PrivateWealth Partners, LLC

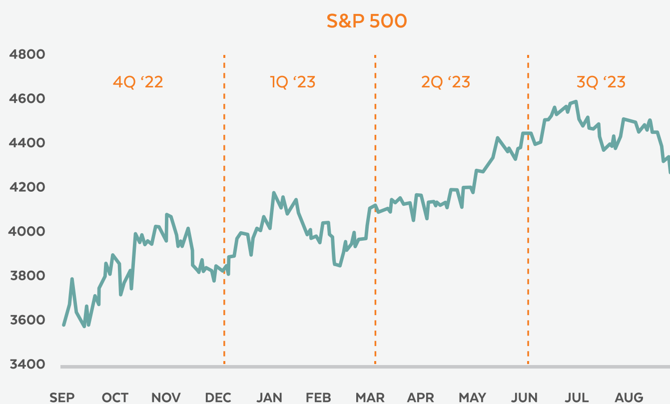
THIRD QUARTER
2023 REVIEW

October 17, 2023

Dear Friend,

Stocks were pressured lower in the third quarter by rising 10-year U.S. Treasury bond yields. In the three months ending September 30, the yield on the 10-year climbed from 3.86% to 4.57%, while the S&P 500 fell -3.3% over the same period. To sum up the third quarter in a single sentence: long-term interest rates went up a lot, and stocks went down modestly (with short-term rates flattish at already high levels). Strong stretches of stock market performance—like we saw in the first half of 2023—eventually gave way to some corrective activity, which we view as normal.

Rising yields in Q3 2023 marked a departure from the first half of the year, when Treasury bond yields moved mostly sideways as inflation trended lower and as investors and economists anticipated a mild economic recession. We noted last quarter that the recession never arrived, and it's even possible the U.S. economy defied expectations and *accelerated* in Q3. In our view, it's this hotter-than-expected economic growth that drove bond yields higher—and stocks lower—for the quarter.



Source: Strategas Research

"We cannot solve our problems with the same thinking we used when we created them."

- ALBERT EINSTEIN

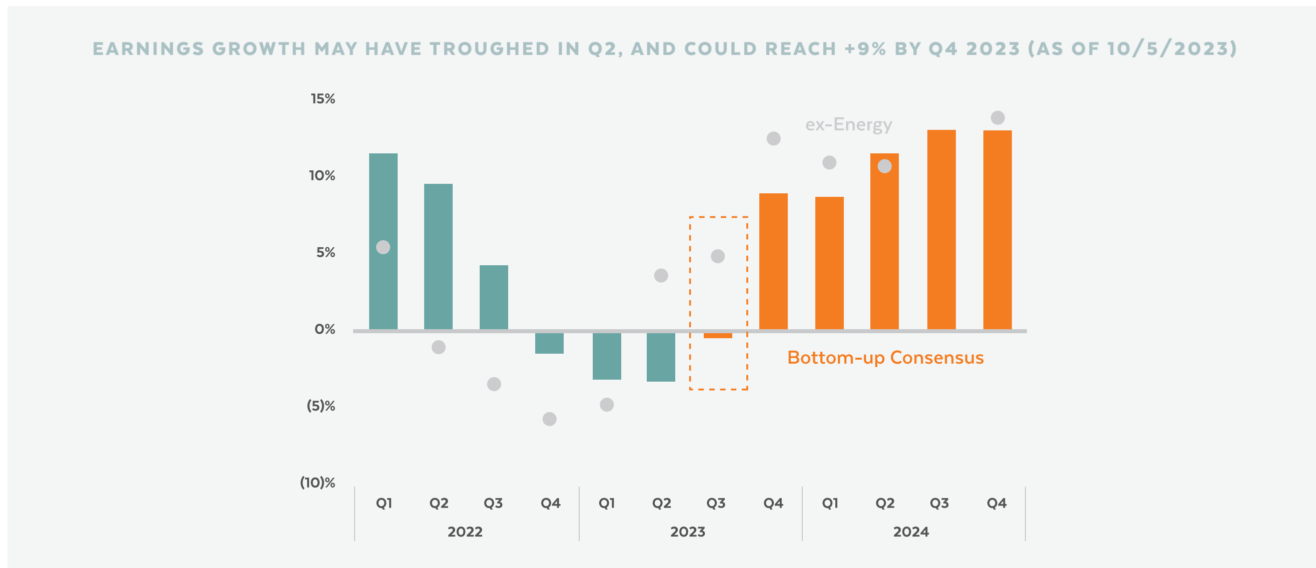
PRIVATE WEALTH PARTNERS, LLC

591 Redwood Highway
Suite 3210
Mill Valley, CA 94941
415 461 3850
pwpart.com

In 2022, interest rates were pushed significantly higher by rising inflation, as investors demanded higher yields in fixed income markets. 2023 looks different, with inflation trending solidly lower throughout the year-to-date. In September, core CPI (which strips out food and energy) was up 0.3% from August and 4.1% year-over-year, an improvement from August's 4.3% print. Importantly, when core CPI is looked at over a 3-month period, it increased at an annual rate of 3.1%, which is a substantial improvement from the 5% annual rate recorded in the spring.

In our view, a steadily improving inflation picture leaves economic growth as the primary factor pushing interest rates higher. Earlier in the summer, interest rates largely reflected a view that the economy was decelerating and heading towards a mild recession. Stronger-than-expected growth—despite the Federal Reserve's efforts with tighter policy—forced investors to 're-price' this economic resiliency.

U.S. corporate earnings offer one of the clearest indications that the U.S. economy is performing better than expected. S&P 500 earnings were negative in the second quarter, but as you can see in the chart below, nearly all of the decline was driven by the Energy sector. Ditto for Q3—excluding Energy, S&P 500 earnings-per-share are forecasted to grow by +5% in Q3 and by double digits in Q4 (ex-Energy).



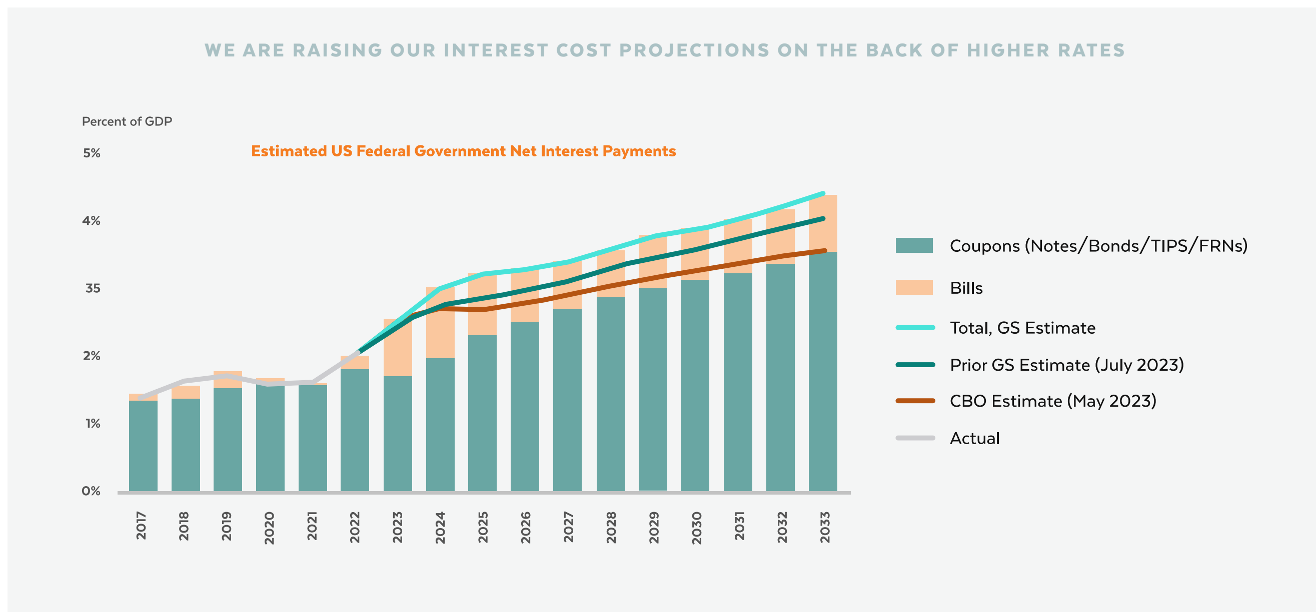
Source: FactSet, Goldman Sachs Global Investment Research

> "Putting this all together, rates are moving higher because the Fed (and the market) is coming to realize that US growth is more resilient than previously anticipated."
>
> – GOLDMAN SACHS ECONOMISTS

THE RISK OF A FISCAL ADJUSTMENT DUE TO DEBT

There is another explanation for upward pressure on interest rates that has been gaining some traction in the financial media: rising debt costs.

Recent projections of interest expense and the federal debt-to-GDP ratio look much worse than before the pandemic. Some have suggested that bond yields are soaring because of rising bond supply, particularly as the U.S. runs a primary (ex-interest) deficit much larger than has been the case historically. Without legislation to curb spending or raise revenues, some estimates show U.S. debt rising from 96% to 123% of GDP over the next 10 years. Nearly all of the increase would be driven by the primary deficit. As seen in the chart below, deficit spending is running much higher than anticipated.



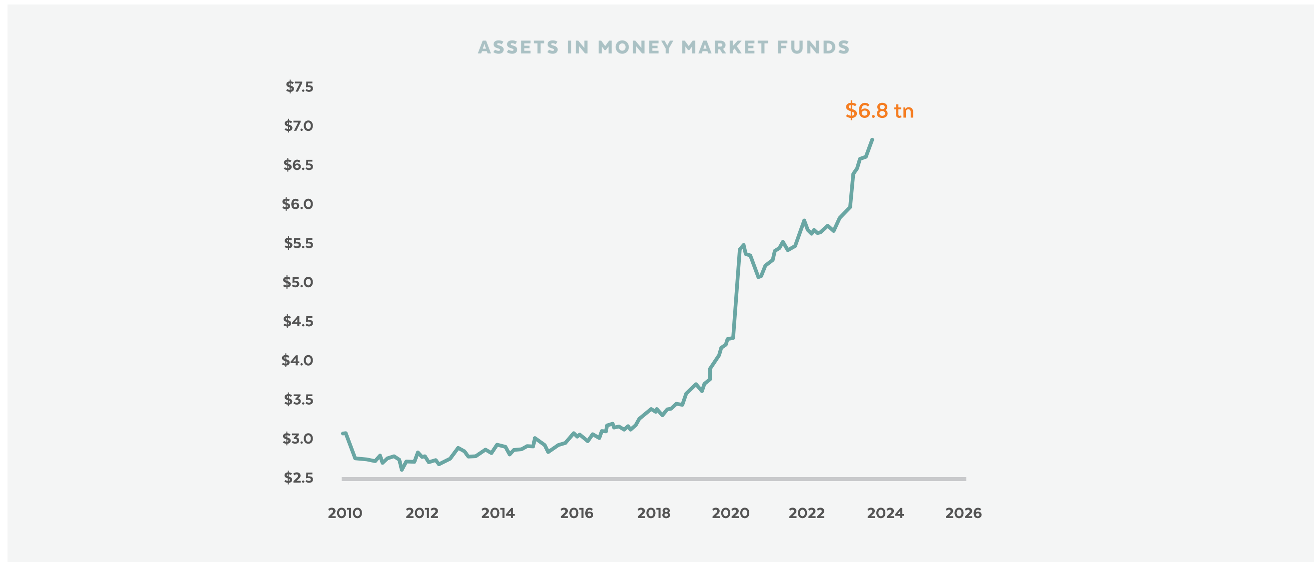
Source: Treasury, Federal Reserve Board, Congressional Budget Office, Goldman Sachs Global Investment Research

The upshot looking forward is that higher interest costs on U.S. debt could result in a greater appetite for fiscal tightening. Ongoing congressional gridlock and an upcoming presidential election may not make deficit reduction legislation likely in the coming year, but history suggests Congress may soon view it as an economic imperative.

A 'forced tightening' of U.S. fiscal policy would be a welcome development, in our view, not only for its potential impact on long duration rates but also because it would provide the Federal Reserve more leeway to ease from the current highly restrictive 5.50% upper bound fed funds rate. We also know from history that the Fed is more likely to cut rates quickly when debt servicing costs are high, as they are becoming now.

On the other side of this debt problem lies a factor that we view as a long-term positive. The amount of money 'hiding' in very short-term debt (money markets funds) has grown to staggering levels, reaching nearly $7 trillion in the U.S. and over $8 trillion globally. We can see a scenario where some of this money is reallocated to regular

investment asset classes as rates start to come down. The exodus from money market funds and into equities could combine with increased corporate buybacks (with corporate cash no longer earning 5%+).



Source: Goldman Sachs

PRIVATE WEALTH PARTNERS STRATEGY UPDATE

If we concede that rising bond yields are being driven mostly by stronger-than-expected economic growth, then we think the resulting investment thesis is clear: keep the odds of rising markets on your side, especially as thematic (e.g., A.I., tech innovation) growth stocks enter a constructive growth environment. A normalizing yield curve could also benefit high-quality value sectors, like Financials.

Private Wealth Partners has also been shifting our thinking on preferred stocks for most of 2023, in this era of rising interest rates. As a quick refresher, preferred stocks are issued mostly by financial and energy corporations to fund their capital markets activities. There are limits on how much these companies—which include very well-known names like Bank of America and Goldman Sachs—can issue in debt, so issuing preferred shares (usually with a callable feature) is a way to amplify their profitability.

From around 2009 to 2021, we saw great value in preferred stocks. As the fed funds rate fell to the zero bound following the Global Financial Crisis, high-quality companies were issuing preferred shares with yields far better than some of the highest dividend-paying common stocks. Moreover, PWP believed that in an era of extraordinary Federal Reserve monetary support (known as quantitative easing), preferred stocks were a special situation that was simply undervalued relative to regular bonds. With the Federal Reserve giving certain banks 'Too Big To Fail' status, combined with preferred stocks special taxation rules where income is taxed at qualified rates similar to capital gains (~20%) – preferred shares for years earned a large premium over regular bonds.

Fast forward to 2023, and bond yields have been driven significantly higher while the Fed's quantitative easing program is over and quantitative tightening has begun. As long duration Treasury yields have risen, the spread between 'risk-free' yields and corporate bonds (and in turn preferred stocks) have come down significantly. In our view, this dynamic now means there is no longer much value in holding preferred stocks.

CONCLUSION

In 2022, the U.S. economy was in a challenging spot with soaring inflation and rapid tightening from the Federal Reserve, which included quantitative tightening. These issues are being resolved slowly but surely in 2023, with inflation trending lower and the Fed appearing poised to hold rates where they are.

Looking ahead, we expect to see softness in the macroeconomy as rates shifted higher, but moderating growth does not necessarily equate to equity market weakness. With the nine-month bear market in 2022, we believe a new sustainable low was established for many important components of the S&P 500. We've now arrived at a time when earnings are expected to accelerate to the upside in the coming months, with continued earnings growth in 2024 as margins rebound after a period of softness.

As we were finishing up this quarter's letter, the awful news broke of Hamas launching an attack on Israel. The humanitarian toll of another war is disheartening to say the least, but we do not see this regional conflict exacting an economic toll on the global economy or commodity prices. We may see some volatility in the short-term, but our other insights in this letter pertaining to economic growth and interest rates remain unchanged and far more applicable for investment strategy.

Within the context of client risk objectives, Private Wealth Partners sees overall fundamentals as generally supportive of the market at current levels. Should markets adversely react to war and possible escalation headlines, we believe our higher-quality bias will help cushion downside, and we would view geopolitical and/or macro-driven headlines as an opportunity to add to core holdings in anticipation of growth in 2024 and beyond.

If you have any questions about this review or if you would like a no obligation portfolio review, please do not hesitate to reach out to us directly. We welcome the opportunity to work with you in the future. Have a festive fall season.

Kenneth F. Siebel
CHAIRMAN

William F. Dagley
CEO

Chris Greene
DIRECTOR OF RESEARCH, PORTFOLIO MANAGER

Richard G. Kuchen
SENIOR VICE PRESIDENT

James Lenczowski
RESEARCH & PORTFOLIO MANAGER

Jason M. Saxon
DIRECTOR OF TRADING

Vickie Marinovich
EXECUTIVE ASSISTANT

Katrina Sutherland
DIRECTOR OF CLIENT SERVICES & OPERATIONS

Michael Yongue
COO & CCO

Ashley Saia
CLIENT SERVICES OFFICER & CONTROLLER

This letter has been prepared by Private Wealth Partners LLC, a registered investment adviser solely for informational purposes. This letter is not an offer of or a solicitation of offers to buy or sell security or investment. The opinions expressed herein represent the current, good faith views of the authors as of the date hereof and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this letter has been developed internally and/or obtained from sources believed to be reliable; however, Private Wealth Partners, LLC does not guarantee the accuracy, adequacy or completeness of such information. Predictions, opinions, and other information contained in this letter are subject to change continually and without notice of any kind and may no longer be true after the date indicated. Any forward-looking statements speak only as of the date they are made, and Private Wealth Partners, LLC assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. his material is directed exclusively at investment professionals. Any investments to which this material relates are available only to or will be engaged in only with investment professionals.