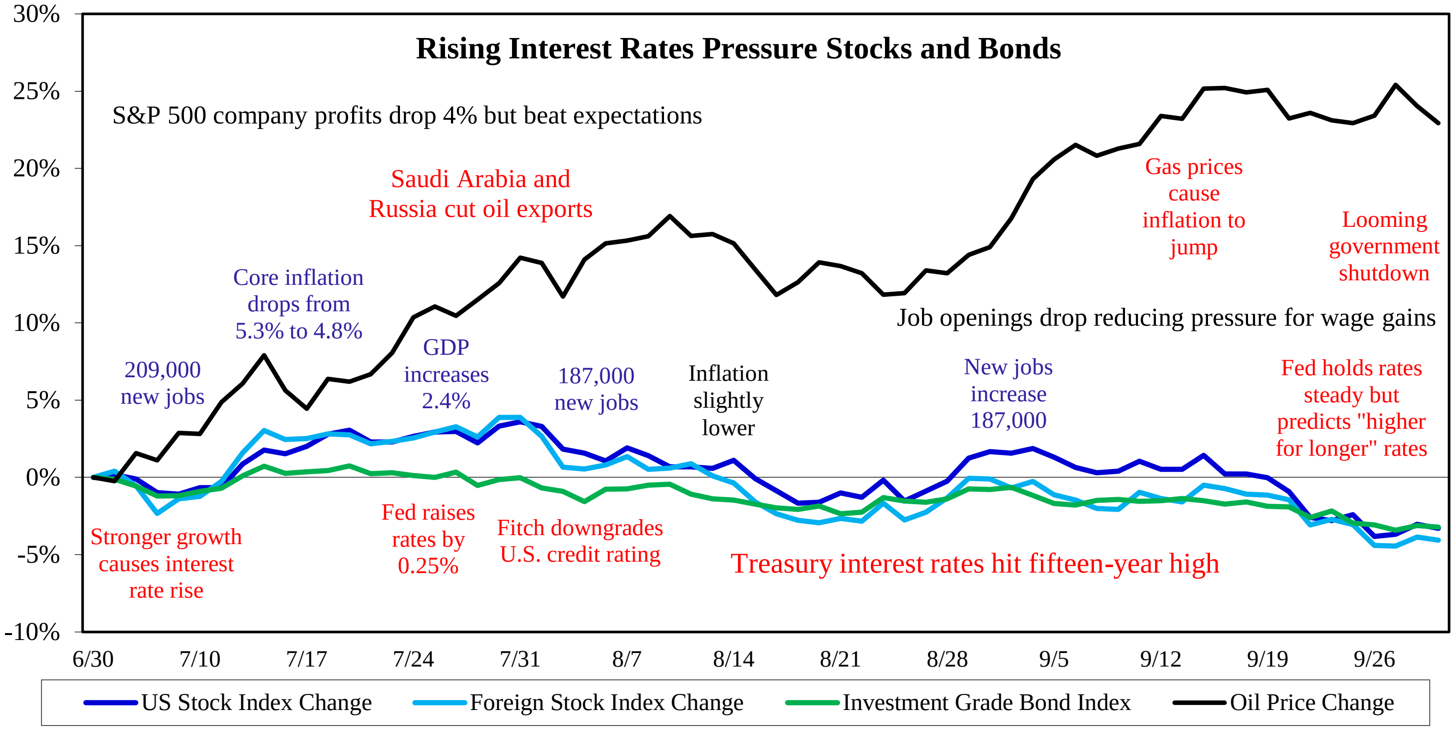
Economic and Financial Market Summary

Third Quarter 2023

After the stock market rallied through the first seven months of 2023, rising interest rates proved too much for the gains to continue. Investors worried that "good news is bad news" because the resilient economy could cause the Federal Reserve to keep interest rates higher for a longer time. This impacts stock valuations in a few ways. Stocks become relatively less attractive with money market funds yielding over 5%. Company earnings in the future are worth less today when they are discounted more due to the higher interest rates. Additionally, the Fed's actions to lower inflation are more likely to cause a recession if rates are maintained at such a high level for a long time.

The third quarter actually started favorably for stocks with more progress being made in bringing down inflation. A turning point happened in early August when Fitch downgraded the rating of U.S. Treasury bonds because of the increased burden of government debt and the dysfunction in Washington, D.C. This contributed to interest rates hitting a fifteen-year high which pressured stocks. Large-cap U.S. stocks and bonds both declined about 3% in the third quarter. Foreign equities fell 4% and small-cap stocks dropped 5% on average in the quarter.



While the Federal Reserve has remained hawkish (partly to rebuild its credibility regarding inflation), the actual rate of inflation is near the Fed's target when excluding the cost of housing. The way housing inflation is reported has an extremely long lag time. With rents falling for several months this will eventually dampen inflation. The jump in oil prices is causing a bounce in inflation but "core inflation" is the main focus of the Fed because food and energy are so volatile. The Federal Reserve should also be happy about the labor market being less tight and wage increases moderating since the Fed wants to avoid a "wage-price spiral" at all costs.

A positive effect of the resilient economy is earnings estimates for 2024 have started to rise. If interest rates peak and the economy avoids a recession, investors are likely to be encouraged and start to bid up stocks. This may or may not happen in the fourth quarter, but historically the stock market is strongest beginning in November in what has been called the "Santa Claus rally". Bonds have had the worst three-year performance since before the Depression, but they will rebound when interest rates start to fall and even the hawkish Federal Reserve expects rates to drop in 2024.

One Liberty Place, Suite 500 • 100 North Sixth Street • Waco, Texas 76701
254.754.7973 • www.DInvestors.com • todd@dinvestors.com