Executive Summary **October 2023**

Dear Clients and Friends,

The major market indices took a breather in the third quarter of 2023, retreating from their highs earlier in the year. As seen in **Exhibit 1**, each of these indices was positive in the first half of the year, and has at least partially given up those gains since, with negative low-single-digit percent total returns in the third quarter. The broad-based decline in markets occurred, despite a persistently strong macro and earnings environment, with higher interest rates the primary driver. Further, a small handful of large-cap tech stocks accounted for much of the year-to-date increase. As a result, following the pullback, the typical stock, as measured by the S&P 500 equal weight, is modestly positive for the year, while bond indices are slightly lower.

While the recent pullback resembles the seasonal weakness that we normally see at this time of year, only time will tell whether the market was simply seasonally weak or if a more dire macro environment is being foreshadowed. We are still early in the fourth quarter, but so far markets have stabilized, and earnings remain strong. While we remain cautiously optimistic given the surprising macro strength, we acknowledge the wide range of future scenarios and uncertainty and have taken a balanced approach to client accounts, managing near-term risk while looking for long-term investment opportunities.

Exhibit 1A: 1st half total return

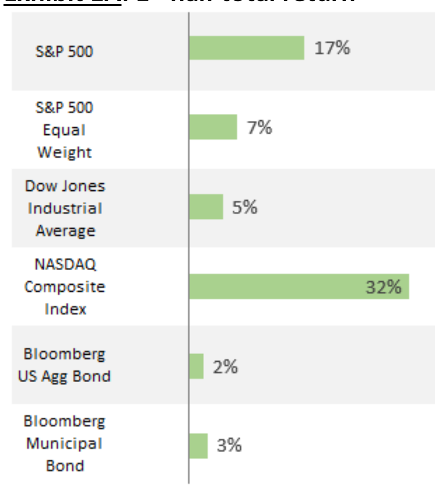


Exhibit 1B: 3rd quarter total return

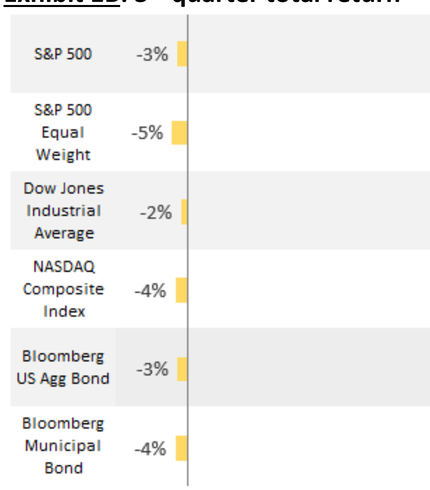
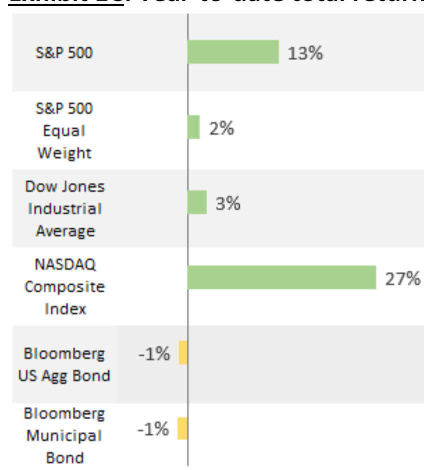


Exhibit 1C: Year-to-date total return



Source: United Asset Strategies, and Bloomberg

Macro & Market Recap

Economy: Stronger for longer. At the start of 2023, the consensus view was that 2022's historically rapid pace of tightening monetary policy, given its long and variable lags, would sufficiently restrict economic activity, such that we were on the doorstep of a recession. Fast forward, and it is fair to say that the economy and earnings have exceeded expectations.

Making up some 65% of GDP, the consumer has been the primary driver of the stronger-than-expected U.S. economy. In our view, as long as the labor market remains strong, the consumer will continue to spend, which will support economic growth. To that end, the September US nonfarm payrolls were exceptionally strong, increasing by 336,000, which was above the consensus expectation of 170,000 and the August increase of 227,000. Going forward, potential headwinds for the consumer include the recent increase in gasoline prices, the resumption of student loan payments and reduced government support for programs such as Medicaid. That said, much of the consumer data has been stronger for longer, leading to upside surprises.

Along those lines, the Citigroup Economic Surprise Index (CESI), which tracks how economic data compares with consensus expectations, more broadly confirms the strong macro data points discussed above. As seen in **Exhibit 2**, the CESI has consistently produced above average readings so far this year. Better yet, this has directly translated into better-than-expected corporate profits, with quarterly S&P 500 EPS exceeding expectations by a wider margin than usual in both the first and second quarters. We are still early in the third quarter earnings season, but so far, earnings have remained strong.

Exhibit 2A: Economic data points have surprised to the upside so far this year….
Citi Economic Surprise Index

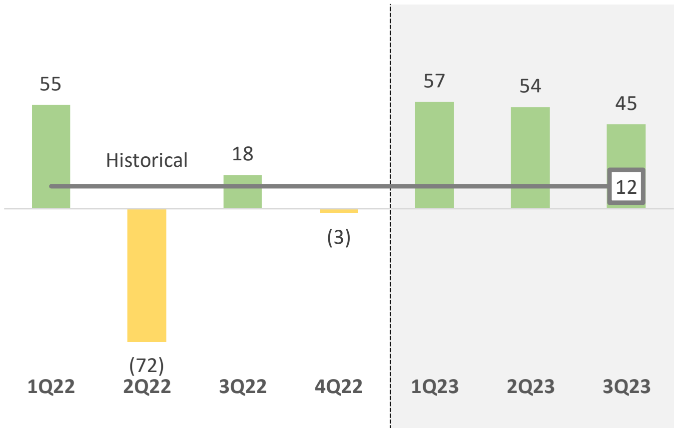
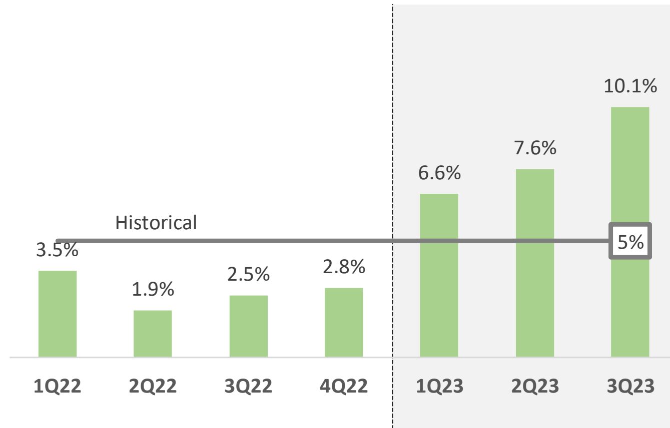


Exhibit 2B: …. And that has directly translated to earnings per share beats.
S&P 500 Earnings Surprises



Source: United Asset Strategies, Bloomberg

Rates: Higher for longer. While inflation continues to moderate from the elevated levels seen in 2022, the stronger-than-expected economic data noted above may have implications for the direction of inflation from here, and we believe has influenced members of the Federal Open Market Committee (FOMC) concerning the appropriate interest rate policy. This was made clear in the FOMC's Summary of Economic Projections (SEP), which was released at the September FOMC meeting and indicated that the average Fed member now sees 5.1% as the likely policy rate by year-end 2024, up 50 bps from the prior 4.6% SEP projection released in June. While still lower than the 5.25% to 5.5% range for the Fed Fund's rate today, it no longer implies the same level of rate cuts and is more consistent with a higher-for-longer rate policy.

This interest rate narrative surprised the market, and we saw that reflected in the yield curve through a bear steepener, in which long-term yields rose more than short-term yields to compensate bond investors for the added uncertainty in long-term rates and the risk of more persistent inflation. For example, to close out the quarter, the 30-year yield increased near 85 bps versus only 15 bps for the two-year yield, implying a nearly 70 bps increase in the 30-year minus 2-year (30-2) yield curve.

Markets: When good macro news becomes bad market news. While the positive surprises to economic data points and corporate profits have continued through the third quarter, around late June, there appeared to be a shift in market sentiment from (a) risk-on behavior that viewed good economic news as good market news to (b) risk-off behavior that viewed good economic news as bad market news. Rather than simply draw the relationship between a strong economy and strong EPS, the equity market now appears to consider the potential for the Federal Reserve to keep interest rates higher for longer, which presents valuation and earnings risks to the market. For example, over the last two months, a large increase in real interest rates has more than offset the accelerating strength that we have seen in earnings, to drive the market lower by reducing valuation multiples. With rates higher, investors are assigning lower valuation multiples to stocks, given the higher perceived risk to EPS from a potential recession and the more competitive yield available through fixed-income securities. Further, market internals are indicative of the risk-off behavior that we would expect in such an environment, with incremental weakness for low quality businesses, cyclical sectors, and small-cap stocks, all of which is consistent with concerns about a weakening macro environment. Further, growth stocks are no longer as strong as they were, consistent with the move higher in rates.

Within the fixed-income markets, we similarly saw prices fall with the increase in interest rates. That pressure was greatest for long-term bonds, given their greater sensitivity to changes in interest rates and the bear-steepening yield curve dynamics that we mentioned earlier, in which long-term rates rose more than short-term rates. Credit risk held up well during the quarter, however, with corporate credit spreads nearly unchanged. While stable credit spreads may suggest that bond investors are less fearful of a recession, we believe that supply-demand dynamics also played a role. Relative to Treasuries, from which credit spreads are measured, corporate credit saw less supply, with corporations having less incentive to issue new bonds at higher rates, and more demand, with investors attracted to yields that are sufficiently higher than that on money market funds.

Market Outlook & Portfolio Positioning

Seasonal weakness or a sign of things to come. The recent pullback in the market is in line with the seasonal weakness that we normally see this time of year, especially in September. For the rest of the year, however, seasonality may become a tailwind, with the fourth quarter historically punching above its weight class on total return. Only time will tell if the market volatility that we have experienced over the last couple of months was simply seasonality or if a more dire macro environment is being foreshadowed. While the seasonal statistics are clear, there is still much uncertainty on the path forward for the economy, as well as monetary, fiscal and geopolitical policy. While we are cautiously optimistic, given that macro uncertainty, depending on the equity strategy used, we currently hold some mix of cash and hedges, such as gold and inverse equity ETFs, or have stop orders in place on a subset of stocks to limit downside should markets trade lower.

It is said that monetary policy impacts the economy with long and variable lags. Overtime, restrictive monetary policy, such as the recent increase in the Fed Funds rate and the decrease in the Fed balance sheet, increases the cost of capital for government, corporations and individuals and reduces their appetites for large investments and discretionary purchases. We have yet to see convincing evidence of this, however, and the timing and magnitude of these impacts remains unclear.

Further, geopolitical risks both domestic and international remain elevated. On the home front, narrow majorities in Congress have led to protracted fiscal battles, including the debt-ceiling debate that led to a rating-agency downgrade and, more recently, the budget debate, which resulted in an extension to keep the government open until November 17 but also resulted in Kevin McCarthy losing his speakership. With budget deficits growing, there is little consensus in Washington on a solution, and this policy uncertainty is likely to continue into the November 2024 elections. Bottomline, fiscal uncertainty is likely to continue given slim majorities in Congress, higher deficits related to interest costs and the pressure to increase defense spending. Abroad, defense spending has risen in recent years, especially with the war in Ukraine, and is likely to gain additional momentum following the surprise Hamas attack on Israel resulting in a declaration of war.

One way we are hedging against geopolitical risk, depending on the equity strategy used, is through traditional defense or cyber security stocks. Further, for accounts with large cash positions, we have opportunistically put some of that cash to work at lower valuations. A sector to which we have added across multiple strategies is Energy, where valuations and fundamentals are attractive. Energy has the added benefit of hedging elevated geopolitical risk or risk of persistently high inflation.

Up in Credit Quality Bias. While the yield curve has steepened, it is still inverted, which is typically a leading recessionary indicator. And despite that recession signal, as we alluded to earlier and as pictured in **Exhibit 3**, credit spreads remain tight. As a result, within fixed income, we continue to maintain an up-in-quality bias. Broadly speaking, we trimmed credit risk during the third quarter, while further increasing exposure to high credit-quality bonds like US Treasury Inflation Protected Securities (TIPS), agency bonds and municipal bonds. Given current market pricing, we do not feel that investors are well compensated for taking on substantial credit risk, especially should the economy weaken. Long-term bonds, however, are increasingly attractive given the rise in rates. We have opted to incrementally add exposure to longer term securities, which not only offer attractive yields but also upside appreciation potential in the event the economy slows and interest rates retreat.

Exhibit 3A: We have recently seen a "bear steepener," in which long-term yields rose more than short-term yields.
30-year vs. 2-year yield curve spread (bps)

Exhibit 3B: Despite a "higher for longer" monetary stance, credit risk held up relatively well.
Bloomberg AGG corporate Option Adjusted Spread (bps)

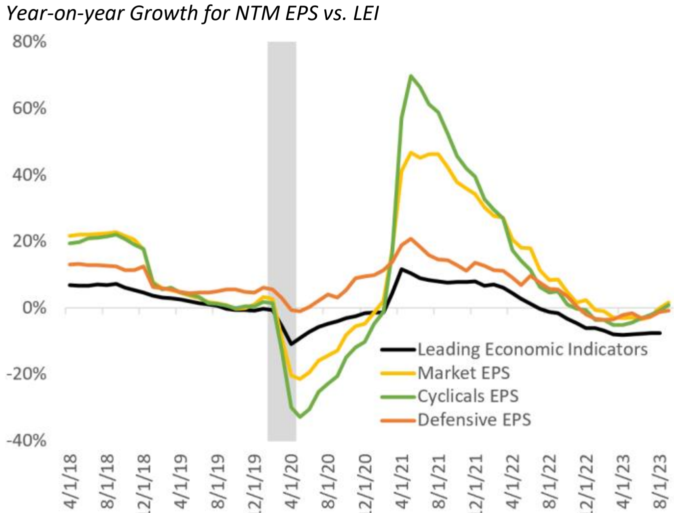
Source: United Asset Strategies, Bloomberg

<u>Path of earnings depends on path of economy.</u> As we alluded to earlier, there is a strong relationship between the economy and corporate earnings, and we highlight that relationship again with the Index of Leading Economic Indicators (LEI), which typically leads the economy by seven months or so. As seen in **<u>Exhibit 4,</u>** LEI has been trending lower and is now negative, providing a recession signal. It is also worth pointing to the strong historical relationship with consensus EPS forecasts, which has followed the LEI lower for much of the last two years. More recently, however, there has been a change in that relationship, with EPS turning higher. It is unclear whether LEI will catch up with EPS or vice versa, but one way to sidestep this uncertainty is to tilt portfolio exposure toward subsets of the market that are less sensitive to the economy. As shown, defensive sectors of the market are much less sensitive to the gyrations of the economy than cyclical sectors. The same could be said of the resilient earnings profile of quality and large-cap stocks (as compared to low-quality and small-cap stocks). In equities, depending on the specific strategy, in an attempt to limit downside in a recession scenario, we have reduced exposure to or are tilting away from a mix of small-cap stocks, cyclical sectors, and low-quality businesses in favor of their large, defensive and quality counterparts.

<u>Equity market is not as expensive as it seems</u>. The S&P 500 (SPX) returned 13% through the third quarter. Much of that upside seems to have come from multiple expansion, with the SPX now at 18 times earnings, above the 17 times mark at the end of 2022 and the 16 times mark that we have seen historically. With interest rates more competitive to equity returns and with recession a risk to EPS, investors may question whether the market is too expensive. While it appears so on the surface, it is worth noting that much of this year's market performance and multiple expansion has been isolated to a select few large-cap tech names better known as the "Magnificent 7," which account for more than 20% of the S&P 500 and are up over 50% so far this year. Excluding the Magnificent 7, the remaining 490-plus stocks in the S&P 500 are up just 3%. As highlighted in **<u>Exhibit 4</u>**, while the broader index trades at a rich multiple, the typical stock is trading at just 14 times EPS, which is both lower than the 16 times mark at the start of the year and the long-run average multiple of 16 times. In other words, there are plenty of opportunities to buy individual stocks at attractive prices. And, while our clients own healthy amounts of the Magnificent 7 given their strong fundamentals, in order to limit downside risk should a higher-for-longer interest rate environment appear, we currently own less of those seven stocks than the broader market or our benchmarks would imply given their lofty valuations.

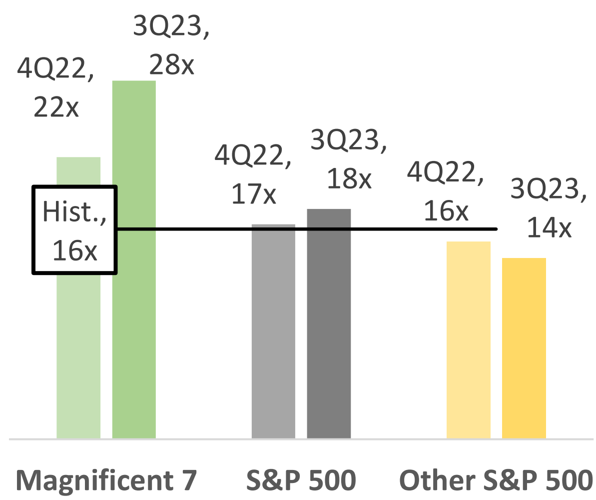
<u>Exhibit 4A</u>: Earnings expectations have turned higher, bucking the LEI's recession signal.

Year-on-year Growth for NTM EPS vs. LEI



<u>Exhibit 4B</u>: P/E valuation multiple for the S&P 500, excluding the Magnificent 7, is not expensive.

P/E Multiples for S&P 500, including & excluding Mag 7



Source: United Asset Strategies, Bloomberg

Cyclical Sectors (Real Estate, Materials, Consumer Discretionary, Financials), Defensive Sectors (Utilities, Consumer Staples, Healthcare), Magnificent Seven (Apple, Microsoft, Google, Amazon, Meta, NVIDIA, Tesla)

United Asset Strategies Update

In September, client accounts formerly custodied at TD Ameritrade were successfully transitioned to the Schwab platform. Client relationships at United Asset Strategies remain unchanged, as we have had long-standing relationships with both custodians. If you have any questions on the transition, please reach out to your client experience team contact at United Asset Strategies. Along those lines, we continue to grow, and to support that growth and better assist our clients, during the third quarter we added two new members to the client experience team. Please welcome Patrice Joi Simmonds and Carole Zito!

Respectfully submitted by the Professional Staff at United Asset Strategies

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