Good morning,
I've been fielding numerous calls lately about the current state of the markets and how recent events in the Middle East may be impacting the financial markets. So, I'd like to address some of those concerns pertaining to your portfolio and the financial markets. Hopefully, this email will provide a little more clarity about what is driving the markets, the returns in the portfolio, and what the future may bring.

**<u>Executive Summary</u>:**

- Recently, one of the three main risk charts flipped "negative,"[1] which requires me to raise cash levels in the portfolio. The cash levels are approximately 30%-35% in the moderate, moderately aggressive, and aggressive portfolios, with the bulk of those funds in a money market yielding close to 5.4%.[2] The conservative portfolio has a cash level of approximately 25%, also in a money market yielding about 5.1%.[3]
- As I write this on October 29th, two of the three main risk charts are "negative,"[4] a repeat of what we saw much of last year.
- In my opinion, the main driver of the weakness we have seen in both the fixed-income and equity markets since August 1st has been the relentless rise in longer-term interest rates.[51]
- Along with the rapid rise in interest rates, the U.S. dollar continues its upward ascent that started back in July, and that is also creating headwinds for some areas of the stock market.[5]
- Technically speaking, the stock market is statistically oversold, and the major indices recently broke important support levels, resulting in a substantive chance we could see a further sell-off in the equity markets.[6]
- For the indices to hold those critical support levels, the Q3 earnings season needed to induce a positive reaction by Wall Street. I was hoping corporate America would come out and say positive things about Q3 earnings and give positive future guidance, resulting in a year-end rally developing from these heavily oversold markets. However, the recent response to earnings has been lackluster.[7]
- The short and intermediate technical data looks weak.[8] Surprisingly, the longer term data still looks constructive for future gains, but that could rapidly change if we see further downside in the markets.[9]
- Corporate earnings and interest rates will dictate the movement of the financial markets. However, the situation in the Middle East could take a turn for the worse, pulling financial markets down.[52] That nascent war is creating much angst and uncertainty in the markets, and the markets hate uncertainty.[52]

It's been a rough three months for the bond and stock markets. Because of the relentless rise in interest rates[10], bonds could have a third negative year of returns for the first time in history.[11] Between August 1st, when Fitch downgraded U.S. national debt from AAA to AA+,[12] and October 29th, the S&P500 was -11.2%[13], and the NASDAQ was -13%.[14] The S&P500 is currently +7.24%, and the NASDAQ is +20.8% year-to-date.[15] As I mentioned in my last email, most of those gains come from the Magnificent 7 stocks-Apple, Amazon, Google, Microsoft, Meta (Facebook), Tesla and Nvidia.[16] Interestingly, the equal-weighted S&P 500 is -5.34% year to date.[17] The S&P MidCap 400 is -3.8% year to date,[18] and the Russell 2000 (small cap stocks) is -6.50% year to date.[19] This recent pullback has taken the stock market back down and through important support levels for both the S&P500 and the NASDAQ markets.[53] For the S&P500, the new support lies at 4,050-3,800, and for the NASDAQ, between 12,000-11,000.[20] So, why are the stock and bond markets struggling for a second consecutive year?

Ultimately, the performance of the bond and stock markets is predicated upon two things: earnings and interest rates.[21] Last year, we saw the NASDAQ bubble burst due to the Fed's multiple interest rate increases,[22] which resulted in the worst year for stocks since 2008[23] and the worst year for core bonds since 1976.[24] I sense that investor fatigue is setting in as we enter the final quarter of 2023.[54] For the greater part of the last fifteen years, when the Fed was conducting its various Quantitative Easing (QE) episodes and keeping interest rates near zero, investors had a fairly easy ride. Central bankers tried to combat the deflation that resulted from the Great Financial Crisis by trying to stoke inflation, which, for the most part, manifested itself in the frequent rise of financial assets.[25] Now that central bankers around the globe are trying to combat the inflation that arose from the COVID-19 pandemic and their response to it (printing of trillions of dollars), life in the financial markets has become more challenging.[55] We no longer have QE but instead have QT (Quantitative Tightening), and the Fed has raised interest rates 11 times since the beginning of 2022.[26,] As I have mentioned in prior emails, QT and rising interest rates are problematic for financial markets.[56] With financial markets facing these headwinds for nearly two years, investors are being reminded that there are risks involved in both the stock and bond markets.[57] If not for the Magnificent 7 stocks, we could see the possibility of two consecutive years of losses in the S&P500, which hasn't happened since the tech bubble burst between 2000-2002.[27] It is understandably hard to see month-over-month declines in statement valuations like we have seen recently in August through October. Still, one has to remember that it is doubtful that monthly declines like that will continue unabated for months on end, which brings me to my next point.

There is some hope that the recent stock market sell-off may be about to end.[58] What precipitated this recent decline was the quick and sharp rise in interest rates, not on the short end of the yield curve, which the Fed controls, but on the long end, which the market controls.[28] When Fitch downgraded the U.S. national debt from AAA to AA+,[29] U.S. Treasuries, unsurprisingly, sold off, and when bond prices went down, interest rates went up. When interest rates go up, that negatively affects both the stock and bond markets, and that is what occurred in August, resulting in losses for both markets.[30] Then, in September, the Fed meeting occurred mid-month. While they didn't raise interest rates, they did leave open the possibility of another rate hike before the end of the year, but what caused interest rates to continue rising was the Fed stating that they didn't expect any interest rate decreases until late 2024 and that rates would stay higher for longer.[31] That wasn't what the bond market wanted to hear, so Treasuries continued to sell off. However, I think the most significant impact on rates rising since the beginning of August is the sheer amount of government debt that has been issued since June.[59] To me, it seems that the bond market is buckling under all the weight of debt that has been issued.[60]

Recently, data shows that China, Japan, Saudia Arabia, and Brazil have been reducing their Treasury holdings by billions[32] for various reasons (China and Japan defending their currencies),[33] which brings supply onto the market. Additionally, in June, the national debt stood at $31.5T,[34] and as of October 22nd, it is at $33.6 T.[35] The over $2T in debt issued over those five months has played a large part in why rates have moved up so quickly since August. It's not that financial markets can't handle higher interest rates; they can. Before 2008, interest rates were at the same levels as today and had been that way for decades, if not higher.[36]

The problem for the financial markets is the rate of change in interest rates, and since August 1st, they have moved in a straight line up from 3.975% to the current 4.845% on October 29th for the 10-year Treasury yield and from 4.04% to 5.023% for the 30-year Treasury yield.[37] Those are very sharp moves in interest rates in such a short amount of time. Therefore, it is no wonder that the stock and bond markets have struggled since the beginning of August. Even the Fed has acknowledged the run-up in rates on the long end of the curve.[61] Several regional Fed presidents have recently stated that they felt no need to raise rates anymore this year since the market did it for them via the long end of the curve.[38] Arguably, rates rising on the long end of the curve have more of an impact on the economy than the Fed raising the Fed funds rate.[62] For instance, mortgage rates are closely tied to the rate of a 10-year Treasury,[39] and with the 10-year getting close to 5%[40], we have now seen 30-year mortgage rates hit 8% recently.[41] That will affect the housing market. It is estimated that the financial conditions index is the equivalent of three .25% increases by the Fed.[42] If you also factor in Quantitative Tightening, which creates a tighter monetary policy, it also acts as a de facto increase in interest rates[43] . Financial markets tend to struggle in that type of environment, which is what we are currently seeing.

So why did I say that I thought the recent sell-off may be coming to an end? Well, it has to do with earnings, specifically Q3 earnings reports. From October 13th until November 3rd, the markets will receive the bulk of reports from corporate America detailing how their businesses did in Q3 and their expectations for Q4 and 2024. Many analysts have forecast that S&P 500 earnings have troughed in Q2 and that Q3 and Q4 should show sequential earnings increases.[44] If that comes to fruition, and companies are optimistic about 2024 earnings, Wall Street should react favorably, pushing up stock prices.63

Additionally, if interest rates cease their rise and pull back some, then growth stocks, i.e., tech stocks, should respond favorably to the pullback in rates, pushing their stock prices higher.[45] Technology is the largest sector of the market,[46] and if that is going higher, then the indices should follow. With the current technical positioning of the market so statistically oversold, with good news from the earnings front and a decrease in rates, the ingredients for a year-end rally will be in place.[64] Interestingly, the longer-term technical indicators never broke down over the past couple of months, and those charts of the major indices look like they want to move higher.[47] It should also be remembered that the corporate buyback window, which has been closed, soon opens up once companies report their earnings.[48] That should also be a tailwind to stock prices as we head into the end of the year. The recent reaction to some of the Magnificent 7 stocks earnings reports has been mixed, so it will be incumbent upon the rest of the corporate earnings releases to step up with some solid reports. So far this earnings season, the amount of beats by corporate America has been higher than usual.[49] However, in technology, the troubling lack of upward revisions to 2024 EPS has been punishing.[50] As I speak to more and more business people about what they see for their businesses in 2024, I am starting to hear that many people are seeing a slowdown to one degree or another for next year. I am also reading various analyses that predict a stagflationary environment in 2024, which would be a challenging environment for the financial markets.[65] So, while I do think that earnings could save the day for the stock market, those earnings are now starting to face more headwinds as prior interest rate increases finally are beginning to make their way through the economy in conjunction with the tighter financial conditions that are beginning to emerge from the continuation of QT and the back-up in long term interest rates.[66]

Additionally, and this shouldn't come as a surprise, the current situation in the Middle East is highly volatile and uncertain. I believe the markets have reacted quite favorably so far. The energy complex has seen oil move up, but not in panic mode.[67] Gold has moved up, but again, not in panic mode.[68] That lack of panic is encouraging but could change rapidly depending on how events evolve. The Israeli-Hamas conflict is a developing story that the financial markets will closely watch along with the world. If the situation in the Middle East deteriorates significantly, markets will probably react.[69] I would expect oil to jump over $100/barrel and gold to test the $2,050 level seen earlier this year.[70]

I have highlighted what I believe are the most critical factors currently driving the markets. There are many other factors and variables that are creating crosswinds in the markets that I am watching closely. I have been managing money for over twenty years, and this year has been as challenging to navigate as 2008 was. But with over twenty years of experience under my belt, the one thing I will say is that tough times don't last forever in the financial markets, and the current environment is no exception. I am confident that the strategy is adaptable and nimble enough to get through this tough time which has spanned the past two years. The goal is to keep losses small while being ready and properly positioned for the markets to move forward when the time is right. There is a large amount of concern in our world, however, ultimately, the markets will focus on earnings and interest rates, and when those two factors start to move favorably, so should the financial markets. I plan on having your portfolio ready for when that time comes.

In the meantime, if you have any questions or want further clarity on anything in this email, please don't hesitate to contact me. I promise to stay in touch!

Jim

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**Value Proposition:**
**We provide proactive and personalized service to help you define objectives to:**

- **Simplify and solve complex financial issues**
- **Preserve your assets and your lifestyle**
- **Stay abreast of financial opportunities and strategies**

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characteristics of Accounts participating in PMP, investment opportunities will not necessarily be allocated among participating Accounts proportional to their overall amount invested.

- Below are some of the general risk considerations associated with the investments included in the PMP investment strategies described in this Brochure. The descriptions are not meant to be a complete list of all investment risks. For more complete information regarding fees, expenses, risks and restrictions associated with these investments please review the offering documents and marketing materials. Investors should consult their tax advisor about their specific tax situation before investing in any securities. In addition, clients should familiarize themselves with the particular market risks and the other risks associated with the specific investment.
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