Capital Market Review

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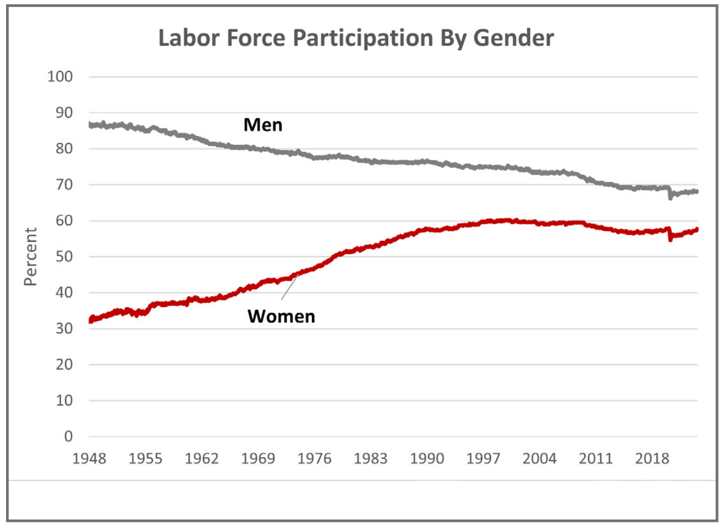
August 2023 Review

The summer stock market rally came to a halt in August. As volatility increased, the S&P 500 Index ended the month 1.6% lower than it began. The only S&P 500 sector ending the month higher was energy, while utilities brought up the rear with a 6.2% decline. I would describe last month's downturn as broad-based rather than attributed to a specific catalyst. After five consecutive months of gains, the most likely reason for a down month was investors taking some of their profits. Historically, August tends to be one of the poorest performing months of the year, leaving few surprised that it was a weak month.

Like 2022, the more surprising aspect of August was the continued rise in bond yields. The Federal Reserve increased rates by 25 basis points at their end of July meeting, but their messaging of keeping rates higher for longer sent rates higher throughout August. If we look back a few months, the market expected the Fed to begin cutting short-term interest rates towards the end of this year or the beginning of next. With inflation continuing to be stickier than anticipated and the labor market remaining strong, rate-cut projections have been pushed back further into next year. There is even the possibility of an additional rate hike or two before the Fed pauses.

Focusing more on bond returns, we are seeing the benefit of higher rates. While 2022 was painful for investors, bonds now pay more interest, helping offset rising rates. The 10-year U.S. Treasury Bond began the year at 3.88% and peaked during August at 4.34%, but bond indexes are positive this year, for the most part.

Economic data continues to present a Goldilocks scenario, increasing investors' confidence in the Fed delivering a soft landing, meaning the Fed successfully lowers inflation to their target without causing a recession. The labor market remains strong, although the unemployment rate increased to the still low rate of 3.8%. This increase was driven by more people entering the labor force than companies laying off workers. The largest gain in the labor force was driven by women, whose participation rate is now the closest to the men's rate since the data point was first recorded in 1948.



Source: FRED Graph (stlouisfed.org)

Labor remains strong, leading consumers to spend more to support economic growth, while inflation is still faster than what the Fed would like (although its growth rate has slowed over the past year). This brings us back to the theory that interest rates will remain higher for longer. The Fed is focused on inflation and wants evidence that it is under control before discussing rate cuts.

In a one-eighty from a year ago, many forecasters have changed their recession calls into expecting a soft landing. A Goldilocks economy seems like the perfect scenario, and it is. Still, investors must remember their long-term objectives, as they should in unfavorable environments. Murphy's Law is always waiting to rear its ugly head, meaning what can go wrong will go wrong. Goldilocks will not stick around forever, and it's anyone's guess what happens when she leaves. The best solution? Maintain a diversified portfolio that will participate if markets continue to rise or protect your assets should the markets fall.

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