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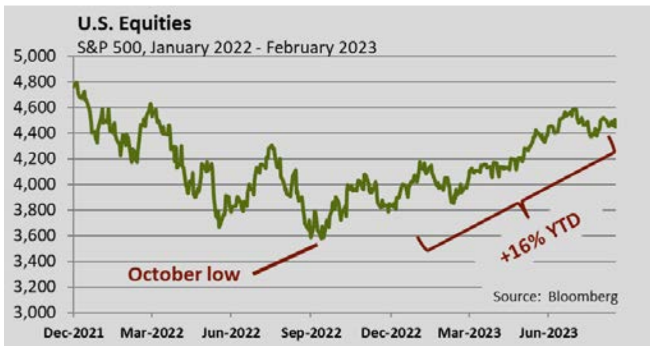
The Perfect Landing

September 2023

Summary

The U.S. stock market saw a strong recovery through the first eight months of the year. After falling by 18% in 2022, the S&P 500 advanced by 16% through September 15. Over the past 18 months, the Federal Reserve raised short-term interest rates 11 times to 5.25%. In the face of the most aggressive monetary tightening in over 30 years, the economy has been quite resilient. Unemployment is near a record low and GDP growth has been steady. Bonds realized their worst return on record in 2022 but have stabilized this year and could be poised for gains once the Fed is finished raising interest rates.



A year ago, fears of a recession were widely held and premature. Since then, the economy has been steady, and expectations of an economic "soft-landing" are now common. While indicators are still positive, it is unlikely that the economy can slow without turmoil in financial markets. No indicator is perfect and there is a lot to digest; below are a few indicators to help assess current market conditions:

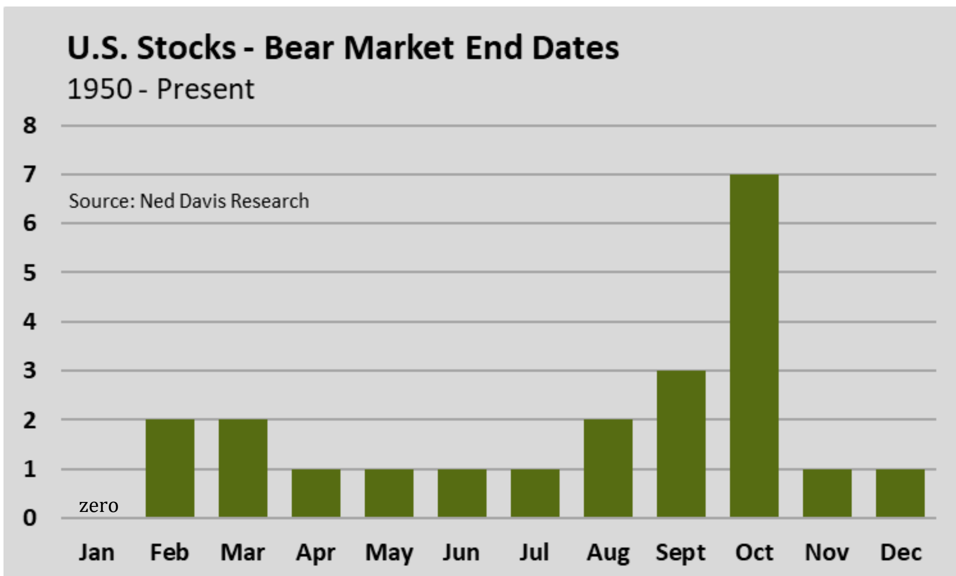
- **The 2022 bear market was merely average.** At their worst, stocks fell by 25% over 9.3 months in 2022; of the 21 prior bear markets since 1950, the median drawdown was 24% over 8.3 months.
- Consistent with historical trends, the 2022 bear market ended in October. **A whopping 45% of bear markets end in September or October**, three times the likelihood if end dates were spread evenly across the year.
- **Of the 14 years with double-digit S&P 500 gains through July, all 14 saw a pause in August, and all 14 years saw strong positive results through the end of the year.**
- As intended by the Federal Reserve, **the economy is slowing but not yet at a concerning pace.** The data on jobs is still strong with no major upticks in unemployment-related data. But indicators such as job openings and credit card delinquencies signal a slowdown is occurring.

Client portfolios utilized reduced equity allocations during the drawdown 2022, and, in February, portfolios were moved to higher equity allocations, participating in the bulk of the advance for the year. So far, the Federal Reserve has been successful at bringing down inflation without cratering the economy. While investor sentiment seems committed to a perfect economic landing, there may a return to volatility in 2024. Economic cycles have not disappeared, and the Fed has not been able to slow the economy without incurring a recession in the past. In assessing the environment, it is important to separate news from indicators. Looking at the past two recessions, job openings are a useful indicator while unemployment is not. Job openings decline prior to the recession while unemployment increases rapidly only after the recession has begun. It is encouraging that unemployment remains low, and the stock market may continue to rally in the fourth quarter, but a defensive shift will likely be warranted in the next six months.

Bear Market Bottoms

In 2022, markets returned to some of the normal cyclical patterns that influence markets. The pandemic was disruptive to market cycles due to extreme swings in economic growth, a large infusion of fiscal stimulus, and new approaches to monetary policy. Outside shocks (wars, pandemics, natural disasters, etc.) almost always have a larger impact on market dynamics than market cycles. However, the impact of market cycles is consistent and important to consider when making asset allocation decisions.

While worrisome, the 2022 bear market was very average. According to Ned Davis Research, since 1950, the median bear market in stocks lasted 8.3 months and incurred a 24% drawdown. Last year, the market fell by 25% over 9.3 months, finally bottoming in October 2022.



The 2022 market bottom was also quite typical. October is the most frequent month when bear markets end and bull markets begin. Of the 22 bear markets since 1950, 10 have ended in either September or October. A whopping 45% of bear markets end in those two months, three times the likelihood if end dates were spread evenly across year. It is not just deeper history that has realized this trend; of the six bear markets since 2000, three (50%) ended in September or October.

Why is October so important? The annual calendar tends to put a spotlight on this time of year. Markets begin to analyze whether expectations for the year will be achieved or not. This applies to the earnings of individual companies, corporate earnings in aggregate and broader economic indicators such as GDP growth and inflation. October also marks the fiscal year-end for most mutual funds. This is important since mutual fund allocations on October 31 are included in the annual report, so equity managers do not want to report large cash holdings and tend to be fully invested in stocks. In addition, at this time of year, mutual fund managers often re-position portfolios to take advantage of gains or losses in the portfolio or to present a certain narrative to investors.

Strong Starts Followed by a Pause

In 2022, investor sentiment was quite negative, with significant concern about a recession and inflation. The recession worries turned out to be premature as economic growth and unemployment remained strong. The October 2022 weakness was an excellent set up for a 2023 stock market recovery. Through July 31, the S&P 500 rose by 19.5%, the tenth strongest start since 1926.

S&P 500 Index Performance After Strong Start

Weak August, then September to December

Year	Return 12/31 - 7/31	Return 7/31/- 8/31	Return 8/31 - 12/31
1938	17.5	-2.7	9.5
1954	24.5	-3.4	20.6
1955	21.0	-0.8	5.3
1964	10.9	-1.6	3.6
1967	18.0	-1.2	3.0
1975	29.5	-2.1	3.8
1976	14.7	-0.5	4.4
1985	14.2	-1.2	12.0
1988	10.1	-3.9	6.2
1995	22.4	0.0	9.6
1997	28.8	-5.7	7.9
1998	15.5	-14.6	28.4
2013	18.2	-3.1	13.2
2019	18.9	-1.8	10.4
2023	19.5	-1.8	??
Mean	**18.9**	**-3.0**	**9.9**
Median	**18.1**	**-2.0**	**8.7**
% positive	**100**	**0**	**100**
All periods mean	**5.2**	**0.7**	**1.9**

Source: Ned Davis Research

August and September are often weaker periods during the calendar year. Summer vacations create low trading volumes in August, and September often mirrors August results. Pauses and pullbacks are necessary elements for healthy markets, and, in years where the S&P 500 begins with double-digit gains, a pause is common during the weaker months. Of the 14 years with double-digit gains through July, all 14 saw a pause in August. More importantly, after the pause, the S&P 500 strong saw positive results through the end of the year in all 14 cases

There are no guarantees when investing in the stock market, but the history of strong finishes is important to consider.

Recessionary Worries Persist

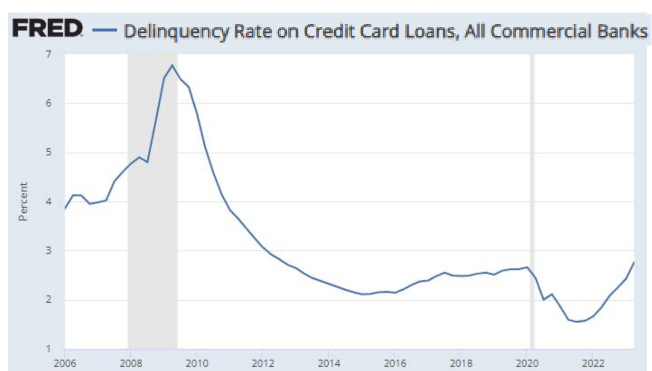
Many investors are celebrating a soft landing by the Federal Reserve. The Fed raised interest rates 11 times over the past 18 months to 5.25%, the highest level since 2007. While the Fed does not want to create a recession, the fight against inflation is difficult to pull off without unemployment going up and economic activity going down. It is not certain that a recession is still on the horizon, but since 1950, repeated increases in rates have almost aways triggered a recessionary environment.

While the historical context is compelling, studies of Federal Reserve actions indicate that monetary policy works with "long and variable lags." The description is frustrating but meaningful. U.S. economist Milton Friedman wrote about this concept from 1960-1980, indicating that tight monetary policy tends to precede peaks in general business by about 16 months and easy monetary policy tends to precede troughs in general business by about 12 months. If the peak interest rate was set in July (this is still unknown), that would indicate a recession is still on the table for mid-2024.

There is clearly uncertainty about the timing of any slowdown. A few indicators below demonstrate that a meaningful slowdown is occurring, and the economy has been quite resilient. An important subtlety… the economy is weakening but is not yet weak.

Initial jobless claims (requests for unemployment benefits) are still quite low and steady, indicating that jobs are still plentiful and no major decline in employment is occurring yet. The chart (to the right) only shows post-pandemic data since the 2020 spike in claims would make short-term changes imperceivable.

Job openings are an economic indicator of unmet demand for labor and labor shortages. This indicator declined significantly in 2023; however, it is declining from a very high level. Despite a drop of roughly 25%, there are still more jobs available now than in any period prior to the pandemic.



Delinquency rates (an account that is more than 60 days past due) on credit cards have risen over the past year. Again, the base effect is important. The 2021 low in delinquencies was a consequence of the pandemic and by far the lowest level in over 30 years. The rate has almost doubled over the past year but is still on par with levels prior to the pandemic.

These indicators and others will be important to monitor to determine if the economy is moving from slowing to weak.

Summary of Current Positioning

There is still room for optimism this year, but it will likely fade in 2024. At some point, the Fed's actions and higher borrowing costs will begin to have an impact. The average rate for a 30-year mortgage is now 7.6%, and the average HELOC (home equity line of credit) rate is now 9.1%. Next year is an election year, and anxiety about the outcome typically weighs on financial markets in the first half of the year. The stock market momentum may continue for a period, but volatility is likely to increase over the coming months. The VIX, a measurement of volatility in the stock market, is at its lowest point since January of 2020. For the moment, the stock market is very complacent about the risks ahead.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

Brock
Karen
Todd
John
Evan
Megan
Lyn
Hank

Brock E. Hastie
Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

Evan LeRoy
Vice President & Wealth Advisor

Megan Flynn
Vice President & Wealth Advisor

Lyn Breen
Wealth Advisor

Hank Peyser
Wealth Advisor