3Q 2023 Market Commentary

With the emergence of artificial intelligence (AI) as an investment theme in April, mega-cap communications and technology stock valuations soared back toward the stratospheric valuations seen at the end of 2021. Yet the surge appears to have ended in July as the combination of rising interest rates, western concerns about Chinese intellectual property theft, and the reevaluation of some of the hype surrounding AI began to take these valuations back down toward earth in August and September.

The major U.S. equity benchmarks produced negative returns for the 3rd quarter as a whole, with the S&P 500 down over 3% and the NASDAQ falling over 4%. This just seems like a start as the modest correction still leaves the indexes and many of the largest capitalization stocks at excessive valuation levels. Bond yields became even more competitive as yields rose 76 basis points (0.76%) on 10-year Treasuries and 85 basis points for 30-year T-bonds. For long-maturity Treasuries, that amounts to a total return loss of approximately 13% just in the last quarter. The risk of falling into recession during the next 12-18 months has increased, not diminished, in our opinion. We are not far from desiring to extend maturity in client bond portfolios.

In this challenging environment, all of SKBA's stock strategy composites (*net of fees*) held up better than the declines experienced by the S&P 500 and the NASDAQ. We continue to find numerous stocks in the market that still possess attractive valuations and fundamentals. In our view, value-oriented strategies are likely to continue to hold up better than the broad market.

With 2-year Treasury notes and 30-year T-bond yields reaching over 5% and 4.7%, respectively, why hasn't the economy already been driven into recession? Demand for many autos and housing has already weakened as the cost of financing new purchases has skyrocketed. Looking ahead at the 4th quarter, as college graduates with high government debt loads face the restart of college loan repayments in October, broad-based demand for consumer goods could weaken further. The upcoming holidays may not be so merry this year. At the same time, the economic picture is about more than just consumer spending.

Although federal government direct payments to individuals have diminished, the direct and tax subsidies for infrastructure, technology reshoring back to the U.S. and the energy transition have sustained aggregate demand in the economy without regard to the massive increase in the federal deficit that has and will continue to build.

The federal government seems to be oblivious to the problem it has been creating. Our view remains that price inflation pressures will not easily be brought back down to the Federal Reserve Board's 2% target as the Fed won't be able to fix the problem alone. If the combination of artificially sustained aggregate demand plus the improvement in U.S. net exports (which adds to GDP growth as China's exports to the U.S. are restricted) reduces the risk of falling into a recession, the likely result will be the "stagflation" we fear. We define this as anemic

economic growth and stubborn price inflation above 3%. Stagflation brings with it pressures on costs and margins as well as on stock valuations, which we do not believe is fully priced in. Therefore, it doesn't appear that now is the time to go gung-ho on stocks with high valuations, high debt ratios, excessive inventories, and generally aggressive expectations for earnings growth.

Where then will world economic growth come from over the next few years? The strong U.S. dollar has added to the pressures on Europe and many emerging market economies that are in worse shape than the U.S. As we reviewed in our economic update titled "China Is Running Out of Rabbits!," it most likely won't be coming from China. While we discussed some of the economic issues, the geopolitical issues are just as important. With China's military strength and accompanying increased belligerence along with ties to Russia, it appears inevitable that the West, particularly the U.S., will need to increase defense spending along with replenishing munitions inventories consumed in the war between Ukraine and Russia. Competition rather than cooperation appears likely.

At home, the stability so far seen in the U.S. labor market is not surprising given the skills shortage that in part is accompanying the progressive retirement of the Baby Boom generation. A massive investment in AI appears necessary to stimulate productivity growth. Yet the need for skilled workers to fill jobs open in the trades, engineering, science labs and small businesses may be among the reasons job openings still far exceed the number of unemployed looking for work. New unemployment claims typically would need to rise well in excess of 300,000 and more likely 400,000 per month to confirm recession is on the way. Yet the weekly readings are still hovering closer to the 200,000 level.

Neither the rising risk of recession nor stagflation are good for financial assets, and investments in private equity, private debt, commercial real estate and many other alternatives (where stated valuations may be subject to the analytical discretion of the manager) are no exception. We are pleased that our portfolio positioning so far has served our clients well during these times of uncertainty.

The information contained herein represents the opinion of SKBA Capital Management, LLC and should not be construed as personalized or individualized investment advice. Analysis and opinion expressed in this report are subject to change without notice. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.

For more information, please contact:
info@skba.com or call 800.969.7852