The Cobblestone Advisor

Investment Brief

October 2023

COBBLESTONE
CAPITAL ADVISORS

Higher for Longer

The resilient markets narrative that was in place over the last year came into question during the third quarter, as both stocks and bonds experienced declines during the period. It was the first time in twelve months that both asset classes posted a quarterly loss. Domestic large cap stocks were down -3.3% and broad investment grade US bond markets declined by -3.2%. International developed and emerging market stocks also suffered losses (-4.1% and -2.9%, respectively).

Despite the market declines during the period, domestic and international stocks remained in positive territory year-to-date, while US bonds were slightly down. Consequently, balanced portfolios have generally delivered healthy returns in 2023 thus far.

To better understand the third quarter's shifting market dynamics, it is helpful to look back over the first six months of the year. Markets had remained on an upward trend and investors appeared unconcerned with the economic uncertainty that the US and other countries across the globe were facing. Economic data had generally come in weak but above expectations. The US economy in particular had proven more resilient than expected, which supported investor sentiment and helped drive markets higher.

In July, however, market trends reversed. The reversals coincided with the July meeting of Federal Reserve policymakers, after which Fed Chair Jerome Powell communicated that monetary policy will likely need to be more restrictive for longer—dubbed "higher for longer"—until he and other policymakers become confident that inflation is coming down sustainably to its 2% target. Following Chair Powell's comments, investor expectations for monetary policy (and policy interest rates specifically) exhibited a fairly dramatic shift higher, which immediately and has since weighed on both stocks and bonds.

Markets are now in the process of digesting that information and adjusting to the new reality that interest rates are likely to remain "higher for longer" than many market participants initially expected. Investors, meanwhile, are contemplating the potential economic ramifications. A "higher for longer" cost of capital has wide-ranging implications across broad swaths of the economy and also markets, as the cost of capital is a direct input in determining the value of an investment.

Despite these recent market developments, the trend of economic growth in the US remains largely unchanged thus far. Growth has continued to slow, but we do not yet see economic extremes suggesting that a deep, prolonged recession is imminent. Leading economic indicators—which provide an early indication of business cycle turning points—are at levels that have accompanied every recession on record and continue to suggest a further slowdown in the months ahead. The timing of a recession, however, remains an open question.

As uncertainty regarding the economic outlook persists, we continue to caution investors that trying to time turns in the economic cycle as well as related movements in financial markets is difficult. One needs to look no further than when concerns surrounding the possibility of a US recession peaked back in June 2022 (according to Google search trends). US large cap stocks went on to deliver a +15.7% return, or +12.3% annualized through the third quarter. That's a significant missed opportunity for investors who tried to time

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Total Return (%), Ending 9/30/2023				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	-3.3	13.1	21.6	10.1	9.9	11.9
Russell 2000 (Small-Cap Stocks)	-5.1	2.5	8.9	7.1	2.4	6.6
MSCI World Ex. US (International Developed Stocks)	-4.1	6.7	24.0	6.1	3.4	3.8
MSCI EM (Emerging Markets)	-2.9	1.8	11.7	-1.7	0.6	2.1
Bloomberg US Aggregate Bond Index	-3.2	-1.2	0.6	-5.2	0.1	1.1
Dow Jones US Select REIT	-7.4	-2.1	2.6	6.1	1.5	5.3
Consumer Price Index (% Chg over Period)	0.9	3.7	3.7	5.7	4.0	2.8

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the market by materially reducing or exiting equities altogether as recession fears peaked.

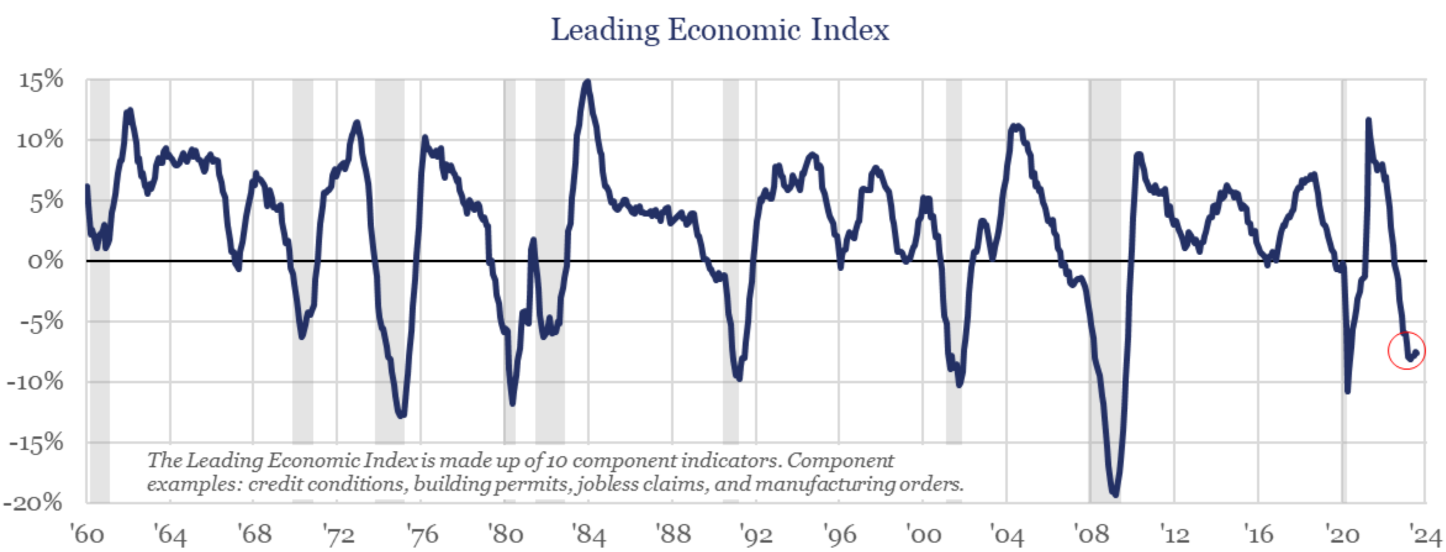
To be sure, historical periods of volatility and market dislocation have provided investors with ample opportunities. That is the case in the current environment as well. Though instead of broad changes to asset allocations, we recommend employing a thoughtful approach to capitalize on select opportunities across various asset classes within portfolios as they materialize.

We have done just that. Consistent with our portfolio management framework, we took advantage of equity market strength earlier this year to rebalance applicable portfolios back to their target weights. The modest cash balance that resulted is earning an attractive yield and can be opportunistically deployed should further market dislocations materialize.

As we have anticipated interest rates remaining “higher for longer” for some time now, we also reduced our exposure to longer duration bonds and increased our exposure to shorter duration bonds early in the year across applicable portfolios. Duration measures interest rate sensitivity, and shortening the duration of a bond allocation reduces the volatility of the portfolio as interest rates change.

Additionally, we recently added floating rate investments within our alternatives allocation across portfolios that participate in alternative investments. The addition of floating rate investments further reduces the interest rate sensitivity of the portfolio. At the same time, the floating rate investments should benefit from the high interest rate environment.

In short, we construct durable client portfolios to weather challenging market environments. Building our portfolios in this fashion negates the need to make broad changes to asset allocations and allows investors to navigate short-term volatility and achieve their long-term investment objectives. Keeping this in mind and maintaining a longer-term perspective can help investors stick with their investment plan in choppy markets, increasing their chances of achieving an optimal investment outcome.



Source: The Conference Board, Bloomberg.