The equity and fixed income markets at the end of the third quarter of 2023 are still in the throes of adjusting to the dramatic change in Federal Reserve Bank policy that began in early 2022. At the end of 2021, we expressed concerns about the health of a stock market led by a small group of stocks, whose valuations were justified by the near-zero rate monetary policy the Fed had followed for a full decade.

The Fed changed direction, steadily raising its benchmark rate seven times in 2022, taking the rate from 0.25% to 4.25% in nine months. It continued to push that rate up this year, with four more increases through the Summer to set the rate at its current 5.25%. As we have noted in the past, the linkage between interest rates and stock market performance is strong and inversely correlated: as interest rates go up, the valuation measures for stocks are compressed. Rational investors expected to see an end to the dominance of the mega-cap tech stocks that led the market coming out of the Coronavirus lockdowns. These rising short-term rates also spelled trouble for long-maturity fixed income investors.

In 2022, we saw both stock and bond indices post seriously negative results, and the market was behaving rationally. Those enormous tech company stocks experienced steep declines, and lower-valuation stocks did much better. Long-maturity bonds really suffered, while short-maturity investors were only slightly bruised. The S&P declined more than 20% to under 4000, and the 10-year U.S. Treasury bond rate rose above 4% as the fourth quarter of 2022 opened. A sudden change occurred in the 4th quarter of 2022. Tech stocks reversed course as the year ended, and a small number of large technology company stocks have led the market in 2023.

This year, we are down to the Magnificent Seven, the stock market equivalent of "the One Percent."

Company / Group	Gain YTD
Apple	29%
Microsoft	30%
Amazon	50%
Meta (Facebook)	144%
Alphabet (Google)	45%
Tesla	96%
NVIDIA	191%
Magnificent Seven (weighted)	52%
The Other 493	0.3%

Seven very large, technology-oriented companies enjoyed a year-to-date increase in market capitalization of over 50%, while the other 493 in the 500-stock index eked out a miniscule gain. We remain concerned about markets with such narrow leadership.

Outside of those few winners that bounced back from the 2022 lows, there has been little safety in the stock market since the end of 2021. It is not even as though technology stocks generally have done well.

Continued on Next Page ☞

Looking at the individual returns of the 500 companies in the S&P 500 Index, there have not been a lot of positive results regardless of the economic sector. From the beginning of 2022 – when the Fed began its rate-raising program – through late September, here is the average return of the stocks in each of the sectors that constitute the market index.

Sector	Average Stock Return (1/22 – 9/23)
Communication Services	-22%
Consumer Discretionary	-18%
Consumer Staples	-11%
Financials	-13%
Health Care	-14%
Industrials	-4%
Information Technology	-12%
Materials	-14%
Real Estate	-31%
Utilities	-14%

If an equity investor was unwilling to maintain a deeply concentrated portfolio of no more than seven large technology companies, then he had a hard time of it in the markets over the past nearly two years. We do not think deeply concentrated portfolios make sense for most of our clients, though we do hold a number of the Magnificent Seven in our client accounts. This imbalance in the equity market suggests to us that risk is not being properly priced at current levels.

The bond market has also experienced difficulties. The leading US corporate/credit bond index is down a bit more than one percent this year. Bond rates in the U.S. Treasury markets have moved up, the one-year Treasury rate moving from 4.75% at the beginning of the year to 5.47% now, and the ten-year Treasury rate moving from 3.87% to 4.60%. Each maturity term has seen a 72-basis point increase, which would be a parallel shift, but the timing of the moves reveals what bond analysts call a "bear steepening" as the longer-maturity rates rose well after the shorter-maturity rates did.

We have even more numbers, but perhaps some trends will be sufficiently explanatory. Payroll employment is not declining, which suggests the Fed may have to increase its benchmark rate further. Credit card balances are quite elevated even as card rates are over 22% on average. Consumers are trading down, shopping at Walmart more and Whole Foods less. Higher-end consumers have been spending: the TSA reported 2.5 million people passed daily through their checkpoints during the summer, which marked a return to pre-pandemic levels. On the other hand, the Conference Board's most recent survey reported declines in consumer confidence across all age groups, and notably among consumers with household incomes of $50,000 or more. It seemed like everyone we knew went somewhere fun on a plane over the summer; it might prove easier in the future for those who travel to book a flight.

Market events, especially downturns, are often severe, as investors tend to rush for the exits as though the building is on fire. We do not think it is on fire, but we are holding back cash reserves (currently paying 5% interest) in the hope of taking advantage of any rush for the doors. Here and there, we see opportunities for investment, as certain stocks have retreated to valuation levels at the bottom of their historical range. Intermediate interest rates might crest at 5%, but we think they will settle eventually below 4%. We have been extending our maturities accordingly.

The risk for investors is that inflation remains stubbornly high by recent standards while growth does not accelerate. We have seen this story before, and it requires a steady hand on the tiller as the market grinds through a secular reset of valuations. Our clients should prepare for more trading activity as markets fluctuate without making material advances. We've seen this in the past 20 years, and we may see it in the next five.

Charles L. Abney III, CFA • Tres R. Carpenter, CFA, CFP® • Krista L. Cosgrove CFA
Stacey D. Ewing, CFA • Edwin J. Feinour • Casey J. Flanagan, CFA • Emilie D. Hill, CFA • Clayton F. Jackson CFA
William B. Miller • Geoffrey Neville Jr., CFA • Kevin C. H. Yang, CFA • Bradford S. J. Young, CFA

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