

Stapp Financial Investment Letter

Stapp Wealth Management, PLLC

Third Quarter 2023

"The stock market is a device for transferring money from the impatient to the patient."
- Warren Buffett

Market Recap

Compared to what we have seen over the last few years, the 3rd quarter was a relatively uneventful period. Investment assets rolled over as inflation and recession fears continue to push and pull at investor sentiment. The S&P 500 hit a peak for the year in July at 4,607 before rolling over and finishing the quarter at 4,288. The index is still roughly 500 points below its peak of 4,818 that was hit at the beginning of 2022. This continues to be a testing period for investors. Stocks across the board were challenged. Small cap stocks plunged by more than 5%, developed international stocks were down by 4%, and emerging market stocks lost 3% during the quarter.

The only positive asset for the quarter was high yield bonds, rewarding investors for taking a degree of credit risk. Investment grade bonds once again dipped into negative territory for the year. The worst period for bonds in market history continues, and we could be on track for three years of negative returns for bonds. We haven't seen that in over 40 years. Fortunately, bond losses lead to higher yields. Yields on the 10-year treasury note finished the quarter at 4.6%, the highest yield on 10-year treasuries we have seen in well over a decade.

Alternatives did well on a relative basis, but on an absolute basis, saw losses as well. Gold traded along with bonds and was down just over 2%. Managed futures were the second-best performer during the quarter, down just under 1% as they saw strength at quarter end.

Asset Class Performance		
	3 rd Quarter	Year-to-date
Investment Grade Bonds	-3.23%	-1.21%
High Yield Bonds	+0.46%	+5.86%
US Large Cap Stocks	-3.27%	+13.07%
US Small Cap Stocks	-5.13%	+2.54%
Developed International Stocks	-4.11%	+7.08%
Emerging Market Stocks	-2.93%	+1.82%
Gold	-2.18%	+3.13%
Managed Futures	-0.78%	-3.4%

Data as of 9/30/2023. Source: Kwanti Analytics¹

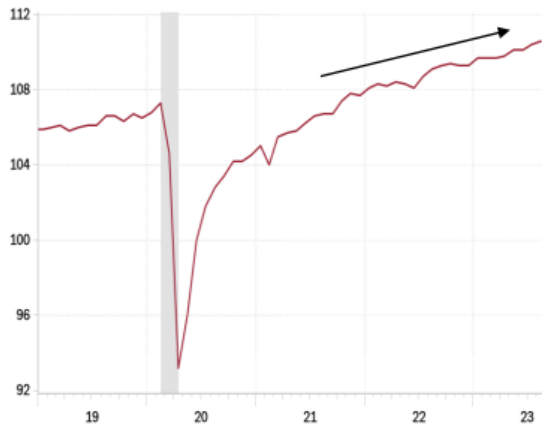
¹ Indexes used: Bloomberg US Aggregate Bond Index, Bloomberg US Corp High Yield, S&P 500 TR, Russell 2000 TR, and MSCI EAFE TR, MSCI Emerging Markets Index TR; Gold represented by the change in the gold spot price; Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.

Note: We have removed floating rate loans as they are not a significant asset class, and we no longer hold them in portfolios. We also replaced the Morningstar US Large Cap TR, Morningstar US Small Cap TR, and Morningstar Developed Markets ex-US indexes with the more commonly referenced S&P 500 TR, Russell 2000 TR, and MSCI EAFE TR indexes for the US Large Cap Stocks, US Small Cap Stocks, and Developed International Stocks performance categories.

Investment Outlook and Portfolio Positioning

We are nine months into 2023, and interestingly enough, we find ourselves in much the same place as we did at the beginning of the year. Recession fears are still top of mind for investors as leading economic indicators continue to decline. The current state of the economy, on the other hand, remains strong, refusing to roll over.

Coincident Economic Indicator (index)

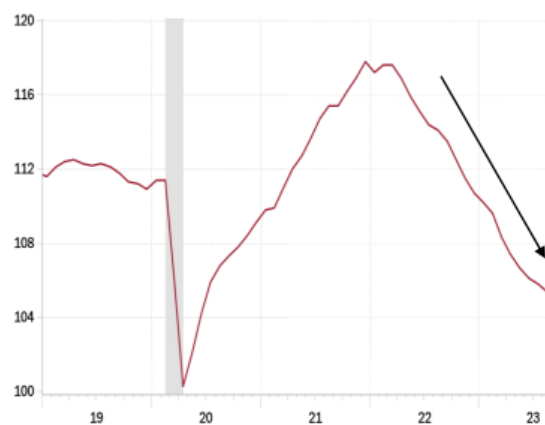


- Non-farm payrolls
- Real personal income
- Industrial production
- Manufacturing sales

Shading indicates recession

Source: Haver Analytics, Conference Board, Rosenberg Research

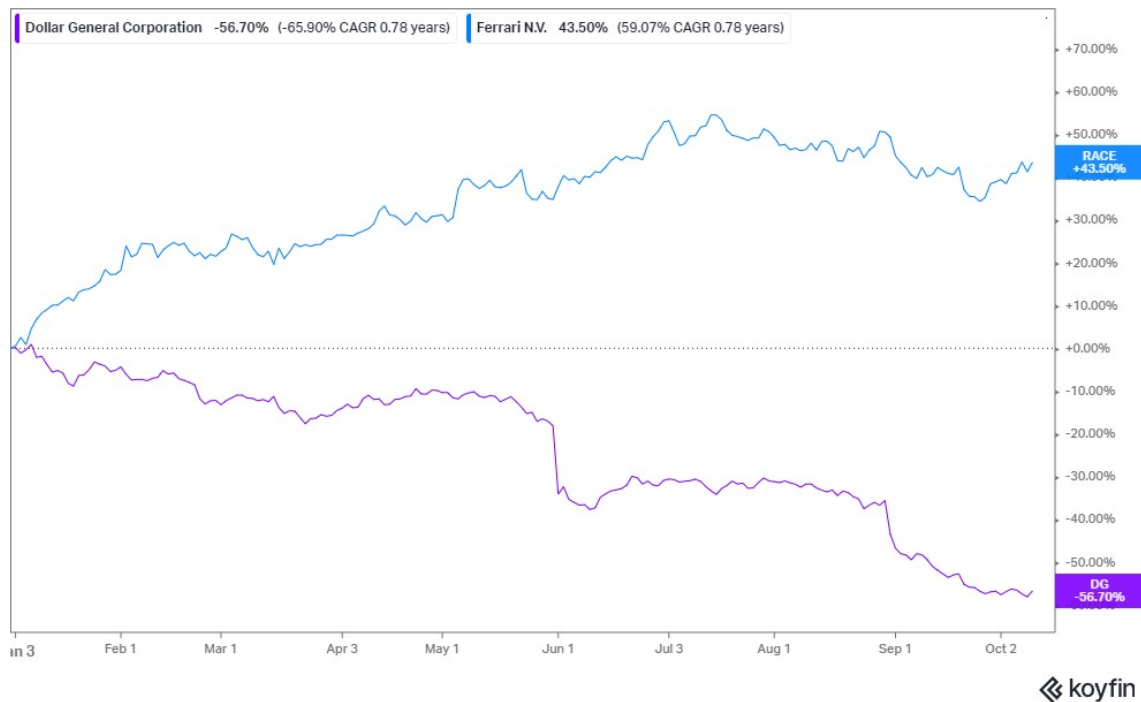
Leading Economic Indicator (index)



- Average weekly hours (manufacturing)
- Initial jobless claims
- ISM & manufacturers' new orders
- Building permits
- S&P 500
- Yield Curve
- UMich consumer expectations

The American consumer has been the biggest source of strength for the economy. The narratives during company earnings calls continue to confirm the unrelenting consumer. The CEO of Carnival Cruise Lines recently said the following: "We just have not seen any sign of slowdown. The only slowdown we see is as we're running out of inventory, it has to slow down. That's it. So we feel quite good." Higher income consumers still have excess savings from Covid and are having no problems spending money, but lower- and middle-income consumers are starting to feel a bit more challenged in this environment. We can see this divergence represented in markets in the performance difference between Ferrari stock and Dollar General stock. Ferrari is having one of its best performing years in a long time as they are unable to keep up with the demand for their supercars. This strong performance has propelled their stock up over 43% so far this year. Meanwhile, Dollar General, a supermarket that predominately serves lower-income households, has been struggling as their customers aren't fairing as well as the wealthy customers Ferrari serves. This has resulted in a stock decline of more than 56% this year for Dollar General.

“A recession for thee, but not for me!”



These stresses to the lower-income consumers are being compounded by a new trend of “premiumization” where businesses are introducing higher quality tiers of their goods and services while eliminating lower quality tiers in order to serve their wealthier customers who still have spending power.

The economy is in an overall tricky situation. We continue to have all of the dynamics of being late in the economic cycle: sub 4% unemployment rate, inverted yield curve, Federal Reserve tightening monetary policy, high inflation, etc. Yet, we have not seen this late-cycle phase roll over into a slowdown or recession. These last several years have been anything but a typical economic cycle, so while there are similarities to previous cycles, there are some notable differences. Among the wide array of research and analysis we consume on economic and financial matters was a recent letter by Alex Gurevich of HonTe Advisors, a hedge fund firm. His letter may have had the best description of this late cycle dynamic that we have seen. As he describes it, the typical late cycle pattern looks like the following sequence:

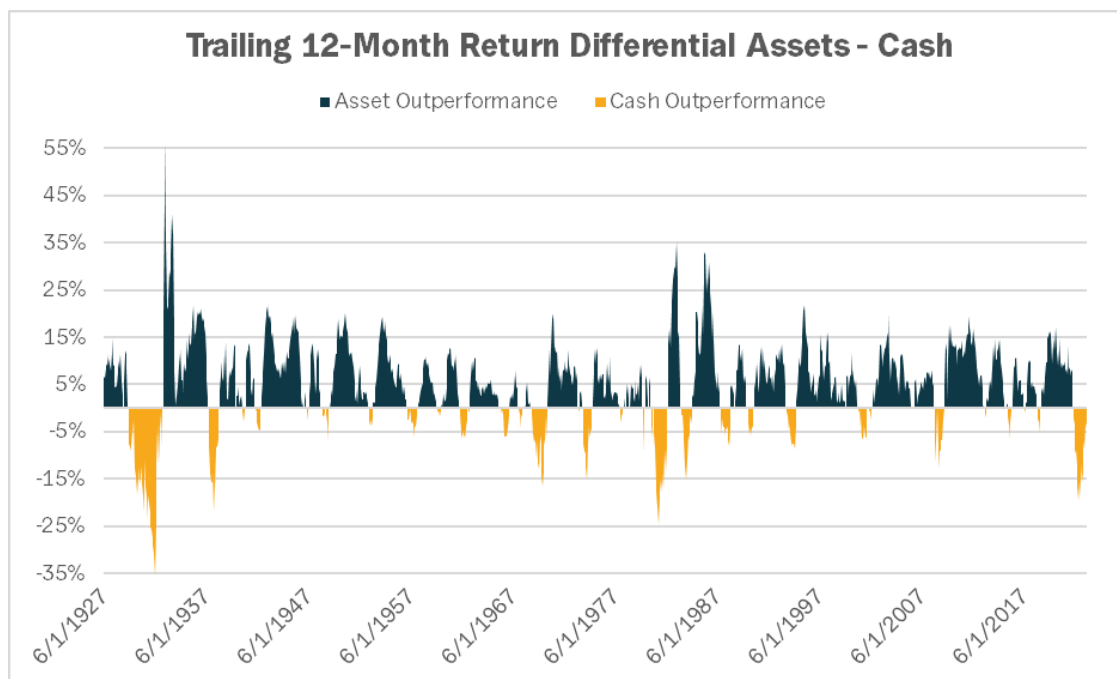
1. Interest rates rise
2. Stock market crashes
3. Economy slows
4. Unemployment rises
5. Inflation declines

Last year, we got through the first three steps of this process, but we stopped there and didn't see phase four or five. Most market participants and economic forecasters have been awaiting phase four and five, but instead, the unique dynamics of the flood of Covid stimulus and interest rates at generational lows have caused the the economy to remain more resilient than almost any forecasts suggested a year ago. Does this mean we have skipped the recession? Alex Gurevich thinks otherwise, suggesting that the late cycle pattern we experience could instead look like the following sequence:

1. Interest rates rise
2. Inflation declines and real rates rise
3. Unemployment rises
4. Economy slows
5. Stock market crashes (or not)

How long would it take for this sequence to play out? It's hard to say, but it could still align with our recession call that we have had - recession begins sometime between the second half of this year and the first half of 2024. Many consumers still have leftover Covid stimulus and wages have begun to rise, but higher interest rates are starting to bite. The risk of recession still remains high, but as we have stated in previous newsletters, it is not necessarily an inevitability. There are plenty of scenarios that could occur where we avoid a recession.

Given this view that a recession is likely to unfold in the semi-near future, a question we are often asked is "why not just be all in cash?" For many, this seems the obvious decision. With short-term rates now at 5.5%, an investor can have their funds in short-term treasuries, risk-free, and earn a 5.5% yield now, so why would you have your money invested in anything else? It's certainly true that there are plenty of times when it pays to be in cash. The following chart by Unlimited Funds highlights all the times when assets outperformed cash and when cash outperformed assets.



Source: FRED, Fama French, Yahoo Finance, Unlimited Analysis.

The results depicted are aggregated results and do not represent returns that an investor attained.

We can see that there are plenty of times when cash outperforms investment assets, but what this chart also shows is that investment assets outperform cash far more frequently than cash outperforms assets. Additionally, that outperformance has far greater depth than when cash outperforms. The truth is that everything we talk about in terms of markets and the economy has a high degree of uncertainty. When markets go down, it seems like they fall for obvious reasons, but many times when they go up, it seems

like there is no good reason they are going up. Yet, that's what markets have always done. Returns in investment assets also tend to be quite lumpy. Stocks, for example, can struggle for several years, and then be followed by years of tremendous performance of 20%+ returns per year. A whole decade's worth of performance can be concentrated in just a few years. If you miss these years, you miss a whole decade's worth of returns.

The success of Peter Lynch likely encompasses this concept best. As the head of Fidelity's Magellan Fund from 1977 to 1990, Peter Lynch achieved a 29.2% compound annual growth rate, one of the best investment track records ever. You would think that with performance like that, the investors in his fund would have been tremendously wealthy. However, that is not the case. Fidelity revealed that the average investor in the fund actually had a negative return. This was because many investors would buy into the fund after a period of strong outperformance and sell after a period of underperformance. The net result of this performance chasing meant that the average investor lost money in one of the best performing funds of all time. Peter Lynch said it best when he stated, "far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves." Of course, there is some nuance to this concept. We do believe that having some cash available to take advantage of opportunities when they arise is useful within portfolios. Also, it is wise to have cash available for short-term spending needs. What we caution against is pursuing unnecessarily aggressive investing strategies. In our view, trying to time the market by going all in cash and then trying to time back in is a very aggressive strategy that rarely works out.

Examining our portfolio positioning, the key investment themes of the last two quarters remain essentially the same: 1) still underweight stocks and bonds in aggregate, 2) a decent sized weighting in the bond-bullion barbell, pairing gold with 10-year treasury futures exposure in the case of an unforeseen negative event, 3) an allocation to alternatives that we believe will continue to benefit in this environment, but also benefiting the overall portfolio by increasing diversification, and 4) an emphasis on emerging markets, value, and commodity sectors within our stock allocation as we continue to believe they will best benefit in this environment and for several years to come. These themes underperformed in the first half of the year, but saw much better performance in the third quarter, leading to outperformance of our strategies during the quarter. The China re-opening did hurt some of these themes, mainly gold, commodities, and emerging markets, but despite the weakness of China's economy, the performance of these themes has been close to flat this year. This is very positive for these themes as many aspects of the macro environment suggest that they should have been much weaker this year. There is already talk of stimulus coming out of China. Chinese stimulus, combined with the ongoing geopolitical issues, should be very positive for these themes going forward. Speaking of China, one change we made during the quarter was to replace one of our emerging markets strategies with an emerging markets ex-China strategy. We would have made this change earlier, but we were unable to until after the Schwab transition. Direct exposure to China is not a risk we want to take in portfolios given the geopolitical uncertainty. Also, ignoring the geopolitical tensions, the business environment in China has been very unfavorable for businesses and for investors. We don't expect that environment to change anytime soon.

Closing Thoughts

As we head into the fall and winter months, we should expect a bit more volatility than what we saw during the summer. Seasonally, the summer is the calmest period in markets as many investors are away on vacation and major decisions are often delayed until the fall. This leads to the fall and winter being

a more volatile period for markets. Depending on how this volatility is realized, we may be presented with opportunities to take advantage of.

As always, we thank you for the trust you place in us to be the stewards of your capital. Please reach out if you have any questions or comments. We are always happy to scheduled time to discuss anything that may be on your mind.

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