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Financial markets delivered adverse performance during the third quarter as interest rates continued to rise and the so-called Magnificent-7; Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla, were mostly flat to down during the quarter, after blistering gains in the first six months. The broader market was also muted with all major indexes lower by (3-5%) for the quarter. August and September historically are the weakest months of the year, and they lived up to that this year.

The year up to this point may be characterized by what has 'not' happened as opposed to what has happened. Even with the yield curve continuing to be inverted, which has preceded every recession, and the Federal Reserve continuing to raise interest rates sharply, the economy has not fallen into a recession. The unemployment rate has not increased. There have not been additional, widespread bank failures and corporate earnings have been better than feared. With labor strikes, rising interest rates, rising energy costs and presidential approval ratings at historic lows, the economy and the stock market remain resilient.

Underestimating the resilience of the U.S. economy has certainly been the most noteworthy forecasting error of the year. Why the economy has not fallen into recession has confounded nearly everyone at this point and I have concluded that there are several explanations. Remarkably, as the Fed has raised interest rates eleven times over the past eighteen months, to the highest levels in 16 years, corporate debt interest payments have actually fallen. U.S. businesses superbly navigated an entire cycle of monetary tightening without sparking a recession. The French bank, Societe General, reported that data going back to 1975 shows corporate net interest payments increase when the Fed raises interest rates, but this has not happened. Usually, net debt payments rise, squeezing profit margins along with the economy. It turns out that during the period of near zero interest rates, corporations refinanced huge amounts of debt into long-term, low interest rate fixed debt. Net interest payments have fallen (25%) when history indicates they should have risen sharply. This has not happened in 40 years. Companies have navigated the yield curve, adding profits, which are almost unheard of. This lack of profit decline means companies did not have to resort to huge layoffs that would have dented the economy and thrown it into a recession. The low interest rate, long term debt held by corporations combined with their pricing power derived at a time of elevated inflation, means most businesses were able to grow profits meaningfully. Higher interest rates simply are not cooling the economy as they normally do.

Similarly, while mortgage rates have risen from around 3% to over 7%, the housing market has not collapsed as many forecasted. It turns out that around 60% of mortgages have rates less than 4%, so although home sales and prices are down, most people are secure in their mortgages and the default rates remain very low. Homeowners seem comfortably trapped in their present homes while a shortage of homes continues to develop. Again, this is highly atypical of a recessionary period where delinquencies rise, home prices decline, unemployment increases and people are forced to move.

Lastly, U.S. fiscal policy is a continuing source of stimulus. Stemming from both the Trump and Biden massive spending policies, fiscal subsidies and stimulus in infrastructure, semiconductors, and energy continue to provide spending support for years ahead in one of the most extensive periods of fiscal

stimulus since the 1930s. History shows that the government has a poor record of picking productivity enhancing projects but much of Biden's legislative spending continues for as long as ten years.

Many headwinds remain such as high interest rates, elevated valuation of most equity metrics, slowing economic growth, another potential government shutdown, uncertain Federal Reserve policy, but the most severe long-term headwind probably is the inability of our political class to address the increasing and unsustainable budget deficits and our ever-expanding national debt. The U.S. budget deficit this year will be about 6% of GDP, approximately what it was in the depths of the Great Financial Crisis of 2008/2009, and the largest as a percentage of GDP outside of wartime or recession. Huge budget deficits are here to stay. The lack of will to cut spending or raise revenues is bipartisan. The present Fed policy seems to envision high short-term rates, permanent ownership of bonds and silence on fiscal policy. I would suggest we need the opposite. The Fed has been silent about the conflict between its mandate to provide price stability and the continuing fiscal blowout. We are adding record deficits in a time of general peace and economic growth. The only way we have sustained this so far is that we maintain the still accepted reserve currency, but this is not guaranteed to persist, as I have noted previously.

While acknowledging the above, there is a very long list of investors who have mistakenly bet against the U.S. economy and the same might be happening once again. Around 100 years ago, the "Roaring 20's" were a time of extreme greed, soaring prices and speculation. The Crash of 1929 ended that and the classic boom and bust caused most investors to dismiss equites for a long time, if not forever. The Great Depression did not end until 1939 as terrible times lasted for a decade. Despite the prolonged misery, the stock market bottomed in July 1932 and then staged an incredible recovery. By the end of 1935 stocks were up 200% and by early 1937, they were up by 340%. The observation and lesson are that stocks do not bottom when everyone is prospering, and times are good. They bottom when everyone has given up and fear is prevalent, and people are out of the market.

During the 1990s, the economy entered a brief recession resulting from the Fed raising interest rates to control rising inflation. The S&P 500 rallied 500% during the decade.

In 2009, the public wanted out of the market as fear and confidence were severely damaged. Again, risk aversion served as a contrary indicator. Extremes in sentiment typically present significant investment opportunities. In 2020, the worldwide economy almost shut down due to the pandemic and the stock market quickly fell (34%) and today, the U.S. is coming out of a very difficult time as the Fed has dramatically raised interest rates to quell inflation.

We are not in a Depression environment today but there are some similarities to the periods mentioned above. We are facing headwinds but nothing like investors faced in 1932, or more recently in 2020. There is approximately $5 trillion in money market funds. Some observers say this is a great investment, as these short-term returns have not been available for over a decade and today's headwinds are daunting. Lost in this perspective is that over the past 233 years, the average yield on the U.S. Treasury 10-year bond is 4.5%, exactly where we are today.

Others maintain that this represents fear of equities stemming from last year's terrible market and will be compelled to rotate into equities as markets rise. This spike in money-market assets indicates investors are not pouring money into stocks, preferring safe yields rather than capital gains, a classic sign of fear. Historically, when money market assets peak, stocks often start to rise. One subset of money market funds, that contributed by retail investors, has soared to an all-time high. Previous peaks in 1990,

2002, 2008 and 2020 coincided with poor periods for stocks and proved to be great times to invest in equities. If the markets begin to rise, the pain of being out of the market becomes acute. The positive argument is that the U.S. economy is entering a massive expansion of innovation due to the convergence of new technologies, enhanced by artificial intelligence, and that life changing inventions are coming our way.

There is always something to be concerned about and the investment picture is never completely clear. It is important to understand and accept the difference between risk control and risk avoidance. Taking too little risk is inappropriate for most investors. A willingness to accept some risk is an essential ingredient in investment success. My risk management philosophy continues to minimize losses and allow profits to grow. As the famous trader of 100 years ago, Jesse Livermore, advised, “Winners take care of themselves, losers never do.”

John Blair