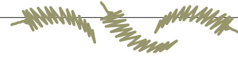
C Y P R E S S

ASSET MANAGEMENT, INC.



MARKET COMMENTARY **October, 2023**

Market Performance

	QTD	YTD
S&P 500 Total Return	-3.26%	13.02%
NASDAQ	-3.93%	27.07%
Dow Jones	-2.08%	2.73%
As of September 30, 2023		

Equities followed a familiar September swoon pattern as higher interest rates and a hawkish Fed put a damper on financial markets. The yield on the bellwether 10-year Treasury rose from roughly 3.8% to 4.6% during the 3rd quarter, a 20% increase, leading to double digit losses in long term Treasuries. September is seasonally the weakest month of the year for equities, and most of the rise in rates and damage to equities took place in September.

We are now entering the seasonally strongest period of the calendar year. According to Bank of America Global Research the S&P 500 has gained 4.8% on average in the 4th quarter and has been positive 80% of the time – significantly better returns than the average for other quarters. While rates remain under pressure, corporate earnings have remained solid. Given elevated valuation levels and higher interest rates the growth in earnings has been an important fundamental positive.

The ingredients are there to have a decent close to the year: reasonable valuations for most equities and sectors of the S&P 500 and the prospect, finally, of an end to Fed rate hikes. The high-quality stocks we own continue to deliver resilient earnings growth, cash flow and impressive profit margins in a challenging global environment.

The Winds of War

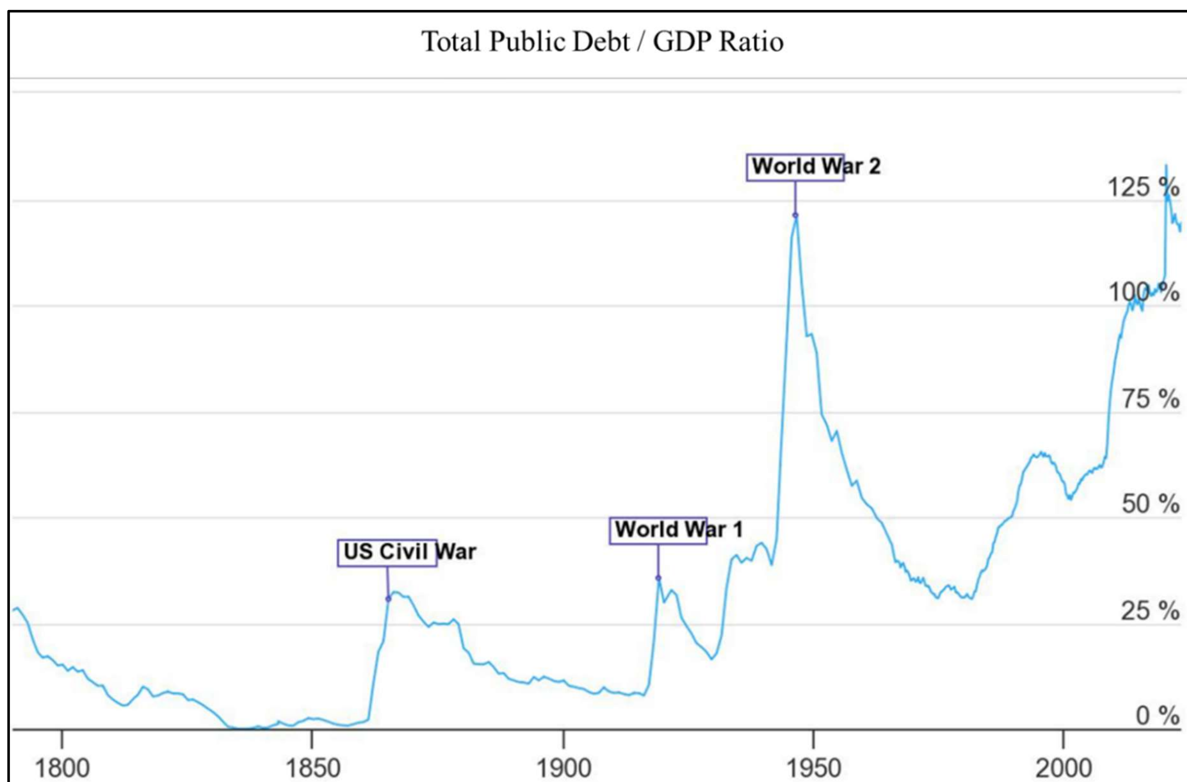
Against the favorable seasonal backdrop, however, there are also unusual countervailing geopolitical forces pressuring financial markets and the entire world. To a great extent the unknowable course of unfolding conflicts on two different fronts will determine the path of markets. The ongoing war in Ukraine, the most lethal conflict in Europe since 1945 with, by some estimates, combined casualties of well over 600,000, and now October's Israel – Hamas War in the Middle East present a great challenge to the United States and its allies. It's a bad situation that in the words of Niall Ferguson creates "an unpleasant 1930s feeling". Not only must the United States support Ukraine and Israel on two different fronts but do so at the same time it is engaged in a cold war with China. Historian and scholar Ferguson explains in a recent interview:

"The thing about cold wars is that they're not entirely cold. In the first Cold War, it became clear that the stakes were high when a hot war broke out in Korea. A hot war broke out in Ukraine that I think played the same role in Cold War II. Cold wars are global. You have to contend with multiple regional crises. We've got one in Ukraine. Now, we've got one in the Middle East. It's conceivable we could have a third in Taiwan if China made some move taking advantage of the fact that the U.S. and its allies look increasingly overstretched."

Troubles at Home: Government Debt and Deficits Bring Back the Bond Vigilantes

In America, we have a tale of two worlds: corporate America and households are enjoying relatively stable financial conditions. Much of corporate America and households used the once in a lifetime decline in interest rates to refinance their borrowing costs. Add to that, U.S. employment remains strong, incomes are steady. In the whole, their balance sheets are strong and finances are sturdy. In sharp contrast, the U.S. government's finances are weaker than they have been in generations. It is concerning that we are seeing record budget deficits, soaring government debt ($33+ trillion and counting or more than 1.25x our nominal GDP) and steadily rising interest rates. As a country, we now spend far more than we take in every year, increasing the government long term debt so much so that interest paid on the debt is becoming one of the major line items in our yearly expenditures.

The Covid pandemic supercharged the federal budget. Government spending exploded in response to Covid and remains 40% above where it was just 4 years ago. What is all the new spending since 2019? The answer is surprising. The main drivers of the recent increases have not been the largest three programs—Social Security, Medicare, and defense—but rather rapid growth in numerous other programs. Covid relief, stimulus, and infrastructure measures enacted since 2019 amount to over $6 trillion, substantially greater than the entire 2019 budget.



Source: Federal Reserve Bank of St. Louis

Return of the Bond Vigilantes

All this deficit spending and government debt brings us into uncharted territory. Bloated debt levels inherently pose challenges: mounting interest payments, risks to economic stability, a financial burden imposed on future generations and "crowding out", a term used to describe large government debts absorbing more and more of the available savings in the economy, to the detriment of private savings and investment, and finally higher taxes for all.

Add to that the unfortunate reality now imposed by global conflict. Ironically, the classic response to an international crisis is a flight to quality where global money seeks the safe haven of the dollar and U.S. Treasury bonds. This drives up the price of bonds and drives down bond yields. And yet, just the opposite is happening as the world faces wars on two fronts, one in Europe and one in the Middle East. The 10-year Treasury yield just climbed above 4.9% for the first time in 16 years.

So, what is going on? Perhaps the threat to inflation from oil price disruption in the Middle East and higher oil prices is a factor. Likely other factors include the current U.S. effort to fight inflation by reversing quantitative easing that lasted from much of the 2010's through Covid, and adopting quantitative tightening. For the last year, in an effort to quell inflation, the U.S. government has been selling off the bonds it accumulated during the easy money years thereby sopping up liquidity in the economic system and adding to an already expanding supply. With borrowing costs soaring and quantitative tightening, increasing supply of government debt is overwhelming demand and driving up yields.

Moreover, it can be argued that interest rates and bonds are currently finding their natural prices. Interestingly, "Bond Vigilantes" of the 1970s and '80s are back. In the early 1980s Ed Yardeni famously wrote: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit market." In the wake of our unprecedented Covid era fiscal and monetary binge, we may face an era of greater austerity to go with our global challenges.

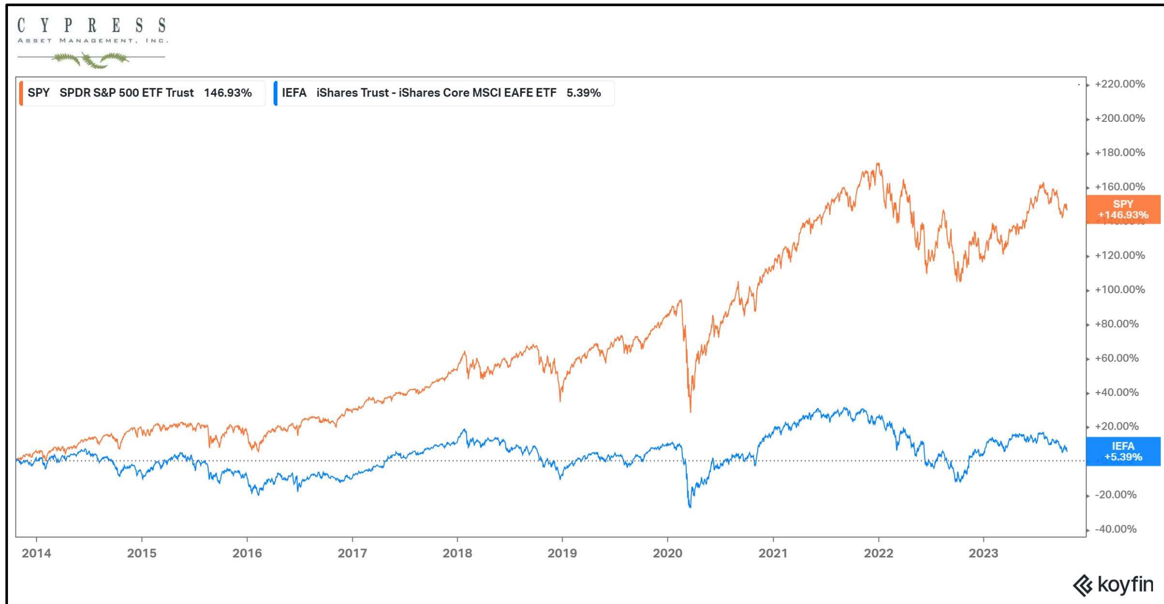
End of Year Outlook

The fourth quarter of 2023 is a highly anticipated few months for investors. The factors highlighted below will shape how the market behaves.

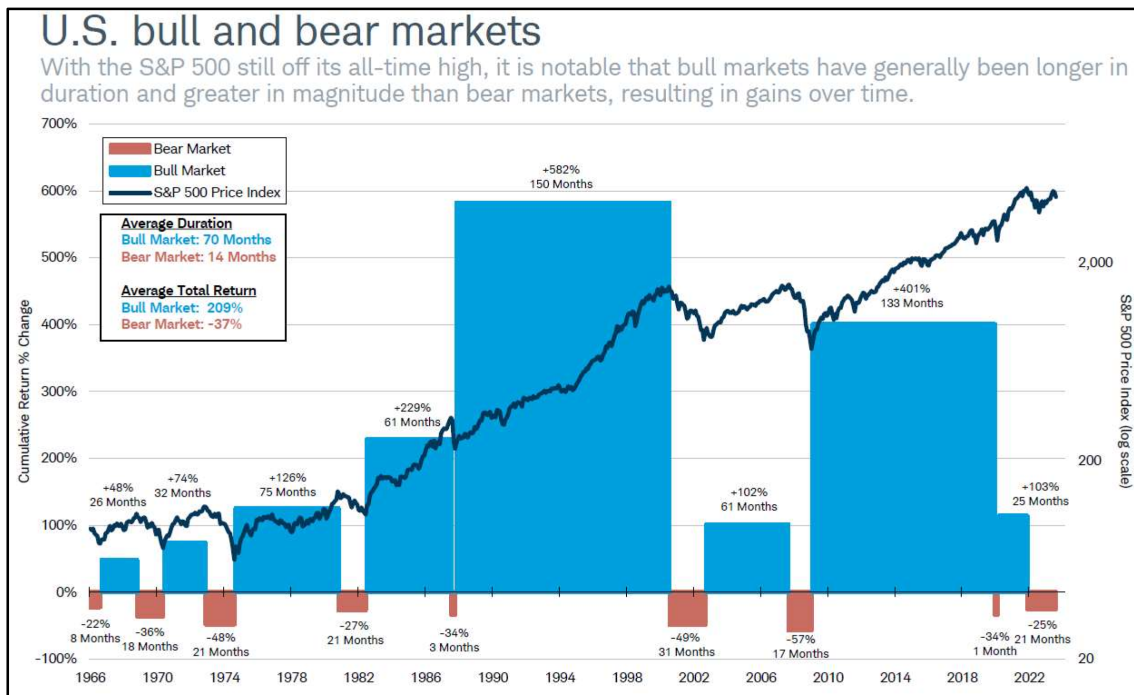
POSITIVE	NEGATIVE
• Inflation Cooling Down	• Israel - Hamas War
• Monetary Tightening Working	• Hawkish Central Bankers
• Expected Fed Hold	• Geopolitical Tension with China
• Labor Market Cooling	• M2 Money Supply Growth Negative/Monetary Tightening Lag
• Positive Earnings	• Major Economic Slowdown/Hard Recession
• AI Technology Innovation	• US National Debt at Record High Level ($33.5T), Greater than Nominal GDP

During times of global turbulence, it is important to remember that as an investor, we are in it for the long-term growth of capital. Time in the market – not *timing* the market – is critical to achieving long-term goals. Although we have discussed global headwinds it is important to remember that our Cypress portfolios are invested in leading U.S. companies. Just as capital retreats into U.S. bonds during global conflict, we believe

that U.S. stocks are the best safe haven for making long-term investments. U.S. stocks have significantly outperformed their global peers over the past decade, as shown in the accompanying chart. As Nick Colas of DataTrek Research says, expanding on an old Larry Summers quip, the U.S. is in a league of its own when it comes to investing: "Europe is a museum, Japan is a nursing home, China is a jail, and America is a business, for better or for worse, and that business knows how to allocate capital and the other parts of the world simply do not."



Source: Koyfin



Source: Bloomberg