

Marketline September 2023

Stocks:

Stocks struggled again in September, with all three indices declining. The Dow was nicked 3.5%; the S&P dropped 4.9% and the Nasdaq – largely at the mercy of technology stocks – sank 5.8%. Overseas returns were also negative, except for European stocks, which managed a 2.3% return. September is the second month running with overall negative returns, and of course, bearishness is cropping up all over the place. Analysts who were issuing buy recommendations just two months ago have gone into hiding.

Last month we noted that technology returns – notwithstanding a couple of slack months – have been substantial this year. That goes for large company stocks in general, actually. The Russell 1000, which is the large-cap segment of the US stock market, is up 11.7% year-to-date, while the Russell 2000, made up of the smallest companies, has managed to rise only 1.4%. The price-earnings ratio (PE) of the largest tech companies in the S&P is 43, while the PE of everything else is about 25. Neither of these is cheap by any means, but in an era of rising interest rates, it's likely that higher PE stocks will suffer more.

Among stock sectors performing poorly this year are real-estate investment trusts. These companies pay out a high portion of their earnings in order to restrain corporate income taxes. Instead, the tax falls solely on the shareholder, who pays based on the amount of dividends. REITs have three problems this year: the first is their dividend payments compete with Treasury yields, and the comparison is not always favorable – i.e., Treasuries are paying more in many cases, at a lower level of risk. The second problem is most REITs borrow money – a lot of it. Payments on those borrowings are rising, cutting into earnings. The third problem is occupancy. In some segments of the real estate market, vacancies are rising (especially in the office segment). This triple whammy has hurt share prices but it's also setting up an opportunity for future profit.

Bonds:

Rates rose across all maturities this month. The two-year reached 5%, a level unseen since 2007. The thirty-year, after backing off 4.8% reached late in the month, closed at 4.7%. We most recently traded at this level in 2011. Normally, slowing growth such as we've seen or a recession – perhaps in our future - knocks yields back to earth. And many pundits expect that rates will back off when the Fed stops tightening. But it's possible that the long end will remain steady. It's even possible that long rates will keep rising as bondholders demand a return after netting out inflation.

So what's going on out there in the long end? We've forgotten that the Fed is allowing its balance sheet to correct back to something more normal, to the tune of tens of billions of dollars per month. The Fed owns trillions of dollars worth of bonds – some in longer maturities. Rather than continuing to make purchases as it did in the recent pandemic-induced recession, the Fed has become passive. Meanwhile, the US Treasury is issuing bonds like there's no tomorrow. Without the Fed as a buyer, these bonds must pay more to attract investors – and so they are.

Sector news still hasn't changed. Despite some notable upgrades in the municipal arena – including Kentucky, Illinois, and other laggards – munis are having a tough time. Liquidity remains abysmal. That makes transactions expensive. While we are seeing long-maturity national munis at 5% here and there, Oregon remains mired in the mid-4's, so we have largely avoided this state.

Good quality corporate bonds are worth a close look. Triple-B bonds are touching 6% in shorter maturities. The albatross of bankruptcies is hanging on the market – Rite Aid is inching toward filing, and Mallinckrodt and Yellow Trucking have filed, along with countless smaller firms. This fraying of credit quality at dodgier firms helps boost yields in much of this asset class, even when many corporations remain flush with cash.

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