CURBSTONE FINANCIAL
MANAGEMENT CORPORATION

From the Curb

Letter to Clients
Quarter Ending September 30, 2023

The S&P 500 started the third quarter largely the same way it ended the second quarter – with gains. Stocks rose broadly in July thanks primarily to "Goldilocks" economic data, meaning the data showed solid economic growth, but not to the extent that would have implied the Federal Reserve needed to hike rates further than investors expected. That solid economic data, combined with a decline in inflation metrics, further boosted stock prices, as investors embraced reduced near-term recession risks. The Federal Reserve, meanwhile, increased interest rates in late July, but also signaled that it could be the last rate hike of the cycle. That tone and commentary further fueled optimism that one of the most aggressive rate hike cycles in history was soon coming to an end. Finally, Q2 earnings season was better-than-feared with mostly favorable corporate guidance, which supported expectations for continued earnings growth into 2024.

Large caps once again outperformed small caps, as they did in the first two quarters of 2023, although both posted negative returns. That relative outperformance by large caps is consistent with higher Treasury yields, as smaller companies are typically more reliant on debt financing to sustain operations. Relatively speaking, rising interest costs create stronger financial headwinds for smaller companies when compared to their larger peers.

The following table shows the differences in return by market capitalization and also begins to demonstrate the impact that the "Magnificent Seven" (Facebook/Meta, Apple, Amazon, Google/Alphabet, Microsoft, Nvidia and Tesla) have had on cap weighted index returns:

US Equity Indexes	Q3 Return	YTD
S&P 500	-3.27%	13.07%
S&P500 Equal Weight	-4.90%	1.79%
DJ Industrial Average	-2.10%	2.73%
NASDAQ 100	-4.12%	26.3%
S&P MidCap 400	-4.20%	4.27%
Russell 2000	-5.13%	2.54%

Markets begin the fourth quarter decidedly more anxious than they started the third quarter, but it's important to realize that while the S&P 500 did hit multi-month lows in September, underlying economic and corporate fundamentals remain generally strong. First, while there are reasonable concerns about a future economic slowdown, the latest economic data remains solid. Employment, consumer spending and business investment were resilient in the third quarter and there simply isn't much actual economic data that points to an imminent economic slowdown. That said, an economic slowdown is certainly possible given higher interest rates, the resumption of student loan payments and declining U.S. savings.

Second, fears that inflation may bounce back are also legitimate, given the rally in oil prices. But the Federal Reserve, and other central banks, typically look past commodity-driven inflation and instead focus on "core" inflation, which continued to tick down throughout the third quarter. Additionally, declines in housing prices from the recent peak levels are only now beginning to work into the official

inflation statistics, and that should see core inflation continue to move lower in the months and quarters ahead.

Finally, regarding monetary policy, the Federal Reserve's historic rate hike campaign is nearing an end. And while we should expect the Fed to keep rates "higher for longer," high interest rates do not automatically result in an economic slowdown. Interest rates have merely returned to levels that were typical in the 1990s and early 2000s, before the financial crisis, and the economy performed well during those periods. Yes, the risk of higher rates causing an economic slowdown is one that must be monitored closely.

In sum, there are real risks to both the markets and the economy as we begin the final three months of the year. These are largely the same risks that markets have faced throughout 2023 and over that period the economy and markets have remained impressively resilient. We remain vigilant towards economic and market risks and are focused on managing both risk and return potential. We are firm believers that a well-prepared, long-term-focused, and diversified financial plan can withstand virtually any market surprise and related bout of volatility, including "higher for longer" interest rates, stubbornly high inflation, geopolitical tensions and recession risks.

We thank you for your ongoing confidence and trust. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

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