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Third Quarter 2023 Market Commentary

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With three quarters of the year behind us now seems like a good time to take stock of our key predictions to see where we were right and what we got wrong. The first nine months of the year have increased our confidence in the accuracy of the investment committee's full year outlook, which remains generally constructive.

During the annual Sierra Ridge market outlook, I predicted a big year for bonds and stocks after both asset classes endured a brutal 2022. Bonds experienced their worst year ever, losing more than 13 percent of their value last year. Meanwhile, the S&P 500 shed more than 18 percent. My 2023 predictions were a mid-to-high teens percent return on the S&P 500 and a high single-digit return for the Bloomberg Aggregate bond index. During the year-to-date period ending October, the S&P 500 has returned 10.69%, while the Bloomberg Aggregate Bond Total Return Index have fallen 2.77%.

Our Investment Committee's macroeconomic forecast for the United States economy appears to have been too bearish given the generally positive macroeconomic backdrop. The investment committee believes the likelihood of a severe recession beginning this year is low. The Federal Reserve's interest rate hike campaign appears to be at, or near, its end. Although generally sturdy macroeconomic data has provided cover for Chairman Jerome Powell's tough talk on the path of future interest rates, we believe the Federal Reserve Board of Governors is quietly concerned about the side effects of their rate increases after an unforeseen mini bank crisis occurred earlier this year in response to a spat of bank runs led to panic among the public. Profit margins at many regional banks are under pressure after eleven short-term interest rate increases raised their funding costs, leaving their profitability at the mercy of the Federal Reserve.

Sierra Ridge Wealth Management Investment Committee 2023 Economic Outlook

What Could Happen to the U.S. Economy in 2023?

Soft landing	(35%)
Mild recession	(45%)
Stagflation	(15%)
Severe recession	(5%)

While most banks remain resilient to macroeconomic shocks, the concentration of commercial real estate loans among banks with less than $100 billion in assets (i.e., regional banks and credit unions) is concerning given the timing of the fundamental shifts occurring in this asset class during a period of shrinking margins. Work-from-home/anywhere policies continue to shake up commercial real estate more than three years after the beginning of the COVID-19 pandemic. Borrowers face an uncertain future after anecdotal evidence of tenants literally returning the keys to properties back to their owners. As we look out into the future, a wave of defaults across commercial real estate coinciding with an above average short term interest rate environment could be a nightmare scenario for small lenders struggling to protect their profitability. If our investment committee can observe this trend, the Federal Open Market Committee can too. In fact, we routinely share our belief that the Federal Reserve understands that regional lenders could be a sacrificial lamb in the fight to tame inflation. Despite the specter of this threat, we believe inflation is decelerating enough to provide an extended window for the Fed to pause its interest rate hike campaign and spare the economy from the worst effects of higher short-term borrowing rates.

Commercial real estate risk concentration (Fitch Ratings, 2023) by bank size

Bank Size (billion)	CRE as Mean % of Total Assets
<$100	14.40
$100-250	8.15
$250-700	5.10
Globally Systemically Important banks	2.91

Source: Fitch Ratings

Our strategies have capitalized from this shift in the interest rate environment. Long government rates historically peak prior to the end of an interest rate hike campaign which suggests two of the more attractive asset classes are long maturity government bonds and so-called infinite duration stocks—high growth companies with small or negative profit margins and a great story. While our more aggressive risk profiles trail their benchmarks due to our decision to include tactical exposure to regional bank shares, our more conservative strategies have performed nicely since they do not include these tactical investments and only hold allocations to high conviction asset classes like long maturity government bonds and large cap growth stocks. We believe that after regional banks join the party as the recovery broadens the Sierra Ridge family of strategies will produce competitive returns up and down the risk spectrum. Right now, most investors are focused on the Magnificent Seven, a group of the largest S&P 500 constituents powering the index through the first half. History, however, shows that a bull run is only sustainable when the rally widens across the economy and we are beginning to see this occur in the more cyclical areas of the investment universe, especially regional banks. We also see opportunities across Utilities given their attractive valuations, generous yields, and defensive nature. Many investors will seek these attributes in the case of a recession. Longer term, electricity demand is set to grow faster during the next decade than it has in 20 years. This asset class could be a great diversifier for investors who wish to maintain equity exposure through a recession.

S&P 500 Total Return by Sector As of 9/30/2023 (%)	1 Mo	3 Mo	6 Mo	12 Mo	YTD
Communication Services	-3.26	3.07	16.54	38.48	40.43
Consumer Discretionary	-5.98	-4.80	9.07	13.77	26.67
Consumer Staples	-4.53	-5.97	-5.54	7.35	-4.76
Energy	2.63	12.22	11.22	30.21	6.03
Financials	-3.14	-1.13	4.15	11.73	-1.65
Health Care	-2.96	-2.65	0.22	8.18	-4.09
Industrials	-5.96	-5.16	0.99	24.58	4.50
Information Technology	-6.87	-5.64	10.59	41.10	34.72
Materials	-4.78	-4.76	-1.61	18.05	2.61
Real Estate	-7.25	-8.90	-7.25	-1.84	-5.45
Utilities	-5.63	-9.25	-11.54	-7.02	-14.41

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