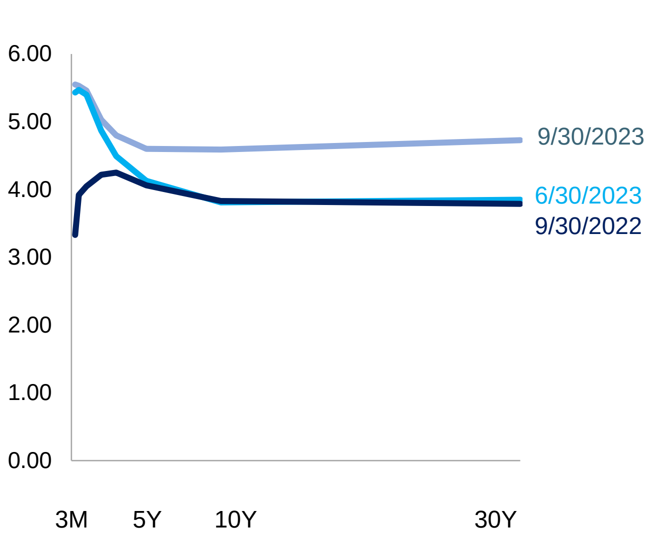
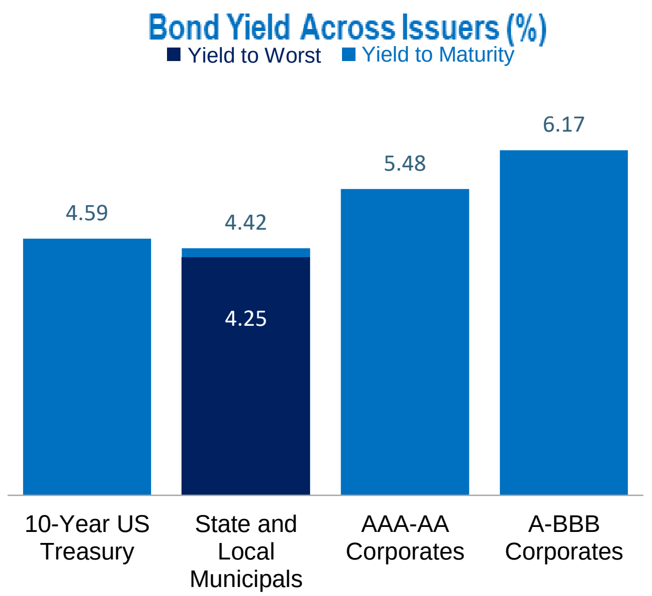
Fixed Income Returns





Circumstances didn't change much at all from quarter to quarter. The third quarter of 2023 saw US bond yields finish discernably higher across intermediate and long bond maturities due to the continuation of a restrictive Fed monetary policy and hawkish forward guidance intent on tamping down inflationary expectations. A strong labor market combined with elevated wage growth to keep Fed anxiety high and contributed to the rationale for a rate hike of 25 basis points in July. That hike brought the current federal funds rate to a target range of 5.25 – 5.50%, with a midpoint of 5.38%. The Federal Open Market Committee ("FOMC"), the division of the Federal Reserve that establishes monetary policy, didn't change the terminal rate forecast for 2023. What did change was the "central tendency" in 2024 for the projected appropriate policy path for the benchmark federal funds rate. That forecast rose from a range of 4.4-5.1% to 4.6-5.4%.[3] In plain English, interest rates are going to stay higher for longer. In fact, much higher and longer than market expectations. Due to the aggressive Fed sentiment, the US treasury yield curve experienced a parallel shift upwards as follows:

- The 1-year US treasury bill yield increased from 5.40% to 5.46% (+6 basis points).
- The 2-year US treasury note yield increased from 4.87% to 5.03% (+16 basis points).
- The 5-year US treasury note yield increased from 4.13% to 4.60% (+47 basis points).
- The 10-year US treasury note yield increased from 3.81% to 4.59% (+78 basis points).
- The 30-year US treasury bond yield increased from 3.85% to 4.73% (+88 basis points).

Similar to last quarter, model portfolios with exposure to ultra-short duration, high yielding treasury notes represent a safe haven for income potential and limited price volatility. At current yield levels, actively managed fixed income portfolios with longer dated maturities may offer a compelling risk-reward profile, dampening the impact of rate increases but offering larger gain opportunities if rates decline.

SIMPLICITY WEALTH

Quarterly Commentary | Q3 2023

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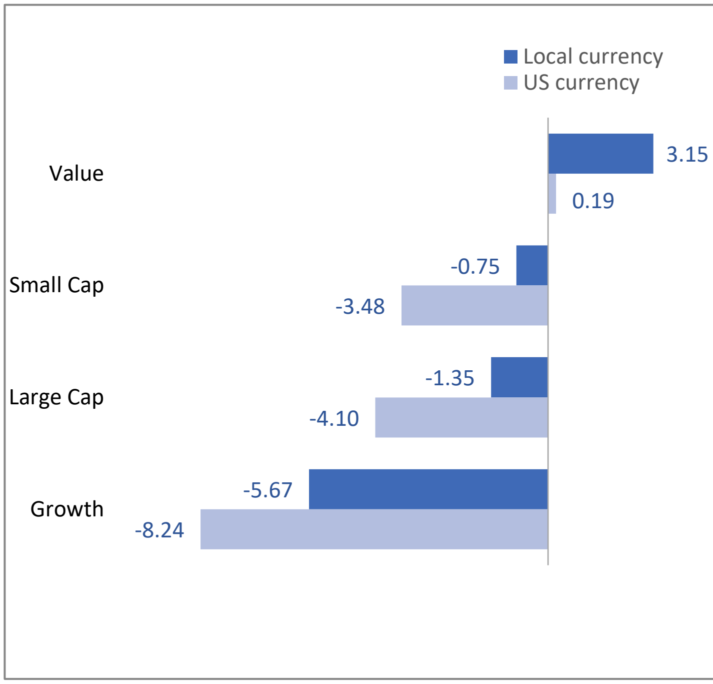
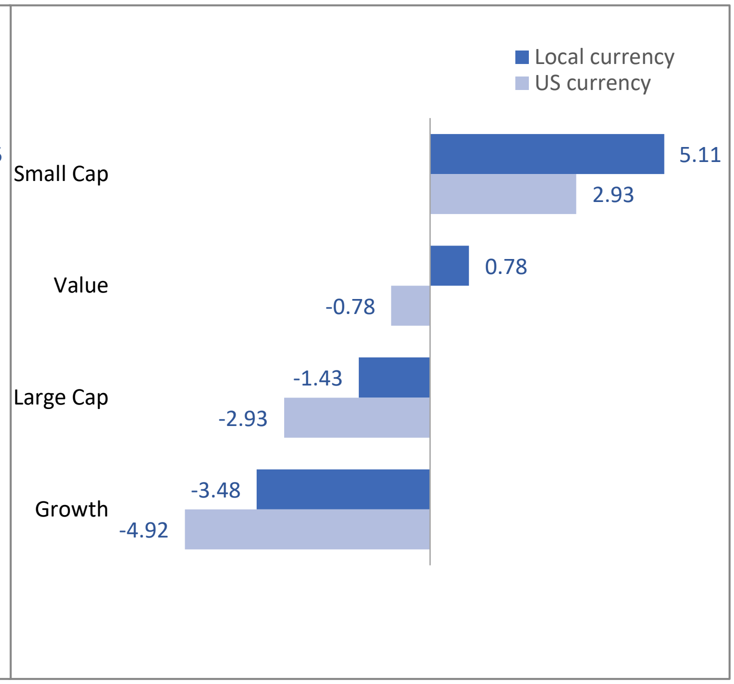
International Developed Stocks Ranked Returns %



Emerging Markets Stocks Ranked Returns %



It was a down quarter for both developed and emerging markets, but they weren't alone as US equities and fixed income markets took a hit as well. Persistent inflation, higher interest rates, and geopolitical risks have had investors on edge for months and are factors that don't appear to be going anywhere any time soon. Adding to the angst is an escalation in the Middle East brought on by attacks from the Hamas terrorist group, and with oil prices rising, the war may contribute to further price increases and/or shortages, impacting global economic growth and output.

On the emerging markets side, countries that make up large portions of the MSCI Emerging Markets Index like China (-2.11%), Brazil (-4.55%), and Taiwan (-5.94%) struggled during the quarter, dragging down the overall index. As was the story earlier this year, the reopening of China has been slower than expected and the ongoing real estate crisis is adding another layer of unknowns as the country tries to spur economic activity and growth. If a collapse of the property bubble occurs and creates a period of low or even negative growth, the value add by active management may become a point of differentiation as skilled managers can sift through the rubble to find strong companies with attractive growth prospects.

Despite the various headwinds and unknowns in both developed and emerging markets, there is some data that supports potential tailwinds. A comparison of forward price-to-earnings numbers for the MSCI ACWI ex US index (international proxy) compared to the S&P 500 (US proxy) shows a steep valuation discount in favor of international equities. Additionally, an analysis from J.P.Morgan indicates that forward dividend yields are expected to be 1.7% higher for international equities than US equities. The combined effect is an avenue for above average growth, along with above average income. We'd like to stress that this doesn't mean clients should institute a heavy overweight to international equities, but it provides a solid basis for including or maintaining exposure to companies outside of the US as part of a well-diversified portfolio.