October 2023 – Back to Normal

**"Having interest rates at zero for such a long period of time is very unusual.
Frankly, no one ever thought we'd get to that place."
- Fed Vice Chairman Roger Ferguson, July 23, 2023**

Good News or Bad News?

The S&P 500 has appreciated 13% through the first 9 months of 2023. At first glance it appears to be a good year for the market. Unemployment (3.8%) is near historic lows. Despite higher mortgage rates, housing prices have proven resilient. The American consumer shows few signs of weakness and our economy continues to grow. Inflation has subsided from peak levels and markets are digesting the higher interest rates necessary to curb inflation. On paper, it seems like we are in a favorable investing environment.

It may not always feel that way, however. The positive performance for the S&P 500 is dominated by a select few companies. The 'Magnificent Seven' (Microsoft, Apple, Google, Amazon, Nvidia, Tesla, and Meta) comprise more than a quarter of the S&P 500, and without these companies the index would be up +4% instead of +13% this year. Contrasting with the S&P 500, the Dow Jones Industrial average is up a modest +2.7% through September. As such, portfolios with less technology concentration than the S&P index may have trailed the market's performance this year. Tracing back to the origins of this interest rate hike cycle, the S&P 500 has returned +1.6% over the two years preceding this letter. Investors may have grown impatient with stocks over this span, particularly when they look at current short-term fixed income returns.

This Normal is the Old Normal

The good news is that the economy and financial conditions are transitioning back to a normal environment, and that should be celebrated. For more than a decade following the Great Financial Crisis, investors and corporations became accustomed to historically low interest rates, oftentimes near zero. We can take Vice Chairman Ferguson's quote to heart: near-zero interest rates were not the new normal. The low-rate environment increased risk appetites and asset valuations. While the long-run average annual return of the S&P 500 (since 1926) is around 10%+, for a dozen years from 2010-2021 the index appreciated +15% annualized.

As investors, we would all prefer that trend to continue of course. But we can't live in an above-average world forever. Inflation was high in 2022 (the highest in decades). This brought markets back to reality, and we are still in that fight against inflation today.

It will take time for inflation to fall back to the Fed's definition of normal. In the meantime, our portfolios react to events like the monthly Consumer Price Index and Fed Chair Jerome Powell's language in press conferences. We may not appreciate the economy's trajectory in each quarter, but higher rates are a necessary medicine and may bode well for the long-term prospects of our portfolios for a few reasons.

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First, it is encouraging and a sign of good health that corporate earnings and the labor market have weathered the rate-hike storm so far. According to FactSet, a market research firm, corporate earnings within the S&P 500 are projected to rise +12% in 2024. We strive to invest in those well-managed companies that adapt to higher rates and continue to grow. Underpinning earnings, job growth continues to surpass expectations month after month. While a strong labor market may contribute to rates staying higher for longer, ultimately low unemployment is a positive as the American consumer drives economic growth. As some of us may recall, stocks did great (+15% annualized) in the 1990's alongside an average Treasury 10-year yield of 6.7% (the 10-year yield is around 4.8% today). Higher interest rates also exist in the good times for stocks.

Another benefit of higher interest rates is that today investors can earn real returns after inflation in fixed income, which has not been the case since 2008. We have written about fixed income opportunities in prior quarterly letters. Since the last time we addressed this topic, rates have risen incrementally and inflation has tapered off slightly, improving real fixed income returns more and giving us another tool to achieve our financial goals.

Lastly, a return to a normal interest rate regime gives our policy makers more dry powder for the future. The Fed typically uses interest rate cuts as the first line of defense in market downturns or recessions. Since interest rates were already near zero over the past fifteen years, the Fed concocted untested methods of stimulus like quantitative easing and Congress passed budget-busting fiscal stimulus packages. Now with higher rates, the Fed has more ammunition at its disposal and can resort to traditional monetary policy in the next time of need.

Our concern over short-term market swings within a turbulent two years may cloud the fact that we are in a positive transition. To improve the long-term economic health for the next decade, markets must go through these short-term trials. We shouldn't miss the forest for the trees: the economy and corporate earnings continue to grow, inflation is gradually subsiding, and we have new fixed income opportunities at our disposal. The fundamental message has not changed: a diversified, well-managed portfolio can achieve your financial goals over the long run.

As always, we are grateful for your support, and we welcome any of your comments and questions.

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