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Redhawk Quarterly Commentary

September 30, 2023

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what is transpiring in the investment landscape and provide our perspective on a variety of topics. These are not predictions, and it represents our perspective on important market and economic information designed to help make decisions affecting your long-term financial strategy. Our goal is to help you understand what is going on in the markets so you can more clearly define investment goals, diagnose unintended risks, and utilize portfolios that can achieve a better financial outcome.

Market Commentary

The positive momentum of the first two quarters of the year did not carry over to the third quarter. Inflation moderated somewhat, but not enough to curb the Federal Reserve's (Fed) hawkish monetary policy. Crude oil and gasoline prices soared during the summer. Job gains, while steady, declined throughout the third quarter. The housing sector slowed on rising mortgage rates and dwindling inventory.

The third quarter saw most of the market sectors decline from the second quarter. Utilities, real estate, technology, consumer staples, and consumer discretionary fell the furthest. Driven by the increase in oil prices as energy stocks rose nearly 16%. Smaller companies, which tend to be more immediately impacted by a slowing economy, felt the economic pain. These companies make up the Russell 2000, which fell the furthest of the major indices during the third quarter. The more tech-heavy NASDAQ was next, and the Dow Jones Industrial average declined the least.

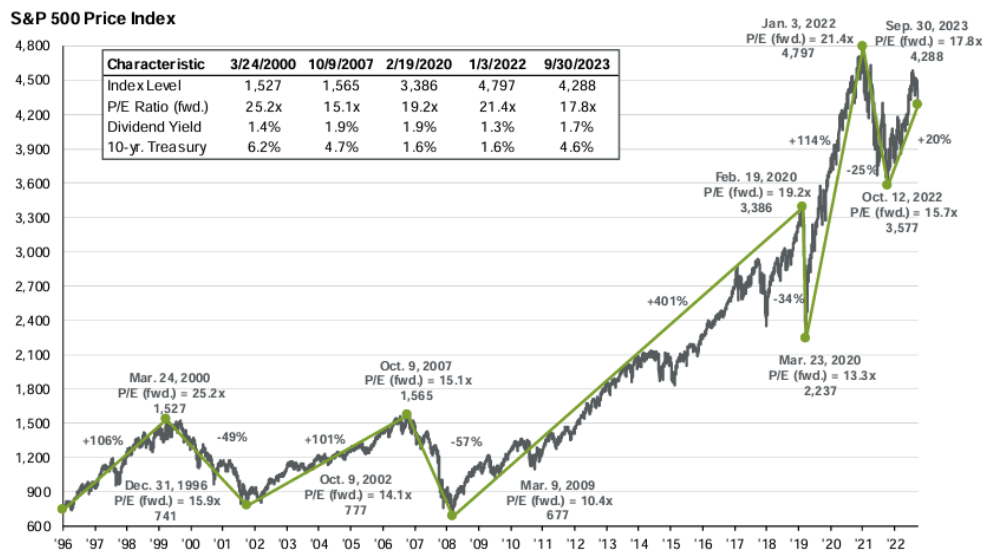
Bond yields rose steadily during the quarter, as investors priced in expectations of interest rates remaining higher for longer. Higher yields generally result in lower bond prices and a stronger dollar, and these dynamics played out during the quarter. The yield on the 10-year U.S. Treasury bill rose to the highest level since 2007. The U.S. dollar also inched higher in the third quarter, hitting its highest level since last November.

The increase in the Federal Funds rate pushed mortgage rates to 7.31% on the benchmark 30-year home loan, the highest rate in 23 years. However, unlike 2000, house prices generally rose alongside mortgage rates, as demand outpaced available inventory. Oil prices rose 30% since June and ended the quarter near $91.00 per barrel, which limited the reduction in the core inflation numbers[1].

The quarter started out strong, with signs of moderating inflation pushing up markets in July. The S&P 500 Index notched its fifth consecutive monthly gain as all eleven market sectors finished higher in July. Overall, small caps outperformed large caps, with the Russell 2000 (up 6.1%) leading the major benchmark indexes. Energy stocks jumped higher on the heels of rising crude oil prices, which hit a three-month high. Ten-year Treasury yields rose above 4.00% during the month, only to retreat somewhat to 3.95% by the end of July. From there, equity markets declined heavily in both August and September, with the NASDAQ 100 falling into correction territory (indicated by a 10% retreat from its prior high)[1].

Much of the pain felt in both the stock and bond markets could be attributed to investors pricing in a longer period of restrictive Fed rate policy (higher rates for a longer time) as well as indications that the consumer may be running out of the means to continue supporting the economy. Credit card balances and defaults increased over the quarter, student loan payments were set to resume in October, and some of the pandemic era child tax credits will be sunsetting, putting pressure on capital markets across the board.

The S&P 500 Index ended the quarter at 4,288 with a forward P/E Ratio of 17.8x and the 10-year Treasury yield closed at 4.6% (see the chart below).



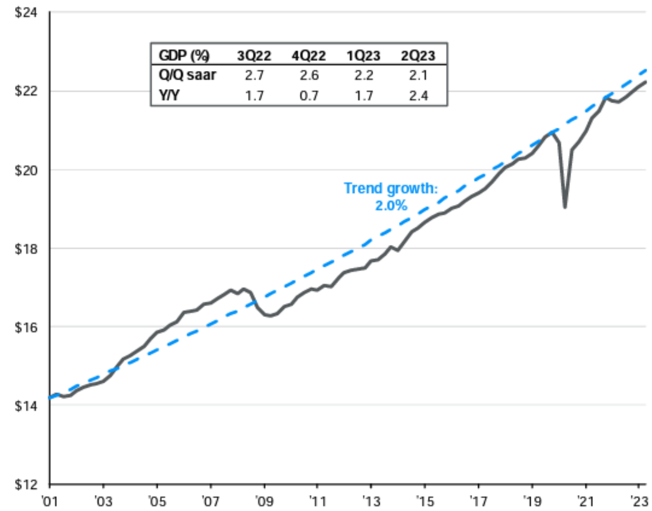
Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2023
Index Level	1,527	1,565	3,386	4,797	4,288
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	17.8x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.7%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	4.6%

Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2023.

J.P.Morgan
ASSET MANAGEMENT

U.S. Market

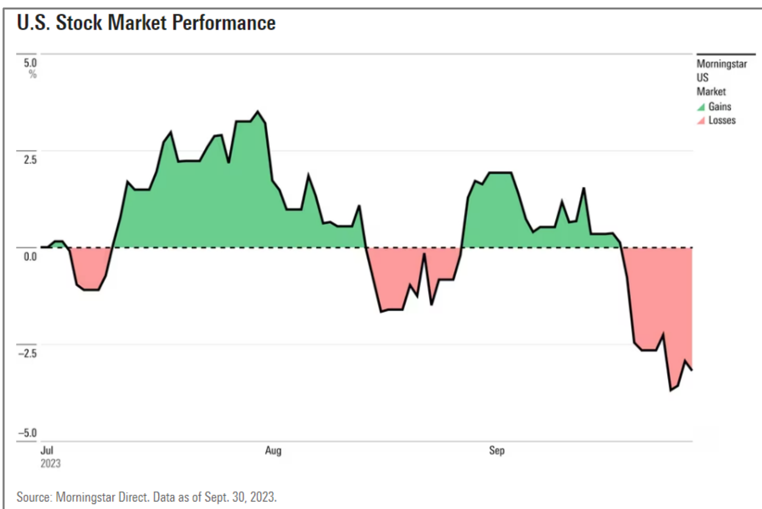
The U.S. economy grew at an annualized rate of 2.1% in the second quarter of 2023 (see the chart to the right), slightly below the upwardly revised first quarter's expansion of 2.2%. Growth rates eased for both consumer spending (0.8% vs 3.8% in Q1) and government consumption (3.3% vs 4.8%), while nonresidential fixed investment saw the most significant increase in almost a year (7.4%). Meanwhile, exports experienced the largest decline since the aftermath of the COVID-19 outbreak (-9.3% vs 6.8% in Q1), and residential fixed investment slumped for the ninth consecutive period (-2.2% vs -5.3% in Q1)[1].



GDP (%)	3Q22	4Q22	1Q23	2Q23
Q/Q saar	2.7	2.6	2.2	2.1
Y/Y	1.7	0.7	1.7	2.4

The shining star in the second quarter GDP was strong business investment in structures, equipment, and intellectual property, which contributed to about half of the growth. Consumer spending slowed from initial estimates, contributing only 0.55% to Q2 growth. Spending for services continued to outpace expenditures for goods, with services accounting for 80% of the 0.55% contribution.

The S&P 500 Index returned -3.27% in the third quarter of 2023 with monthly returns of 3.21%, -1.59% and -4.77% for July, August, and September, respectively (see the chart to the right). The S&P 500 Index has climbed 13.07% since the start of 2023. An equity market rally in July, a surprise downgrade of U.S. credit by Fitch Ratings and regional bank downgrades, combined with concerns about economic growth in China, drove the S&P 500 Index to return -4.66% from the end of July through August 18. The market rebounded partially, with a 3.41% return



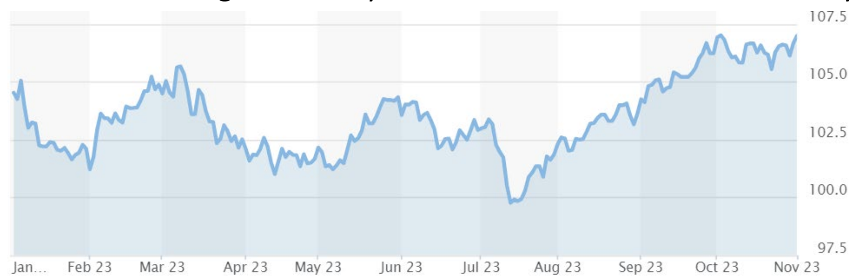
from August 18 through September 1. However, as the yield curve continued its shift higher and interest rates maintained new-found heights, the equity market declined -4.94% from September 1 through quarter-end[2].

Total returns by asset class are shown in the chart to the left and only two of eleven sectors were positive in the third quarter. energy (+12.66%) was the top performer as the price of WTI crude oil increased by 29% to $91 per barrel. Interest rate sensitive sectors, including real estate (-8.46%) and utilities (-9.27%), were the laggards. The three worst performing sectors of 2022 were the top performers through Q3, which were consumer discretionary (26.6%), technology (34.7%), and communication services (40.4%). Note that these three sectors include the “Magnificent 7” stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta Platforms), which have been responsible for most of the S&P 500 Index’s gain this year despite mixed results in the quarter.

	Performance (%)		
Cyclical	Q3 2023	Q2 2023	1 Year
Basic Materials	-4.96	3.63	20.05
Consumer Cyclical	-4.69	12.14	16.05
Financial Services	-0.16	5.15	14.16
Real Estate	-8.46	2.30	-0.82
Sensitive			
Communication Services	2.51	12.59	36.44
Energy	12.66	-0.48	28.90
Industrials	-4.85	7.40	24.40
Technology	-4.91	16.48	40.99
Defensive			
Consumer Defensive	-5.22	0.56	8.16
Healthcare	-3.46	2.99	7.04
Utilities	-9.27	-2.75	-6.85

Source: Morningstar Direct. Data as of Sept. 30, 2023.

Higher interest rates usually come with a stronger currency. The U.S. dollar’s run since mid-July has been impressive (see the chart to the right). Recent strength reflects how investors think about the level and direction of relative interest rates. The major central banks, such as the Bank of England, the Bank of Japan, and the European Central Bank, are fighting inflation. The Bank of Japan continues its program of loosening yield curve control, and the Bank of England and European Central Bank have held the line on rates even though economic concerns mount. Both the level and direction of relative interest rates between the U.S. and its partners are not conducive to a retesting of the highs of last year[3].



Source: MarketWatch 2023.

Going back to the early 1970s, an inverted yield curve (when the 10-year Treasury yield is lower than the 2-year Treasury yield), has been a leading indicator for a recession in every occurrence (except in 1998 when it briefly inverted). While the yield curve has started to normalize with the sell-off in long term bonds, it remains inverted (see the chart below). As mentioned, when this curve inverts a recession typically occurs, on average of 11 months later. Since this curve inverted in November 2022, history would suggest a recession as early as Q4 2023[4].

During the quarter, oil prices rose to a 12-month high. Oil rose above $90 per barrel in September, from approximately $70 per barrel at the end of June (see the chart to the right). Demand for oil remained strong as the global economy continued to grow even though OPEC announced extended production cuts through the end of 2023. Additionally, the Strategic Petroleum Reserve (SPR) is at its lowest level since the 1980s, leaving little capacity to mitigate a potential supply disruption. OPEC's production cuts squeezed global supply and oil prices surged nearly 30% in the third quarter.

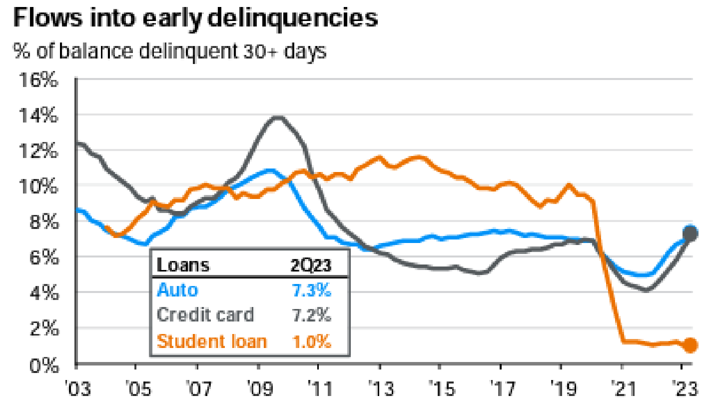
The rise in oil prices caused inflation to re-accelerate in August, with gasoline prices accounting for over half of the monthly increase. Oil impacts nearly every segment of the economy, and a continued rise in oil prices kept upward pressure on inflation as rising fuel costs were passed through to the consumer. Inflation

fell to under 4% during the quarter, however getting to the Fed's goal of 2% may prove to be difficult with higher oil & housing prices, and the continued strength in the labor market.

The Fed's series of interest rate hikes led to a sharp rise in borrowing costs. For example, the interest rate on a 48-month auto loan has risen from 4.6% at the end of 2021 to 7.6% at the end of June. Additionally, the average 30-year fixed-rate mortgage has increased from 3.8% to 7% over the same period. The recent rise in Treasury yields pushed mortgage rates above 7.30% during the third quarter, which implies that interest rates on auto loans also increased during the quarter[4].

According to the National Association of Realtors, the average monthly house payment has risen from $1,249 at the end of 2021 to $2,052 at the end of June. Factoring in the rise in mortgage rates during the third quarter, the current monthly house payment is likely even higher. While many homeowners locked in low mortgage rates during the past few years, new homebuyers are navigating a combination of higher mortgage rates and home prices that remain elevated. Home values that have held and increased in some cases are due to homeowners' unwillingness to sell because mortgage rates have increased (see the chart below)[4].

It's not just homebuyers and consumers who faced higher borrowing costs during the quarter. Borrowers of all types, including businesses and commercial real estate owners, had to adjust to a new world with higher interest rates. The unknown question is whether borrowers can manage the increased interest rates and maintain their payments. Data already indicates consumers, businesses, and commercial property owners are feeling the stress of higher rates. The percentage of early delinquencies, which is defined as loans 30 days or more overdue, is rising across auto and credit card loans (see the chart above).



Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.
Data include households and nonprofit organizations. SA – seasonally adjusted. *Revolving includes credit cards. Values may not sum to 100% due to rounding. **3Q23 figures for debt service ratio are J.P. Morgan Asset Management estimates.
Guide to the Markets – U.S. Data are as of September 30, 2023.

The rising number of Chapter 11 bankruptcy filings suggests businesses are being impacted by higher rates, while some commercial real estate owners have made the strategic decision to foreclose than invest more money in undesirable (or unprofitable) buildings. These early signs of stress suggest lenders and investors should be mindful of potentially above-average credit risk in the coming years (see the chart below).

U.S. commercial Chapter 11 filings.

	2023	2022	Increase
Jan.	378	225	68%
Feb.	375	204	84%
March	570	306	86%
April	387	249	55%
May	682	332	105%
June	581	450	29%
July	363	212	71%
Aug.	634	414	53%

Table: CFO • Source: Epiq Bankruptcy • Get the data • Created with Datawrapper

Fixed Income Markets

Yields increased across the Treasury curve. The 2-year Treasury increased from 4.88% to 5.03% and the 10-year rose from 3.84% to 4.59% during the quarter. Interest rates moved higher due to the economy performing better than expected, continued elevated inflation, higher oil prices, a renewed focus on the country's debt and deficit problem, and the Fed's new higher-for-longer outlook combined with their quantitative tightening program.

Short-term Treasury yields, including, the 3-month (5.5%), 6-month (5.5%), and 12-month (5.4%) are at their highest levels since the early 2000s. Once the Fed starts cutting the Federal Funds rate, short-term Treasury yields should also decline[5].

The Bloomberg US Aggregate Bond index (Agg), which acts as a proxy for the intermediate-term investment-grade bond market, decreased by -3.2% in the third quarter as the 10-year Treasury yield increased to 4.59% in the period (bond prices move inversely to interest rates and credit spreads). The bond market has now declined by -1.2% in 2023. The last two-plus years have been frustrating for intermediate-term fixed income investors as bonds have provided negative returns. Since September 1, 2021, the Agg bond index has decreased by over -18% (see the chart below) as the 10-year Treasury yield has increased by 3.3%[7].

Source: Yahoo Finance 2023.

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International Markets

International developed markets struggled throughout the third quarter, and returns were further dampened by the U.S. dollar's increased strength. The MSCI EAFE Index posted a quarterly loss of -4.1% (see the chart to the right).

Global Equity Market Returns as of 9/30/2023				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	-3.4%	20.8%	6.9%	6.5%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	-3.3%	21.6%	10.2%	9.9%
Russell 1000 Growth	-3.1%	27.7%	8.0%	12.4%
Russell 1000 Value	-3.2%	14.4%	11.1%	6.2%
Russell 2000	-5.1%	8.9%	7.2%	2.4%
Russell 2000 Growth	-7.3%	9.6%	1.1%	1.6%
Russell 2000 Value	-3.0%	7.8%	13.3%	2.6%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-4.1%	25.6%	5.8%	3.2%
MSCI EAFE Hedged USD	-1.3%	20.3%	10.8%	5.6%
MSCI EAFE Small Cap	-3.5%	17.9%	1.1%	0.8%
MSCI Europe	-5.0%	28.8%	7.2%	4.0%
MSCI Emerging Markets	-2.9%	11.7%	-1.7%	0.6%
MSCI Emerging Markets Small Cap	2.9%	23.1%	10.6%	6.5%
MSCI China	-1.9%	5.2%	-14.3%	-4.2%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	-0.8%	9.3%	6.5%	5.2%
HFRI Emerging Markets	-0.6%	8.8%	2.5%	3.2%
HFRI ED: Activist	-3.1%	13.7%	6.4%	3.6%
HFRI ED: Merger Arbitrage	4.4%	4.1%	8.1%	5.4%

Source: NECP 2023.

Within the Eurozone, inflation cooled throughout the quarter and dropped to the lowest level in two years but persisted well above the European Central Bank (ECB)'s target. The ECB raised interest rates to a 23-year high in July but paused in September, noting that rates have not necessarily peaked, and additional hikes may be necessary. European government bond yields climbed throughout the quarter as revised data showed the Eurozone narrowly avoided a recession in Q1 and began to expand in recent months. Within the UK, the Bank of England raised interest rates to a 15-year high, which reaffirmed the commitment to hold rates higher for longer. Housing prices fell at the fastest pace since 2009 during Q3, but GDP exceeded expectations. In Japan, the Bank of Japan increased flexibility around its yield curve control target, and the 10-year yield rose to the highest level in over a decade. Inflation fell throughout the quarter, and the yen weakened to an 11-month low[6].

Elsewhere, the MSCI Emerging Markets Index slipped -2.9% during the third quarter. Data published throughout the quarter showed signs of China's weakening economy. China's Q2 GDP disappointed, growing just 0.8%, and youth unemployment jumped to a record

21.3% as the technology and real estate sectors that employ many recent graduates have failed to recover post-pandemic. Exports fell to the lowest level since the onset of COVID-19, and top-ranking officials pledged to boost domestic consumption and strengthen the post-COVID recovery but took no specific action. During the quarter, consumer and producer prices fell concurrently as retail spending and manufacturing production slowed, and household debt surged to 1.5 times that of income. India, on the other hand, was the index's best-performing country of the quarter as the economy continued to display strong signs of growth[6].

Economic Outlook

Most investors were glad to see the third quarter come to an end. Ultimately, markets gave way to weaker historical patterns and stocks moved lower due to persistently high interest rates and a challenging investment environment. After the S&P 500 Index hit its closing year-to-date high of 4,589 on July 31, stocks quickly spent the rest of Q3 moving lower. September, which is notorious for its historically poor market performance, lived up to its negative reputation.

So, what are some of the factors that could impact the markets in the fourth quarter?

Headwinds

The investment landscape is clouded by many of the same negative items that moved markets lower in the third quarter and complicated the picture. Some of the headwinds include[7]:

- Hawkish commentary from global central banks to increase rates or keep them high.
- Tight monetary policy and a higher for longer interest rate message from the Fed.
- Fewer rate cuts projected in 2024 which could drive the economy into a recession.
- Higher energy prices.
- Weakening consumer trends.
- Increasing consumer credit card usage and balances.
- Increasing Treasury yields.
- Continuing wars in Ukraine and Israel.
- Resumption of student loan payments.
- Potential government shutdown in November.
- Increasing costs in servicing the national debt.

Tailwinds

While the above headwinds are unlikely to fade away during the quarter, there are reasons to remain constructive as the year winds down. Some of the tailwinds include[7]:

- Stocks are higher year-to-date and tend to finish positively in the final quarter when up this late in the year.
- Seasonality factors should improve as the year ends.
- Economic fundamentals remain sound, and earnings growth is trending higher.
- Core inflation should trend lower, especially for shelter costs, which represent over 40% of the core CPI.
- Jobs should remain steady, and economic growth should remain positive.
- Declines in housing prices should help lower core inflation.
- The Fed's historic rate hike campaign is nearing an end and higher rates are not causing a material loss of economic momentum.

Summary

As you can see, there are real risks to both the markets and the economy as we begin the final three months of the year. But these are largely the same risks that markets have faced throughout 2023 and over that period the economy and markets have remained resilient. So, while these risks and others must be monitored closely, they do not present any new significant headwinds on stocks that have not existed for much of the year. Expect a push and pull market dynamic for the fourth quarter.

We continue to focus on managing both risks and return potential. We understand the risks facing both the markets and the economy and are committed to helping you effectively navigate this challenging investment environment.

Acknowledgements

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7. Magnus Financial Group, "Market Commentary Q3 2023," https://magnusfinancial.com/market-commentary-q3-2023/

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