THE BOSTON FAMILY OFFICE
INVESTMENT SERVICES

Market Update

Third Quarter 2023

Returns for the stock and bond indices below were all modestly negative for the quarter, with an unusually minimal dispersion of returns. Despite this, stocks have rallied over the past twelve months since the S&P 500 was essentially hitting its lows for the year at this point in 2022. Smaller domestic and emerging markets stocks have lagged on a relative basis. A handful of mega-cap stocks including Nvidia, Apple, Microsoft, Google, Meta (formerly Facebook), Amazon and Tesla, continue to account for a significant portion of those positive returns for the past year and year-to-date time periods.

Having only just gotten the country past the threat of a default in the second quarter, Congressional wrangling around a possible government shutdown filled the headlines during September. While shutdowns have happened before and are vastly more benign than a default would be, recent events highlight the chronic dysfunction in Washington and this frustrating pattern presents repeated distractions to investors.

Equity Markets (Total Return)	3Q'23	1-Year
Dow Jones Industrials	-2.1%	19.2%
S&P 500	-3.3%	21.6%
S&P 400 Mid-Cap	-4.2%	15.5%
S&P 600 Small-Cap	-4.9%	10.1%
MSCI All-Country World	-3.3%	21.4%
MSCI Foreign Developed Markets	-4.0%	26.3%
MSCI Foreign Emerging Markets	-2.8%	12.2%
US Bond Markets (Total Return)	**3Q'23**	**1-Year**
Bloomberg US Treasury	-3.1%	-0.8%
Bloomberg US Municipal	-3.9%	2.7%
Bloomberg US Corporate Investment Grade	-3.1%	3.6%

There are several near-term challenges facing the economy as we enter the fall. Consumer spending may slow because student loan payment furloughs are ending and the excess savings from pandemic stimulus programs are drying up, and China's much anticipated economic rebound after relaxing its zero-Covid policies has fizzled. However, the narrative that a recession in 2023 resulting from higher rates was inevitable has abated. After doing quite well in June, the S&P 500 continued to rise through July as the preponderance of economic evidence led more stock investors to abandon the idea that a hard landing was imminent. While we have noted the prevalence of opinion on this topic for the last year, we have not necessarily felt strongly one way or another and certainly have not made significant changes in client portfolios as a result. Recessions are normal parts of the business cycle that economies inevitably grow back out of just as inevitably as they periodically occur.

On the other hand, at the start of the quarter Treasury yields still reflected bond investors' collective belief that a recession was quite likely, with the 2-year bond yield at about 4.9% while the 10-year bond was well below at about 3.8%. Normally longer-term rates are higher, due to what is known as the term premium which is the extra return an investor should demand for the uncertainty of a longer holding period. When this relationship is inverted, short term rates are anchored by the elevated Fed funds

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rate, and investors price longer-term bonds to yield less in anticipation of a slowdown to come and a lower growth environment over the holding period. The bond market's implicit position in this scenario is that shorter-term rates will drop before too long, even though they seemingly present an attractive risk-reward tradeoff.

Early in August, several factors worked to start pushing longer-term Treasury rates higher. On August 1st U.S. debt was downgraded by one of the three major credit rating agencies, citing the near default in June amongst other fiscal challenges; the Fed's bond buying program continued to wind down; and bond investors seemed to come around to stock investors' evolving view that the economy was not on the verge of recession. The prospect of further growth led longer term rates to climb throughout the rest of the quarter. The 10-year yield ended September at about 4.6% and has continued to rise in October. This increase in yields first hurt the valuations of growth stocks in August, but the selling spread to so-called bond alternatives in the stock market, such as consumer staples, real estate, and utility companies as their dividend yields were becoming less and less attractive in comparison to bond yields. The S&P 500 ended the quarter down almost 7% from its July 31st high for the year.

The Fed has a dual mandate from Congress to maintain stable prices and maximum employment over time. The job market has been tight dating back to 2018 when the number of job openings first exceeded the number of unemployed workers and continued through the pandemic when people were disinclined to take jobs because of various government stimulus programs. The job market has not loosened despite all the Fed interest rate hikes over the last year and a half but will likely need to do so to enable inflation to ease further. With unemployment near historic lows, the Fed is certainly meeting that portion of its mandate, but price stability has obviously been more elusive. The question becomes, at what point can the Fed say that inflation is back to an acceptable level?

Several years ago, the Fed established a new approach of targeting an average level of inflation over time. It acknowledged that prices are volatile in the short run and there should be no concern about regular fluctuations above and below an otherwise acceptable level. This was and is quite sensible, and at the time that target was set at 2% where it remains today. For years the economy had struggled to produce inflation at that level because of weak growth after the great financial crisis. At that time, achieving even 2% inflation seemed like a fairly aspirational goal, but after recently experiencing high-single-digit inflation it now seems as though the Fed should increase the target. However, in all their public messaging, Fed governors stand by the 2% target, presumably out of a reluctance to be perceived as moving the goal posts too quickly and hurt the institution's inflation-fighting credibility.

Having admittedly just spent several paragraphs talking about the Fed, we do want to say that we think investors pay it too much attention. However, even if we do not make short-term changes in client portfolios because of the Fed's actions or inactions, it is important to understand how investors collectively move markets. Ultimately the companies that produce long-term value for shareholders through innovation and strong market positioning do so regardless of the shape of the yield curve, or the absolute level of it.

The information contained in this market update has been taken from sources which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.

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