SUMMIT
ASSET MANAGEMENT

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"A Tricky Irony"

Dear Clients and Friends: October 15, 2023

We're living in a weird place right now. There seems to be a universal gloom amongst almost everyone. Whether it's rising crime rates across the country, the ongoing political dysfunction in Washington, the war in Ukraine, or the constant reminder of inflation with every trip to the grocery store; it's easy to find something to keep the cheer at bay. However, that gloom doesn't seem to be affecting our spending behaviors. The third quarter saw financial markets pull back as investors came face to face with a tricky irony. Sustained strong employment, consumer spending, and housing prices continue to surprise to the upside forcing the Federal Reserve to keep its foot on the brakes, trying to slow things down.

It's the surprising resilience of the U.S. economy that is foiling the Fed's plans. While economic growth has slowed and inflation has come down, both are still higher than they would like. In September, the Fed paused on hiking interest rates further, but reiterated its theme of keeping rates "higher for longer" than most had hoped. Simply put, the ongoing unanticipated economic strength is driving interest rates higher, causing bond prices to head lower, and creating headwinds for stocks.

Almost every major index we follow was down between -3% and -5% during the quarter. This includes large and small domestic stocks, value and growth, developed international and emerging markets. Even the aggregate bond index was down -3%, and now down -1% for the year, as longer-term interest rates reacted to the Fed's language. For the year, the S&P 500 remains up about 13%. As chronicled in last quarter's letter, it has been boosted in an outsized way by the returns of a handful of large technology companies. Also mentioned last quarter, contradictorily, the equal weighted index remains up less than 2% for the year. The latter demonstrates a much more difficult market for the average stock than it appears on the surface.

Current Conditions

The pandemic economy was strange and hard to predict. Regrettably, while progress has been made, things have not completely normalized. We recently came across this "meme" on Twitter. It seems to perfectly sum up the crosscurrents and difficult environment that investors find themselves in today when making decisions. We have conflicting data and fast changing trends. Things aren't adding up as normal.

> Our Current Conditions:
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> 1. Stocks are falling like a recession is coming
> 2. Oil prices are rising like there's no recession in sight
> 3. Interest rates are rising like we have 10% inflation
> 4. Gold is falling like inflation is gone
> 5. Housing prices are rising like interest rates are falling
> 6. Commercial real estate is falling like its 2008
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> Nothing adds up here.

Most of the problems stem from interest rates. Under normal circumstances, the yield curve is upward sloping; as the time to maturity increases, so does the associated interest rate. This makes sense as debt issued for an extended term generally carries more risk because of greater likelihood of inflation or default in the long run. The front end of the curve is anchored by the Fed Funds Rate, acting as a

risk-free benchmark. As the Fed hiked rates by 5.25% since early 2022, we saw the front end move up in lockstep. However, while the longer end of the curve moved up as well, it was at a slower pace and not to the same levels. This has left the yield curve "inverted" for quite some time. Inverted yield curves have historically preceded recessions, seemingly pricing in eventual rate cuts to spur growth and counter the slowdown higher rates have caused. The current cycle has been no different until recently.

A famous economist, Milton Freedman, once said, "Monetary policy operates with long and variable lags." He was describing the fact that it takes time for the rate increases to affect the macroeconomy and that the cause and effect can differ from episode to episode in a way that is difficult to predict. Expectations for the current cycle have been that these effects would have been much more pronounced by now. The sudden move up in the longer end of the yield curve is the reckoning and adjustment in the outlook to the continued strength in much of the economy. Projected rate cuts are being pushed out and delayed.

What we are left with is an environment where financial conditions have tightened considerably, increasing the chances for recession. However, in the short run, the economy is not reacting in its usual manner, denying those tighter conditions and continuing to power ahead. The rate hikes WILL have an effect, but in the interim we are all left scratching our heads wondering when and by how much.

Why has this time been different? We believe there are many reasons. First, consumers have obviously continued to spend at elevated levels. Pandemic shifts in behaviors have not been fully normalized and have been partially funded from the excess savings accumulated during 2020-2021. Thoughts were that these savings were close to being depleted. However, recently revised government data indicates that Americans have hundreds of billions of dollars more in extra cash stashed away than previously believed.

The unemployment rate continues to be at generational lows. Everyone that wants a job generally has one, and we continue to create new ones at a brisk clip. The September jobs report indicated that the U.S. economy added 336,000 jobs, more than double the number anticipated. Wages have also increased. So, while inflation remains elevated, there are more workers, and they have more money in their pockets to combat it.

Manufacturing is also seeing a small renaissance. The shocks from the COVID supply chain disruptions, ongoing tariffs and trade wars, desires to reduce dependence on China, and government incentives in bills like the Inflation Reduction Act have all incentivized companies to bring production closer to home. This has resulted in more jobs in both manufacturing itself and building of the infrastructure to make that production possible.

The rise in rates, and therefore interest expense to businesses, consumers and governments, has had a smaller impact than anticipated. The interest rate regime since the Financial Crisis has allowed everyone to finance debt at incredibly low rates for an extended period of time. Whereas a new mortgage might fetch 8%, the vast majority of existing homeowners have a fixed rate below 4%. Unless they choose to move, that will not change. Corporations and governments around the world are in a similar position. They have trillions of dollars in debt locked in at very low rates. Slowly, portions of that debt will mature and be forced into potentially higher cost loans. Yet, this will not happen all at once and there is a high probability that rates will have fallen before most of that debt comes due.

Lastly, there is a positive to higher rates that most people don't talk about. According to the St. Louis Fed, there is over $6 trillion sitting in money markets across the United States. This is money that two years ago was generating little to no income. Today, those funds are producing upwards of $300 billion annually. That's real money going to either further shore up a balance sheet or make its way back into the economy.

Outlook

To be sure, headwinds are appearing amidst other ongoing challenges. The full force of those long and variable lags likely won't be felt until sometime in 2024. Specifically, employment and housing have historically been delayed in feeling the impacts. Consumer spending has been resilient, but the combination of waning pandemic related savings and the resumption of student loan repayments could soon take a bite. With the UAW strike heading into its second month, reduced production and lower inventories are starting to be felt, just as that industry was getting back to normal. Fears are the strike could lead to a resumption in car price inflation and fuel further strength in rising wage inflation.

The downside to most current homeowners having a sub 4% mortgage is that no one is moving. Housing inventories have dried up quickly. The reduced number of houses available has kept existing home prices elevated, feeding into the current inflation data. Another inflation worry is gas prices. Demand for oil has stayed strong while seeing curtailed production in Saudi Arabia and Russia. The U.S.'s own production recently hit new all-time highs, attempting to offset those declines. However, that production may be peaking as "capital discipline" is leading oil companies to plow money into stock buybacks and increased dividends rather than into new drilling. Additionally, while Washington managed to avoid a government shutdown in September, a new one on November 17th looks all but unavoidable.

As we write this letter, Hamas terrorists have attacked Israel, igniting a new bloody conflict in the Middle East, unleashing even more complications to an already unsettled world.

Markets have come a long way this year, swinging from recession to soft landing to no landing at all. We have cautioned about excessive optimism and pessimism before. The reality of the economy since the pandemic has never been as hot or cold as it seemed in the moment. Navigating today's mixed signals places more importance than ever on staying diversified and making sure you have the staying power in your investments and mindset. This means sticking with the right asset allocation for your situation while maintaining enough cash and short-term holdings to meet expected and unexpected demands. Please let us know if your situation has changed.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

Summit Asset Management LLC