SEPTEMBER 2023

MARKET UPDATE

Market volatility returned throughout much of August, though a rally in the final few days of trading helped dampen the pain. At one point during the month the S&P 500 was down over 4.78% though was able to end the month down only 1.59% due to the rally late in the month. US equity markets outperformed their international peers by a significant margin with the MSCI EAFE and Emerging Markets indices down 3.83% and 6.16% respectively. Second quarter earnings season saw better than expected results on a top- and bottom-line basis, but despite beating analyst expectations, earnings across the S&P 500 overall fell by nearly 6% according to analysis by Bloomberg through the end of August. It's worth noting that the first half of the earnings season led to more optimism than the second half, which may have contributed to August's equity market volatility.

Bonds also came under pressure with yields rising across the intermediate and long end of the yield curve, putting downward pressure on bond prices. The Bloomberg US Aggregate index fell by 0.64% in August and is now up 1.37% on a year-to-date basis. The next Fed meeting wraps up on September 20th and the next inflation report will be released on the 13th, as of the end of August, the Fed Fund Futures market was implying an 88% chance the Fed holds rates steady in September.

Economic data continues to point to a cautiously optimistic environment with employment strong, although slowly softening, and consumer-related data, such as real personal income and spending, continue to be robust. While headline year-over-year inflation slightly ticked up in July, the month-over-month figures, as well as core figures, still provide evidence that the trend continues to move in the right direction.

ADVISORS' PERSPECTIVE

While the second quarter earnings season was better than expected, an overall contraction in corporate earnings may have put a slight dampening on investors' moods and contributed to the current volatility. That, combined with ratings downgrades of US Treasuries and several regional banks, created unease amongst investors until the last week of the month. Economic risks and the Fed will remain front and center now that earnings season is over.

The banking industry is facing difficulties following the failures of Silicon Valley Bank and two other banks this spring, along with the Federal Reserve's anti-inflation rate hikes. In August, Standard & Poor issued downgrades to 82 financial institutions, marking the highest number of downgrades in a single month, with some attributed to deposit outflows, funding risks, and constrained profitability. The downgrades are expected to lead to higher borrowing costs and stricter lending standards. Additional challenges for the banking sector include the possibility of a recession and potential losses on commercial real estate loans due to remote work trends.

Office real estate delinquencies have increased significantly in August, with 90+ day delinquencies skyrocketing to 2.28%. The situation could worsen as 30 and 60-day delinquencies become 90-day delinquencies. US cities are considering converting empty office spaces into apartments to address housing shortages and office vacancies. For example, New York City plans to transform old office buildings into 20,000 new apartments over the next decade. Challenges persist in cities like San Francisco due to high building costs, slow approval processes, and limited interest from residents.

Three years ago, President Xi's "common prosperity“ drive cracked down on a booming real estate market to reduce risk and make homes more affordable. Now, it appears that the government may have gone too far. One major developer, Country Garden Holdings, is on the verge of default, with more private developers expected to shut down. Almost a third of Chinese developer bonds are in default, but the government is reluctant to bail out the industry. Transitioning to less real estate-dependent growth may increase financial and political risks for China.

Inventory of homes for sale in July was the lowest for any July since 1999, with 1.11 million homes on the market. Higher mortgage rates are adding to potential homebuyer woes by deterring homeowners from selling, keeping inventory low and home prices elevated. The median selling price increased by 1.9% year-on-year to $406,700, with 74% of homes selling in less than a month. At the current sales pace, it would take 3.3 months to sell all the properties on the market. Realtors see anything below five months of supply as a sign of a tight labor market.

We remain cautiously optimistic and continue to use a quantitative investing approach. In times of uncertainty, it is more important than ever to follow the data and not make decisions based on emotions. Hilltops partnership with Helios relies on facts and data, which we use during our recalculations on a bi-weekly basis. Our models adjust appropriately to market conditions.