Patten & Patten

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QUARTERLY INVESTOR LETTER

Reversal Quarter

Reversal was the theme of the Third Quarter. Through the first half of the year, stock market gains reflected an extreme narrowness last seen during the dot-com bubble. A mere handful of stocks (the “Magnificent Seven”) contributed the entire gains of the S&P 500 index. The other 493 stocks posted an aggregate negative total return. Artificial intelligence was the common attribute of market leadership, and we cautioned against unrealistic growth expectations for the innovation. During the Third Quarter, market breadth improved as leadership succumbed to gravity and the average stock performed better. Seasonality and concerns over a government shutdown contributed to heightened volatility as the quarter drew to a close.

Outlooks

Bond yields collapsed in the First Quarter as several regional banks failed. They remained at low levels as the recession outlook grew popular. At the beginning of the Third Quarter, we felt economic sentiment remained predominantly negative. Economic data during the quarter vindicated our optimism. As the prevailing narrative from the Spring reversed, the yield on the 10-year Treasury climbed from 3.8% to above 4.5%. Market sentiment rapidly shifted to a consensus “soft landing” outlook.

Resilience

The US economy has demonstrated remarkable resilience. In addition, the Fed maintained a hawkish monetary policy posture with defeating inflation the primary objective. Nevertheless, bond market participants stubbornly expected rate cuts, and yields rose during the quarter when investors reversed positioning. We anticipated these developments and argued last quarter that a bond market adjustment was highly probable. We also identified value among shorter Treasury maturities and cautioned against longer maturities.

Impact of Higher Rates

We acknowledge the lagged impact of higher rates on the economy. Therefore, it is premature to dismiss recession probabilities. Moreover, we become wary when consensus shifts rapidly. Consumers have nearly depleted excess savings accumulated over the past three years. Certain economic indicators suggest a slowing economy, and there are growing signs of credit pressures. However, higher rates primarily hurt borrowers, and many people have not sought financing in the new rate environment. For example, approximately 80% of mortgages are fixed at rates below 5.0%. At the same time, savers now earn five times more on cash than the prior fifteen years.

A so-called economic “soft landing” scenario implies moderating inflation with growth sufficient to avoid recession. The Fed’s track record with respect to soft landings is mixed, at best. Higher rates have the additional impact of reducing valuations of all financial assets. Consequently, further market adjustments are likely to include equities and real estate. The duration and intensity of corrections are dependent on the state of the economy and corporate earnings growth.

It is prudent to remain vigilant with respect to negative trends in certain sectors. Economic conditions in China, particularly its real estate sector, are concerning. The global economy cannot escape the impact of a recession in the world’s second largest economy, but a recession in China is also likely to further dampen inflation. For these reasons, we agree with consensus that the Fed is near the end of its rate hikes. We look forward to meeting with you to review accounts and discuss our outlook.