Northwestern Mutual®

Quarterly Investment Newsletter

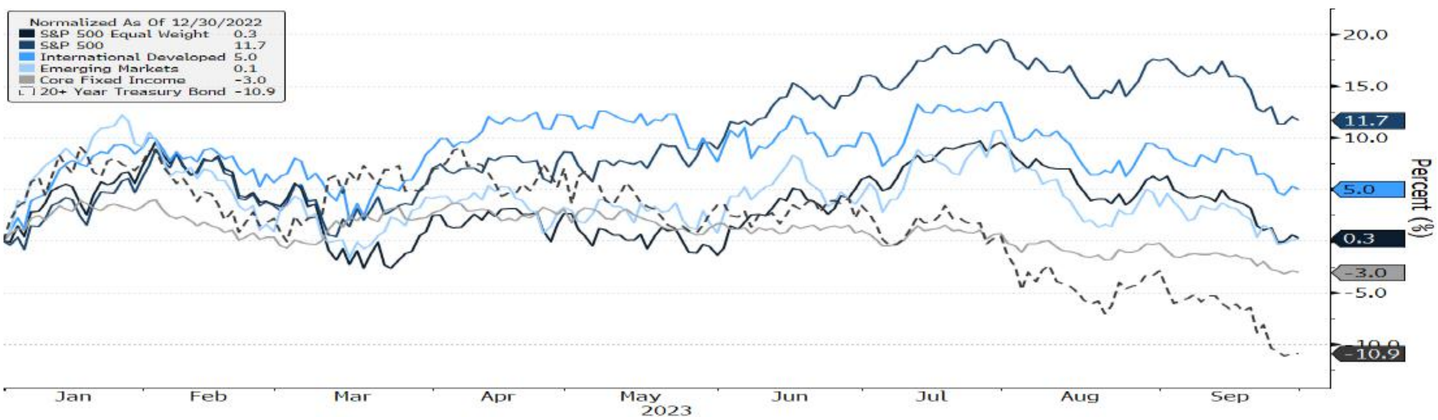
2023 Q3 Economic and Market Overview

SOCIUM
ADVISORS

Performance Summary

September lived up to its reputation of being one of the most challenging months for investors from a seasonal perspective with the S&P 500 falling by -4.8%. The third quarter was negative for all asset classes except for commodities, which rallied modestly on the back of oil supply cuts from Saudi Arabia. Most asset classes are largely unchanged year-to-date as shown in the chart below. The 7 largest stocks in the market capitalization weighted S&P 500 comprise a very high, unusual 35% concentration of the index and have an average Price to Earnings ratio (P/E) of around 50x. This compares to the Small Cap P/E of around 11x (see page 3 Small Cap Valuation Graph). S&P 500 index concentration obscures what is happening beneath the surface as evidenced by the equally weighted S&P 500 being flat on the year. While timing is difficult, we continue to anticipate a "buy the laggards" trade that will meaningfully benefit our strategic allocation to small and mid-cap value-focused equities. A peak in interest rates is a catalyst for this inflection to occur.

Asset Class Returns Equity and Fixed Income, Year-to-Date

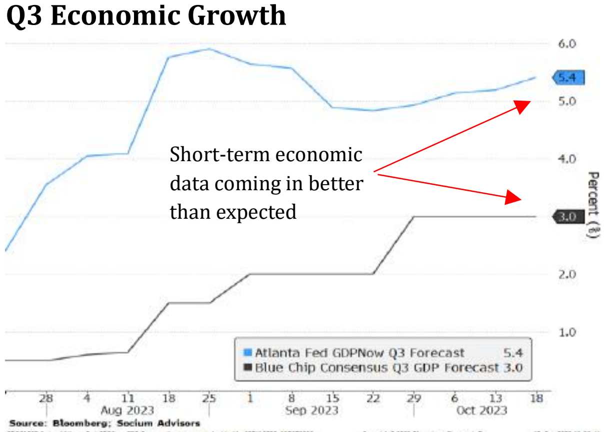


Source: Bloomberg; Socium Advisors
SPW Index (S&P 500 Equal Weighted Index) Returns Quarterly Daily 30DEC2022-30SEP2023

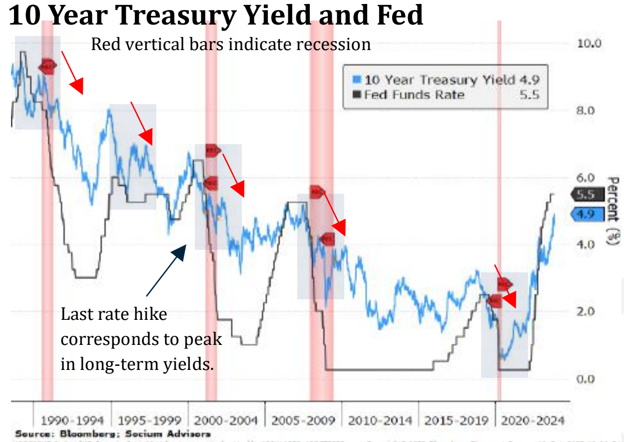
It's all about Interest Rates

Interest rates surged in the quarter as U.S. Q3 economic growth tracking data is running ahead of street forecasts with the consumer remaining resilient. We believe this puts the Fed in a "higher for longer" posture to bring inflation back to their 2.0% target. The equity and fixed income markets were thereby under pressure with the S&P 500 and Bloomberg Agg falling -3.3% and -3.2%, respectively, in the third quarter. The speed of the recent move higher in long-term interest rates is reverberating into the equity markets as cash flows are discounted at a higher rate and bonds now offer competitive alternatives to stocks. The Fed is watching the action in the bond market closely and, in our view, likely gives them some pause in moving rates much higher into even more into restrictive territory. The swaps market suggests we have likely seen the last hike of the cycle already- although we do expect December to be a "live" meeting where they could raise. Historically, when the Fed rate hike cycle ends, long-term interest rates peak. This would lift an overhang on the equity markets in particular for small and mid-sized companies which are more susceptible to higher rates in terms of refunding.

Q3 Economic Growth



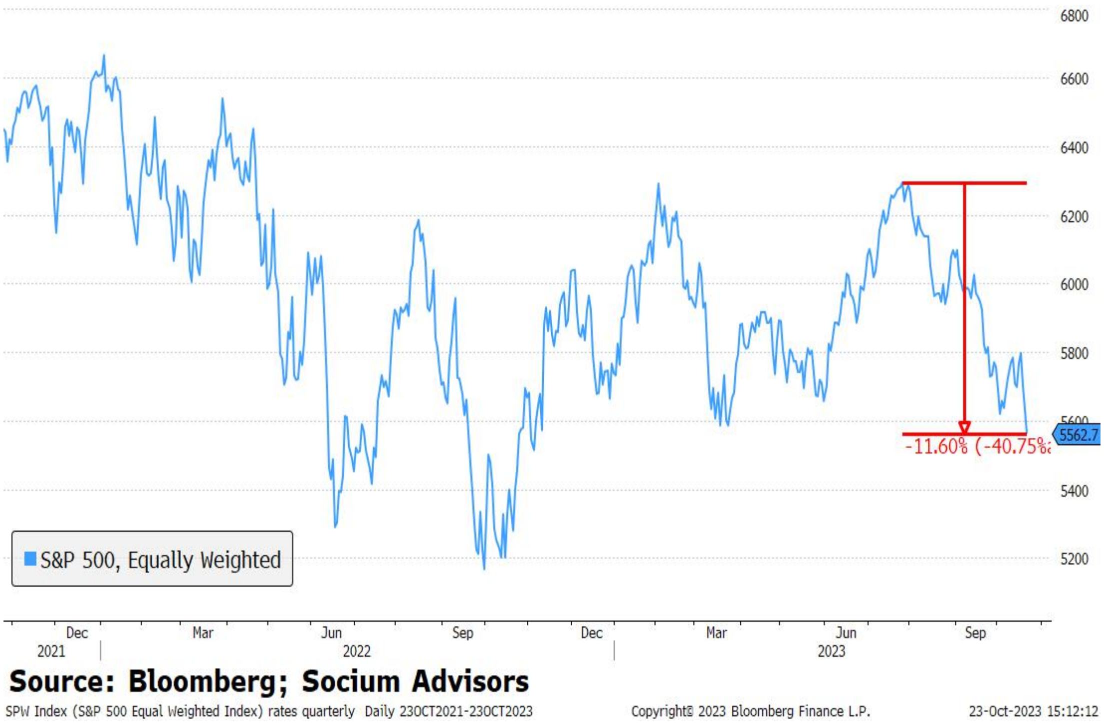
10 Year Treasury Yield and Fed

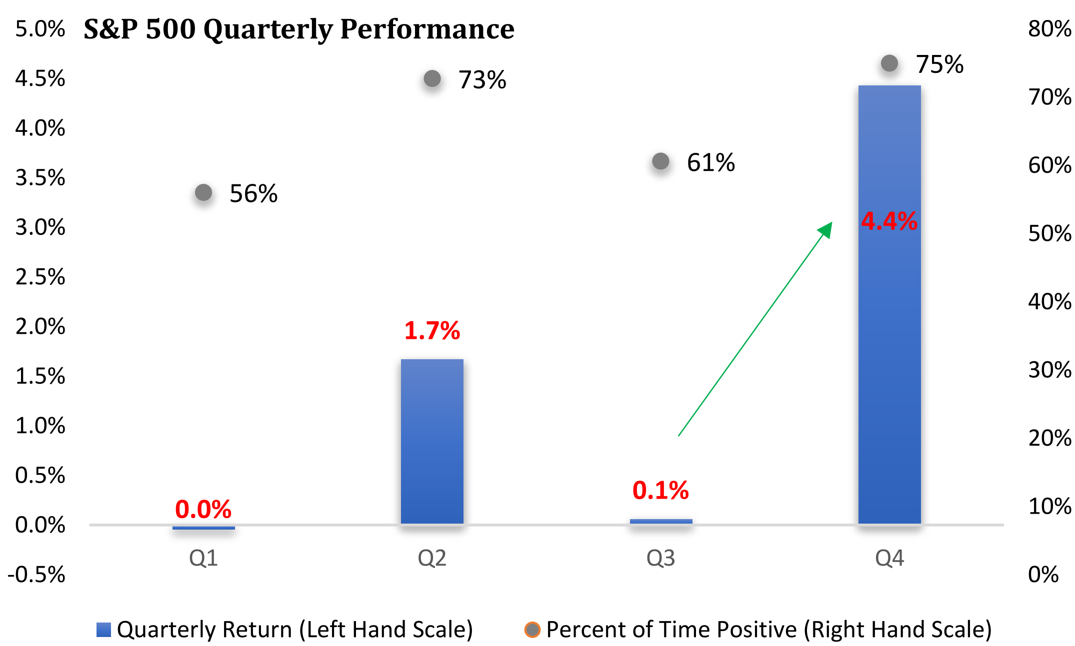


Moving into a period of historically strong seasonality

Equity markets corrected sharply in recent months with the S&P 500 equally weighted index falling nearly -11% peak to trough in a matter of weeks. It is important to remember this type of movement is not abnormal in the equity markets. On average, markets experience a 10% correction at some point each year and typically it occurs quickly. Seasonally, Q3 is weak, but you tend to see a strong rebound in Q4 as the average return is 4.4% with a positive hit rate of 75%. When Q3 is negative, as it was this year, returns are even stronger. Since 1990, there have been 11 times when Q3 experienced a negative return. Following a negative return in Q3, returns have averaged 10.6% in Q4 with 9 of the 11 years being positive.

Equity Market



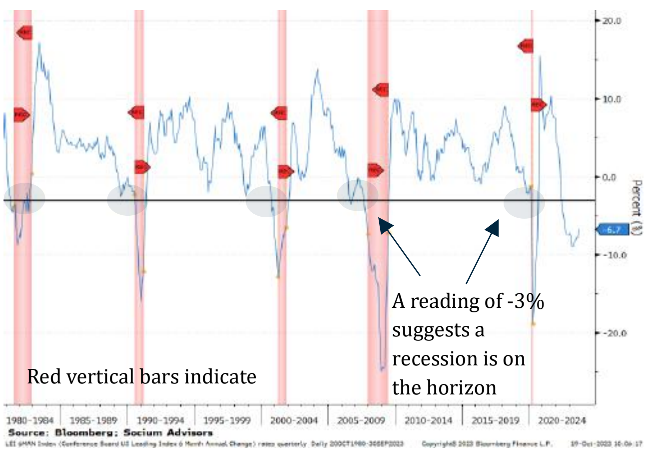


Source: Bloomberg; Socium Advisors SPW Index (S&P 500 Equal Weighted Index) rates quarterly Daily 23OCT2023

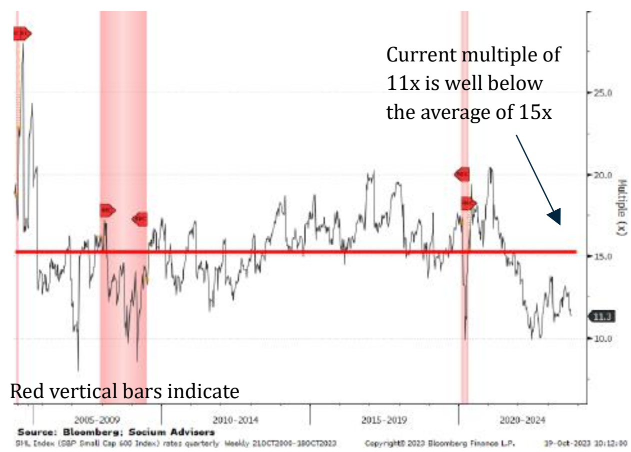
Recession is still our base case, but some of this risk is priced in

The U.S. economy has remained resilient in 2023 despite the significant rise in interest rates. The economy has been stronger than many had expected this year due to excess consumer savings following pandemic stimulus measures, late cycle fiscal stimulus from the Inflation Reduction Act and CHIPS Act, and a limited impact from rate hikes due to company's terming out their debt when rates were low. Our base case is the U.S. will enter a modest recession in 2024 or 2025 as excess savings are depleted, projects are denied due to a higher cost of capital, and the corporate refinancing cycle takes a toll. The leading economic indicators (LEI), which has a perfect track record of predicting past recessions, is flashing red. Despite this view, we find some of this recession risk to already be in the market. For example, small cap stocks which tend to be economically sensitive are trading at valuation levels seen during the depths of severe recessions and remain down -30% from their highs seen in 2021. Although currently down, we see compelling long-term opportunity in these stocks.

Leading Economic Indicators, 6 Month



Small Cap Valuation, Price to Earnings Ratio



Left Source: Bloomberg; Socium Advisors LEI 6MAN Index (Conference Board US Leading Index 6 Month Annual Change) rates quarterly Daily 20OCT1980-30SEP2023
Right Source: Bloomberg; Socium Advisors SML Index (S&P Cap 600 Index) rates quarterly Weekly 21OCT2000-18OCT2023

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