The Weekly Market Update – 10/2/23: Equities Weak in Q3, Balancing Risks

Major Indices (Price Returns)	Close	Last Week	Quarter-to-Date	Year-to-Date	Trailing 12-Months	All-Time High	% to High
S&P 500	4,288.05	-0.74%	-3.65%	11.68%	19.59%	4,796.56	11.9%
Dow Jones Industrial Average	33,507.50	-1.34%	-2.62%	1.09%	16.65%	36,799.65	9.8%
NASDAQ Composite	13,219.32	0.06%	-4.12%	26.30%	25.00%	16,057.44	21.5%
Russell 2000	1,785.10	0.48%	-5.49%	1.35%	7.23%	2,442.74	36.8%
MSCI EAFE (USD)	2,031.26	-1.62%	-4.71%	4.49%	22.26%	2,398.71	18.1%
MSCI Emerging Markets (USD)	952.78	-1.19%	-3.71%	-0.38%	8.79%	1,444.93	51.7%
Bloomberg Commodity Index	104.84	-1.30%	3.31%	-7.06%	-5.96%	237.95	127.0%
Barclays U.S. Aggregate Bond	86.33	-1.05%	-3.86%	-2.87%	-1.58%	112.07	29.8%

Source: FactSet

Lower equity prices in September drove major indices into the red in the third quarter (3Q23), the first down quarter since 3Q22. Including the third quarter decline, U.S. equity indices remained largely positive for the year-to-date (YTD). The widely followed, large-company S&P 500 index decreased 3.7% in 3Q23 (price return, does not include dividends), the large-company, growth- and technology-centric Nasdaq Composite index dropped 4.1%, and the small-company Russell 2000 index declined 5.5%. In 2023 YTD (through 9/30/23), the S&P 500 gained 11.7%, the Nasdaq Composite increased 26.3%, and the Russell 2000 remained up 1.4%. We attribute 3Q23 equity market weakness to a rapid rise in long-term interest rates, emerging concerns that consumer spending could slow, and tense federal budget negotiations (settled for now) that have highlighted the expanding deficit and increasing debt issuance. As of 9/30/23, the 10-year U.S Treasury yield (we consider a proxy for long-term interest rates) was 4.62%; this compared to 3.81% three months earlier and is its highest level since 2007. Rising interest rates can create challenges for stock valuations as the present value of future cash flows erodes. Strong consumer spending, a bright spot for the U.S. economy throughout 2023 to-date, faces new headwinds as jobs growth slows (Bureau of Labor Statistics, BLS), credit card balances and delinquencies rise (New York Federal Reserve Bank), and federal student loan payments resume this month after a three-year hiatus. While Congress negotiated an 11th hour budget (spending) extension on 9/30/23, spending appropriation bills remain in limbo (the new deadline is 11/17/23). At the same time, the U.S. fiscal deficit through August 2023 (representing 11 months of fiscal 2023) was $1.52 trillion, compared to $946 million over the first 11 months of 2022 (Congressional Budget Office). The rising deficit, along with existing debt maturities, must be financed in a higher interest rate environment, creating higher interest expense, which in turn can pressure the federal budget.

Balancing those investor risks is solid economic growth, the expected resumption of year-over-year (Y/Y) earnings growth, and a consensus view that the U.S. economy can avoid recession. According to the Bureau of Economic Analysis (BEA), the U.S. economy grew at an annualized rate of 2.2% and 2.1%, in 1Q23 and 2Q23, respectively, and the FactSet economists' consensus estimate for 3Q23 is 2.4% (as of 9/30/23). At the beginning of the year (as of 12/31/22), the FactSet consensus estimate for 2023 full-year growth in gross domestic product (GDP) was just 0.3%, indicating that both actual results and revised estimates are a positive surprise. In addition, S&P 500 earnings (weighted by market capitalization for all index constituents) appear to have bottomed following three consecutive quarters of Y/Y percentage declines. Most recently, in 2Q23, S&P 500 earnings per share (EPS) decreased 2.8% vs. 2Q22, but consensus estimates for 3Q23 and 4Q23 are for Y/Y growth of 0.6% and 9.2%, respectively. The prospect of ongoing GDP growth, along with an earnings growth rebound, provides a positive offset to emerging risks discussed above, which could provide downside support to equity markets in the fourth quarter.

The upcoming week includes key jobs data for August and September. On Friday, the BLS will report the September change in nonfarm payrolls (jobs), with the FactSet consensus estimate reflecting an increase of 156 thousand (K). This would be a downtick from 187K in August, and in-line with the average of 150K monthly over the past three months. Tuesday includes the BLS' August job openings (JOLTS), with 8.9 million (same as July) expected. The July ratio of job openings-to-unemployed was 1.5x and moving lower.

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