ICR® 3rd Quarter Newsletter – October 2023

Markets pulled back in the third quarter, with the S&P 500 losing 3.7% as rising yields weighed on stocks. After being the biggest laggard in the first half of the year, the energy sector led the way in the quarter, posting a 12% gain as oil prices rose almost 30%. Interest sensitive sectors, real estate and utilities, continued to be the biggest laggards with losses of almost 10% each during the quarter.

Foreign markets didn't fare any better, with the MSCI EAFE Developed Country Index losing 4.7%, though over half of that loss was due to the relative strength of the dollar. Emerging markets were a similar story, losing 3.7% in the third quarter. The price of gold retreated by more than 3%, though it has been rallying since the end of the quarter in the wake of the conflict in Gaza.

The biggest story in the markets remains the steady rise in interest rates, despite the Federal Reserve pausing their interest rate hiking campaign. The yield on the 10-year Treasury note rose from 3.84% to 4.58% in the third quarter, causing a 3.2% loss in the Bloomberg Aggregate Bond Index. That just adds to the massive losses for 10-year Treasury bondholders who have now experienced a drawdown of over 25% over the past two years, which is the largest in U.S. history.

Bond Market's Risk/Reward

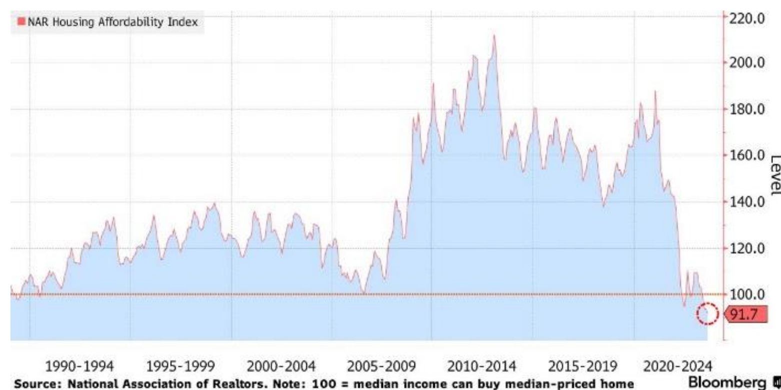
Estimated 12-month total returns based on different yield movements

	300bp rise	150bp rise	50bp rise	50bp fall	150bp fall	300bp fall
2-year Treasury	2.3	3.7	4.6	5.53	6.5	7.9
5-year Treasury	-5.5	-0.6	2.9	6.45	10.2	16.1
10-year Treasury	-14.9	-5.8	1.0	8.34	16.4	29.8
20-year Treasury	-24.7	-11.6	-1.1	11.37	26.0	53.2
30-year Treasury	-30.4	-15.7	-2.9	13.19	33.5	74.7

Source: F/m Investments, Bloomberg Bloomberg

The good news is that with yields having risen to their current levels, the risk/reward calculation is now skewed in favor of owning bonds. As seen in the table to the right, decreases in interest rates from here would provide a larger gain than the loss from a commensurate rise. For example, a 150 basis point fall in the ten-year yield would result in a 16.4% gain over the next year, whereas a 150 basis point increase would only cause a 5.8% loss. When yields were near zero, many were referring to bonds as "return-free risk," but that has changed and bonds now offer respectable prospects for future returns, despite the losses they've experienced over the last two years.

One of the biggest impacts of higher yields on the average person is in the form of mortgage interest rates. In just the last two years, the average 30-year mortgage rate has risen from around 3% to about 8% as of this writing. To put that in perspective, someone buying a $500,000 house with a 20% down payment in 2021 would have a monthly payment of $1,686. Currently, that same person would be assuming a monthly payment of $2,824. Over the life of the loan, the homebuyer in 2023 would pay about $450,000 more in total than the same homebuyer in 2021. As seen in the chart to the left, home affordability is now the lowest it has been since 1989.



With affordability at historic lows, it's not surprising that the housing market has slowed this year. Existing home sales just recorded their lowest seasonally-adjusted level since 2010. And it's not just because homes are unaffordable for first-time homebuyers. Almost two-thirds of existing mortgages are below 4%, so those people likely feel "stuck" because if they were to sell their house and buy a different one, they would have to get a new mortgage at a much higher rate than what they currently have.

One might think that home prices would have to come down to compensate for the higher mortgage rates, but so far that hasn't happened. That probably has to do with the limited supply of houses on the market. Other than simply waiting for either prices or rates to come down, potential buyers have been forced to hold their nose, pay top dollar, and take on a high-rate mortgage. For those who remember buying a house in the 1980s, 8% likely doesn't sound all that high, but we've been living in a very low interest rate world for the last 15 years, so the sudden change in just two years is jolting.

This new world of higher interest rates provides challenges like decreasing the affordability of housing, but also provides new opportunities – especially for savers who can now take advantage of higher yields on their bond and cash investments. With inflation (slowly) coming down, yields on these instruments are now actually outpacing inflation. All eyes will be on the Fed in the coming months and how they react to new Consumer Price Index readings. If inflation proves persistent, it's possible we will see interest rates move even higher.

As always, thank you for allowing us to help you achieve your financial goals. Please don't hesitate to call or email with any questions or thoughts you may have.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 9/30/23)

Index	**2023 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	11.7	8.4	8.0
Dow Jones Industrial Average	1.1	6.5	4.8
U.S. Aggregate Bond Index	-1.2	-5.2	0.1
MSCI EAFE (Foreign Index)	4.5	3.1	0.6

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