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HORAN Capital Advisors

Quarterly Investor Letter

Fall 2023

"If something cannot go on forever, it will stop."
- Stein's Law

HORAN

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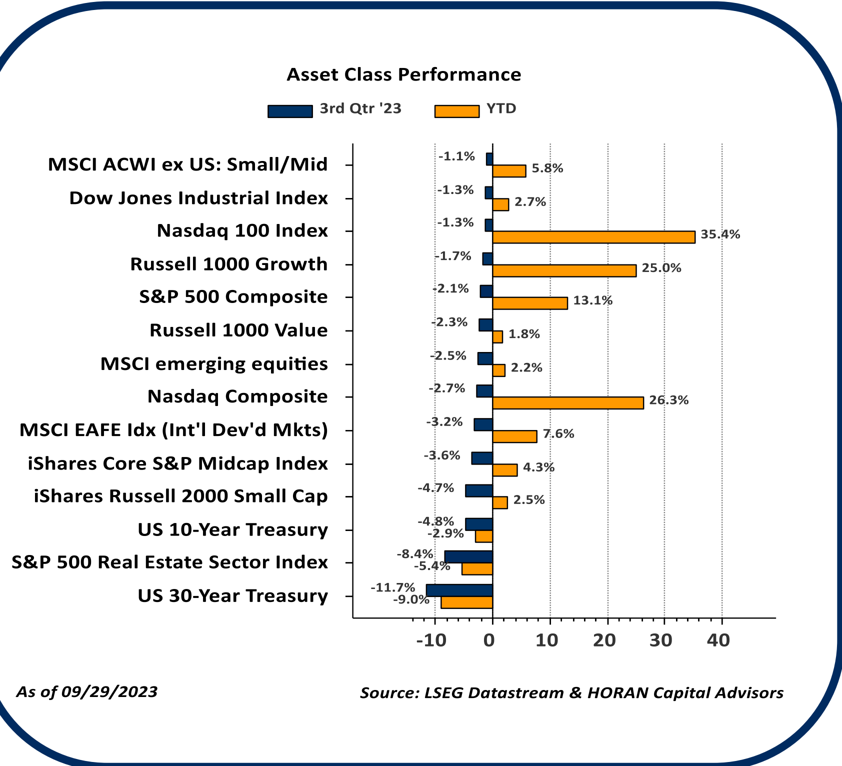
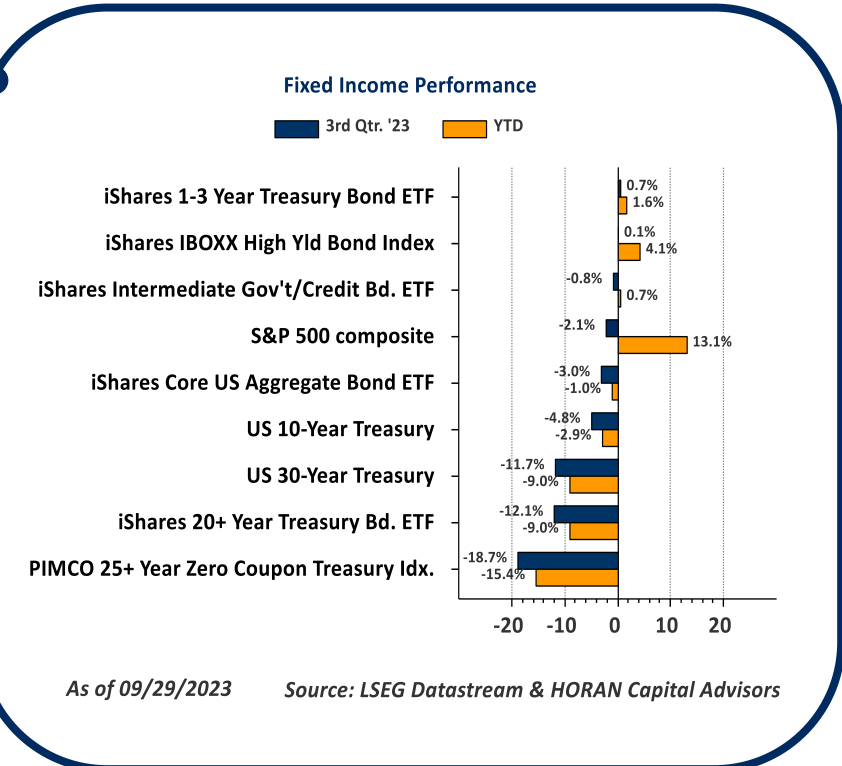
A Third Quarter Pause

The third quarter saw a pause across many asset classes following a strong first six months of the year. Although the declines in the quarter were low single digits, the market weakness picked up steam as the quarter progressed. One area of the market that experienced significant weakness was in the bond or fixed income market, particularly long-term bonds. Some of the weakness in bonds can be attributed to the strong economic data investors received over this time period. The better economic data did not go unnoticed by the Fed as their comments following the September FOMC meeting led investors to believe interest rates will be higher for longer.



The other factor influencing bond yields in the quarter was the credit rating firm, Fitch, downgrade of the credit rating for the U.S. government to AA+ from the highest rating of AAA. This downgrade follows Standard & Poor's 2011 downgrade. With the U.S. Government spending money in excess of what is taken in, the level of government debt is on an unsustainable path. This deficit spending requires the issuance of more bonds to operate the government, and as supply increases, the price of bonds fall, pushing interest rates higher. As a recent Wall Street Journal article noted, "Total federal government spending was $4.4 trillion in fiscal 2019. Four years later, in 2023, Washington spent about $6.4 trillion. The federal debt has surpassed $33 trillion, and the deficit for 2023 alone approached $2 trillion. Federal spending, deficits and debt are out of control, as is the dysfunctional appropriations process that facilitates spending."



The interest cost is now approaching $1 trillion annually and the average weighted interest rate as of August 2023 was 2.92%. This implies that if market interest rates remain where they are today the Federal interest cost will climb significantly over time. The higher interest rates on government debt have led to higher bond rates broadly; hence, the negative returns generated by bonds this year, after a negative bond return in 2022.

Earnings – A Bright Spot

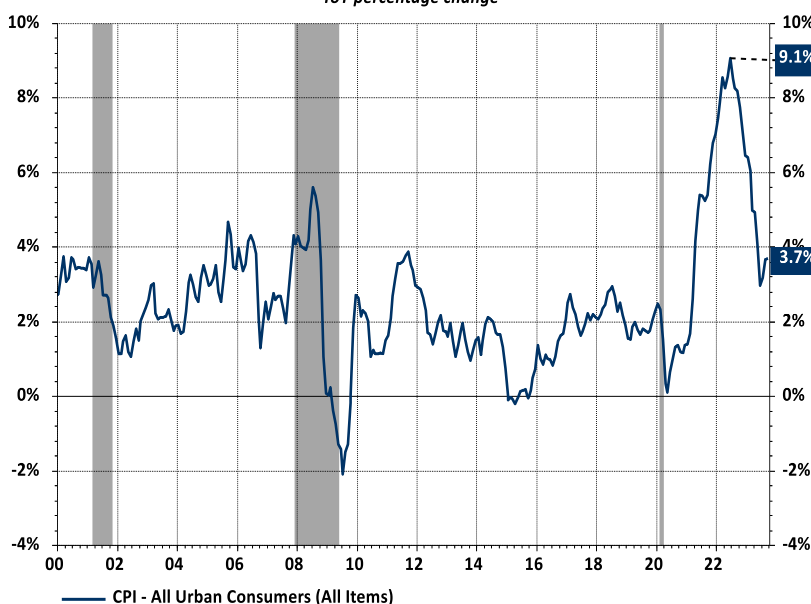
The third quarter market performance started strong as companies reported stronger second quarter earnings due to subsiding input costs. Year-over-year margin growth was above the 20-year average, making it the largest contributor to earnings growth. Although year-over-year earnings growth was negative -2.8% in the second quarter, this was better than expected. As we begin third quarter earnings season, expectations are for YOY earnings growth to resume their positive growth rate, increasing 1.3%. As noted by Refinitiv, "This sets up another opportunity for Q3 to deliver a better-than-expected quarter if history repeats itself following a very strong earnings surprise rate in Q1 and Q2, which were the highest since 2021. The earnings growth rate is expected to mostly increase over the next four quarters, leading to 12.1% earnings growth in 2024. Also shown in the table, beginning in Q3 2023, revenue growth shows some acceleration to a mid- single digit YOY growth rate.

S&P 500 Y/Y GROWTH RATES

	23Q1	23Q2	23Q3	23Q4	24Q1	24Q2	24Q3	24Q4	2022	2023	2024
Revenue	3.6%	0.5%	0.9%	3.6%	4.4%	5.1%	5.5%	5.1%	11.7%	2.1%	5.1%
Earnings	0.1%	-2.8%	1.3%	10.8%	9.1%	12.4%	13.3%	13.3%	4.8%	2.3%	12.1%

Source: LSEG I/B/E/S , as of 10/6/2023

A common theme for goods-based companies, was the fact some experienced unit volume declines, but offset this with higher prices. We do believe the market will begin to once again reward companies that can expand their margins at a time price increases become more difficult to pass through to consumers. The Federal Reserve's higher interest rate policy is having its expected effect on bringing down inflation from 9.1% to 3.7%.



FED Up

Since the Fed began increasing interest rates in March 2022, Fed actions have been top of mind for investors. In fact, we have discussed the Fed and their actions in each one of our newsletters going back to the end of 2021. While market sentiment was projecting the possibility of four rate cuts in 2024, expectations have shifted to a "higher for longer" point of view with only two rate cuts expected now. This paired with solid economic and employment data has led to a spike in longer term yields. Indeed, this past quarter saw the 10- Year U.S. Treasury reach its highest yield since 2007.

We believe interest rates are at a reasonable level and coincide with where rates have been on average during the years preceding the zero interest rate policies that followed the financial crisis in 2008/2009. We view the current rate environment as a return to normalcy. We do believe the Fed is nearing completion of the interest rate hiking cycle.

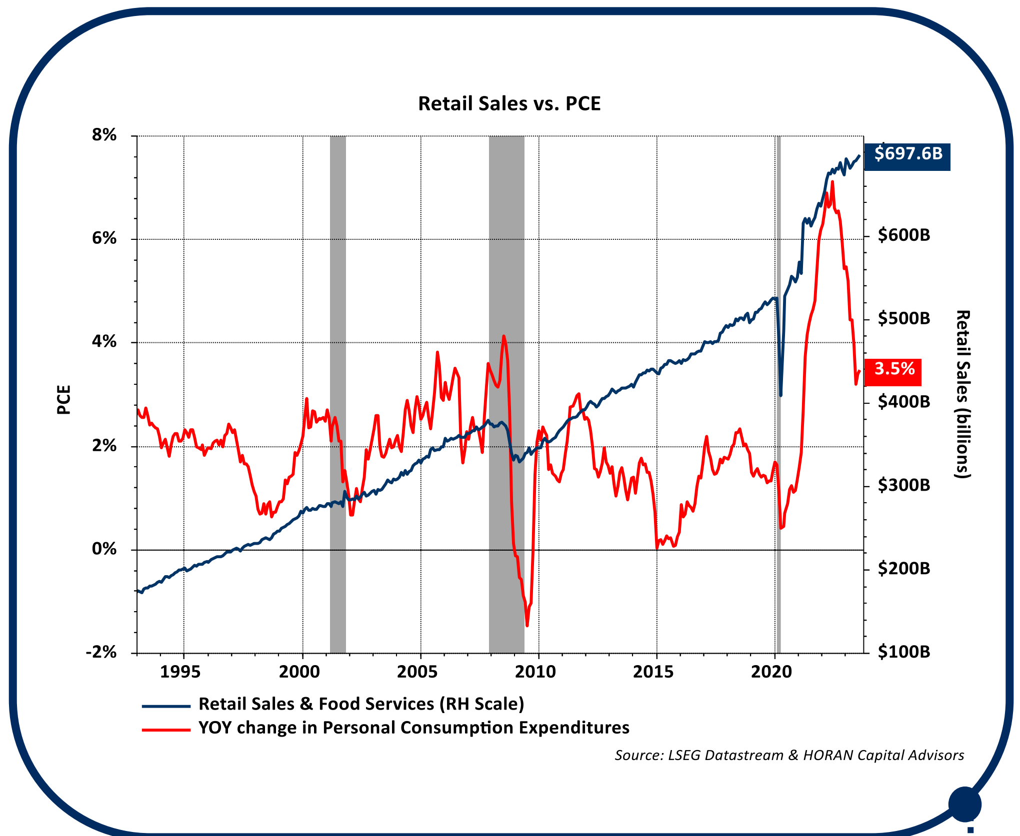
The higher yield investors can now obtain on other asset classes, like bonds and money market assets, has created competition for yield oriented equities. Year to date through the end of the third quarter, the S&P 500 Utility Sector is down -14.4%, the average return of the 401 dividend paying stocks in the S&P 500 index is a negative -0.18% while the average return of the 102 non-dividend payers is a positive 9.51%.

S&P 500 Dividend Payers vs. Non-payers
Total return as of 9/29/2023

	Average Return		Weighted	Weighted Total
	Payers	Non-payers	Change	Return
Month	-4.78%	-6.25%	-4.87%	-4.77%
YTD	-0.18%	9.51%	11.68%	13.07%
12 Month	12.05%	19.37%	19.59%	21.62%
Issues	401	102	503	503

Source: S&P Dow Jones Indices

Don't Count Out the American Consumer

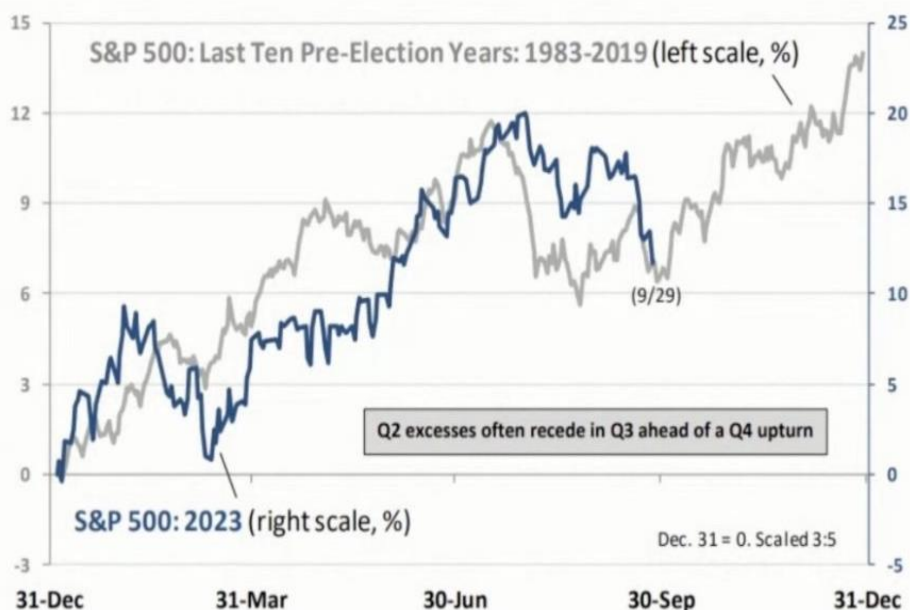


Since the beginning of 2022 economists and strategists called for the economy to be in a recession by this time in 2023; however, recent rhetoric has shifted into the belief a soft-landing for the economy is possible. As our investor letters have noted over the past year, we did not expect a recession at this point in time. Now that more strategists are moving away from the recession call, we are mindful of everyone moving to the same side of the boat.

Several factors have contributed to the resiliency of the American economy, the largest being the American consumer. The consumer accounts for about 70% of GDP in the economy. Americans continue to spend despite the economic uncertainty that has loomed over the course of the year. The personal savings rate as a percentage of disposable income equals 3.9% and is much lower than the long-run average of 5.9%. A part of this lower savings rate is attributable to the excess savings built up during the Covid recession. This savings peaked at nearly $3 trillion and now stands at about $650 billion. Even at this level, excess savings is about $400 billion. The year-over-year change in personal consumption expenditures, an important measure of inflation for the Fed, is 3.5% and remains above the Fed's 2.0% target. A part of the reason for the elevated PCE is the strength of the consumer, i.e., strong demand, and is reflected in the upside surprise in retail sales. Although, much of the consumers excess Covid savings is gone, the strong employment market can continue to drive consumer spending. In fact, the labor market this quarter has proven its resiliency with the economy adding roughly 800K jobs since June. Additionally, job openings and labor turnover remain high.

Cautiously Optimistic

While the market pulled back over this past quarter and individual market sentiment leans bearish, we remain cautiously optimistic. Individual investor sentiment can be viewed as a contrarian measure at its extremes. With an improved earnings outlook, as noted earlier, and looking back historically, a negative 3rd quarter tends to lead to a positive comeback for the market as the year comes to an end.



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