Davenport Asset Management Quarterly Update | Q3 2023

September 30 2023

Market Returns	Q3 2023	2023
U.S. Large Caps	-3.3	13.1
U.S. Mid Caps	-4.7	3.9
U.S. Small Caps	-5.1	2.5
International Developed Markets	-4.1	7.1
Emerging Markets	-2.9	1.8
Intermediate Term Bonds	-0.8	0.7

Source: Morningstar Direct. Please see index for definitions.

Stocks seemed to run out of gas in the third quarter. The S&P 500® Index and Russell 2000® Index lost 3.3% and 5.1%, respectively. Most of the losses were concentrated in September, which historically is the worst month of the year for stocks. It wasn't surprising to see equity markets stall a bit, especially after a surprising first half rally. Even large cap technology stalwarts cooled off as the artificial intelligence (AI) craze seemed to fade. Year-to-date, the S&P and Russell finished the period up 13.1% and 2.5%, respectively.

We think there are a few reasons most stocks have recently lost ground. For starters, we've begun to see some signs of consumer stress. Consumers comprise about two-thirds of all economic activity. Recent commentary from numerous retailers suggests consumer spending is a little softer. Goldman Sachs recently noted that credit card losses are rising at their fastest pace since the 2008 financial crisis. This clearly indicates the average consumer's ability to spend and take on extra debt may be more restrained. The pandemic bounce back appears to have run its course, the government moratorium on student loan payments has ended, and inflation still lurks with the cost of everything from olive oil to car insurance moving higher. Of note, CNBC recently highlighted a recent Fed study showing that 80% of Americans have less cash on hand than they did at the start of the pandemic. The positive offset is that unemployment remains very low and the consumer still appears quite healthy in absolute terms.

The next issue is the Federal Reserve. Inflation has receded from the extremes of last year, but remains stubbornly high. Major inputs such as oil prices and wages are pushing higher. With inflation still high and economic growth still decent, the Fed sees no need to back away from tighter monetary policy and has embraced a "higher for longer" approach to interest rates. At its September meeting, the Fed held its benchmark interest rate at 5.25%-5.5%, which is the highest level in 22 years. Policymakers also indicated one more rate hike would be coming before year-end and talked down the likelihood of rate cuts next year. Another increase would make a total of 12 rate hikes since policy tightening began in early 2022 and would be the fastest pace of tightening on record. Higher rates can have a dampening effect on borrowing, economic activity and asset values. They also increase the allure of bonds and other fixed income instruments, thereby creating stiffer competition for stocks.

Having described a somewhat cautionary narrative, we also note a large swath of stocks are already trading well off their highs and look attractive. Indeed, the performance of the S&P 500, which year-to-date has largely been driven by a handful of stocks, does not reflect the performance of the average stock. Interestingly, the equal-weighted S&P 500 index, which adjusts for the outsized contribution of the large tech companies that have led the market, is now up only 1.9% year-to-date. Many names have actually been hitting new 52-week lows. For the trading week that ended September 22, 120 stocks on the New York Stock Exchange hit new 52-week highs while 303 hit new lows, while NASDAQ had 161 new highs compared to 750 new lows. Not surprisingly, shares of income-oriented stocks (e.g. REITs and utilities) that are especially sensitive to higher interest rates have been particularly vulnerable. The same goes for shares of businesses that are more economically sensitive or consumer exposed. This tells us equity markets partially reflect the aforementioned interest rate and consumer headwinds.

We recognize the headwinds facing markets, but have continued to find a number of deals for our strategies. In many of these cases, recent price pullbacks have created alluring risk/reward profiles. With the S&P trading at 18x forward earnings estimates, we wouldn't classify the overall market as being a great deal in the context of the current interest rate environment. This is especially true if higher wages and financing costs eat into those earnings estimates. However, we think we can earn reasonable returns by identifying solid franchises trading for valuations that already discount some duress (the equal-weighted S&P trades closer to 14x earnings). We also note that, while "higher for longer" is the mantra du jour, the worst of Fed tightening may be behind us. Fresh signs of "peak Fed" could once again breathe life into stocks. Finally, we note sentiment indicators currently sound a bearish tone. The CNN "Fear & Greed Index" currently stands at 25 out of 100, putting it in the "fear" zone. As we've seen before, widespread negativity can sometimes reverse and lead to market gains. Enjoy the rest of the year and we look forward to reporting back to you soon.

The third quarter presented opportunities and challenges as yields drifted higher while credit markets felt fragile. Macroeconomic drivers continued to dictate market behavior with investors acutely focused on economic data and monetary policy. The Federal Reserve raised its target interest rate range a well telegraphed 25 basis points to 5.25% - 5.5% in July and paused in September. The updated quarterly Summary of Economic Projections (SEP), also known as the dot plots, for September illustrated a Fed bias towards economic growth with moderating inflation. During the final week of the quarter, mixed messages emerged from the central bank spanning from hawkish to dovish outlooks that fueled rate volatility. Idiosyncratic and sector level opportunity were subdued in the third quarter with range bound corporate spread movement.

Bloomberg Market Returns	Q3 2023	YTD	2022
U.S. Govt/Credit	-3.00	-0.85	-13.58
U.S. Govt/Credit Interm	-0.83	0.65	-8.23
High Yield Corporate	0.46	5.86	-11.19
Municipal 1-10Y Blend 1-12Yr	-2.23	-0.81	-4.84
U.S. Govt/Credit 1-5 Yr	0.21	1.40	-5.50
U.S. Govt/Credit 1-3 Yr	0.73	1.87	-3.69

Source: Morningstar Direct. Please see last page for index definitions.

Looking ahead, labor market strength and elevated commodity prices underpin the likelihood for persistent inflation above the Fed's 2% target. The impact of higher for longer interest rates on individual and corporate balance sheets does not happen immediately, but with a lag that impacts aggregate economic growth. At the same time, consumer savings remain a concern as borrowing will likely play a more important role in spending trends. The resumption of student loan payments in October also will draw disposable income out of the economy. Countering these concerns is the reality of higher interest rates, which bode well for returns and performance in many parts of the fixed income arena.

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