STOKES CAPITAL ADVISORS, LLC

Market Commentary
September 30, 2023

Quarterly Market Review

Global equities reversed course during the quarter, trading back to the closing levels of early June. Rising bond yields and growing concerns over the prospects of the Federal Reserve engineering a soft landing for the U.S. economy weighed on global equity markets during the quarter.

Dissecting the U.S. equity market performance for the quarter, energy was the best performing sector recoding a 12.3% gain as supply constraints for crude oil remain in place for the foreseeable future. Utilities and Real Estate, which have historically been more interest rate sensitive sectors of the equity market, were the worst performing sectors with both recording declines of -9.0%.

In terms of capitalization, smaller companies or small cap stocks continue to trail their larger counterparts by a very wide margin. On a trailing 1-year basis, the Russell 2000 has gained 8.9% versus the S&P 500 gain of 21.6%, an indication that the U.S. economy is slowing and/or entering a late cycle contraction phase, i.e. recession.

Turning to bonds, prices declined during the quarter as well, taking the total return for most of the investment grade bond market into red figures for the year. The Aggregate Bond Index is now down -1.2% year to date coming off the worst performance on record in 2022 where investors witnessed a -13% thumping. To put this into an historical perspective, the investment grade bond market has now lagged the returns on cash on a trailing 10-year basis….an unprecedented event. To add insult to injury, if you net out the effects of inflation over the last decade you end up with negative returns for both cash and bonds. Indeed, equities were the "only game in town".

Index Description	1 Yr.	3 Yr.	5 Yr.	7 Yr.	10 Yr.
Aggregate Bond Index	0.6%	-5.2%	0.1%	-0.1%	0.8%
3 Month T-Bill	4.6%	1.8%	1.8%	1.6%	1.7%
S&P 500 Index	21.6%	10.0%	9.8%	12.2%	11.2%

Reviewing the commodity and currency markets for the quarter, the energy complex was mostly higher on the news of tightening supply conditions and some bullish calls of $100/barrel by several investment banks. Gold closed the quarter at $1,871 and continues its decline from the decade high of $2,050 put in back in April of this year. Historically, a strengthening U.S. dollar and rising real yields make the yellow metal less attractive. This negative correlation looks to be holding true so far this year.

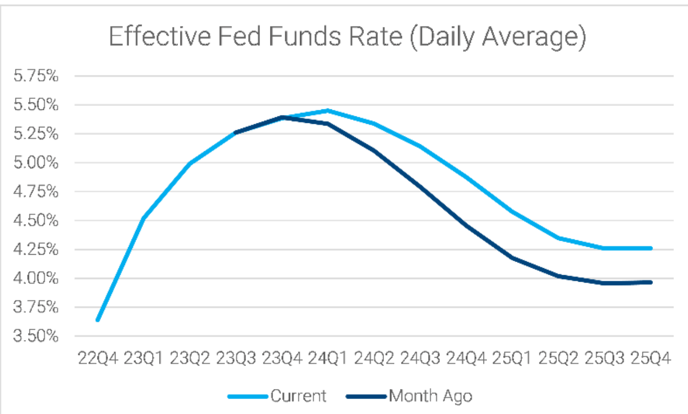
Investment Strategy & Outlook

It's been a long time since we have seen short-term interest rates at current levels. Indeed, you must go back 17 years or to September 2006 when the Fed Funds target rate peaked at 5.25%. However, back then it took the Fed almost 5 years implementing ¼ point increases to bring the target rate to 5.25%. By comparison, the current tightening cycle is unlike anything witnessed in history with the Fed taking rates from effectively the zero bound to 5.50% in just 18 months. So, if Milton Friedman's theory that "monetary policy operates with long and variable lags" is correct, we (nor the Fed) will know the real impact of such policy actions for some time.

In the interim, capital markets are adjusting in real time to the implications of transitioning from a 0% world to a 5.50% world. Here is an updated casualty report: (1) The Bond market bubble popped in 2022 with record losses witnessed in bond portfolios of Banks, Insurance Companies, Pension Plans, as well as individual investors. We will not know the implications of this for some time. (2) A "perfect storm" for the bond market has appeared as the Federal Reserve raises short term interest rates to contain inflation while massive deficits and spending require the U.S. Treasury to increase debt issuance and essentially monetize the deficit. A seemingly negative feedback loop is created which places more upward pressure on bond yields with higher borrowing costs as a result. Indeed, the U.S. Treasury will spend over $1 Trillion in interest cost over the next 12 months alone. (3) Investors suffered a lost decade in the Bond market primarily attributed to "twin central bank policy mistakes" of (a) keeping rates artificially low for 12 years and (b) Raising rates at unprecedented speed. (4) Interest rate sensitive sectors of the equity market are now flagging concern. For example, the Utilities and Real Estate securities sectors have turned sharply negative this year.

Looking into 2024, there could be some more damage control ahead. Highly leveraged segments of the economy could be facing higher borrowing costs as the Federal Reserve in its last meeting signaled no intentions of lowering rates anytime soon and markets are 50/50 on an increase in November, this was characterized as a "hawkish pause". In addition, Banks could be forced to tighten credit standards which would effectively reduce liquidity as they look to repair their balance sheets and protect capital levels.

However, there is the prospect of peak rates in 2024 along with the hopes of a "softish landing" for the U.S. economy. Indeed, the futures market is pricing in rate cuts in the middle of next year.



Taking a broader look or macro view of the U.S. economy, the Fed's medicine appears to be working as it relates to their dual mandate of employment and inflation. The labor market and ultimately the consumer have been extremely resilient through the storm discussed above. Households have significant levels of liquidity/savings, wages are growing and everyone who wants a job has one. This has essentially given the Fed a "wide runway in which to land the economy".

In terms of the inflation mandate, stripping out energy and food, the Core Personal Consumption Expenditure Index or Core PCE last reading was 3.9%. While above their 2.0% target, it is headed in the right direction. However, there is an important question that no one knows the answer to, but the market will ask every day: In order to achieve their 2% inflation target will the Federal Reserve have to sink the economy and trigger higher levels of unemployment? My expectation about the Jay Powell Fed is that he will achieve his goal and if the economy goes through a brief period of contraction, then over the long run the U.S. economy is better off. This is a page right out of the Paul Volker Fed of the 1980s. We shall see.

Finally, if there is a silver lining to all the carnage in the bond market, normalizing interest rates while painful in the short run, will reward investors with higher levels current income and a diversification tool that was not available for over a decade. The decade of "TINA" - There Is No Alternative may indeed be over.

However, we would caution investors to resist the temptation to pile into the front end of the yield curve and refrain from holding excessive levels of cash as short-term interest rates could decline and so will your portfolio's income. Interest rate risk is just as important to manage as market risk and purchasing power risk. Instead, we see value in gradually extending maturities into the "belly" of the curve, looking for 7-10 year bonds yielding 5.0% or more.

Last quarter there was much discussion about the "Fabulous Five" or "Sensational Seven" and how the leadership in the U.S. market was narrowing. Apple, Microsoft, Amazon, Tesla, Nvidia, Google. These widely held names represent 28% of the S&P 500 Index and if you remove them from the S&P 500 Index the return for the year is -5.9%. We think for the equity market rally to hold, we will need to see a broadening out of the market. In addition, valuations are elevated compared to historical averages and rising real yields alongside a contraction in corporate earnings will likely remain a headwind for equities throughout the remainder of this year.

Capital Markets Scorecard

Benchmark Description	Q3	YTD	1 Year
U.S. Treasury 3 Month T-Bill	1.3%	3.7%	4.6%
Barclays Aggregate Bond Index	-3.2%	-1.2%	0.6%
Bloomberg US High Yield Bond	0.5%	5.9%	10.3%
S&P 500 Index Total Return	-3.3%	13.0%	21.6%
NASDAQ Composite Total Return	-3.9%	27.1%	26.1%
NASDAQ Dividend Achievers TR	-3.9%	3.8%	17.3%
Russell 2000 Index Total Return	-5.1%	2.5%	8.9%
Alerian MLP Index Total Return	9.9%	20.6%	32.7%
MSCI Emerging Markets Index	-1.3%	4.4%	11.4%
China SCI 300 Index LC	-2.9%	-2.5%	-0.5%
U.K. FTSE 100 Index LC	1.9%	5.5%	14.7%
Japan Nikkei 225 Index LC	-3.3%	24.5%	25.5%

Performance data as of 09/30/2023. Stokes Capital Advisors, LLC is a Registered Investment Adviser. This market commentary is solely for informational purposes. Advisory services are only offered to clients or prospective clients where Stokes Capital Advisors, LLC and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Stokes Capital Advisors, LLC unless a client service agreement is in place.

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