

October 2023



Dear Donor,

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Third Quarter Review and Fourth Quarter Outlook

When the third quarter of this year began on July 1, the yield on the 10-year Treasury note was 3.8 percent. That was about 15.8 percent higher, in percentage change terms, than the low mark for the 10-year this year. That low mark was a yield of 3.29 percent on April 6, when the bond market was still reacting to the collapse of several prominent US and foreign banks, a month beforehand. Now, when any price moves by nearly sixteen percent – the price of a consumer good, the price of a share of stock or the price of credit (which is what a bond yield signifies) – it is not a small thing. But as the third quarter got underway, Treasury yields were just getting started. After some volatile but mostly sideways movements throughout July, yields started rising in a much more directional trend in August and, especially, September. By the end of the third quarter the 10-year yield had soared to 4.6 percent, on its way to a year-to-date high of 4.8 percent on October 9.

In terms of percentage change, a yield of 4.8 percent represents a 45.9 percent change from that April low point. Imagine how much chatter there would be in the news if stock prices had gone up or down by 45.9 percent in a six month time span. But that's how much the price of credit, as represented by what is supposed to be the world's safest publicly traded investment asset, went up. As we know, when yields on bonds go up, the price of those bonds goes down. For the second year in a row, the so-called "safety" portion of diversified investment portfolios has found itself in negative territory, with most of the pain being felt in longer-maturity, fixed coupon asset classes (shorter duration and floating rate exposures have performed somewhat better).

This year, fortunately, the performance by major US equity asset classes has been strong enough to offset the continued troubles in the bond market. With the Fed's monetary tightening program either very close to or already at an end, moreover, we also think there is a strong case to make that the upward surge in rates from August through early October should start to taper off. That could be positive for both equities and fixed income, and also provide an opportunity to lock in yields not seen in high quality fixed income securities for, at least, a quarter century. Given the many variables of both a positive and a negative character currently present in the market, however, one could make an argument for the glass being half empty just as easily one could for the glass being half full.

The glass-half-empty argument focuses on what Wall Street types like to call the "wall of worry." This argument typically starts with the observation that there is a time lag between when interest rates go up and when their effect is felt directly in the day-to-day economy. That effect, according to this view, is starting to happen now and will manifest itself through metrics like rising credit card delinquencies, declining levels of consumer spending on high-ticket discretionary goods and services, and waning demand in the housing market. Scaling the wall of worry also involves confronting China's flagging economy, geopolitical crises (most recently the unfolding Israel-Hamas war), the still-active threat of a US government shutdown, and potential blows to the economy from labor strikes in key industry sectors, the auto and insurance industries being the latest examples. These concerns, all of which are very real and present, could still prove to be the catalyst for the recession many economists expected at the beginning of this year that has not yet occurred.

For those who prefer to see the glass half full, there is that fact we noted in the previous sentence: the much-anticipated recession of 2023 has not happened and, barring a couple of whopping surprises when the GDP numbers for the second half of the year come out, seems destined not to happen. The economy, indeed, has substantially outperformed expectations this year, driven by resilient consumer spending and decent levels of nonresidential business investment. The unemployment rate remains close to historical lows and nowhere near the levels typically associated with prolonged downturns. Wage growth has slowed, but average hourly wage growth is outpacing inflation at a rate that improves household purchasing power without potentially triggering a destructive wage-price spiral reminiscent of the early 1970s. The Fed has been consistent and methodical in its interest rate policy (and the bond market finally seems to understand this). A soft landing, usually a more elusive phenomenon than Yeti sightings, remains a meaningful possibility. As for geopolitical problems, which unfortunately are not likely to go away any time soon, there is the plain fact that markets most often ignore them.

As we often say, we do not possess a crystal ball to give us a clear picture of which of these scenarios will play out. We also believe that 2024 is going to be full of surprises – and again, these could be good surprises or nasty surprises. But betting on uncertain outcomes is not what we do. We maintain portfolios positioned for long-term growth taking into account each client's financial objectives and risk tolerance. We believe this discipline will be the right way to play through whatever surprises lie in store as we move through the rest of this year and into the next.

With warm regards,
Masood Vojdani

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MVCM 2023 0057
DOFU: October 2023