FOLLOWING THE FUNDAMENTALS

4TH QUARTER 2023: ISSUE 28

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

SPOOKY SEASON: 2023 EDITION

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

As we enter the 4th quarter, we are keeping a watchful eye on the traditionally weak seasonal trends that accompany the late summer and early fall months and how those trends may affect the portfolios we manage. After a strong start to the year, the S&P 500 has been falling in line with those seasonal trends as the index has retraced lower over the last 8-10 weeks. Since posting a 52-week high on July 27th, the S&P 500 is down 6.92% through the end of September. (ThomsonOne) In last year's 4th Quarter Following the Fundamentals update, we discussed potential reasons why late summer and early fall months tend to experience relative weakness compared to other times of the year.

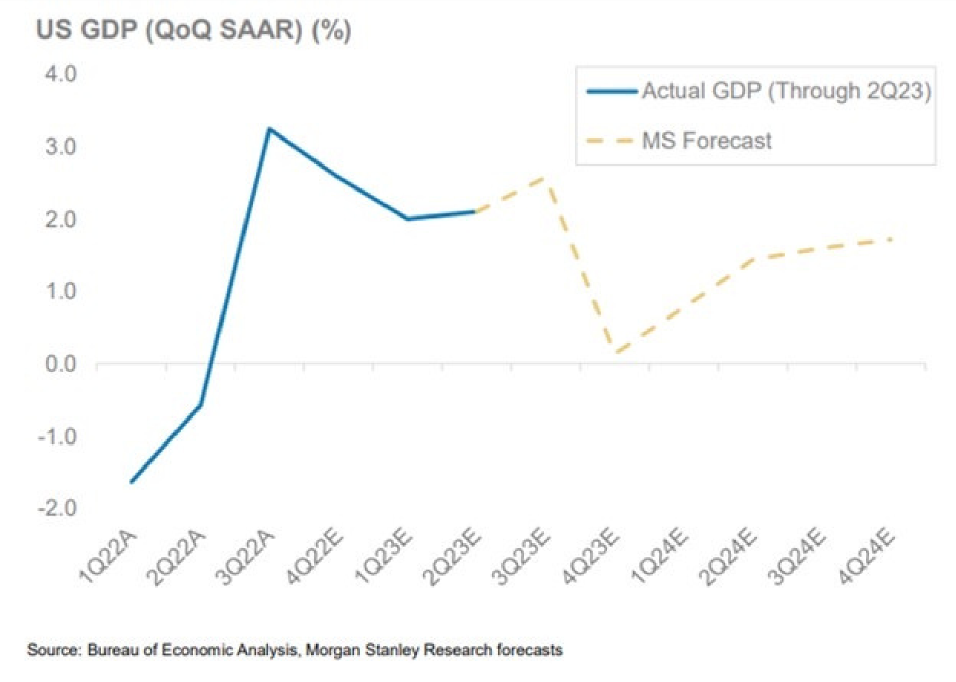
This quarter's theme, "Spooky Season" may seem familiar as it is the same theme we used for last year's 4th Quarter issue. When we were considering different themes for this update, we were struggling to come up with a fresh idea. We reached out to Hollywood for help, but couldn't find anyone willing to cross the picket line of the writer's strike. When we turned to ChatGPT, we learned it wasn't nearly as creative as what we needed, so we dusted off last year's topic and are revisiting the "Spooky Season" theme. Similar to last year's update, we will be covering current economic conditions and emphasize why ghouls, goblins, and scary creatures (AKA – Children with sugar overload) aren't the only things to keep an eye out for during the "Spooky Season".

IN THIS ISSUE WE'RE COVERING

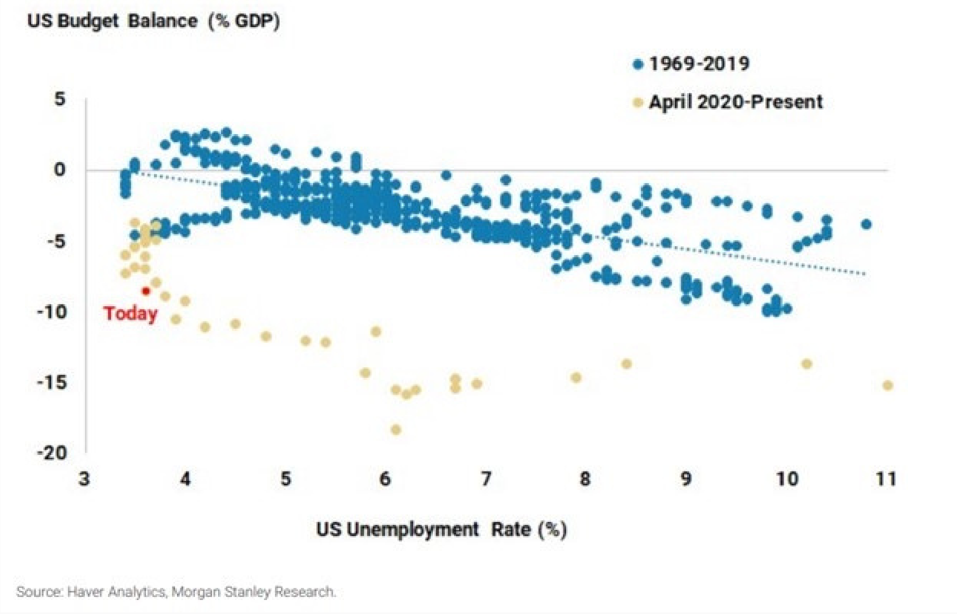
4300 E. 53rd Street
Suite 300
Davenport, IA 52807
563-344-4327

ECONOMIC ACTIVITY & FISCAL STIMULUS

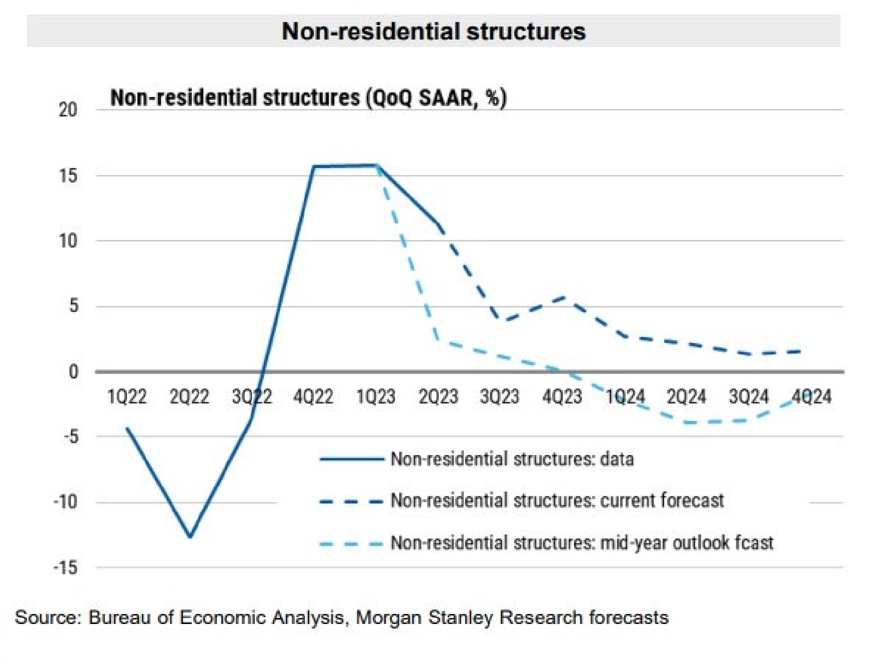
In recent updates, we covered high inflation rates in the US and the aggressive actions the Federal Reserve has taken to raise rates to combat that inflation. Due to the fast pace of interest rate hikes, many on Wall Street were expecting economic activity to continue to slow in 2023 as it did in 2022. At the start of the year, economists at Morgan Stanley expected domestic GDP growth to be 0.4% for the year. However, as seen below, GDP growth has surpassed expectations and Morgan Stanley recently upped their expectations to 1.7% growth for 2023.



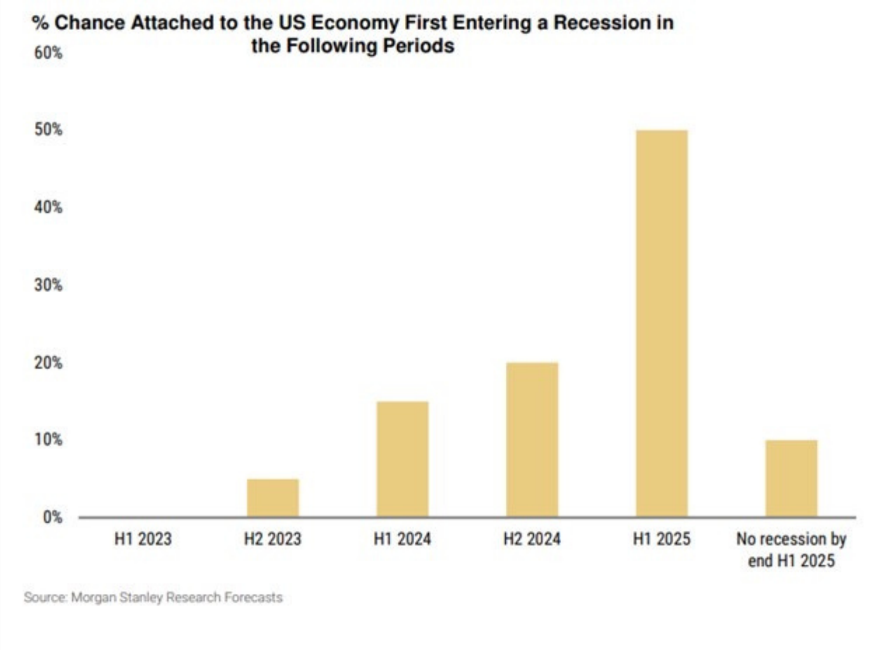
With the S&P 500 off to a hot start for the year and GDP surprising expectations to the upside, many are wondering what has led to these surprises. We believe the answer can be found in the chart below showing a regression analysis of the US Budget deficit/surplus and the unemployment rate. The US budget deficit is at levels rarely seen in the last 50+ years and at levels never seen with the unemployment rate this low.



We believe the current budget deficit stems from Covid era stimulus, and that deficit has kept US economic activity at elevated levels. In the below chart, you can see the large spike in growth in Non-residential structures in the 2nd half of 2022 and into the 1st half of 2023. This growth in Non-residential structures has made up large portion of the economic growth experienced the last 9-12 months. We believe this growth can be attributed to the fiscal stimulus that stems from the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act.



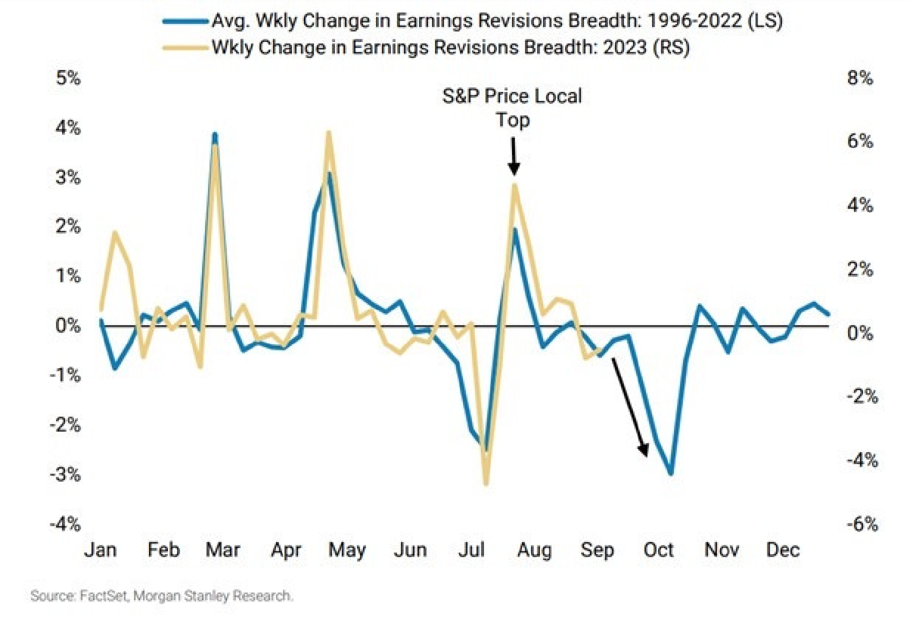
With economic activity surprising to the upside and many economists raising their economic forecasts for the year, economists have also started to push back the expected timing of a recession. Recently, Morgan Stanley economists updated their expectations and now see a 50% chance of the US entering a recession in the 1st half of 2025.



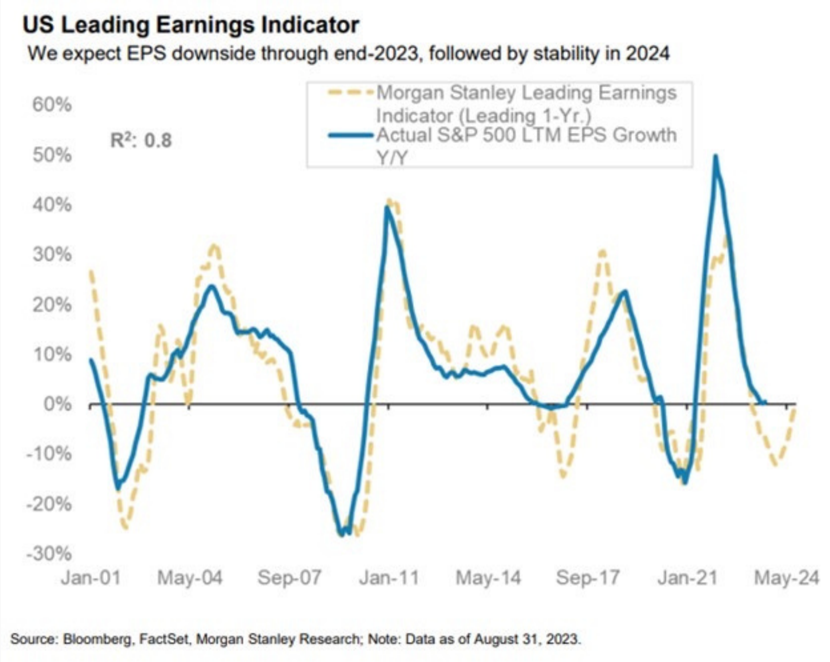
Source: Haver Analytics, Morgan Stanley Research

SPOOKY SEASON

While the surprise in economic activity has pushed back Morgan Stanley's recession expectations, we believe we are still facing short term headwinds for the S&P 500. As we discussed in last year's Spooky Season update, September and October have historically been months when analysts on Wall Street make significant cuts to the earnings expectations of companies they follow. If this trend holds as it has throughout the year, we expect to see cuts in earnings expectations over the next 4-8 weeks.

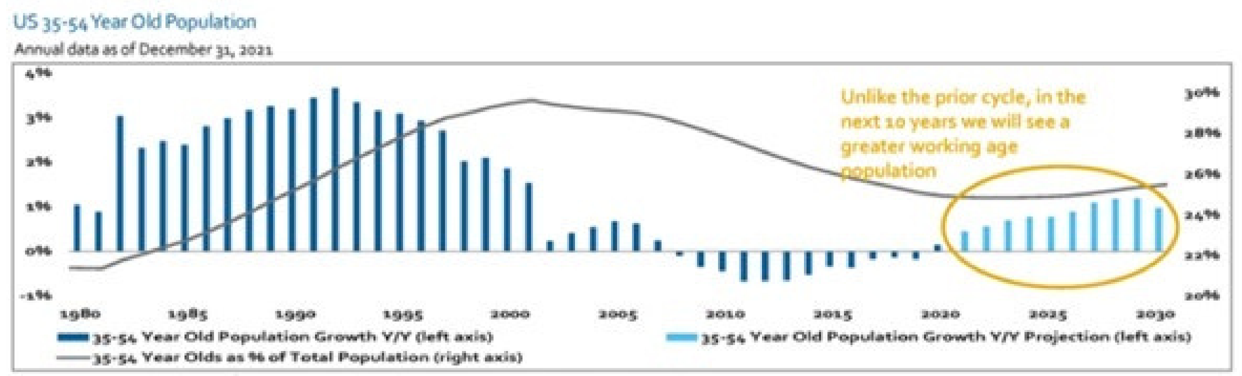


The short-term seasonality trend in earnings revisions also matches up with Morgan Stanley's Leading Earnings Indicator Model. The Leading Earnings Indicator model suggests that earnings expectations of the S&P 500 are set to decline and potentially trough for the current cycle at some point in the next 6-9 months. If earnings expectations for the S&P 500 were to align with Morgan Stanley's model, we believe that will act as a headwind for the performance of the S&P 500 during that same time frame.



CONCLUSION

Over the past 18 months we have expressed our concerns about the short-term returns of the S&P 500 and have remained cautious in the portfolios that we manage. As of the publication of this note, we have not seen any data to change that long-held opinion and we expect conditions to worsen over the next 6-9 months. However, we also want to highlight the chart below as one of the many reasons we feel much better about the stock market and the economy in the future. As seen below, the 35–54-year-old working age population in the United States is expected to grow significantly over the next few decades as the Gen Y and Gen Z mature. This is a significant difference in demographics from what we saw between the years 2000 and 2015 as we suffered through the previous secular bear market. As this population gains employment, forms families, and builds homes, we believe the economy of the US will see significant growth leading to growth of earnings for the companies we invest in. It's key to remember that the market will move based on short term headlines, but ultimately, the direction of the stock market is guided by economic and corporate earnings expansion or contraction.



Source: Haver Analytics, Morgan Stanley Wealth Management GIC. *Estimates by the Census Bureau from 2020 on.

JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on October 17th at 6:00 PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index.
Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other important information about the mutual fund. Read the prospectus carefully before investing.

Treasury and Government Money Market: You could lose money by investing in the Fund. Although the Fund seeks to preserve your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

You could lose money by investing in a Money Market Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund’s liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

This material has been prepared for informational and illustrative purposes only. It does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley Smith Barney LLC. Member SIPC. CRC5990758 10/23