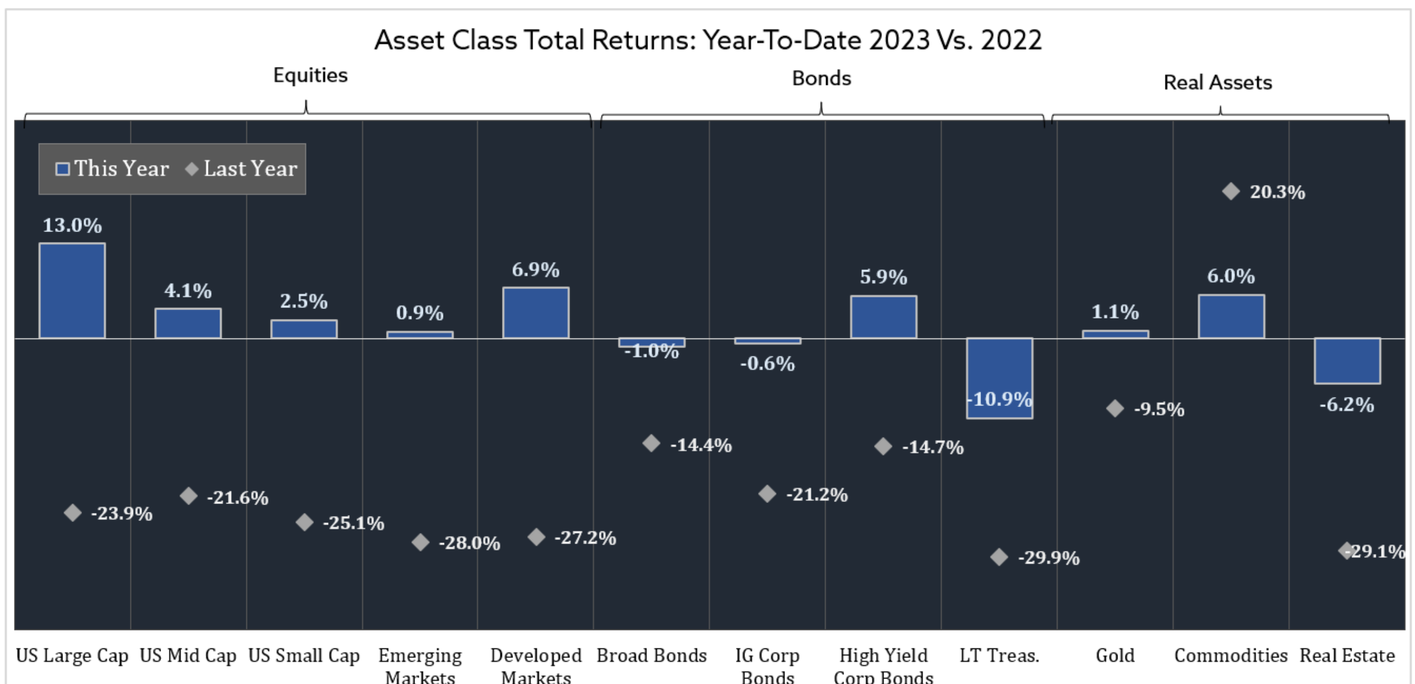
PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
3rd Quarter 2023 Investment Commentary
October 13th, 2023

Index Returns	3rd Quarter	Year-To-Date	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	-3.3%	13.1%	21.6%
Russell 2000 Small Cap Stock Index	-5.1%	2.5%	8.9%
MSCI All Country World Ex-USA Stock Index	-3.8%	5.3%	20.4%
Barclays Capital US Aggregate Bond Index	-3.2%	-1.2%	0.6%
US Core Consumer Price Index - (Inflation)	0.6%	3.1%	4.4%

Markets declined broadly during the 3rd quarter, as investors digested better-than-expected economic news leading to a higher likelihood that the Federal Reserve would keep interest rates higher for longer. Volatility in equity and bond markets has continued into the 4th quarter, whittling away at gains built in the first half of the year.

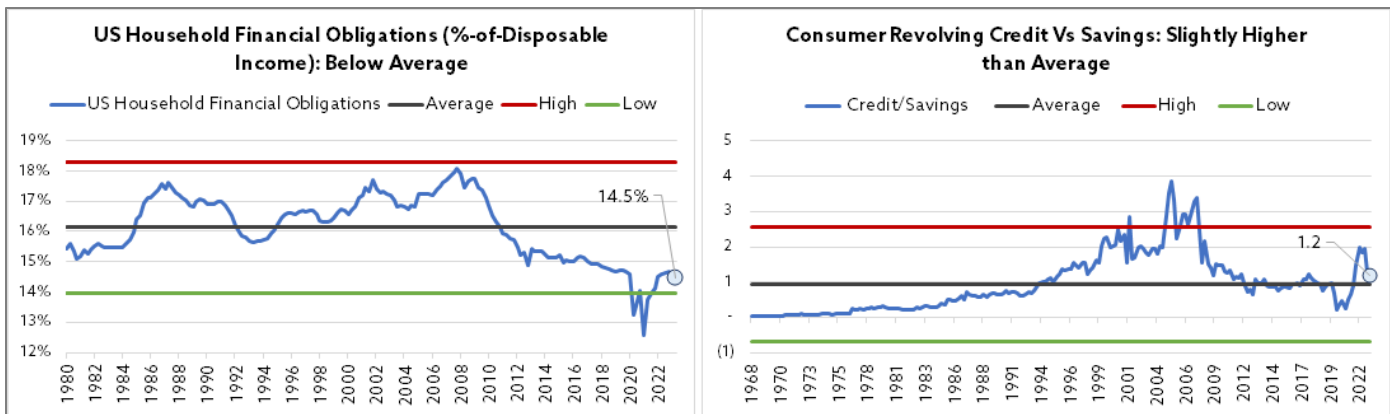
While performance across asset classes is still far better than during 2022, market behavior – specifically in the bond market - during the 2nd half of this year indicates to us that the challenges of higher interest rates are here to stay indefinitely. But, higher interest rates have also given birth to new opportunities for higher expected returns at lower risk. After a high-level review of economic and market health, we will drill down into the current state of the bond market and the role of bonds in portfolios.



Economic Overview: The US economy has so far continued to surprise nay-sayers with strength, despite concensus views earlier in the year of an imminent recession.

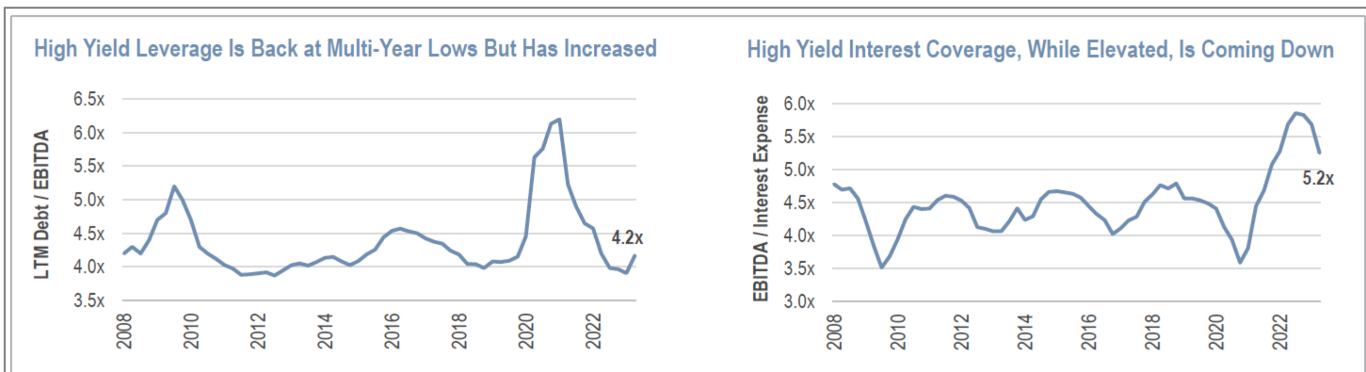
Market Drivers	Indicator Levels As Of... 5-Year Average	2020 Year-End	2021 Year-End	2022 Year-End	Most-Recent	Expected in 2023
Inflation (CPI Year-Over-Year %-Change)	3.7%	1.4%	7.0%	6.5%	3.7%	*3.70%*
Source: Source: Source: Loading...		*12/31/20*	*12/31/21*	*12/31/22*	***8/31/23***	
Effective Federal Funds Rate	1.71%	0.09%	0.07%	4.33%	5.33%	*5.60%*
Source: Source: Source: Loading...		*12/31/20*	*12/31/21*	*12/31/22*	***9/30/23***	
Actual Real GDP Growth (Yr-Over-Yr-%)	2.22%	-1.08%	5.42%	0.65%	2.38%	*2.10%*
Source: Federal Reserve		*12/31/20*	*12/31/21*	*12/31/22*	***3/31/22***	

- The unemployment rate remains below 4%.
- Inflation has moderated significantly (down to 3.67% in August from over 9% in the summer of '22) and continues to trend down.
- Consumers have continued to spend more, without getting out over their skis in terms of solvency and liquidity... yet.



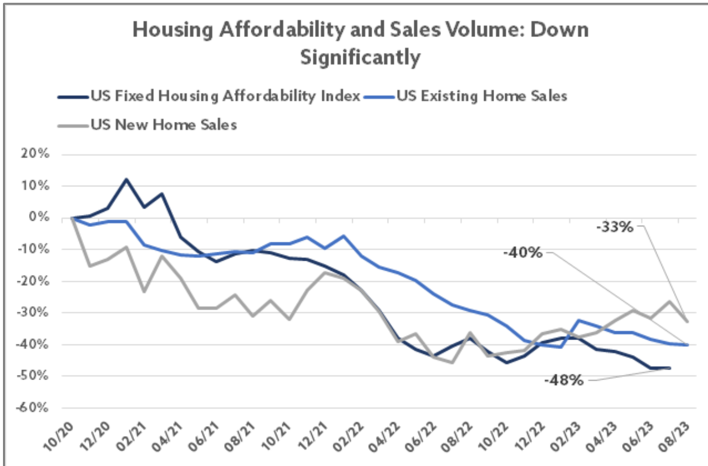
While recession is possible, we view it as a likely scenario only if the Fed continues its hawkish policy and is unable or unwilling to adjust quickly enough to stop one. That's not to say that challenges don't exist:

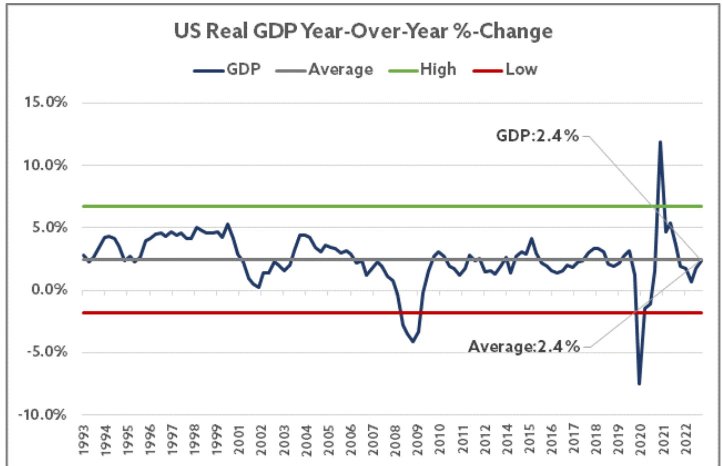
- Companies face pressures on sales and profitability from inflation, the rising cost of debt, and the tight labor market. But, even amongst lower quality borrowers, fundamentals suggest that companies entered the new rate regime with lower leverage and higher profitability which allows room for more debt even at a higher cost, if necessary.



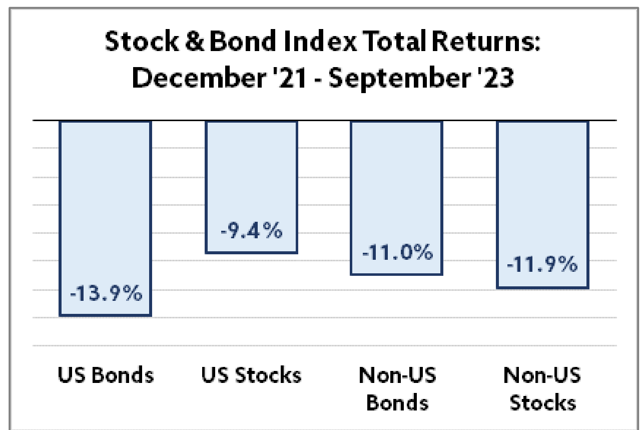
- Households face the rising pressures of higher prices on everyday goods and services, along with the least affordable housing market in decades.

But, the economy's resilience in the face of an historic rise in interest rates and decades-high inflation is notable.

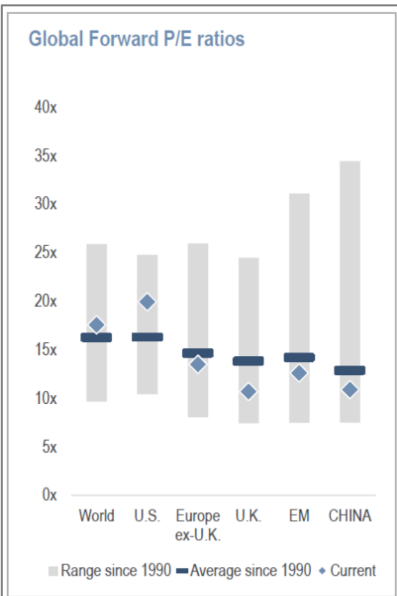


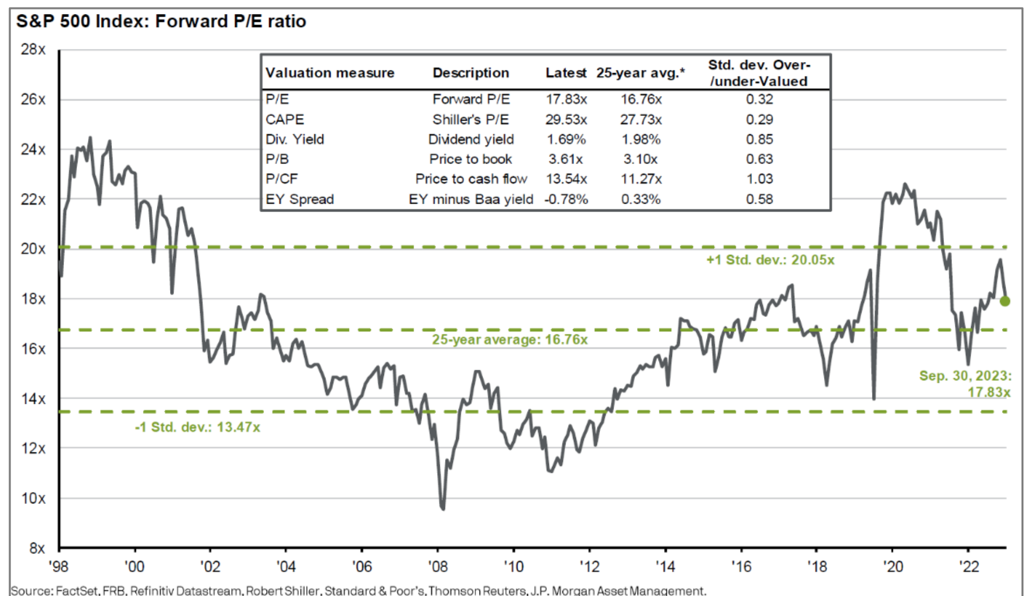


Markets: While the economy has been resilient against twin headwinds of high inflation and rising interest rates, financial markets have experienced large drawdowns; persistently higher volatility; and wide dispersion of performance across asset classes and market sectors. Both stock and bond indexes remain below levels preceding rate increases that began in early '21, but **US bonds have led the decline.**



Stocks: Currently, stock valuations are mixed, with US stocks above peers and the historical average in terms of Price-to-Earnings ratios. But, by that measure even **US stocks are well within a normal range that indicates fair – not over – valuation.**

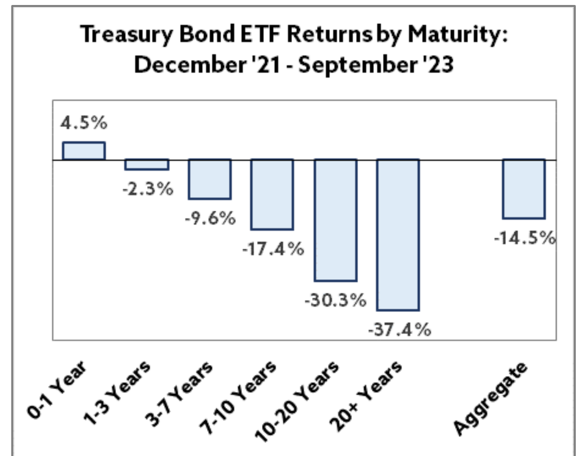




Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.83x	16.76x	0.32
CAPE	Shiller's P/E	29.53x	27.73x	0.29
Div. Yield	Dividend yield	1.69%	1.98%	0.85
P/B	Price to book	3.61x	3.10x	0.63
P/CF	Price to cash flow	13.54x	11.27x	1.03
EY Spread	EY minus Baa yield	-0.78%	0.33%	0.58

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Bonds: As mentioned above, bonds have declined significantly in value as rates have increased. In general, increasing rates drive bond yields higher, which in turn drives bond prices lower. When yields increase, prices on fixed-rate bonds must decline in order for the yield-to-maturity to increase with the market. For example, if you bought a bond with a 5% yield for $100 and yields on similar bonds in the market increased from 5% to 7% the following week, then the market value of your bond would be lower because the buyer of your bond could go to the market and achieve a higher yield without taking more risk.

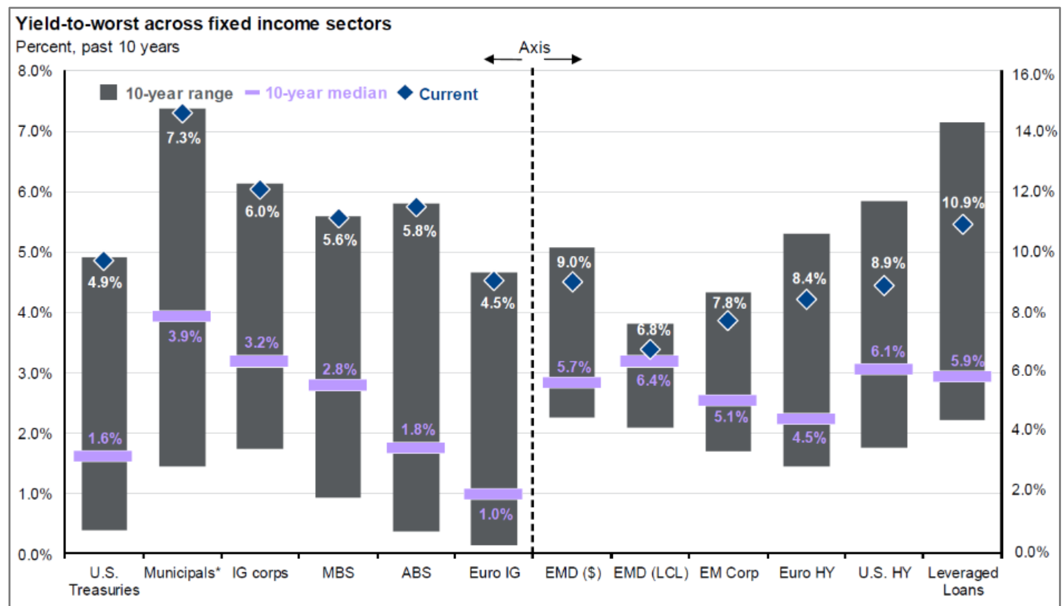


The included chart of Treasury bond ETF performance shows us that rising interest rates have resulted in negative performance, causing more damage to longer-dated bonds than short-term.

How have we managed bond allocations in portfolios over the last two years?

- In client portfolios, we have been wary of holding longer-dated bonds since well-before 2022 specifically because of the risk of rising rates. As a result, portfolios have avoided much, but certainly not all, of the impact of rising rates.
- In addition, we significantly cut bond exposure early in 2022, and a short time later we redeployed that into variable-rate bonds that do not suffer from the same level of price volatility as fixed rate bonds (because their coupon rate adjusts, rather than the price).

What role do bonds play in portfolios going forward?



Bonds still represent a large allocation in fully diversified client portfolios, with our most significant allocation to an exchange traded fund of US bonds diversified across the credit and maturity spectrums (*NYSE:BND*). We view BND as an efficient way to maintain exposure to the bond market, but also as a source of liquidity to diversify into better areas as we find them.

Yields have increased significantly across the fixed income asset class, and we are evaluating opportunities to add income to portfolios after considering both interest rate risk and credit risk. Most notably, we are evaluating funds that lend directly to middle market businesses as an alternative to lower-yielding publicly traded fixed-rate bonds. The funds we are evaluating make debt investments directly with companies that are predominantly floating rate (meaning if market rates go up, the interest rate on those debt investments increases, too), and first-lien (meaning in the event of a bankruptcy they would have first claim on assets).

At our firm, we prioritize regular dialogue with you to address evolving circumstances and maintain a thorough understanding of your goals. Your decision to entrust us with your business is not taken lightly, and we greatly value your patience. Our dedicated client-service team will continue their efforts to arrange a meeting with you, as per our usual practice. Should you prefer an earlier appointment, please feel free to reach out to us at your convenience. We eagerly anticipate hearing from you.

Contact: Matt Morley, CIO
Pendleton Street Advisors, LLC
www.pendletonstreetadvisors.com