Third Quarter 2023 – Investment Commentary

WEST SHORE BANK

Rising inflation and the Fed's aggressive rate hike campaign to quell inflation sent capital markets sharply lower for most of 2022. Twelve-month headline inflation peaked in June 2022 at +8.9% and has since abated to +3.7% in August 2023. The relatively consistent decline in headline inflation propelled the expectation that the Fed was close to being done raising rates and that rate cuts would quickly follow. These narratives sustained a stock rally from fourth-quarter 2022 through this past July.

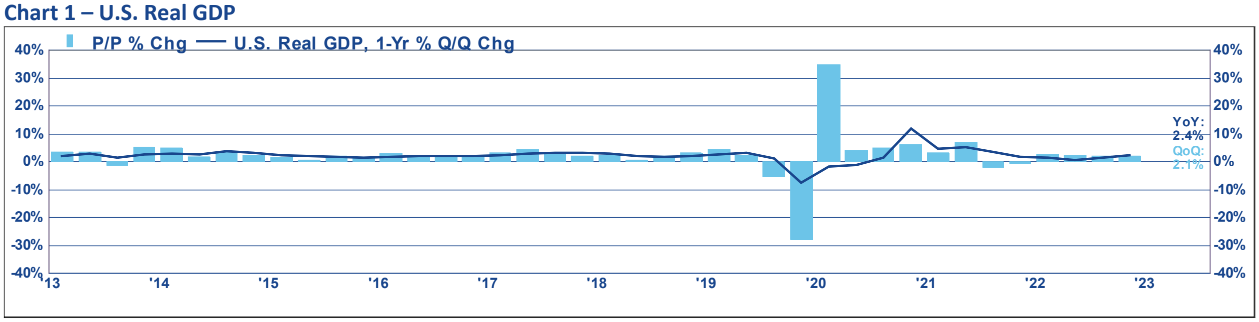
Table 1 – Stock Index Returns – as of September 29,2023

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	-5.77	-3.94	27.11	26.11	6.60	11.41	14.52
S&P 500	-4.77	-3.27	13.07	21.62	10.15	9.92	11.91
MSCI Developed	-3.42	-4.11	7.08	25.65	5.75	3.24	3.82
S&P 400	-5.26	-4.20	4.27	15.51	12.05	6.06	8.94
Dow Jones Industrial	-3.42	-2.10	2.73	19.18	8.62	7.14	10.79
Russell 2000	-5.89	-5.13	2.54	8.93	7.16	2.40	6.65
MSCI Emerging	-2.62	-2.93	1.82	11.70	-1.73	0.55	2.07

In August, stock and bond markets began to come under pressure for a couple of reasons. First, a new and unexpected development was the downgrade of U.S. Government by the Fitch credit rating agency. The reasons for their downgrade include a steady deterioration in standards of governance, the steady rise in government deficits, and the expected increase in interest debt burden. Second was economic activity coming in stronger than expected buoyed by consumer spending strength. The first estimate of second-quarter U.S. GDP posted annualized growth of +2.4% vs consensus forecast of +1.5% marking consecutive quarters of much healthier-than-expected readings. These developments pushed stocks lower and bond yields higher.

In September, released economic data continued to paint a picture of above-trend economic activity. On September 26th the Federal Reserve Bank of Atlanta report GDPNow, which is a running estimate of real GDP based on available economic data for the current measured quarter, estimated third-quarter economic growth of a whopping +4.9%. This estimate moved higher with most economic releases in the month including manufacturing, auto sales, monthly jobs report, imports and exports, CPI, PPI, monthly Treasury statement (deficit), and retail sales.

Chart 1 – U.S. Real GDP



Heading into the second half of this year most economists and pundits, including the Fed, were forecasting weaker U.S. economic growth. Moreover, FactSet consensus economic forecasts for the third and fourth quarter of this year were +0.8% and +0.4% respectively. These stronger than expected U.S. GDP readings were raising the angst of investors as the possibility that the Fed may need to keep short-term rates higher for longer was gaining traction.

Investor concerns were cemented at the conclusion of the September FOMC meeting when the Fed's Summary of Economic Projection (SEP) showed that short-term rates were indeed forecasted to be higher for longer. The Fed's SEP in June projected four rate cuts in 2024 and the short-term rate moving down to 4.6% from 5.6% in 2023 or a 1% rate cut. September's SEP shows only two rate cuts and the short-term rate moving down to only 5.1% from 5.6% or a 0.50% rate cut.

As shown in Table 2 below, longer-dated bonds (U.S. Aggregate) underperformed short-dated bonds (Intermediate Gov't/Credit) for the month, quarter, and year-to-date timeframes. After the September Fed SEP release, longer-dated bond yields pushed even higher with the 10yr Treasury note settling at 4.57%, up 76 basis points from the June 30 level of 3.81%. For the quarter, the yield curve flattened as the inversion spread between 2yr and 10yr bond yields narrowed from -1.06. to -0.60 basis points.

Table 2 – Fixed Income Index Total Returns – as of September 29, 2023

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	-1.18	0.46	5.86	10.28	1.76	2.96	4.24
Bloomberg Inter Gov't/Credit	-1.08	-0.83	0.65	2.20	-2.93	1.02	1.27
Barclays Michigan Muni	-2.85	-3.78	-1.14	2.46	-2.43	1.14	2.54
Bloomberg U.S. Aggregate	-2.54	-3.23	-1.21	0.64	-5.21	0.10	1.13
Bloomberg Municipal	-2.93	-3.95	-1.38	2.66	-2.30	1.05	2.29

The general consensus is that the Fed is done or close to being done raising rates, but this could change depending on how the data develops between now and year end. The long end of the curve still has room to move higher but even this will likely be capped with the 10yr yielding somewhere between 4.75% and 5.50%. Declining inflation is the reason for the long-end rate cap. Real rates (rates less inflation) have been rising significantly, and if inflation continues to move lower, the Fed would have room to lower rates thereby steepening the yield curve and capping long-end.

At the latest FOMC press conference, Fed Chair Powell stated, "I would say you know sufficiently restrictive when you see it. It's not something you can arrive at with confidence." After aggressively raising rates 11 times since March 2022 and the short-term rate from +0.25% to +5.50%, the Fed is in a position to be patient and to assess the lag effect of rate hikes. We believe rates are sufficiently restrictive and that the yield curve will continue to flatten and then begin to steepen once it becomes clearer that inflation is under control, the economy is experiencing below trend growth, and the Fed is done raising rates. We look for these circumstances to materially unfold over the next six to nine months.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – October 2, 2023

Sources: FactSet, The Federal Reserve, Federal Reserve Bank of Atlanta, and Fitch Ratings