Third Quarter 2023 Commentary

An Oxford Harriman & Company Market Commentary

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Stocks and bonds were both impacted by a combination of events during the third quarter, starting with an increase in oil prices, which caused inflation to re-accelerate in August. The rebound in inflation contributed to a sharp rise in interest rates, with the 10-year Treasury yield rising from 3.82% at the beginning of the quarter to 4.57% at quarter end. The rise in interest rates put pressure on the stock market, and the S&P 500 declined 3.2% during the third quarter.

Rising Oil Prices Renew Inflation Fears

After trading lower during the past year, oil prices rose to a 12-month high during the third quarter. Oil rose above $90 per barrel in September, from approximately $70 per barrel at the end of June. Demand for oil remains strong as the global economy continues to grow, while OPEC recently announced extended production cuts through the end of 2023. Additionally, the US's Strategic Petroleum Reserve sits at its lowest level since the 1980s, which leaves little capacity to mitigate a potential supply disruption. With OPEC's production cuts squeezing global supply, oil prices surged nearly 30% in the third quarter.

The rise in oil prices caused inflation to re-accelerate in August, with gasoline prices accounting for over half of the monthly increase. Oil's use as a transportation fuel means that it impacts nearly every segment of the economy, and a continued rise in oil prices could keep upward pressure on inflation as rising fuel costs are passed through to the consumer. Indeed, the CPI for August 2023 of 3.7% was higher than the 3.0% reading in June 2023. Overall, inflation has fallen from the 9.1% reached in July 2022 to under 4% but getting below 3% (where the Fed has maintained as its goal) may prove to be difficult with higher oil & housing prices, and the continued strength in the labor market.

Treasury Yields Rise Sharply in the Third Quarter

Reignited inflationary fears contributed to the rise in interest rates during the third quarter. Short-term yields are highly sensitive to Federal Reserve Policy and the Fed's sole action was a .25% interest rate hike at the July meeting. During the third quarter there was a sizeable increase in yields on longer-maturity Treasury bonds. The 7-year yield rose 0.64% during the quarter, while the 10 and 30-year yields both rose by more than 0.75%. Excluding the pandemic, the last two times the 10-year yield rose by over 0.75% in a 3-month period were in 2013 and 2016.

Throughout the first half of 2023, investors believed that falling inflation would result in fewer interest rate hikes by the Fed and potentially quicker interest rate cuts. However, with the economy remaining stronger than expected and oil prices rising, there is a growing concern that the Fed may need to keep interest rates higher for longer to continue fighting inflation. The recent rise in yields indicates the market is preparing for a longer period of higher interest rates and no expectation of near-term rate cuts.

Treasury bond issuance is forecast to increase in the coming quarters, and investors are concerned that the surge in supply may outpace investor demand and cause yields to rise further, and bond prices to decline.

Another contributing factor to the increase in yields was the increased issuance of Treasury bonds. Following the debt ceiling resolution in May, the Treasury Department was able to issue more bonds to fund the growing U.S. government deficit. Treasury bond issuance is forecast to increase in the coming quarters, and investors are concerned that the surge in supply may outpace investor demand and cause yields to rise further, and bond prices to decline.

We have also witnessed a reduction in the buyers of U.S. Treasury bonds. In recent years, the Fed, foreign governments, and the banking sector were large buyers of U.S. debt. The Fed is no longer buying these securities and foreign governments have reduced their purchases. Additionally, given the higher interest rate environment, banks have been more willing to keep money with the Fed in overnight agreements rather than purchase Treasury bonds which exposes these institutions to interest rate risk. As we saw this past spring, the banking sector has already had issues with their bond portfolios. Foreign retail investors also have less incentive to purchase Treasury debt, as negative interest rates in Europe and elsewhere are no longer a factor. The U.S. retail investor now plays a larger role as the buyer of U.S. debt. Rising supply and reduced demand for Treasury securities are certainly not conditions conducive to lower interest rates.

Borrowing Costs Continue to Increase

The Fed's series of interest rate hikes have led to a sharp rise in borrowing costs. For example, the interest rate on a 48-month auto loan has risen from 4.6% at the end of 2021 to 7.6% at the end of June. Additionally, the average 30-year fixed-rate mortgage has increased from 3.8% to 7% over the same period. The recent rise in Treasury yields pushed mortgage rates above 7.30% during the third quarter, which implies that interest rates on auto loans also increased during the quarter.

Part of the reason we believe home prices are holding and, in some cases, still increasing is due to some homeowner's unwillingness to sell because mortgage rates have increased.

According to the National Association of Realtors, the average monthly house payment has risen from $1,249 at the end of 2021 to $2,052 at the end of June. Factoring in the rise in mortgage rates during the third quarter, the current monthly house payment is likely even higher. While many homeowners locked in low mortgage rates during the past few years, today's homebuyers are navigating a combination of higher mortgage rates and home prices that remain elevated. Part of the reason we believe home prices are holding and, in some cases, still increasing is due to some homeowner's unwillingness to sell because mortgage rates have increased. The theory is that some people are unwilling to trade for a more

expensive home because they do not want to pay 7%+ when they currently have a mortgage below 4%. This may be hurting the supply of homes while these homeowners wait out this interest rate cycle. As a result, home prices are not falling like some experts predicted when rates started to increase.

Borrowers of all types, including businesses and commercial real estate owners, are adjusting to a new world with higher interest rates.

It's not just homebuyers and consumers who face higher borrowing costs. Borrowers of all types, including businesses and commercial real estate owners, are adjusting to a new world with higher interest rates. For some borrowers, the math of higher monthly payments doesn't work like it used to when interest rates were lower during the past decade. The looming question is whether borrowers can manage the increased interest rates and maintain their payments.

Data already indicates consumers, businesses, and commercial property owners are feeling the stress of higher rates. The percentage of auto loan delinquencies, which is defined as loans 90 days or more overdue, is rising across every age group, and there is a similar trend in credit card delinquencies. The rising number of Chapter 11 bankruptcy filings suggests businesses are likely being impacted by higher rates, while some commercial real estate owners have made the strategic decision to hand keys over to lenders rather than invest more money in undesirable (or unprofitable) buildings. These early signs of stress suggest lenders and investors should be mindful of potentially above-average credit risk in the coming years.

S&P 500 Ends the Third Quarter with a Loss

Stocks traded down in the third quarter, with most of the losses occurring in August and September as rising interest rates weighed on equity market valuations. The S&P 500 declined 3.2% in the third quarter, while the Russell 2000 Index of small cap companies fell 5.2%. The Nasdaq 100, which primarily tracks growth stocks, declined 2.9%.

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At the sector level, Energy was a top performer as oil prices climbed nearly 30%. Communication Services was the only other sector to trade higher, while the remaining nine sectors posted single-digit losses. Defensive sectors underperformed as rising interest rates weighed on the Utility, Real Estate, and Consumer Staple sectors.

International stocks underperformed U.S. stocks during the third quarter as rising Treasury yields caused the U.S. dollar to strengthen. The MSCI EAFE Index of developed market stocks fell 4.9%, while the MSCI Emerging Market Index declined 4.1%. Year-to-date, international markets have underperformed U.S. stocks due to their lower exposure to growth-oriented stocks and the rising U.S. dollar.

Bonds Prices Fall as Interest Rates Rise

Rising interest rates were a significant headwind for bonds during the third quarter. The Bloomberg Bond Aggregate Index, which tracks a wide array of Treasury, corporate, and

municipal bonds, declined 3.2% during the third quarter. The negative total return indicates the decline in bond prices more than offset the interest income received.

Bonds haven't experienced a sequence of negative returns like the current trend since the 1980s, which was the last time the Fed aggressively raised interest rates to combat inflation. Factoring in the third quarter sell-off, four of the ten worst quarters for the Bond Aggregate Index have occurred since the start of 2022. While savers are earning significantly more interest compared to the last decade, the higher interest income is being offset by falling bond prices.

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Elsewhere across the bond market, riskier bonds continued to outperform higher-quality bonds during the third quarter. High-yield corporate bonds fell 0.3%, while investment-grade corporate bonds declined 4.6%. The performance gap can be attributed to two factors. First, high-yield bonds typically have shorter maturities than investment-grade bonds, and rising interest rates have less of a negative impact on shorter-term maturities. Second, high-yield bonds offer a higher yield than investment-grade bonds to compensate for their increased credit risk. This higher yield boosted high-yield's total return and offset a portion of capital losses.

Fourth Quarter – What We are Watching

Several factors will influence how the market finishes the year, including the paths of oil prices and interest rates. Corporate earnings and economic data will also be an important factor.

In the first week of the fourth quarter, the trends discussed above remain the same. Equity markets are being pressured by higher rates, with the 10-year Treasury yield reaching 4.8%. While both stock and bond performance over the past few months have been negative, on a year-to-date basis, the S&P 500 is still positive. Several factors will influence how the market finishes the year, including the paths of oil prices and interest rates. Corporate earnings and economic data will also be an important factor. The third-quarter earnings season starts in mid-October, and it will provide key insights into consumer spending and the impact of higher interest rates. On the economic front, investors will be focused on the labor market, the trajectory of inflation, and third-quarter GDP growth, which will be released in late October. Additionally, investors must consider geopolitical tensions, the potential of another government shutdown, and the resumption of student loan payments. As we are finishing this commentary, Hamas and Israel are at war, another unexpected geopolitical event.

Our team will be tracking corporate earnings and economic trends throughout the fourth quarter to help guide portfolio positioning. The market is entering the final stretch of 2023, but there are still a lot of important data points to be released and questions to be answered before we turn the calendar to 2024.

We thank you for your continued support,

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Sources:

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index

with each stock's weight in the Index proportionate to its market value. The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ 100 Index is an unmanaged group of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade. The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is designed to represent the performance of large- and mid-cap securities in 24 Emerging Markets. Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Additional information is available upon request. PM -04092025-6007192.1.1