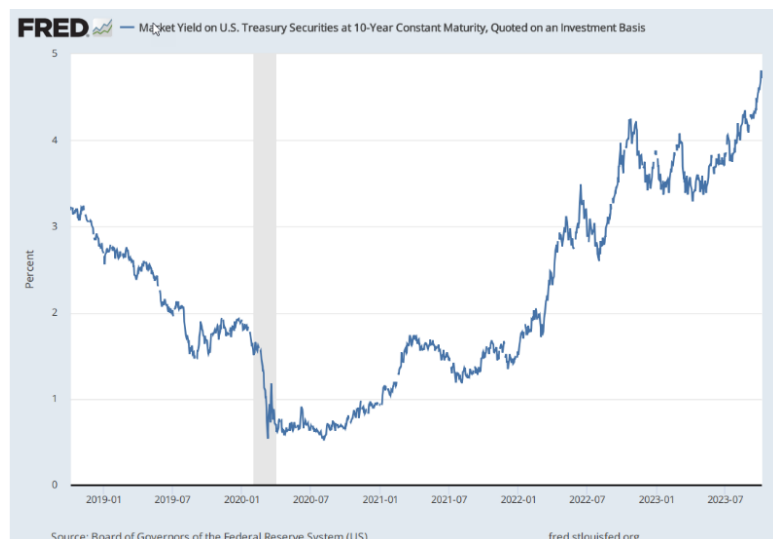


## THIRD QUARTER 2023 REVIEW AND OUTLOOK

	3Q23 RETURN	YTD23 RETURN
S&P 500® Index	-3.27	14.37
Dow Jones Industrial Average	-2.10	3.09
NASDAQ Composite Index	-3.94	29.68
Russell 2000® Index	-5.13	0.89
VIX Volatility Index	28.92	-18.32
Barclays U.S. Aggregate Bond Index	-3.23	-2.36
10-Year U.S. Treasury Yield	19.95	17.78
Baltic Dry Index – Spot (Ocean Cargo Shipping Rate)	55.91	14.37
Gold (per ounce) – NY Spot	-3.72	3.09
Oil (per barrel – West Texas intermediate)	28.46	29.68
Bitcoin	-10.05	0.89

Source: FactSet Research Systems, Inc. Data reflects percentage change over the period, unless otherwise noted.

**Regime Change.** The S&P 500® Index fell by about 3% in the third quarter. Most other American stock indices fared similarly. This came after a ripping first half which saw the S&P 500® gain 16%. Often, when there’s an abrupt about-face in markets, analysts struggle to craft narratives that explain these turns. But no tortured narrative has been needed to explain *this* shift. The market’s recent swoon, which began late in the third quarter, can be traced directly to a sharp jump in U.S. interest rates (see graph). But *why* have rates, especially long rates, jumped so much – over 60 basis points (0.63%) – just in a few weeks? At this writing, the 10-year Treasury bond yield stands at 4.7%, its highest level in 16 years. The long bond’s rate began moving up sharply *exactly* when the Federal Reserve Bank last met (Sep. 19-20) to review the funds rate. Though the Fed decided *not* to raise rates (currently at 5.25-5.50%), the bank made clear its intention to hold rates “higher for longer”. And the view of Fed rate makers – expressed in their so-called “dot plot” – was to raise their consensus estimate of the funds rate by 50 basis points (0.5%) in both ‘24 and ‘25.



One dawning concern is the federal deficit, which continues to grow. The non-partisan Congressional Budget Office (CBO) pegs the deficit at \$1.5 trillion this year, or 5.9% of GDP, one of its highest ratios outside of wartime or domestic crisis. Funding just the interest on the debt is believed to be close to 14% of budget receipts, a line that fiscal experts have warned against crossing. The CBO states that the federal deficit will grow both absolutely and as a ratio of GDP over the next ten years, to \$2.9 trillion, or 7.3% of expected GDP by 2033. Higher rates may be needed to induce long-term bond investors to close this deficit, though we believe it’s unlikely that the U.S. will rely *wholly* on borrowings to finance the deficit. But Congressional dysfunction does nothing to inspire observers that this (or other) problems will be resolved satisfactorily or soon.

**Whatever It Takes.** Another reason for the rate jump has been the Fed’s “whatever-it-takes” policy of fighting inflation by raising the short-term (federal funds) interest rate sharply and quickly. As Fed Chair Jerome Powell made clear (yet again) in his September 20 press conference, the Fed is playing the long game: expect no letup in rates soon. This is an about-face from the Fed of 2018-2022. Back then, the central bank applied monetary medicine – cheap money, and lots of it – to an often-ailing economy. The Fed kept rates incredibly low for exceptionally long by aggressively buying Treasury debt. This quantitative easing (QE) saw the Fed balloon its balance sheet by \$5 *trillion* from 2008 to 2022. Because of QE, interest rates trended sharply lower at that time. In 2020, for example, the 10-year Treasury bond yielded *under 1%*. This may have been needed to nurse the economy back to health after the shocks of the banking crisis of 2008/2009 and the COVID-19 pandemic of 2020-2022. In retrospect, though, we make two observations: (1) the Fed overstayed its love affair with cheap money, contributing to the price inflation of 2022-present; and (2) cheap money played a key supporting role in some epic market fails: IPOs of enterprises with no clear path to profitability and, more damaging, investors’ purchases of long-duration/low coupon bonds *and* stocks which have fallen since the era of easy money ended.

**Regime Change: Investment Implications.** So, that was then (easy money/investment promiscuity), and this is now (tight money/investment discipline). For most of the last decade, the acronym TINA – “there is no alternative” (to equities) – rang true in investors’ ears. The reasoning then was that it made little sense to invest in low yielding bonds when high quality common shares, which frequently raise dividends, yielded 1-3 percentage points more than bonds. But that situation has flipped; for the first time in years risk-free Treasuries *are* viable alternatives to stocks. The S&P 500® Index today yields 1.6%, well under the yields of both 1-year bills (5.4%) and 10-year Treasuries (4.7%).

**Long-Tailed Risk – Not Just a Problem for Bonds.** Because interest rates on risk-free bonds have moved up so much, equity investors now confront a more demanding “hurdle rate” for stocks: Does a company’s return on invested capital (ROIC) *plus* a premium for its riskiness exceed the risk-free return of a Treasury? In the old days – pre-tightening – equity investors could smoothly step over that hurdle. But that’s not as easily done today. The problem with long-duration assets – both stocks and bonds – is that so much of their promised returns lie so far into the future that even small rate increases produce disproportionately heavy hits to their present values. With little current cash flow to support their lofty valuations, high- (or infinite-) price/earnings stocks have been the first casualties to be carried off the investment battlefield.

**But Wait – It’s More Nuanced Than That.** So, with what we’ve observed, one might think that a portfolio of “deep value” low p/e stocks might be just the ticket to surviving – even prospering – in today’s new investment regime. But that could be a terrible mistake. Utilities, a traditionally go-to sector for the risk-averse, has been *the* worst performing major market sector of 2023 (the XLU exchange traded fund of utility shares is down by 16% YTD). The group’s 3.7% yield cannot compete with the 10-year Treasury’s yield of 4.7%. Also, public utilities are among the slowest growing companies in America. They raise their dividends slowly and by not much when they do. Further, their elevated levels of debt make them vulnerable in a rising interest rate environment. Much the same might be said about real estate investment trusts (REITs): cheap stocks for good reasons.

Another mistaken notion would have been selling technology shares thinking that their high p/e’s equal high downside risk in a rising rate environment. But even with their high price/earnings multiples, tech shares have been one of the two best-performing S&P sectors of 2023 (the XLK exchange traded fund has gained 36% YTD). Why? Because: 1) the giants of tech enjoy high growth *and* high ROICs; 2) they generate outsized free cash flows; and 3) their products and services offer practical solutions to every customer’s dream of improving the productivity of their labor and capital.

**What We Expect Now.** Here are our key expectations through year-end. **We expect the yield curve to continue to normalize** (short rates flat or lower with long rates rising); that would be a welcome development for lenders and for lending activity. The Fed could effect this just by declaring it will not raise the federal funds rate for a time (a “pause for evaluation” perhaps?). And the long rate will rise if Treasury focuses its periodic bond sales on longer maturities.

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**The consumer – nearly 70% of GDP – seems in good health:** payrolls are growing steadily (over 300,000 new jobs added in September) as are wages, and consumer inflation is falling. And after struggling so hard to attract, train, and retain workers, employers are not likely to drop them at the slightest tremor of economic concern. High mortgage rates (7.5% for a conventional 30-year residential mortgage) do not seem yet to have dented the residential property market. Finally, **government and private investment** seems likely to grow steadily. Last year, Congress allocated over a trillion dollars to improve infrastructure and build out a “clean” energy grid. Little of those funds have been spent to date but should begin to work into the construction pipeline in 2024 and beyond.

As for equities, **we are generally constructive on the American stock market.** We *do* think too much of the market’s value is tied up in just six or seven tech-focused names, but that we will see a gradual widening out of the market’s value distribution among a greater number of companies and sectors. As far as bonds go, we like short-duration/high-coupon issues – we think it’s hard to beat Treasury bills at this time: safety, high yield, limited duration risk, and freedom from state and local taxes make +5% Treasury bill yields good alternatives to lower yielding, slow growing equities in sectors like utilities and REITs.

Thank you for allowing us to manage your investments. We aim to reward your faith in us with creativity, diligence, and good results.

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Palisade Capital Management

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The Bloomberg Barclays U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Baltic Dry Index (BDI), is issued daily by the London-based Baltic Exchange. The BDI is a composite of the Capesize, Panamax, and Supramax Timecharter Averages. It is reported around the world as a proxy for dry bulk shipping stocks, as well as a general shipping market bellwether.

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