HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

Volume 96 October 2023

We like the idea that the fun of writing about financial markets is the challenge to piece together a puzzle with moving parts. Sometimes those parts fit together neatly. But the current period is not one of those times. In this presently complicated puzzle, the U.S. economy and financial markets are still struggling with the aftermath of the pandemic disruptions.

We expressed concern from the outset of 2023 that the stock market would need time to sort itself out. We were somewhat surprised in the first half of the year when investors – especially in technology – brushed aside all the various issues and concerns. We are not surprised by the downturn in the third quarter as investors took a pause to assess the many difficult realities.

The concerns are multifold. Inflation has subsided but is not subdued. The Federal Reserve will keep rates at their current levels for an extended period and may even raise them higher again. As a result, the threat of recession is still real. The political turmoil in Washington and strong likelihood of government shutdown add to the economic anxiety.

We expect the market to be nervous for the remainder of 2023. It will probably fluctuate sideways without clear direction. Our posture with client portfolios is defensive and cautious. As always, we look for stocks that can weather through uncertainty and have potential to show gains as hopefully the puzzle pieces come together more neatly and clearly in 2024.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends for the third quarter and year-to-date. The stock market took a setback in the quarter but is still positive for the year. Bond prices continued to fall in the face of higher interest rates.

Equity Market: Most investors spent the first half of the year feeling largely upbeat. Inflation appeared to be subsiding and many believed the Fed would switch from raising interest rates to cutting them. This sentiment was dampened after the Fed meeting in August when Chairman Powell was clear that inflation was a continued problem and that higher rates would remain in place for the foreseeable period. Investor fascination with artificial intelligence and big technology stocks also took a reality check. The third quarter was negative and cut away from the first half gains.

The S&P 500 Total Return was down 3.27% in the third quarter and ahead 13.07% for the year on September 30. The early days of October have seen more rough trading. This trend is largely the result of the decline in big technology stocks. The Nasdaq Composite was negative 3.94% for the quarter but still 27.11% positive for the year. The Dow Jones Industrial Average took a 3.31% hit in the quarter and was ahead just 3.08% for the year. This result was largely caused by Fed policy. A similar outcome was seen in the Russell 2000 which was down 5.13% for the quarter and ahead only 2.54% for the year.

Fixed Income Market: Higher interest rates are not good for the bond market. The yield on the 10-year U.S. Treasury Note (which moves inversely to prices) was 4.572% at the end of September versus 3.818% at the end of June. The Bloomberg U.S. Aggregate Index – composed of Treasury, mortgage-backed, and corporate bonds – was down almost 3% for the quarter and 1.1% for the year.

MAJOR MARKET INDEXES

	3Q 2023 Return	YTD Return
Dow Jones Industrial Average TR	-3.31	3.08
S&P 500 Index TR	-3.27	13.07
Russell 2000 Index TR	-5.13	2.54
NASDAQ Composite TR	-3.94	27.11
EAFE Index NR	-4.11	7.08
Bloomberg Aggregate Bond Treasury TR	-3.06	-1.52

Source: Morningstar® as of September 30, 2023

THE OUTLOOK

The Economy: Much of the economic data suggests the economy is headed for a controlled or so-called "soft landing." Labor markets are healthy but cooling. Wage growth is moderating. Consumer and business spending is slowing. One relatively optimistic forecast is that U.S. GDP growth will be about 2.2% in 2023 and then slowing to 1.3% in 2024. This forecast exists even though the Federal Reserve has moved interest rates to a range of between 5.25% and 5.5%, the highest in 22 years. One group of financial analysts believe the economy will avoid recession.

However, other analysts are less sanguine and point to imminent risks in the picture. The Fed seems intent on keeping interest rates at their current level until inflation is more clearly subdued. There is even the likelihood of another 50-basis point hike in rates. The impact of higher rates may not have been fully absorbed yet. Then we have the triple threat of an economic drag created by the resumption of student loan payments, a government shutdown, and a prolonged auto worker strike. All of these domestic concerns come parallel to the obvious economic slowing in Europe and China. At Hudson Advisors, we look at this whole picture and conclude that recession is still quite possible in 2024.

The Market: Even without recession, S&P 500 corporate earnings dropped 5.2% year-over-year in the second quarter. Morgan Stanley has predicted that U.S. corporate earnings are expected to decline by 16% for full-year 2023. Weak earnings have an obvious impact on stock valuations. We always look carefully at the Price/Earnings ratio for the S&P 500. The forward 12-month P/E ratio is now about 18 – much higher than the 100-year average of 15. The effect of lower corporate earnings may push the ratio even higher in the months ahead. So, yes, many stocks are richly priced. With the boon in technology fading, we expect many equity investors will be cautious in the months ahead when they can park money in cash at a 5% return.

As stated, we are defensive at Hudson Advisors. Given the risk of recession, and the reality of sluggish earnings, we expect the market to move sideways or even slightly downward in the fourth quarter. It will be a good outcome if the S&P 500 can hold its current year-to-date gain of 10%.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For some clients, we may recommend taking some money off the table right now. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18-month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors at the current time:

HEALTH CARE: This sector has proven to be economically resilient and has provided good returns historically.

ENERGY: Higher oil process should boost the earnings of these companies.

INDUSTRIALS: Companies in this sector have provided consistent earnings and good dividends.

CONSUMER STAPLES: These companies can do well in uncertain times when consumers stick to basics like food and household items.

FINANCIALS: Higher interest rates can improve banking net interest income and we are interested in certain money center and super regional banks.

Other Assets: Our aversion to long-term bonds remains and is reinforced by the inflationary situation. We like bond maturities under two years which now have higher rate returns than previous years. We like laddered investments with a mix of U.S. Government, municipal, and high-quality corporate bonds. We also like the new better-paying opportunities in money market funds.

Also, for some clients, we look at alternative investments through Broadly Syndicated Loan vehicles and Collateralized Loan Obligations which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

.

William Hudson, Jr., William Hudson, III CFP ®, Jeremy Hudson, & Evan Coppola
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (772) 231-8101
237 Main Street, Suite 600 • Buffalo, New York 14203 • (716) 803-6587
David Burrows
504 W Lyon Farm Drive • Greenwich, CT 06831 • (203) 302-3530
www.hudsonadvisors.com • **(877) 504-1964**