JJ BURNS

3rd Quarter Newsletter | September 2023

“I watch the sun go down / And I keep hanging on, waiting for my lucky day” **Chris Isaak, “*Waiting For My Lucky Day*”**

Last quarter, we discussed the almost existential patience of investors waiting for something, specifically the much-anticipated U.S. and global recession. Spoiler alert: it still hasn’t occurred. What *did* occur in the just-concluded quarter is more of a reckoning of investor perceptions with the Fed’s comments and actions thus far into the tightening cycle. As we’ve noted in our conversations with clients, many recession signals are now flashing red except for employment numbers. Add in the realization that rates are going to remain elevated for some time and that consumers are seeing the effects of higher rates in their personal consumption patterns, and suddenly the bogeyman seems more real and a lot closer. As we can see below, the market reaction last quarter was much like children a little scared at night—investors sold risk assets and sought refuge ‘under the bed’ in seemingly safe short-term cash instruments. Cooler heads would note that, while this is a temporarily comforting behavior, it offers only short-term solace. In fact, valuations for many regional-equity markets and many bond sectors are quite attractive after a decade of depressed interest rates and moribund equity returns. This offers the opportunity to look forward and consider positioning for the bumpy few quarters ahead to be ready for an eventual rebound:

Index Returns
as of 9/30/2023

Index	Q3 2023	Q2 2023	YTD 2023	2022
FIXED INCOME				
BbgBarclays US HY 2% Issuer Cap	0.46%	2.14%	5.87%	<11.18%>
BbgBarclays Municipal	<3.95%>	<2.99%>	<1.38%>	<8.53%>
BbgBarclays Global Aggregate	<1.82%>	<1.87%>	1.09%	<11.22%>
BbgBarclays US Agg Bond	<3.23%>	<3.58%>	<1.21%>	<13.01%>
U.S. STOCKS				
Russell 1000 [Large-cap Stocks]	<3.15%>	3.39%	13.01%	<19.13%>
Russell 2000 [Small-cap Stocks]	<5.13%>	2.59%	2.54%	<20.44%>
S&P 500	<3.27%>	3.12%	13.07%	<18.11%>
INTERNATIONAL STOCKS				
MSCI ACWI Ex USA NR [All Stocks]	<3.77%>	0.54%	5.34%	<16.00%>
MSCI EAFE NR [Developed Markets]	<4.11%>	0.25%	7.08%	<14.45%>
MSCI EM NR [Emerging Markets]	<2.93%>	0.76%	1.82%	<20.09%>
REAL ASSETS				
U.S. Dollar	3.22%	1.82%	2.61%	7.87%
Morningstar US Real Asset Index	<3.75%>	<1.08%>	<1.72%>	<8.24%>
Bloomberg Commodity	4.71%	8.94%	<3.44%>	16.09%
S&P GSCI Crude Oil Spot	<3.28%>	<5.85%>	2.18%	<0.13%>
S&P GSCI Gold Spot	28.52%	33.34%	13.12%	6.71%
S&P United States REIT	<7.02%>	<2.30%>	<1.95%>	<24.36%>
S&P Global Ex US REIT	<4.28%>	<4.92%>	<7.50%>	<21.91%>

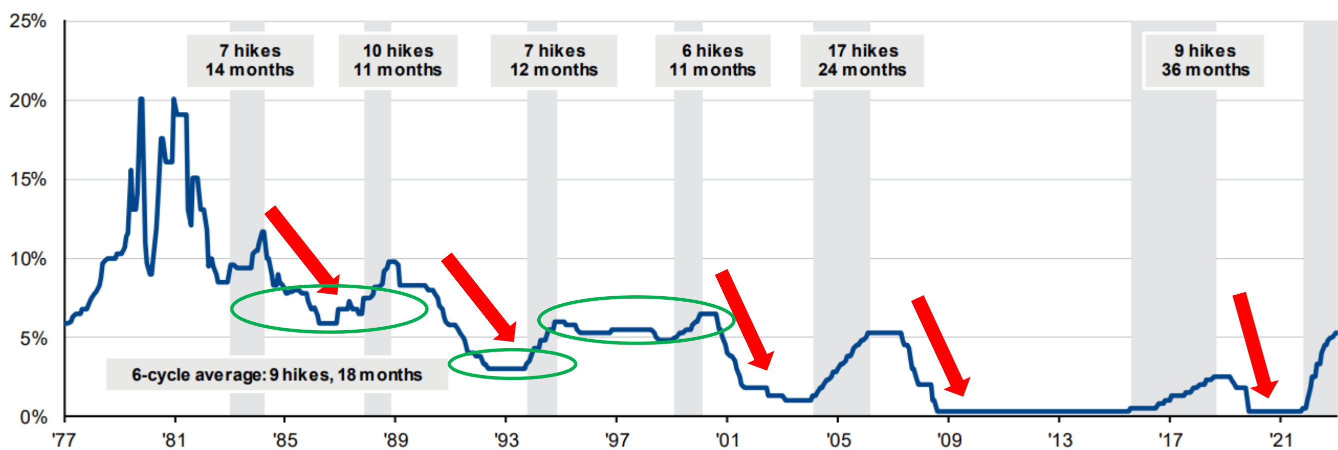
Source: Morningstar, Inc. USD data with dividends and interest

“What goes up must come down / Spinnin' wheel got to go 'round” Blood, Sweat and Tears, “*Spinning Wheel*”

One scenario currently developing is a ‘soft landing,’ in which the Fed cools inflation and growth without pushing the economy into recession. Markets are pricing in more rate hikes and no cuts until mid-2024. This has led to an unusual portfolio barbell of sorts, with very short-maturity investments balanced with very long-duration instruments such as the handful of big-tech equities that are popular with investors. This has skewed risk profiles to likely imprudent extremes. Right now, we think that investors can confidently believe that, regardless of the ultimate level of the Fed’s rate hikes (we think that the 7% number quoted recently is an extreme scenario), rates will eventually drop. The most likely circumstances that will cause the Fed to ease will be either a recession or a geopolitical event that requires swift intervention to boost confidence. If we assume a higher probability of the former case, we can see that the Fed has historically lowered rates much faster than they raise(d) them. The table and graph below show the Fed’s history back to the late 1970s with respect to rate changes:

Federal funds rate

Target rate*, shaded areas denote periods of rate hikes



Looking closely at the ‘steps’ both up and down in rate levels, the slope of rate decreases is sharper (red arrows) than the hikes, which are generally measured and incremental, much like a steady hand on an engine throttle. We can also see periods in which the economy grew (the 1990s in particular) with short-term rates at much higher levels for a longer period than they have been in recent history (green ovals). We also noted that rates never touched the 0%—0.25% level seen in the post-Financial Crisis period *even* during the bumpy bear market and slow-growth era of the early 2000s. This implies that rate policy is important to consider for all assets, and is *not* always the severe impediment to growth often believed. Investors may recall some robust equity-market returns during this time as well.

Fed policy and market reaction in the year following peak of previous rate hiking cycles

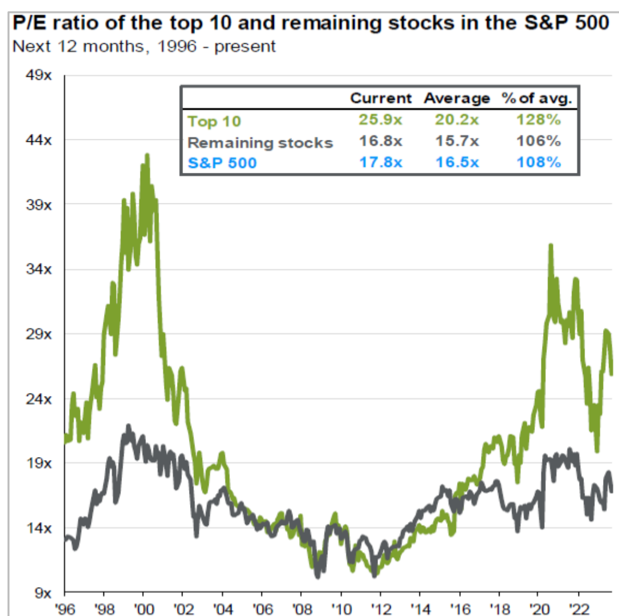
Date of last rate hike	Jun. 1984	Feb. 1989	Feb. 1995	May 2000	Jun. 2006	Dec. 2018	Avg. after past 6 rate hiking cycles
Yield change (bps)							
Federal funds rate	-325	-106	-75	-250	0	-75	-139
2-year Treasury	-416	-84	-240	-264	-34	-104	-190
10-year Treasury	-325	-57	-203	-95	-19	-87	-131
S&P 500 return	23.1%	10.7%	35.7%	-12.3%	18.1%	30.6%	17.6%
U.S. dollar	6.7%	0.7%	0.7%	5.4%	-4.6%	0.1%	1.5%

Source: FactSet, Federal Reserve, Standard & Poor’s, J.P. Morgan Asset Management.

The table above illustrates market reactions to Fed decisions to begin lowering rates (i.e., end the hiking cycle). The top row lists the changes in the Fed's target rate (one basis point, or bps, equals 0.01%), and covers the past six (6) easing cycles. We can see that the U.S. 2-year Treasury rate, which is more sensitive to Fed actions, falls more than the U.S. 10-year Treasury, which tracks growth expectations. This implies that high money-market rates will quickly become *less* attractive than other assets, as evidenced by the S&P 500 *price-only* returns listed in the second-from-bottom row. Longer-term bonds should also do well as rates begin to drop. We believe strong relative positioning in quality and duration *across and within* asset classes will be a key to reaping benefits from these changes, which seem to be a matter of timing as we look ahead.

"Since it costs a lot to win, and even more to lose / You and me bound to spend some time wond'rin' what to choose" Grateful Dead, "*Deal*"

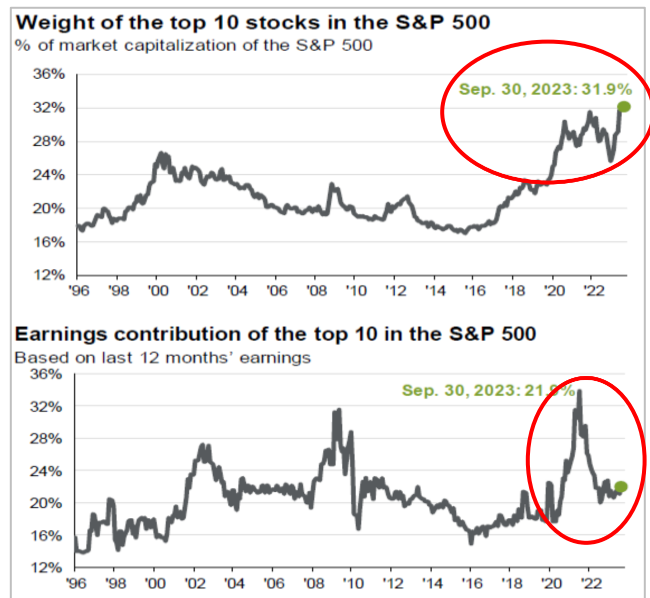
We would be remiss as stewards of capital if we ignored the current dichotomy in valuations in the most-followed equity barometer, the S&P 500. The following two (2) graphs indicate that behavior and sentiment seem little changed for the tech-heavy names at the top of the index portfolio. Despite a punishing 2022 for these stocks, investors have returned to these names with enthusiasm, apparently regarding them as possibly more secure than U.S. Treasuries.



This graph represents the weighted rolling 12-month forward P/E ratio of the top-10 names in the S&P 500 each month for the period represented. The recent data includes the growth-focused names that have clever acronyms composed from their initials. Valuations this year are elevated, and approached the twin peaks of recent excess. Last year pulled top-10 expectations back to more realistic—if still elevated—levels that promise a recalibration of prospects and valuations for other names in the index, as represented by the gray line and data in the key. While it can be exhilarating to own a fast-rising name, there are 490 other stocks in the index that may be worthy of additional investor research and attention.

Both graphs from J.P. Morgan Asset

We can see further evidence of the expectations investors have built for these top-10 names. The average index-weight has been consistently high for this cohort since the beginning of the new tech/growth run in 2016, surpassing the highs of the tech run-up the late '90s. This is not intended as a buy or sell recommendation on these names; it is simply an illustration of how deep expectations for these stocks are. Also worrisome is the very high valuations and ownership that appears out-of-line with the cohort's actual earnings contribution, as illustrated in the bottom graph. This implies that other, smaller names may offer better growth potential and more palatable valuations despite lacking a marquee name or investment in a 'hot' area such as artificial intelligence (AI).



"It's money that matters / Hear what I say / It's money that matters / In the U.S.A." Randy Newman, "*It's Money That Matters*"

Our expectations for 2023 and 2024 are for more volatility in both equity and bond markets. The confluence of mixed economic signals and high investor-and-consumer expectations seems bound to clash with fiscal and monetary at the federal level. As we discussed last quarter, interest costs for the U.S. debt are expected to soar in the next few years after decades of tax cuts and increased spending. Defense and transition programs (Social Security and Medicare) are the lion's share of expenditures, and little appetite exists to seriously reform the structure of these programs. This policy inertia comes amid rising geopolitical tensions, promising a heady mix for the markets in the months ahead.

We recommend that clients consider their short-term needs for the next 12-24 months and plan now for anticipated expenditures or withdrawals in the near future. Cash rates are attractive, and current market strength makes raising reserves more appealing. We expect to take advantage of higher interest rates and market pullbacks by rebalancing portfolios as opportunities arise. If you have any questions, please contact our office.

As always, we welcome your comments, questions and feedback, and thank you for your trust in us.

– Your Wealth Management Team at JJ Burns & Company

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Unless otherwise stated performance numbers refer to indexes, which cannot be invested in directly and have no fees or trading expenses associated with them. All index data provided by Morningstar, Inc.

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Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. The Barclays U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Citi World Government Bond Index (WGBI) provides a broad benchmark for the global sovereign fixed income market. It measures the performance of fixed-rate, local currency, investment grade sovereign bonds, currently includes sovereign debt from over 20 countries denominated in a variety of currencies.

The Morningstar® US Real Asset Index is a diversified portfolio of four different asset classes that have historically displayed high sensitivity to inflation. Real assets are defined as TIPS, commodity futures-based strategies, real estate investment trusts, and inflation-sensitive equities such as upstream commodity stocks and master limited partnerships

The S&P U.S. REIT Index defines and measures the investable universe of publicly traded real estate investment trusts domiciled in the United States. The S&P Global REITis a comprehensive benchmark of publicly traded equity REITs listed in both developed and emerging markets. The S&P 500® index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The MSCI ACWI index captures large and mid-cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries.

The Bloomberg Commodity Total Return index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. The index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity.