MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

October 20, 2023

2023 Q3 Investment Commentary

During the third quarter of 2023, the positive themes that led to performance in the first half of the year endured; a "soft landing", slowing inflationary trends, a strong labor market, consumer resiliency, and improving corporate earnings. Markets reached new highs for the year but then succumbed to renewed concerns about a potential economic slowdown due to restrictive rates and the bloating Federal deficit. As a result, long-term yields broke higher, equity momentum waned, valuations compressed, and breadth deteriorated as markets retreated. The cyclical bull market remains intact but is being tested, keeping equity markets rangebound for now.

The US economy and job market remain strong. A recession is not imminent. The Atlanta Fed's GDPNow model currently estimates the US economy to be growing at 5.4%, up from the 2.1% growth we saw in the second quarter, as Retail sales rise more than expected and Industrial production is stabilizing. Since the end of June, the Blue-Chip consensus went from expecting zero growth in the quarter to now well over 3% (Chart 1). The labor market remains tight with the unemployment rate hovering at 3.8%. Payrolls continue to surprise to the upside, recently adding 336k to non-farm payrolls vs estimates of only 170k. Wages continue to grow, but at a moderate 2.4% annualized rate. But this good news has been poorly received. While these data points are positive, they add leeway for the Federal Reserve to prolong restrictive rate policy, increasing the likelihood of something eventually breaking.

The most significant shift in the quarter occurred in the bond market with long-term yields breaking higher, sending equities lower. The 10-year Treasury yield broke out to a 16- year high, rising nearly 1% since the end of June to nearly 5% (Chart 2). The move can be attributed to a flood of treasury issuance and massive increases to fiscal spending, quickly growing the fiscal deficit, now over 7% of GDP, as well as shrinking demand for treasuries by sovereign nations, notably China, and the Federal Reserve running down its balance sheet. The market is concerned by the fact the deficit is growing so quickly with strong employment and economic growth.

This move in yields was different than earlier in the cycle in that the long end moved higher while the front end did not. There has been no change in Fed Policy since the July meeting when they paused rates. The yield curve is beginning to un-invert, as term premium (extra yield that investors demand for holding longer-term debt) rises. This directly impacts long term borrowing, like corporate debt, bank lending and mortgages (the 30-year mortgage is nearly 8%, a 23 year high), which will weigh on margins and slow demand. On the positive side, this will aid in the Fed's tightening efforts and will likely take further rate increases off the table.

A narrow market, or poor breadth, continues to drive a divergence in equities and is challenging the new cyclical bull market. The concentration of gains among the biggest stocks is one of three features that distinguish this cycle (Chart 3). That typically happens at the end of bull markets, late-cycle, not at the start. The other two unusual features are poor bank performance and the lack of a recession from which to recover. In the first year of a new bull, banks typically lead the market higher, as investors anticipated the end of the recession. The explosion of AI further drove market divergence as large cap Tech has benefited most. Small-cap stocks are now trading at 20-year valuation lows relative to large cap. Breadth has been highly correlated to the 10-year Treasury yield (Chart 4). A reprieve in bond yields is needed for equities to trend higher. Because this new cycle is atypical, it doesn't mean it won't last. Further confirmation is needed.

For Q3 2023, according to Factset's October 20th *Earnings Insight*, the expected year-over-year earnings decline for the S&P 500 is -0.4%, an improvement from -4.1% decline in Q2. Revenues are expected to grow 1.8% and margins have stabilized around the 5-year average. For Q4 2023, analysts are projecting earnings growth of 6.7%. For 2024, analysts are projecting earnings growth of 11.7%. Forward P/E valuations are 17.7, in line with the 10-year average. The 12-month bottom-up target price for the S&P 500 is now 5103, 19% above Fridays close. Estimates are supportive of higher prices (Chart 5).

The tragic war in Israel has renewed geopolitical concerns for spreading conflict and unrest. As we saw with the Ukraine and Russia war, if contained, it should not have a material effect on the US economy or our markets. Established trends will take over after a short period of headline volatile.

Our playbook continues to focus on significant secular, cyclical, and structural trends. Innovation continues. We favor moderately cyclical sectors over defensive and will continue balancing portfolios with high-quality growth at reasonable prices and businesses with stable free cashflow and healthy balance sheets.

Bond yields and market breadth continue to warrant attention as we enter a seasonally strong period. We maintain that employment, and thus consumer spending (2/3 of GDP), is the key economic barometer. We will respect the current trends and cautiously await further confirmation.

Morse Asset Management Investment Team

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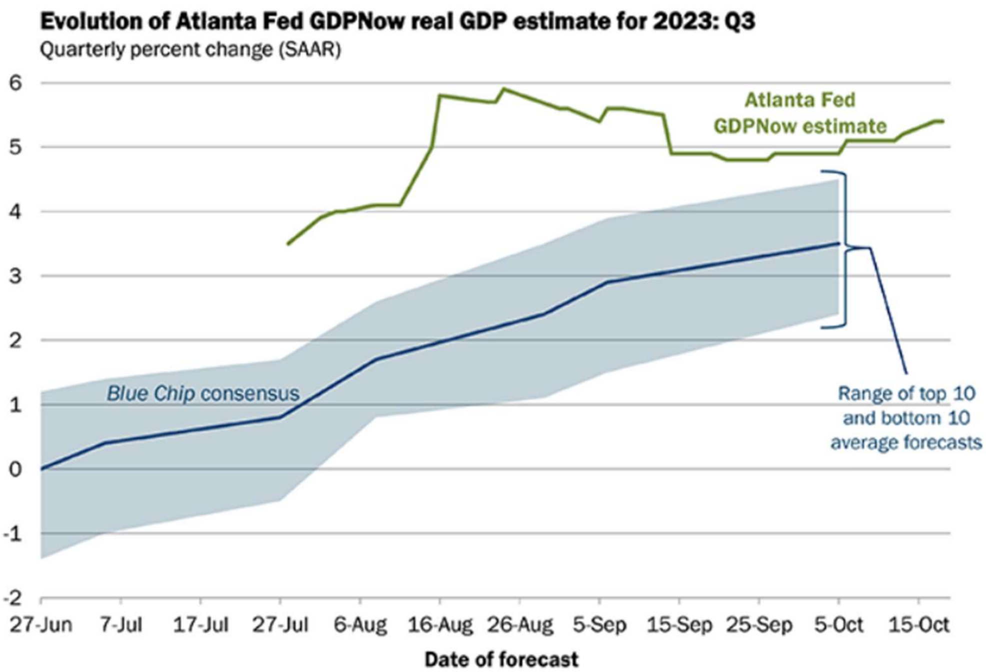

Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

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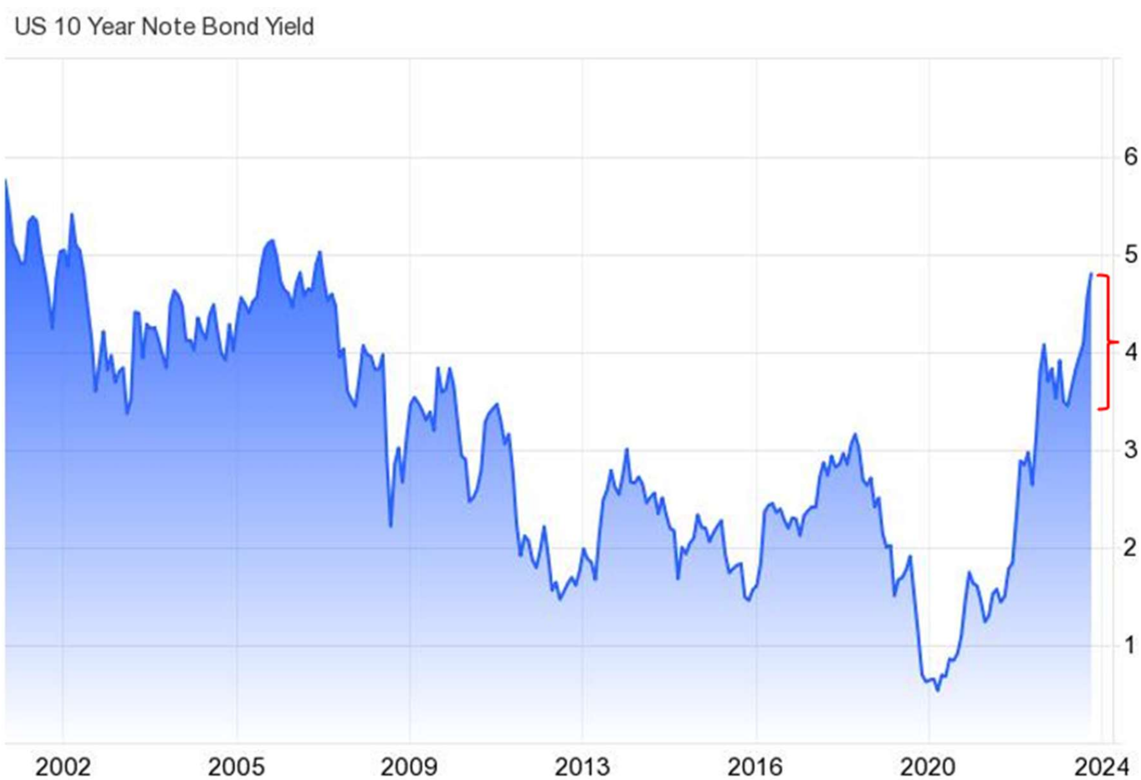

source: tradingeconomics.com

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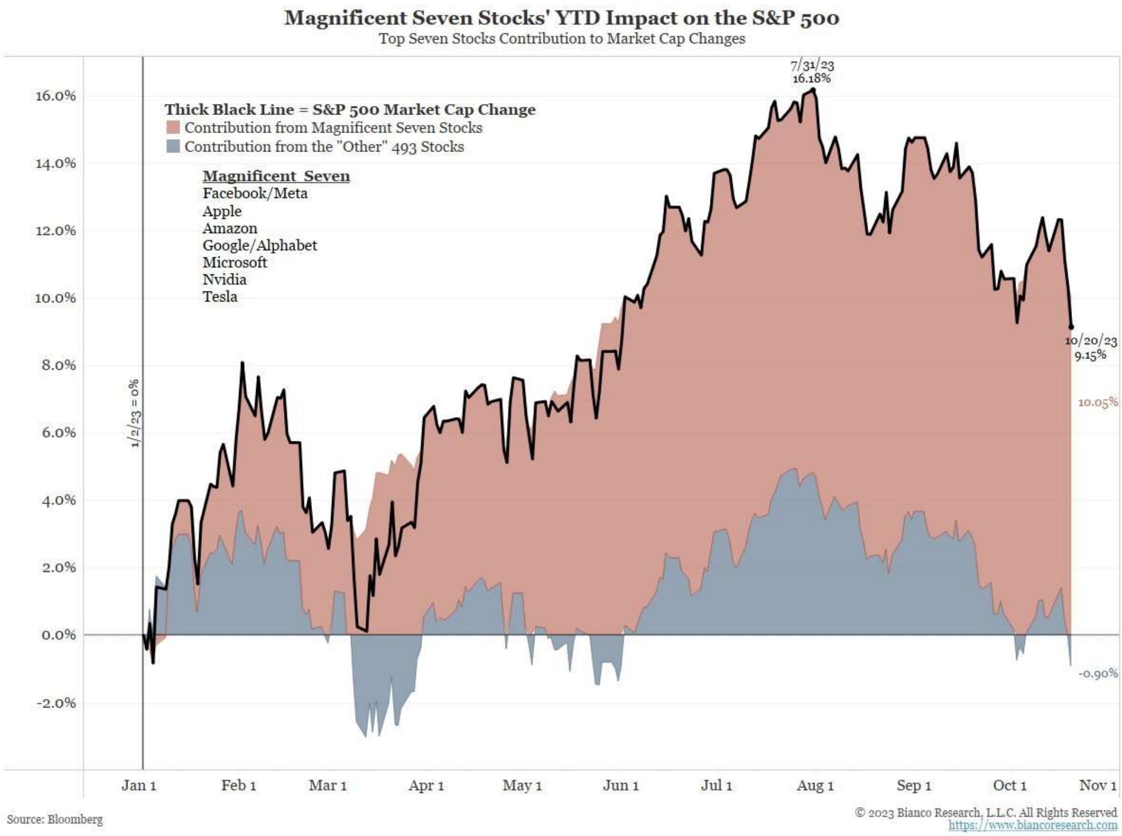
Magnificent Seven Stocks' YTD Impact on the S&P 500
Top Seven Stocks Contribution to Market Cap Changes
Thick Black Line = S&P 500 Market Cap Change
Contribution from Magnificent Seven Stocks
Contribution from the "Other" 493 Stocks
Magnificent Seven
Facebook/Meta
Apple
Amazon
Google/Alphabet
Microsoft
Nvidia
Tesla
7/31/23
16.18%
10/20/23
9.15%
10.05%
-0.90%
1/2/23 = 0%
Source: Bloomberg
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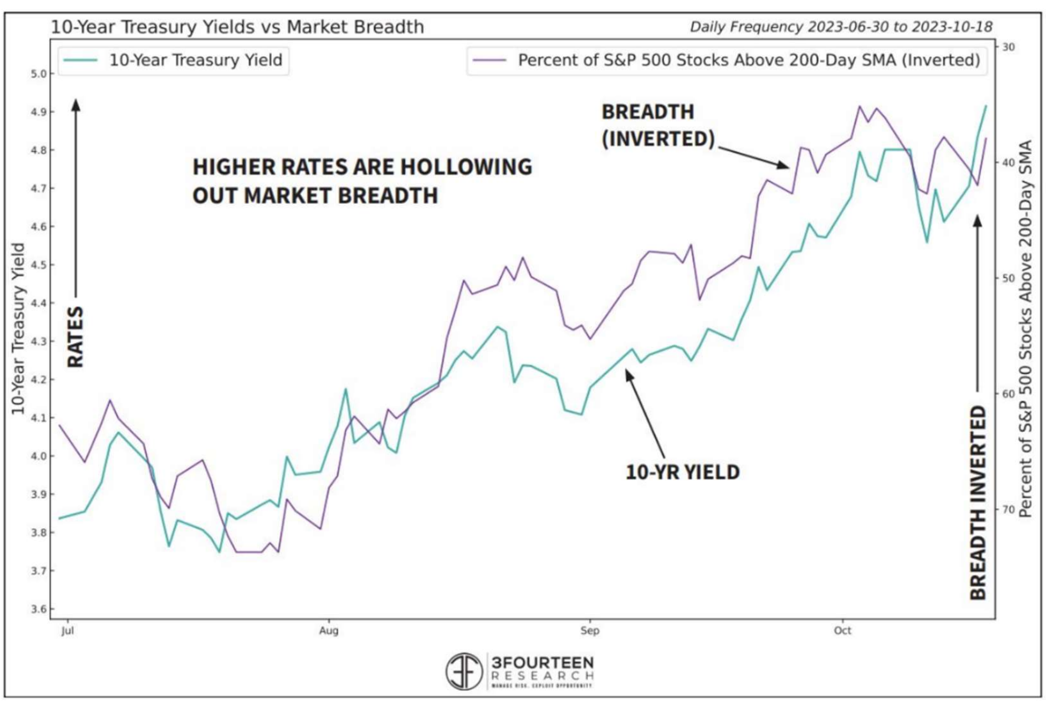
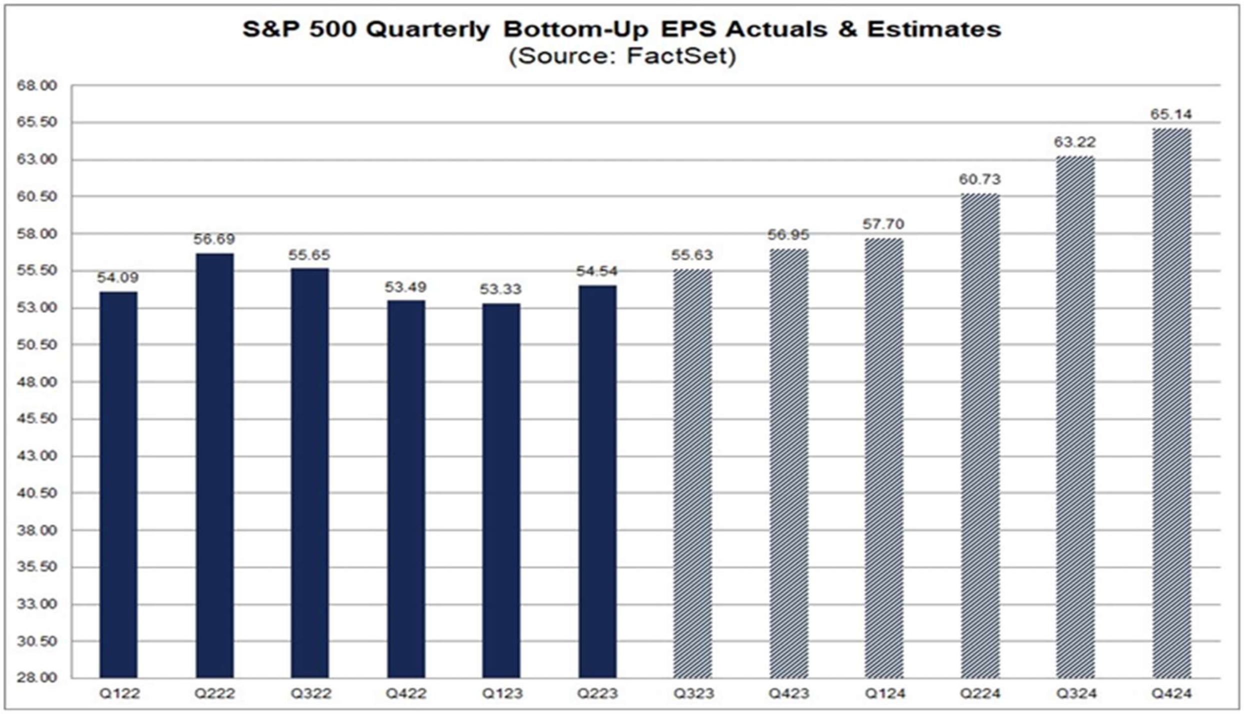

10-Year Treasury Yields vs Market Breadth
Daily Frequency 2023-06-30 to 2023-10-18
10-Year Treasury Yield
Percent of S&P 500 Stocks Above 200-Day SMA (Inverted)
HIGHER RATES ARE HOLLOWING OUT MARKET BREADTH
BREADTH (INVERTED)
RATES
10-YR YIELD
BREADTH INVERTED
10-Year Treasury Yield
Percent of S&P 500 Stocks Above 200-Day SMA
3FOURTEEN RESEARCH

5.


S&P 500 Quarterly Bottom-Up EPS Actuals & Estimates
(Source: FactSet)
68.00
65.50
63.00
60.50
58.00
55.50
53.00
50.50
48.00
45.50
43.00
40.50
38.00
35.50
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