Q3 2023

Quarterly Market & Economic Perspective

Keeping a Balanced Approach

SUMMARY

- Stock and bond markets mostly fell during Q3 but generally remained positive over last 12 months
- Fed continued to raise interest rates with 0.25% increase in July and paused during September meeting
- Fitch ratings downgraded the US government credit rating from AAA to AA+
- Mixed inflation readings from August

POSITIVE SIGNALS

- Government shutdown was averted at September month-end, though limited market impact was expected
- There is more “income” from fixed income than there has been in years
- Labor market remains strong

REASONS FOR CONCERN

- Expectations are the Fed will keep rates higher for longer, contributing to higher intermediate and longer-term yields
- US large cap stocks’ return is being driven by only a small number of stocks, and they comprise a sizable percentage of the S&P 500
- The stronger US Dollar negatively impacted the returns of non-US stocks, while also hurting the returns of multi-national US companies

SOURCE: MORNINGSTAR; RUSSELL, MSCI, DOW JONES, BLOOMBERG, ICE BOA ML BENCHMARKS SHOWN; PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

COMMENTARY

Fitch Ratings downgraded US government credit rating

On August 1, 2023, Fitch Ratings downgraded the US government's credit rating to AA+ from AAA citing a "steady deterioration in standard of governance" over the past 20 years, highlighting this was more of an erosion vs. anything that suddenly caused this change. For reference, Fitch Ratings is one of three major credit rating agencies. S&P is another agency, and they actually downgraded US government credit quality back in 2011, while Moody's, the third agency, still has the US with a AAA rating. A lower rating (or an even lower rating in the future) could not only impact the US' ability to borrow in the future, but it could also create higher borrowing costs, which could have an impact on investments, but also fiscal, taxation, and other Federal policies. Despite the downgrades, we still view US Treasuries among the most liquid and safest bonds in the world.

US government avoided a shutdown, for now

Speaking of governance, Congress came to a compromise at the end of September to avoid a government shutdown, at least for now, as the bill just signed only funds the government through November 17, 2023. Should investors be concerned about a shutdown having a significant negative impact on the economy and markets? No, if history is any indication. Overall, there have been 21 government shutdowns since 1976 and one could classify the mixed market results as noise.

In summary, of the 21 previous shutdowns, 11 saw the S&P move in a positive direction during the shutdown with nine experiencing declines (one shutdown occurred overnight, when markets were closed, so there was no market impact).

Remember, the potential economic or market fallout from a government shutdown is very different vs. the potential for what could have occurred during the debt ceiling debate, where the US could have defaulted on their debt, which likely would have had a more significant impact.

An update on US inflation and the Fed

Year-over-year inflation data in August was mixed (there are various measures of inflation). Regardless of which inflation measure you look at, Exhibit 1 clearly shows all of them are above the Fed's 2% inflation target.

EXHIBIT 1

	50-yr. avg.	Jul. 2023	Aug. 2023
Headline CPI	3.9%	3.3%	3.7%
Core CPI	3.9%	4.7%	4.4%
Food CPI	3.8%	4.9%	4.3%
Energy CPI	4.7%	-12.3%	-3.7%
Headline PCE deflator	3.4%	3.4%	3.5%
Core PCE deflator	3.3%	4.3%	3.9%

SOURCE: BLS, FACTSET, J.P. MORGAN ASSET MANAGEMENT. CPI USED IS CPI-U AND VALUES SHOWN ARE % CHANGE VS. ONE YEAR AGO. CORE CPI IS DEFINED AS CPI EXCLUDING FOOD AND ENERGY PRICES. THE PERSONAL CONSUMPTION EXPENDITURE (PCE) DEFLATOR EMPLOYS AN EVOLVING CHAIN-WEIGHTED BASKET OF CONSUMER EXPENDITURES INSTEAD OF THE FIXED-WEIGHT BASKET USED IN CPI CALCULATIONS. GUIDE TO THE MARKETS – U.S. DATA ARE AS OF 9/30/2023.

With inflation still higher than desired, and with a labor market that remains tight, the data-driven Fed increased the Fed Funds rate by 25 bps (0.25%) in July but decided to hit the pause button on another increase during their September meeting. They have continued to promote the idea that even though inflation has moderated from last year's highs, there is still a long way to go to hit their 2% target, and that investors should prepare for more hikes in the future.

Currently, investors are expecting one more rate increase at one of the Fed's two remaining sessions in 2023. Similarly, the Fed has suggested that they will keep the Fed Funds rate higher for longer, meaning they are not expecting to cut rates soon, unless there is some market incident that forces their hand.

U.S. Equity

- All US stock indexes fell for the quarter, with large cap stocks outperforming smaller ones.
- Large growth stocks have the highest year-to-date (YTD) returns (+25.0%), but returns are only being driven by a few stocks.

To illustrate the second bullet, let's look a little closer at the S&P 500. On a YTD basis, its 13.1% return looks great. However, when you look a little deeper, the returns are really being driven by just 7 stocks. As you can see from this post from Apollo Global Management on 9/22/2023, they refer to the S&P 7 and S&P 493, highlighting how differently each segment behaved YTD.

While the S&P 500 is one of the more common large cap stock indexes, the Russell 2000 (or R2000) is one of the more common indexes for small cap stocks.

A challenge for the Russell 2000, and one of the reasons why we it isn't one of our favorite indexes to track for investment purposes, is that as of quarter end, 45.5% of the companies held in the Russell 2000 (roughly 900 companies) are not profitable (see Exhibit 2). It just makes economic sense that, over time, companies that are profitable should outperform companies that are not profitable. Ultimately, if a company keeps losing money, it may not be in business for very long.

EXHIBIT 2

SOURCE: SOURCE: COMPUSTAT, FACTSET, FTSE RUSSELL, NBER, J.P. MORGAN ASSET MANAGEMENT. THE S&P 500 IS USED FOR LARGE CAP AND THE RUSSELL 2000 IS USED FOR SMALL CAP. GUIDE TO THE MARKETS – U.S. DATA ARE AS OF SEPTEMBER 30, 2023. 1Q98-2Q23, PRO-FORMA EPS

A preferred approach, in particular in small cap stocks, is to focus on companies that are more profitable vs. those that are not. As a comparison, the S&P 600 is another index that invests in small cap stocks, yet unlike the R2000, it does include a positive earnings requirement, which is a fair, even if imperfect, proxy for profitability in its index construction rules. If you look at the last 20 years ending 9/30/2023, the S&P 600 has earned 1.5% more per year on average vs. the R2000. While we cannot attribute the entire difference to just the S&P's inclusion of profitability, we do believe it is an important component.

Non-U.S. Equity

- Non-US developed large cap stocks underperformed their US counterparts over the quarter, but non-US developed small cap stocks outperformed US small caps.
- A strengthening dollar negatively impacted non-US stock index returns.
- Even with the poor quarter, global stocks as represented by the MSCI ACWI, are still up 10.1% YTD.

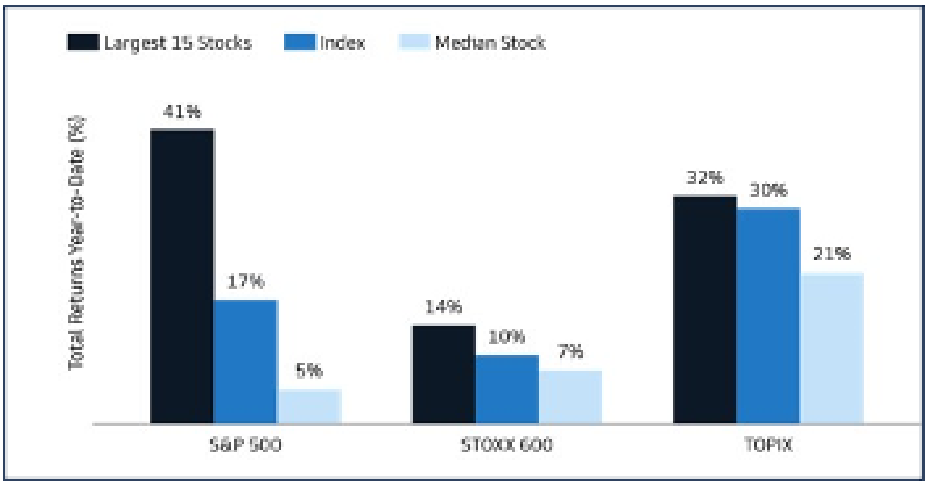
Unlike the S&P 500, whose return is dominated by just a few stocks, international indexes are currently more balanced and diversified.

Unlike the S&P 500, whose return is dominated by just a few stocks, international indexes are currently more balanced and diversified. Per Exhibit 3, if you held the largest 15 stocks in the STOXX 600 (representative of European stocks), the YTD return through 9/17/2023 was 14% vs. 10% for the entire index.

Similarly, the TOPIX (Tokyo Stock Exchange) also shows considerably less concentration regarding its overall return being driven by the top 15 holdings. Overall, a market that has more breadth of winners is often believed to be a healthier market.

The rising US Dollar relative to foreign currencies was another factor in the quarterly underperformance of non-US stocks relative to US stocks. To put this in numeric terms, let's look at a common non-US benchmark, the MSCI World ex USA.The return of the index in dollar terms (which is what a US investor would receive assuming the return is unhedged) over the previous quarter was -4.1%, but it was -1.35% in local currency terms. In other words, the stronger dollar cost US investors 2.75% in return over the last three months.

EXHIBIT 3



SOURCE: BLOOMBERG AND GS ASSET MANAGEMENT, AS OF SEPTEMBER 17, 2023. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Recently, there have been plenty of negative headlines related to China, both political and economic, resulting in inquiries about possibly divesting from Chinese stocks. As we have previously noted, China constitutes roughly 1/3 of emerging markets stocks and is the second largest economy in the world, making it sort of a big "call" to exclude such a large player. Plus, if you remove China from an emerging markets allocation, the unintended impact is that you now overweight all the remaining countries, which may not necessarily provide a better outcome. Overall, it is not our general approach to make "bets" for or against specific countries and would recommend staying invested as long as Chinese markets remain open and don't have issues with market pricing.

Global REITs

- Global REITs, as represented by the Dow Jones Global Select REIT, fell -6.6% for the quarter but are still up 2.6% over the last 12 months.
- US REITs slid -7.4% for the quarter while non-US REITs fared better, though were still negative, losing -4.0%.
- From a sector standpoint, most REIT sectors are down YTD with the exception of a few including data centers (16%) and health care (3%). Source: NAREIT

Global Fixed Income

- With yields rising across the Treasury curve over the quarter, fixed income indexes declined with longer duration bonds being hurt more than shorter duration bonds.
- Most bond indexes are positive over the last 12 months with the exception of intermediate and long-term Treasuries.

Fixed income investors expect to be compensated for holding longer maturity bonds vs. shorter maturity bonds, which is known as the term premium.

As short-term yields rose, we saw an even greater increase in yields over the quarter across the intermediate and longer-term parts of the yield curve.

More specifically, the 10-Yr Treasury is a barometer of sorts as it can be used as a benchmark to measure investor confidence, but it's also important because it influences rates set for mortgages and other types of debt.

For reference, the 10 Yr Treasury was yielding 4.59% at the end of September 2023, 3.83% a year earlier, and a paltry 0.69% three years ago, when outlooks were not so rosy in the middle of the pandemic.

Despite the recent rise in yields, as Exhibit 4 shows, the 10 Yr Treasury still hasn't reached the 9/30/23 level since October 16, 2007, when it closed at 4.66%. As a reminder, as yields rise, prices fall, and this is the dynamic impacting bond investors over these recent periods of rising yields.

Nonetheless, we continue to view fixed income as a method of reducing overall portfolio risk (as measured by standard deviation), given that equities are expected to have much higher volatility. Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration government and corporate bonds, where default risk has historically been relatively low.

EXHIBIT 4

SOURCE: US DEPARTMENT OF THE TREASURY, DATA THROUGH SEPTEMBER 29, 2023. Y-AXIS SHOWS % YIELD. X-AXIS SHOWS TIME

AUTHORS

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Mario is the Chief Investment Strategist for XYPN Invest and the President & Founder of East Bay Financial Services. Mario began his investment career in 1999 with Vanguard mutual funds in Valley Forge, PA, where he consulted institutions and financial advisors on investment policy, portfolio construction, and Exchange-Traded Funds (ETFs). He also held roles as a research analyst, a municipal bond fund specialist, among others, during his tenure. In 2003 he earned the Chartered Financial Analyst designation, and he continues to mentor aspiring Charter candidates and young investment professionals.

Mario is Past President of CFA Society South Carolina and Former Chairman of the College of Charleston Finance Department Advisory Board. His approach to investments and the industry has been featured in Investment News, NAPFA Advisor Magazine, South Carolina Public Radio, and other publications and media outlets.

Eric Stein, CFA

Prior to joining East Bay, Eric worked for a variety of firms, both large and small. This includes 7+ years with Goldman Sachs Asset Management where he held roles in areas such as performance measurement, client service, risk analysis, and portfolio construction. During his tenure there, Eric had the opportunity to cover many different types of asset classes, vehicles, and client types. Eric also worked at RSM U.S. Wealth Management for 10+ years, serving as the Chief Investment Officer while providing strategic leadership and solutions for their national investment platform.

As a Partner at East Bay, Eric serves a select group of financial advisory firms as their outsourced Chief Investment Strategist. Responsibilities of this role include continuous oversight of advisor clients' investments, bespoke strategies for unique situations, client communications, and more.

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Investors cannot invest directly in an index. Indexes are unmanaged and reflect reinvested dividends and/or distributions, but do not reflect sales charges, commissions, expenses or taxes.

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Benchmark descriptions: MSCI ACWI Index, MSCI's flagship global equity index, is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets, covering approximately 85% of the free float- adjusted market capitalization in each market. Russell 3000 Index is a market-capitalization-weighted equity index that tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities. Standard & Poors 500 is an index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices. Russell 1000 Index is an index of approximately 1,000 of the largest companies and is a subset of the Russell 3000, comprising approximately 90% of total market capitalization of all listed US stocks. 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MSCI EAFE Small Cap Index captures small cap representation across Developed Markets countries around the world, excluding the US and Canada. MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries and covers approximately 85% of the free float-adjusted market capitalization in each country. MSCI Frontier Markets Index captures large and mid cap representation across 29 Frontier Markets countries and covers about 85% of the free float-adjusted market capitalization in each country. Dow Jones Global Select REIT Index is designed to measure the performance of publicly traded REITs and REIT-like securities and is a sub-index of the Dow Jones Global Select Real Estate Securities Index (RESI), which seeks to measure equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally. The index is designed to serve as a proxy for direct real estate investment. Dow Jones U.S. Select REIT Index tracks the performance of publicly traded REITs and REIT-like securities and is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index. Dow Jones Global ex-US Select REIT Index is designed to measure the performance of publicly traded REITs and REIT-like securities traded globally ex-US. ICE BofAML 3-Month T-Bill Index is an unmanaged index that measures returns of three-month Treasury Bills. ICE BofAML 1-5 Year US Treasury, Corporate and Municipal Indexes are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Indexes including all securities with a remaining term to final maturity greater than or equal to 1 year and less than 5 years. ICE BofAML 5-10 Year US Treasury, Corporate and Municipal Indexes are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Indexes including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 10 years. ICE BofAML 10+ Year Treasury, Corporate and Municipal Securities Index are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Securities Indexes including all securities with a remaining term to final maturity greater than or equal to 10 years. Bloomberg Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets (one version shown with its currency hedged back to the USD and is noted as such). Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed- rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency). J.P. Morgan Global (ex-US) Government Bond Index: Is the standard unmanaged foreign securities index representing major government bond markets outside the US markets (one version shown with its currency hedged back to the USD and is noted as such). ICE BofAML US Inflation-Linked Treasury Index tracks the performance of U.S. dollar denominated inflation linked sovereign debt publicly issued by the U.S. government in its domestic market. Qualifying securities must have at least one year remaining term to final maturity and no more than 5 years to maturity. Bloomberg Barclays U.S. Corporate High Yield Bond Index is a total return performance benchmark for fixed income securities having a maximum quality rating of Ba1.