GEOPOLITICAL CONFLICT TAKES CENTER STAGE WITH FED TONE

Geopolitical events took center stage in early October and our thoughts and prayers go out to all the innocent people who are suffering at the hands of this tragedy. This is a life changing event for many people in the Middle East and for people around the world with family members in the region. We can only hope that there is a swift resolution that allows for peace.

Third Quarter: A Look Back

For the third quarter, the S&P 500 Index rose to the highest level since March 2022, but rising global bond yields, fears of an inflation rebound, and concerns about future economic slowing weighed on the major indices in August and September. The S&P 500 finished the third quarter with a modest loss.

Volatility spiked following the September Fed decision as the Federal Open Market Committee delivered markets a hawkish surprise, despite not increasing interest rates. Specifically, most Fed members reiterated they anticipated the need for additional rate hikes before the end of the year, and forecasted only two rate cuts in 2024, down from four cuts at their June meeting. This rhetoric meant that rates would likely stay "higher for longer" and stocks declined. Then, late in September, two additional developments weighed further on markets.

First, the United Auto Workers labor union began a general strike, a move that would disrupt automobile production and temporarily weigh on economic growth. Second, the U.S. careened towards another government shutdown as Congress failed to agree on a continuing resolution to fund the government. The shutdown was avoided at the last minute, but the funding extension only lasts until November 17. The S&P 500 sold off further in the third quarter, hitting a fresh three-month low and posting a negative return for the quarter, albeit still positive year to date.

As we communicated last quarter, the market breadth has been very narrow and weak, so narrow that a new moniker was coined for these top performing stocks, i.e., the Magnificent Seven.* Market breadth continued to deteriorate by 1.6% in the third quarter, this deterioration is represented via the difference between the S&P 500 and its sister index, the S&P 500 Equal Weight. The dominance of these seven stocks point to a sign of an unhealthy market. Trends supported by just a handful of stocks tend to be weak. The risk is this divergence between S&P equal weighted and S&P market-cap weighted indices are at extremes and may need to come back into balance. This divergence calls for an even more disciplined approach and a focus on prudent portfolio diversification.

US Equity Indexes	Q3 Return	YTD
S&P 500	-3.27%	13.06%
NASDAQ Composite	-3.94%	27.11%
DJ Industrial Average	-2.10%	2.73%
S&P 500 Equal Weighted	-4.90%	1.78%
Russell 2000 (Small Cap. Stocks)	-5.14%	2.51%

Source: Bloomberg Professional

Switching to fixed income, the leading benchmark for bonds, Bloomberg Barclays US Aggregate Bond Index, also posted a decline for a second consecutive quarter as hawkish Fed rhetoric and hints of a rebound in inflation weighed broadly on fixed income markets.

Looking deeper into bond markets, shorter-duration debt securities posted a positive return and outperformed those with longer maturities in the third quarter, as the Fed decided to skip a rate hike at its September policymaking meeting. Longer-duration bonds, however, were severely pressured by the combination of inflation indicators, keeping rates higher for longer, and ample new supply in Treasuries due to a doubling in our US fiscal deficit. All in all, it was tough quarter for investors in longer term bonds as yields surged and prices – which move inversely to yields – dropped. The sell-off was in intermediate and long-term Treasury bonds, where yields rose to the highest levels in more than a decade.

US Bond Indexes	Q3 Return	YTD
BBgBarc US Agg Bond	-3.23%	-1.21%
BbgBarc US T-Bill 1-3 Month	1.34%	3.70%
ICE US T-Bond 10-20 Year	-9.97%	-7.18%

Source: Bloomberg Professional

In sum, both bond and stock investors felt pain during the quarter, but on a more positive note, inflation is trending lower and approaching the Fed's 2% target. This may be a sign that the worst of the bond market selloff should be behind us. The shift away from the Fed's zero interest rate policy sets the foundation for a new normal but will also provide opportunities for long-term cash flow-oriented investors.

Fourth Quarter: What Lies Ahead

Markets are decidedly more anxious than the beginning of the third quarter. While there are reasonable concerns about a future economic slowdown, the latest economic data remains solid. Employment, consumer spending, and business investment were all resilient in the third quarter. While a future slowdown is certainly possible given higher interest rates, the resumption of student loan payments and declining U.S. savings, the current economic data has been surprisingly positive.

Fears that inflation may bounce back are also legitimate, given the rally in oil prices. The Federal Reserve typically looks past commodity-driven inflation and focuses on core inflation, a metric that continued to decline throughout the quarter. Additionally, declines in housing prices from the recent peak are only now beginning to impact the official inflation statistics, implying that core inflation could continue to move lower in the months and quarters ahead.

Finally, regarding monetary policy, the Federal Reserve's historic rate hike campaign is nearing an end. While we would expect the Fed to keep rates higher for longer, high interest rates do not automatically result in an economic slowdown. Interest rates have merely returned to levels that were typical in the 1990s and early 2000s before the financial crisis, and the economy performed well during those periods. Yes, the risk of higher rates causing an economic slowdown must be monitored closely, but for now, higher rates are not causing a material loss of economic momentum.

To put it all in perspective, if we were writing this letter last week, we would argue that the direction of bond yields would also dictate the impact on stock prices. We would also conclude the stock sell-off last quarter would persist as the combination of a rapid rate hiking cycle and investors having the benefit of +5% short term yields too good to pass up. The Fed was expected to hike again – at least once if not more.

Following the horrific events in Israel, the Fed must take current and changing events into account. Conflict in the Middle East could exacerbate persistent high prices and higher energy prices, both could send the US economy over the edge if they continue to raise rates. In the end, the Fed script has likely changed. No one saw this event coming and even fewer will want it to lead to a repeat of the early 80's. The period saw inflation speed up and an oil shock sparked a period of stagflation.

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We thank you for your ongoing confidence and trust. Your SlateStone team will remain dedicated to helping you accomplish your financial goals. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

SlateStone Wealth's Investment Committee

**Magnificent Seven stocks include NVIDIA, Meta Platforms, Amazon, Microsoft, Apple, Alphabet and Tesla*

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