# Quarterly Chartbook
3Q2023

# Summary Comments

After a strong first half of the year, stocks and bonds gave ground in the third quarter due largely to a tough September. (And the trend unfortunately continued into October.) Our summary notes are included here. If you would like to review detail, we elaborate in the pages that follow.

- The top 10 largest companies in the S&P 500® Index have trailing P/E ratios that are significantly higher than the median trailing P/E ratio for the remaining 490 stocks in the index (range from 24X-100X v 19X). While this does not necessarily mean these companies are destined to post future losses, it does mean that investors have placed a high degree of faith in the companies to grow future earnings at an outsized rate for an extended period.
- We believe the current business environment is in a relatively precarious spot, and because of this, 2024 earnings expectations may be too optimistic. This is primarily because we do not believe investors have fully appreciated the negative impact higher interest rates and restrictive U.S. Federal Reserve (Fed) policies will have on consumers and the financial health of businesses.
- Our focus on opportunities in equities remains tilted to smaller companies and non-U.S. stocks (more recently Japan).
- On the economic front, the U.S. economy exhibited better than expected growth, expanding by 4.9%, despite undergoing one of the swiftest tightening cycles in recent history. However, underpinning this growth was the fact that consumers had to tap their savings to fund spending. The savings rate dropped to 3.8% from 5.2% in the second quarter, which cannot last forever. Neither can government spending, which was up 12.4% year-over-year and contributed significantly to GDP data during the quarter.
- The Fed chose to leave rates unchanged at 5.25% at its June meeting, which marked the first time in ten consecutive meetings that it did not make a move. However, it resumed rate hikes in July, pushing rates up to 5.50%. At that meeting, officials claimed interest rates were already in restrictive territory, but signaled two additional hikes this year. Financial markets still think there will be small reductions in rates early next year.
- In terms of positioning, the inverted yield curve is allowing us to capture ample yields in shorter maturity bonds. However, with the recent backup in longer term rates, there could be value in locking in yields at longer durations in advance of rate reductions. As a result, we may consider a modest extension of durations, based on the belief that these maturities could represent value over the intermediate-to-long term. We will be cautious not to extend too far as the picture further out is highly uncertain. Higher inflation, increased debt loads (due to deficit spending), and a shrinking Fed balance sheet are reasons to be careful.

# Welcome

It has been over five years since we have had the opportunity to discuss a new member of the Entasis team, but we are pleased to announce the addition of Ashley Fredricks, CPA.

- Ashley has 22 years of experience in public accounting as a tax professional and has her Master of Science in Professional Accounting, with a concentration in Tax, from the University of Wisconsin-Milwaukee.
- She focuses on assisting clients in identifying opportunities for tax savings, optimizing their financial structures, and ensuring full compliance with tax regulations. Her approach to tax planning is rooted in building strong client relationships and understanding their unique financial objectives.
- Ashley is a member of the AICPA (American Institute of Certified Public Accountants) and WICPA (Wisconsin Institute of Certified Public Accountants) and concentrates on continuing her professional education each year to stay ahead of new laws and practices. In that spirit, she is studying hard to become licensed as a registered investment advisor.
- Our partnership will allow Ashley to continue to lead her firm Fredricks CPA, LLC, while leveraging the investment management and financial planning benefits of our firm and help us evolve our business model by taking the lead on an expanded tax planning service offering for Entasis clients.

Please help us welcome Ashley to the team.

# Table of Contents


Market Performance

Concentrated Returns

U.S. Valuations

U.S. Earnings

U.S. Equity Risks

U.S. Valuations

U.S. Opportunity

Foreign Opportunity

Economic Growth

Inflation

Fed Tightening

Yields & Spreads

Bond Positioning


Entasis
ASSET MANAGEMENT

# Market Performance

## Annualized % Returns (As of 10/31/2023)

| Index Name | Index Category | 1 year | 3 year | 5 year | 10 year |
|---|---|---|---|---|---|
| S&P 500 Index | Large Cap Stocks | 10.14 | 10.36 | 11.01 | 11.18 |
| Russell 1000 Index | Mid/Large Cap Stocks | 9.48 | 9.53 | 10.71 | 10.88 |
| Russell 1000 Growth Index | Growth Stocks | 18.95 | 8.70 | 14.22 | 13.82 |
| Russell 1000 Value Index | Value Stocks | 0.13 | 10.21 | 6.60 | 7.60 |
| Russell 2000 Index | Small Cap Stocks | -8.56 | 3.95 | 3.31 | 5.63 |
| MSCI EAFE Index | Non-U.S. Developed Market Stocks | 14.40 | 5.73 | 4.10 | 3.05 |
| MSCI Emerging Markets Index | Emerging Markets Stocks | 10.80 | -3.67 | 1.59 | 1.19 |
| MSCI ACWI Ex USA Small Cap Index | Non-U.S. Small Cap Stocks | 8.82 | 2.96 | 3.51 | 3.43 |
| BofAML Preferred Stock Fixed Rate Index | Preferred Stocks | 2.18 | -3.14 | 1.29 | 3.82 |
| Barclays Municipal Bond Index | U.S. Municipal Bonds | 2.64 | -2.48 | 1.00 | 2.12 |
| Barclays Aggregate Bond Index | U.S. Bonds | 0.36 | -5.57 | -0.06 | 0.88 |
| Barclays Intermediate U.S. Gov/Credit Index | Government/Corporate Bonds | 2.18 | -3.01 | 0.95 | 1.16 |
| BofAML U.S. Treasury Master Index | Treasury Bonds | -0.85 | -6.19 | -0.30 | 0.49 |
| BofAML U.S. Mortgage Backed Securities Index | Mortgage Backed Bonds | -0.76 | -5.76 | -1.02 | 0.34 |
| BofAML U.S. Corporate Master Index | Corporate Bonds | 3.25 | -5.19 | 0.97 | 1.97 |
| BofAML U.S. High Yield Master II Index | High Yield Bonds | 5.81 | 1.24 | 2.86 | 3.77 |
| BofAML Euro Broad Market Index | European Bonds | 6.61 | -9.52 | -3.35 | -2.02 |
| BofAML Local Debt Market Plus Index | Emerging Markets Bonds | 8.69 | -3.05 | 1.17 | -0.34 |

## Calendar Year % Returns (YTD as of 10/31/2023)

| | YTD | 2022 | 2021 | 2020 | 2019 | 2018 |
|---|---|---|---|---|---|---|
| S&P 500 Index | 10.69 | -18.11 | 28.71 | 18.40 | 31.49 | -4.38 |
| Russell 1000 Index | 10.28 | -19.13 | 26.45 | 20.96 | 31.43 | -4.78 |
| Russell 1000 Growth Index | 23.20 | -29.14 | 27.60 | 38.49 | 36.39 | -1.51 |
| Russell 1000 Value Index | -1.80 | -7.54 | 25.16 | 2.80 | 26.54 | -8.27 |
| Russell 2000 Index | -4.45 | -20.44 | 14.82 | 19.96 | 25.52 | -11.01 |
| MSCI EAFE Index | 2.74 | -14.45 | 11.26 | 7.82 | 22.01 | -13.79 |
| MSCI Emerging Markets Index | -2.14 | -20.09 | -2.54 | 18.31 | 18.44 | -14.58 |
| MSCI ACWI Ex USA Small Cap Index | -0.84 | -19.97 | 12.93 | 14.24 | 22.42 | -18.20 |
| BofAML Preferred Stock Fixed Rate Index | -0.01 | -14.60 | 2.24 | 6.95 | 17.71 | -4.34 |
| Barclays Municipal Bond Index | -2.22 | -8.53 | 1.52 | 5.21 | 7.54 | 1.28 |
| Barclays Aggregate Bond Index | -2.77 | -13.01 | -1.54 | 7.51 | 8.72 | 0.01 |
| Barclays Intermediate U.S. Gov/Credit Index | 0.19 | -8.23 | -1.44 | 6.43 | 6.80 | 0.88 |
| BofAML U.S. Treasury Master Index | -3.05 | -12.85 | -2.38 | 8.22 | 6.99 | 0.80 |
| BofAML U.S. Mortgage Backed Securities Index | -4.17 | -11.88 | -1.21 | 4.09 | 6.51 | 1.00 |
| BofAML U.S. Corporate Master Index | -1.38 | -15.44 | -0.95 | 9.81 | 14.23 | -2.25 |
| BofAML U.S. High Yield Master II Index | 4.66 | -11.21 | 5.35 | 6.07 | 14.41 | -2.27 |
| BofAML Euro Broad Market Index | -0.30 | -22.04 | -9.66 | 13.35 | 4.11 | -4.39 |
| BofAML Local Debt Market Plus Index | 1.76 | -11.73 | -6.53 | 4.50 | 16.44 | -4.90 |

Source: Morningstar Direct

# Equity – Concentrated U.S. Returns

Source: The Bespoke Report – September 29, 2023

**S&P 500 Largest Stocks' Year to Date Contributions**

| Ticker | Name | Market Cap (bn USD) | YTD % Change | S&P 500 Point Contribution |
|---|---|---|---|---|
| AAPL | Apple | 2,668.61 | 32.61 | 75.64 |
| MSFT | Microsoft | 2,330.27 | 33.38 | 71.11 |
| GOOGL | Alphabet | 1,673.41 | 49.53 | 58.66 |
| AMZN | Amazon.com | 1,299.83 | 51.69 | 46.02 |
| NVDA | NVIDIA | 1,064.30 | 198.94 | 85.92 |
| META | Meta Platforms | 782.14 | 152.97 | 49.17 |
| TSLA | Tesla | 782.01 | 104.29 | 41.09 |
| BRK/B | Berkshire Hathaway | 778.37 | 14.16 | 9.34 |
| LLY | Eli Lilly & Co | 516.84 | 47.07 | 16.12 |
| V | Visa | 484.15 | 11.76 | 4.77 |

| | Total Market Cap (bn | Avg. YTD % Chg | Total Index Contribution |
|---|---|---|---|
| **Top 10 Largest Stocks** | **12,379.93** | **69.64** | **457.84** |
| **Rest of S&P 500** | **25,228.10** | **1.73** | **60.75** |

Source: The Bespoke Report – September 29, 2023

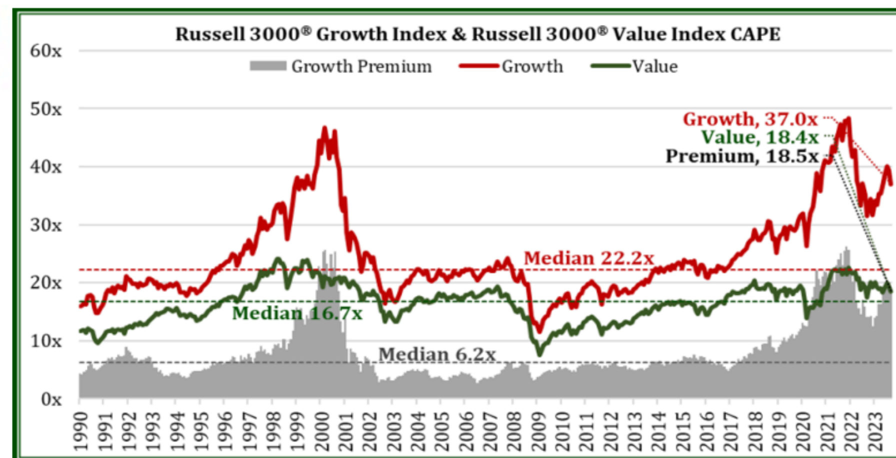
The third quarter ended in negative territory for most areas of the market. However, mega-cap tech stocks continued to be the main driver of S&P 500® Index gains on a year-to-date basis.

- The outsized impact mega-cap technology stocks had on the S&P 500® Index is evident in the chart above (left). The market-capitalization weighted S&P 500® Index gained 12.2% year-to-date; however, if we were to examine the same index on an equal-weight basis, the gain was only 3.0%. The median stock return in the S&P 500 Index was even lower, with a positive return of 0.4%. At the opposite end of the market-capitalization spectrum, small-cap stocks have not fared as well.
- The “Magnificent Seven” (Apple, Microsoft, Nvidia, Amazon, Meta, Tesla, Alphabet) remain the dominant contributors for the S&P 500® Index return year-to-date (chart above right).

Despite large gains for the year-to-date period, the sustained rise in interest rates during October resulted in some of the previous high-flying technology stocks to lose their luster. We believe the trend of lackluster results for these types of stocks will continue in the near term as investors choose to take profits and others question lofty expectations reflected in their prices.

# Equity – U.S. Valuations

Source: The Bespoke Report – September 29, 2023



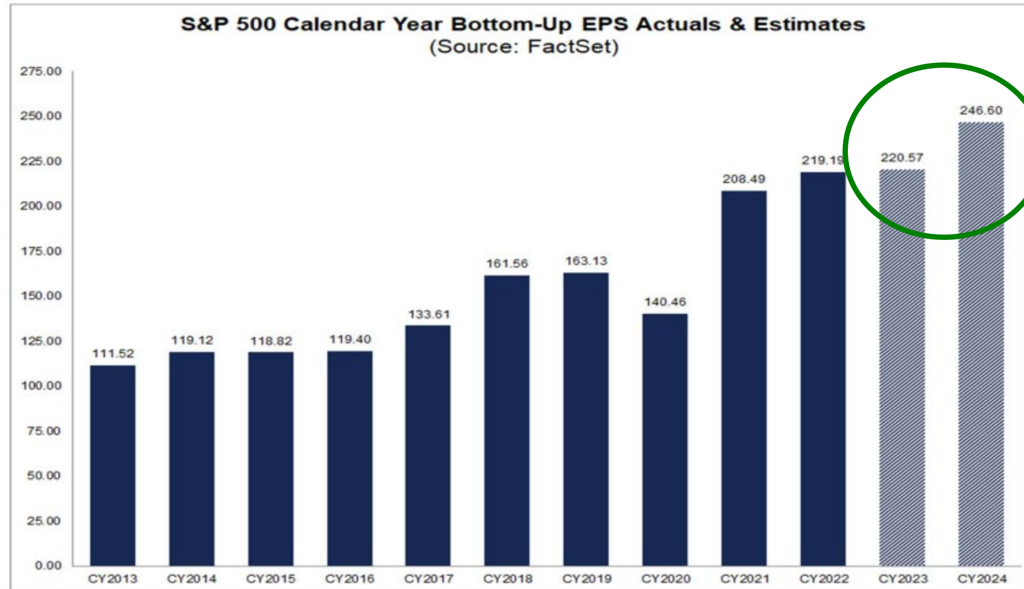

Source: Equity Investment Corporation – Third Quarter Commentary (October 2023)

The sharp rise in prices noted on the previous slide has also resulted in high trailing price-to-earnings (P/E) ratios.

- In fact, the top 10 largest companies in the S&P 500® Index have trailing P/E ratios that are significantly higher than the median trailing P/E ratio for the remaining 490 stocks in the index (chart above left). While this does not necessarily mean these companies are destined to post future losses, it does mean that investors have placed a high degree of faith in the companies to grow future earnings at an outsized rate for an extended period.
- Many of these stocks have also had an oversized impact from an equity style perspective (i.e. growth vs. value). For instance, the Russell 3000® Growth Index is currently trading at a large premium compared to the Russell 3000® Value Index on a cyclically-adjusted price-to-earnings ratio (CAPE ratio - chart upper right). The current growth "premium" (grey bar) of 18.5x is well in excess of the historic median of 6.2x.

At some point, the "premium" valuation for growth stocks over value stocks will revert to longer-term averages. We believe investors should be wary of a meaningfully large investment in growth stocks and should instead look to invest in high-quality (financially strong), consistently growing companies that are trading at more reasonable prices.

# Equity – U.S. Earnings

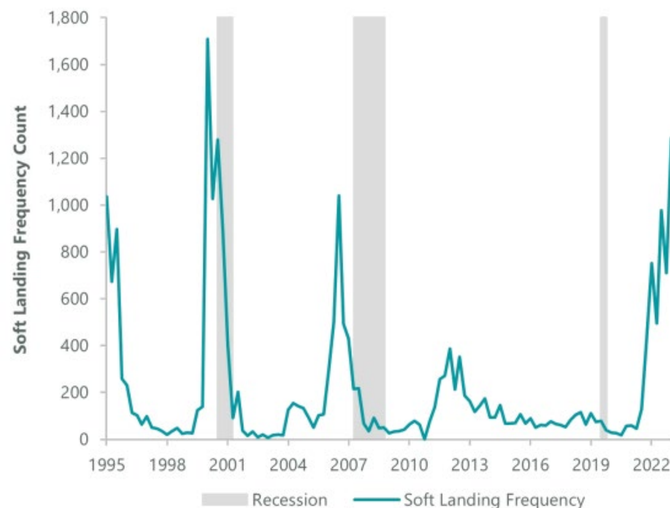



Source: FactSet – Earnings Insight (October 27, 2023)

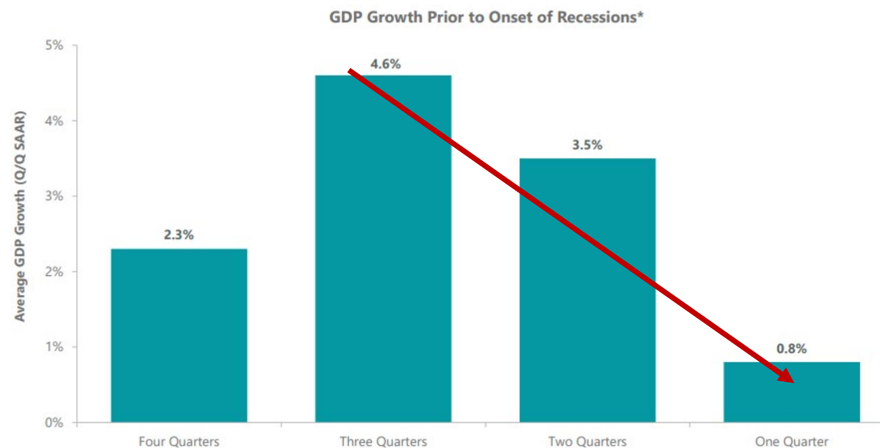
Aggregate earnings for the S&P 500® Index are expected to finish 2023 roughly flat year-over-year compared to 2022.

- On a positive note, analyst estimates for 2024 corporate earnings growth remain quite robust (green circle above).
- However, analyst expectations have historically been slow to adjust to changing business environments. This is reflective of a behavioral bias defined as "anchoring." In this instance, analysts are slow to adjust their estimates too significantly from their existing "base" estimate. In turn, earnings expectations tend to decline (or increase) slowly over longer periods of time as analysts wait for data to adjust their estimates.
- We believe the current business environment is in a relatively precarious spot, and because of this, 2024 earnings expectations may be too optimistic. This is primarily because we do not believe investors have fully appreciated the negative impact higher interest rates and restrictive U.S. Federal Reserve (Fed) policies will have on consumers and the financial health of businesses.
- Overall, we think investors should remain relatively cautious in the short-term and avoid "anchoring" on year-to-date market-cap weighted equity market results. Instead, we believe it is prudent to focus on quality businesses that have the financial health to navigate a relatively more tumultuous business environment.

# U.S. Equity – Risks




Source: ClearBridge – The Anatomy of a Recession (Fourth Quarter 2023)



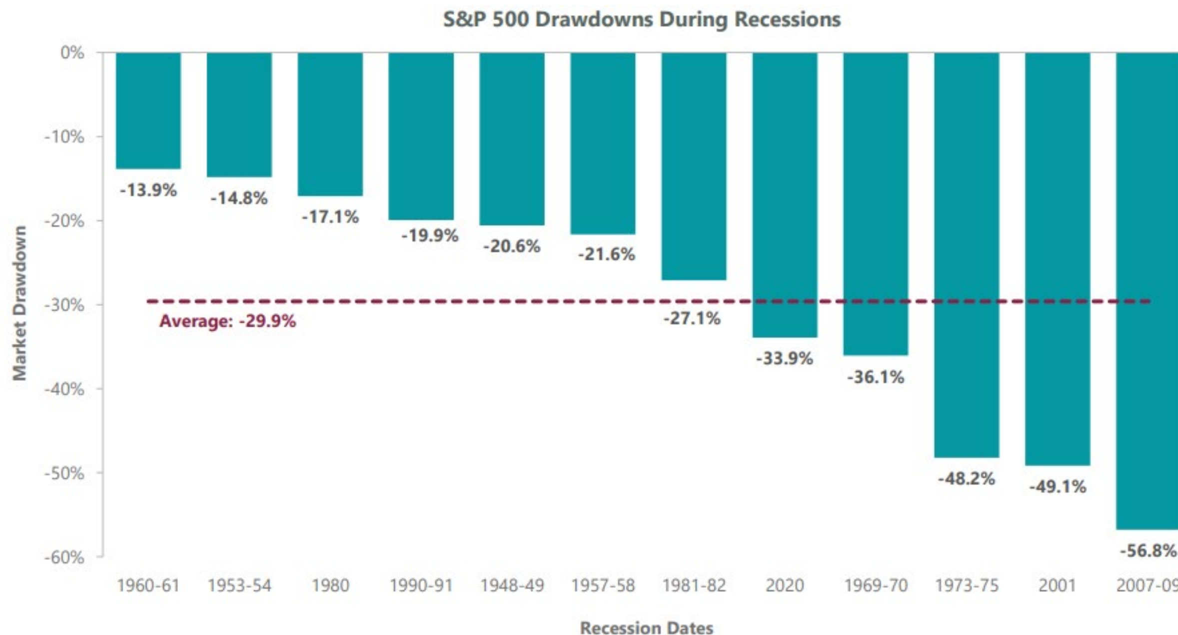

Source: ClearBridge – The Anatomy of a Recession (Fourth Quarter 2023)

One of the primary storylines the financial media has routinely discussed since the Fed began its interest rate tightening cycle has been a belief the U.S. economy would be able to avoid an economic "hard landing."

- Instead, financial media pundits believed the Fed would be able to navigate the inflationary environment through a series of interest rate hikes that would contain inflation (economic slowdown) but avoid overtightening to the point where the economy would fall into a recession (economic contraction).
- Economic optimism prior to a recession is not new. Historically (chart upper left), the frequency of corporations that mentioned a "soft landing" in company filings, transcripts and presentations has typically seen a spike just prior to the onset of an actual recession (the exception being the pandemic-induced recession).
- Part of the reason there is optimism (or hope) of a "soft landing" prior to an actual recession is because recessions are hard to predict in advance. To be sure, economic growth often holds up very well heading into a recession with a rapid decline generally occurring just before the onset (chart above right).

While we do not know if, or when, the U.S. economy will enter a recession, we believe the data has begun to "tip the scales" towards further economic hardship in the coming quarters.

# U.S. Equity – Risks




Source: ClearBridge – The Anatomy of a Recession (Fourth Quarter 2023)

History has shown that recessions have been detrimental to U.S. equity results. However, not all recessions are created equal.

- Since World War II, the average U.S. equity market decline (as measured by the S&P 500® Index) during recessions has been -29.9% (see chart above). At the same time, the range of equity declines has been quite wide.
- It is also important to note that economic conditions and equity market activity leading into recessions also play a big role in determining how segments of the equity market perform from a market-cap, style and sector perspective during a selloff. For instance, the global financial crisis (2007-2009) led to a broad-based selloff in stocks with financial stocks being particularly hard hit, while the selloff in 2001 hit overpriced large-cap stocks and technology stocks significantly harder than other market-caps and sectors.

Overall, while we do believe data has begun to “tip the scales” towards a challenging economic stretch in the short-term, we do not believe adverse financial conditions are present for a significant economic contraction. Furthermore, we believe the impact any potential recession may have on the equity market will be nuanced. Expensive areas of the market may be more susceptible to larger losses, while other areas of the market may hold up relatively better. We have positioned portfolios to reflect our outlook.

# U.S. Equity – Risks

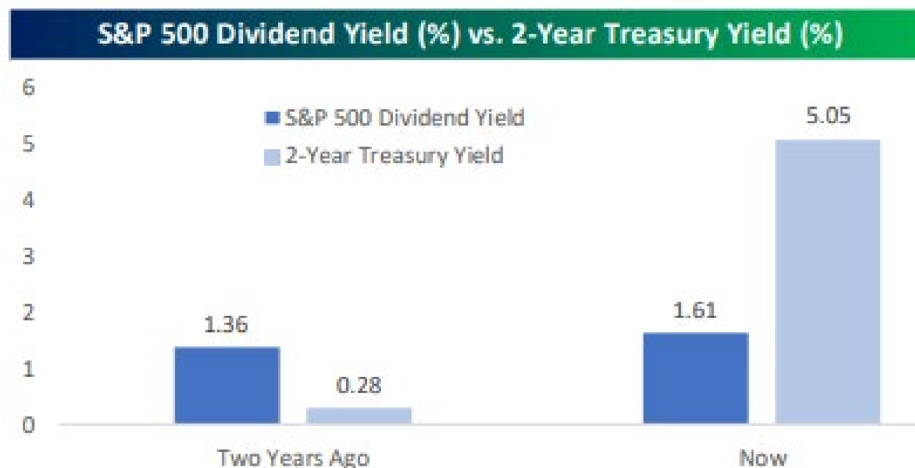
Source: J.P. Morgan

Another reason for our cautious stance towards equities is because of a dramatically different interest rate environment compared to just two years ago.

- The chart above (left) plots the forward P/E for the MSCI US Index compared to the real yield (incorporates inflation) of the 10-year U.S. Treasury. These data series generally follow each other closely on a directional basis. However, the relationship has broken down recently as the real yield on the 10-year Treasury increased, while forward P/E levels continued to rise.
- Historically, based on the data in the chart, the rise in yields would have driven forward P/E levels down towards the lower teens. However, the artificial intelligence (AI), technology-fueled rally among mega-cap companies this year caused a large divergence in the two data series. The divergence is even more pronounced when examining the chart above (right), which plots the tech-heavy Nasdaq 100 Index relative to the 10-year Treasury return index.

Whether or not the historically tight relationship between the data series remains broken will be closely followed in the coming quarters. If the data series do eventually converge, that would mean yields have declined sharply, or mega-cap technology companies have registered large losses. Based on the significant weight of mega-cap technology companies in market indices, and the effect of interest rates on the economy, sizable changes in either data series will have a meaningful impact on markets.

# U.S. Equity– Risks



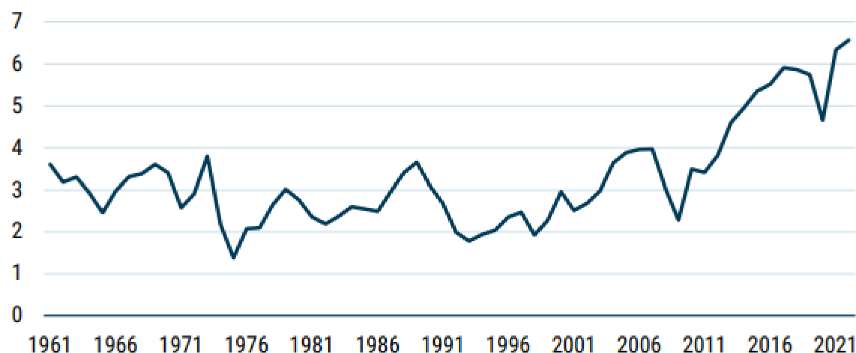

Source: The Bespoke Report – September 29, 2023

For years, the Fed's extended low (zero) interest rate policy left investors with few choices to generate yield outside of dividend-paying stocks. This led to a phenomenon among the investment public described by the acronym "TINA" (There Is No Alternative) to stocks.

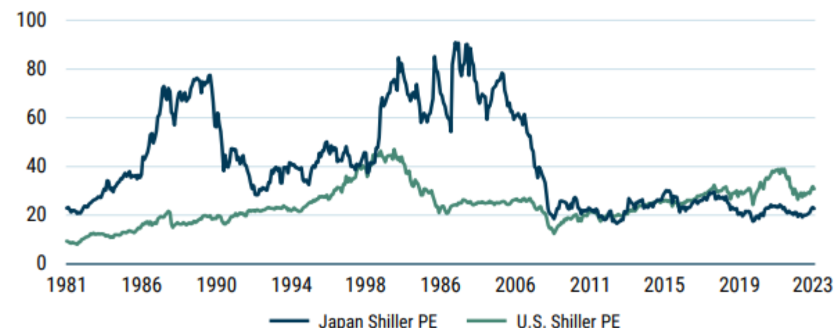
- Two years ago, "TINA" could be clearly seen by comparing the S&P 500® dividend yield to the 2-year Treasury (chart above left), where the dividend yield on stocks was over a full percentage point higher than 2-year treasuries.
- Fast forward to now, and the advantage stocks had over treasuries in the form of dividend yield has completely vanished. In fact, 2-year treasuries now hold a yield advantage over the dividend yield for stocks in the S&P 500® Index of nearly three and a half percentage points! Needless to say, investors now have an alternative to stocks.

The sharp rise in interest rates has had a large impact on markets over the past two years, and we believe they will continue to have a meaningful impact in the future. This has been evident in our positioning of client portfolios where we have eschewed a focus on dividend yields, have not chased segments of the market that have historically been sensitive to changes in interest rates, and have managed equity risk using a relatively higher-yielding cash position.

# Foreign Equity – Opportunity (Short-Term)




Source: GMO – Japan: The Land of Rising Profits (October 2023)



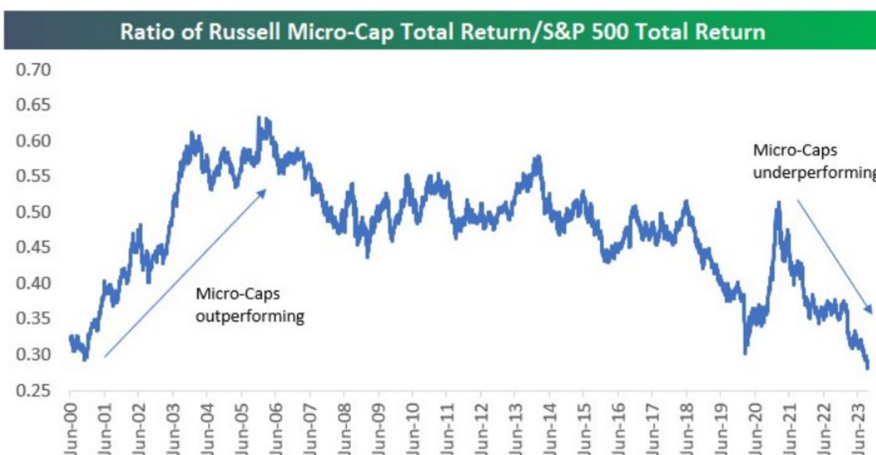

Source: GMO – Japan: The Land of Rising Profits (October 2023)

Even with a number of short-term concerns, opportunities for investment remain. One such area is among foreign equity markets, which continue to be relatively attractive compared to the U.S. equity market from a valuation perspective. This is particularly true for Japan, which has seen a steady increase in profitability in recent years (chart above left).

- Despite the increase in profitability, Japanese equities have seen little, if any, increase in valuation levels. One measure where this is apparent is the cyclically-adjusted P/E ratio (CAPE), which incorporates earnings over a 10-year period, adjusted for inflation. Based on the data in the chart (above right), the U.S. CAPE ratio (also known as Shiller P/E) is roughly 30x compared to the Japan CAPE ratio of approximately 18x.
- The increased profitability for Japanese companies comes on the back of a multi-decade period of deleveraging that followed the "bubble" years during the 1980's. Corporations have begun to borrow again in recent years. However, companies continue to have large cash reserves to offset the borrowing. More shareholder-friendly practices have also begun to ramp up, such as share buybacks, which have increased per share profitability and valuation metrics.

Based on the specific strategy and risk tolerance of investors, some portfolios have seen the addition of a dedicated Japanese equity offering, while other portfolios continue to get indirect exposure to Japan through actively-managed foreign equity managers. We believe Japan is one of few global equity markets (over the short-term) that has demonstrated an improvement in fundamentals in tandem with attractive valuation levels.

# U.S. Equity – Opportunity (Long-Term)



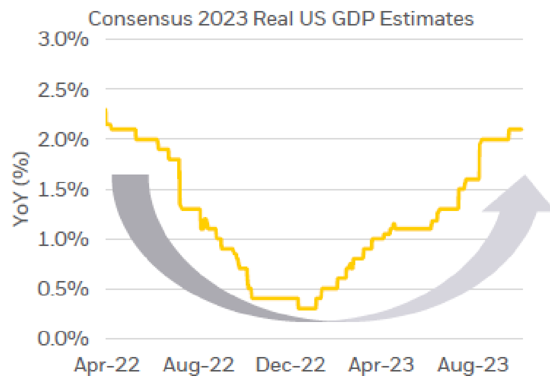

Source: Bespoke Investment Group – October 16, 2023

Source: Bespoke Investment Group – October 16, 2023

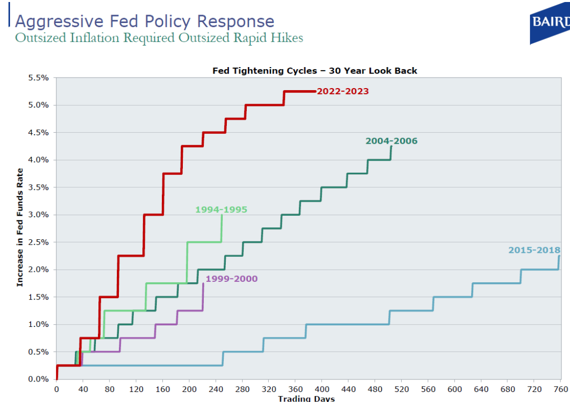
One area of the U.S. market we believe has the potential to deliver attractive returns over the long-term is among smaller-cap companies. We highlighted small-cap value equities last quarter, but we also believe micro-cap companies may offer investors an attractive risk/reward profile at some point in the not-too-distant future.

- Micro-cap companies have significantly underperformed large-cap companies for an extended period (chart above left). The only exception to the underperformance came shortly after the pandemic shutdown when a flood of easy fiscal and monetary policies led to rampant short-term speculation (mid-2020 to mid-2021).
- While no two periods are ever the same, micro-caps endured a similar period of underperformance relative to large caps during the late 1990's into 2000 during the blue chip/technology rally. As the tech boom turned into a bust, micro-caps enjoyed an extended period of outperformance relative to large-caps (the same was true for small-cap value stocks).
- Unlike large-cap stocks, and in particular technology stocks, the relationship between micro-cap performance and the 10-year Treasury yield (inverted) has remained intact on a directional basis (chart above right). Historically, micro-caps (and smaller-cap companies) have performed relatively well coming out of recessions as restrictive policies from the Fed are relaxed. In turn, while we believe the setup has become more attractive for these types of stocks, we also believe patience is required over the short-term given our less than optimistic view of the economy and equity market fundamentals.

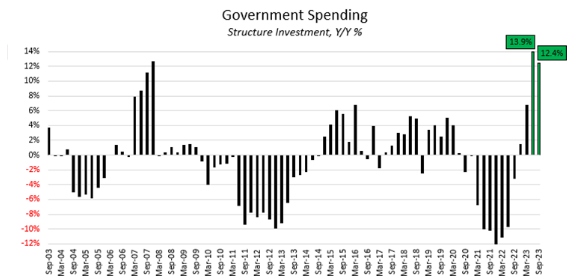
# Fixed Income – Economic Growth




Source: Blackrock



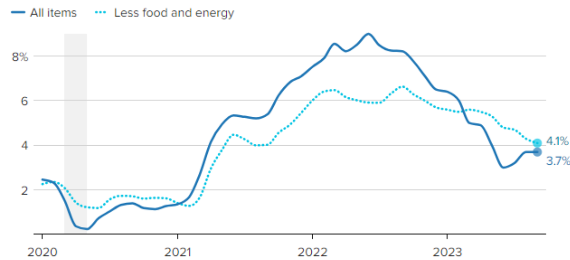

Source: Baird




Source: Hedgeye

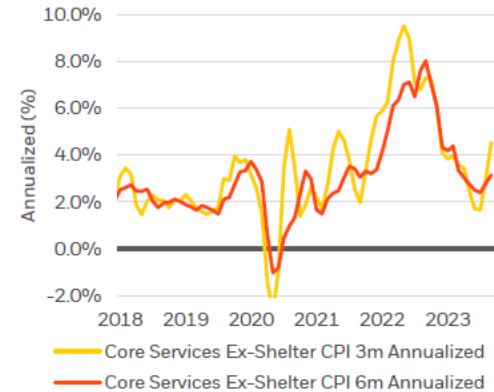
- The U.S. economy exhibited better than expected growth in the third quarter of 2023, expanding by 4.9%, despite undergoing one of the swiftest tightening cycles in recent history (middle chart above). The resilience raised questions about the efficacy of current monetary policies. Some believe that interest rate sensitive sectors are a diminishing portion of the overall economy, and the policy tool has become less effective as a result.
- Under the hood, growth in consumer spending, which accounts for more than two-thirds of U.S. economic activity, accelerated at a 4.0% rate after only rising at a 0.8% pace in the second quarter. It added 2.69% to GDP growth and was driven by spending on both goods and services. However, underpinning this growth was the fact that consumers had to tap their savings to fund spending. The savings rate dropped to 3.8% from 5.2% in the second quarter, which cannot last forever.
- Additionally, an increase in government spending, up 12.4% year-over-year (chart above right), also contributed significantly to GDP data during the quarter. This can be attributed to previous bills passed under the Biden administration such as the Inflation Reduction Act, CHIPS and Science Act, and the American Rescue Plan. The government's contribution to growth is unlikely to continue at this rate going forward, as money from these bills is spent and not replaced due to divided government.
- Other headwinds, such as resumed student loan payments, elevated oil prices, and a potential government shutdown, could dampen growth in the future. As a result, we view the reacceleration in growth as temporary. It is likely growth will decelerate from here, which means a recession in 2024 is possible.

# Fixed Income – Inflation




Source: BLS

Source: Blackrock



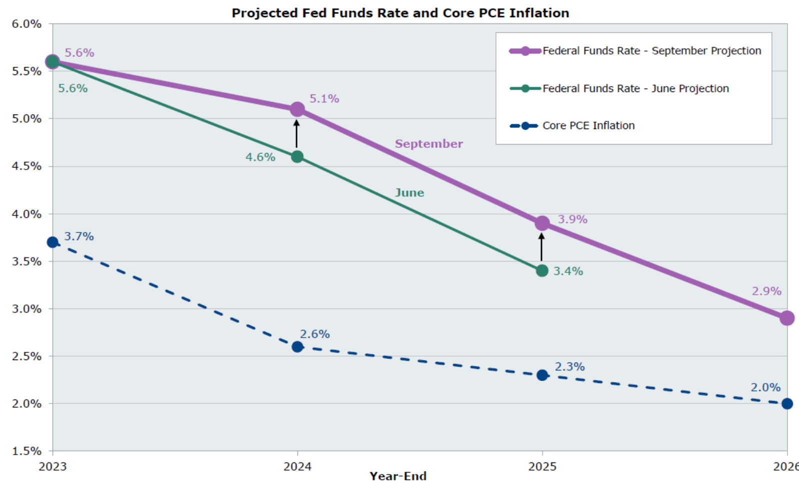

Source: Blackrock

## U.S. Federal Reserve(SEP) projection - PCE inflation

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|---|---|---|---|
| Actual | 2.0 | 1.6 | 1.4 | 4.7 | 4.8 | - | - | - | - |
| Upper End of Range | - | - | - | - | - | 4.2 | 3.6 | 3.0 | 2.9 |
| Upper End of Central Tendency | - | - | - | - | - | 3.9 | 2.8 | 2.4 | 2.3 |
| Median | - | - | - | - | - | 3.7 | 2.6 | 2.3 | 2.0 |
| Lower End of Central Tendency | - | - | - | - | - | 3.6 | 2.5 | 2.0 | 2.0 |
| Lower End of Range | - | - | - | - | - | 3.5 | 2.3 | 2.0 | 2.0 |

- Following a decline to 3.0% in June 2023, headline CPI inflation experienced a resurgence, reaching a year-over-year pace of 3.7% in September (left chart above). The move can be primarily attributed to oil prices surging nearly 30% in the quarter due to extended output cuts by Saudi Arabia and Russia. However, there is a positive aspect when considering the exclusion of the volatile food and energy components. Core inflation has consistently decreased since its peak eleven months ago, registering a 4.1% year-over-year increase by month-end. Despite the recent uptick, there is a strong indication that inflation has likely reached its peak for this economic cycle.
- Despite progress, inflation remains significantly above the Federal Reserve's 2% target, and indicators such as wage inflation (middle chart above) and core services inflation (right chart above) suggest it will remain that way for some time.
- At the last meeting, The Federal Open Market Committee's (FOMC) statement of economic projections (SEP) indicated the Fed doesn't expect to reach their inflation target until 2026.

# Fixed Income – Fed Tightening




Source: Baird

Source: PGIM

- The Fed chose to leave rates unchanged at 5.25% at its June meeting, which marked the first time in ten consecutive meetings that it did not make a move. Before the June meeting, market pricing had indicated the Fed would "skip" a rate increase at the meeting but would resume hiking rates in July. This prediction turned out to be accurate as the Fed announced a 25 basis point (0.25%) increase in rates at the July meeting.

- At the July meeting, officials claimed interest rates were already in restrictive territory, but signaled two additional hikes this year. Financial markets still think there will be small reductions in rates early next year. As of now, the expected rate cuts are anticipated to happen slowly, but history indicates this is unlikely as the Fed usually "breaks" something (the economy) prior to easing policy. If something "breaks," rates tend to move lower more quickly to limit the damage. The unprecedented speed of this tightening cycle makes it unlikely the easing cycle (lowering rates) will deviate from history.

# Fixed Income – Yields & Spreads

| Maturity | 12/31/22 | 6/30/23 | 8/31/23 | 9/30/23 | 1 Mo Chg | Q3 Chg | YTD Chg |
|---|---|---|---|---|---|---|---|
| 3 Mo | 4.41% | 5.31% | 5.47% | 5.46% | -0.01% | 0.15% | 1.05% |
| 1 | 4.73% | 5.44% | 5.40% | 5.48% | 0.08% | 0.04% | 0.75% |
| 2 | 4.43% | 4.90% | 4.87% | 5.05% | 0.18% | 0.15% | 0.62% |
| 3 | 4.23% | 4.53% | 4.56% | 4.81% | 0.25% | 0.28% | 0.58% |
| 5 | 4.01% | 4.16% | 4.26% | 4.61% | 0.35% | 0.45% | 0.60% |
| 7 | 3.97% | 4.01% | 4.21% | 4.62% | 0.41% | 0.61% | 0.65% |
| 10 | 3.88% | 3.84% | 4.11% | 4.57% | 0.46% | 0.73% | 0.69% |
| 20 | 4.15% | 4.08% | 4.41% | 4.90% | 0.49% | 0.82% | 0.75% |
| 30 | 3.97% | 3.86% | 4.22% | 4.70% | 0.48% | 0.84% | 0.73% |

Source: Baird

**Option-Adjusted Spreads (in bps)**

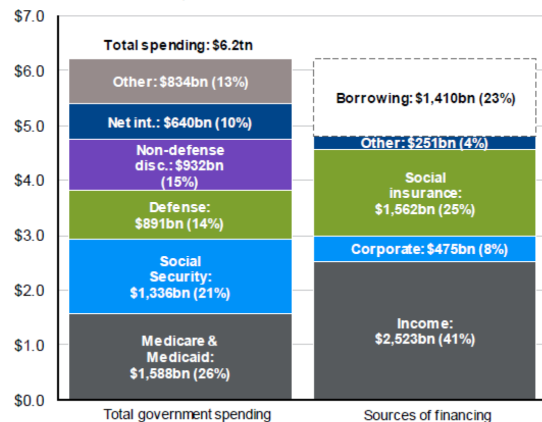
| | 12/31/22 | 6/30/23 | 8/31/23 | 9/30/23 | 1Mo Chg | Q3 Chg | YTD Chg |
|---|---|---|---|---|---|---|---|
| U.S. Aggregate Index | 51 | 49 | 48 | 52 | 4 | 3 | 1 |
| U.S. Agency (non-mortgage) | 26 | 19 | 19 | 16 | -3 | -3 | -10 |
| Mortgage and ABS Sectors | | | | | | | |
| U.S. Agency RMBS (Pass-throughs) | 51 | 52 | 53 | 66 | 13 | 14 | 15 |
| U.S. Agency CMBS | 52 | 51 | 58 | 54 | -4 | 3 | 2 |
| U.S. Non-Agency CMBS | 179 | 211 | 202 | 203 | 1 | -8 | 24 |
| Asset-Backed Securities | 76 | 68 | 63 | 67 | 4 | -1 | -9 |
| Corporate Sectors | | | | | | | |
| U.S. Investment Grade | 130 | 123 | 118 | 121 | 3 | -2 | -9 |
| Industrial | 125 | 113 | 108 | 110 | 2 | -3 | -15 |
| Utility | 129 | 132 | 124 | 122 | -2 | -10 | -7 |
| Financial Institutions | 140 | 139 | 132 | 140 | 8 | 1 | 0 |
| Non-Corporate Credit | 66 | 58 | 54 | 56 | 2 | -2 | -10 |
| U.S. High Yield Corporates | 469 | 390 | 372 | 394 | 22 | 4 | -75 |
| Emerging Market Debt | 687 | 681 | 649 | 648 | -1 | -33 | -39 |

Source: Baird

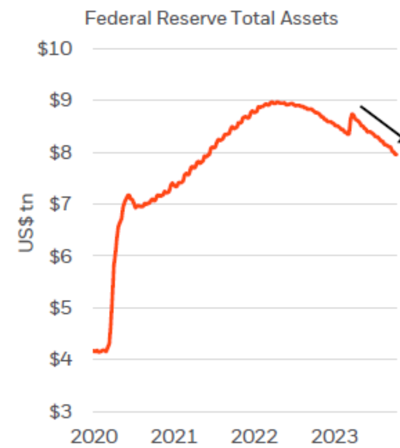
- Treasury yields experienced a consistent increase during the third quarter. The 10-year yield rose by 46 basis points (bps) in September and 73 bps in 3Q23. This upward trend led to a less inverted yield curve, indicating investors' demand for additional income to extend the duration of their investments.
- The Treasury 2-year-to-10-year slope hit its lowest point of -108 bps in early July but improved to -48 bps by the end of September. This shift was driven by the belief the Federal Reserve might need to maintain a restrictive stance for a more extended period than previously anticipated.
- In terms of spreads, Investment Grade (IG) Corporate spreads widened slightly by +3 bps in September but tightened by -2 bps for the quarter. Asset-backed securities (ABS) spreads remained stable, while non-Agency Commercial Mortgage-Backed Securities (CMBS) tightened by -8 bps in the quarter. However, Agency Residential Mortgage-Backed Securities (RMBS) bucked the trend, widening by +14 bps in the quarter, with +13 bps occurring in September. U.S. High Yield Corporates widened by +22 bps for the month and +4 bps for the quarter.
- From a performance perspective, the Bloomberg Barclays U.S. Aggregate Bond Index declined by -2.54% in September and -3.23% for the quarter, bringing year-to-date returns to -1.21%. Agency mortgage-backed securities notably underperformed due to reduced demand and increased rate volatility, with excess returns at -0.81% for the month and -0.85% for the quarter. In contrast, IG Corporate excess returns were strong for the quarter at +0.84%. Taxable municipals offered robust excess returns of +0.49% for the month and +1.45% for the quarter.

# Fixed Income – Positioning

- In terms of positioning, the inverted yield curve is allowing us to capture the ample yields in shorter maturities. However, with the recent backup in longer term rates there could be value in locking in yields at longer durations in advance of rate reductions. As a result, we may consider a modest extension of durations, believing that these maturities could represent value over the intermediate-to-long term.
- We will be cautious not to extend too far as the picture further out is highly uncertain. Higher inflation, increased debt loads (due to deficit spending), and a shrinking Fed balance sheet are reasons to be careful (see charts below). Waiting for the story to play out may be wise amid changing economic dynamics and the potential for higher interest rate structures to increasingly weigh on governments in the U.S. and elsewhere.
- On the credit side, we continue to be patient with investment grade and high yield corporate bonds. EBITDA margins and interest coverage have continued to decline, which is a notable downgrade to fundamentals. We believe securitized products remain attractive across various sectors, maturities and risk profiles. We continue to emphasize municipal bonds in tax aware portfolios due to their attractive fundamentals.
- Overall, we believe it is important to remain cautious in this environment, seeking higher-quality, more liquid, and resilient investments. Later this year or early next, if the economic outlook reaches a point of greater clarity, accompanied by a repricing of economically sensitive market sectors, it could be time to go on the offensive. In the meantime, we believe portfolio yields in the 5.0-5.5% range provide a nice backdrop for near-term return potential.




Source: JP Morgan




Source: Blackrock

# Our Team

## We are an investment firm, founded by investors.

**Bob Batchelor, CFA®, CFP®** is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 25 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee. Bob has also earned the right to use the Certified Financial Planner™ certification and SE-AWMA™ professional designation.

**Charles (C.J.) Batchelor, CFA®** is Co-Founder and Chief Investment Officer of Entasis Asset Management. C.J. has 19 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a voting member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee.

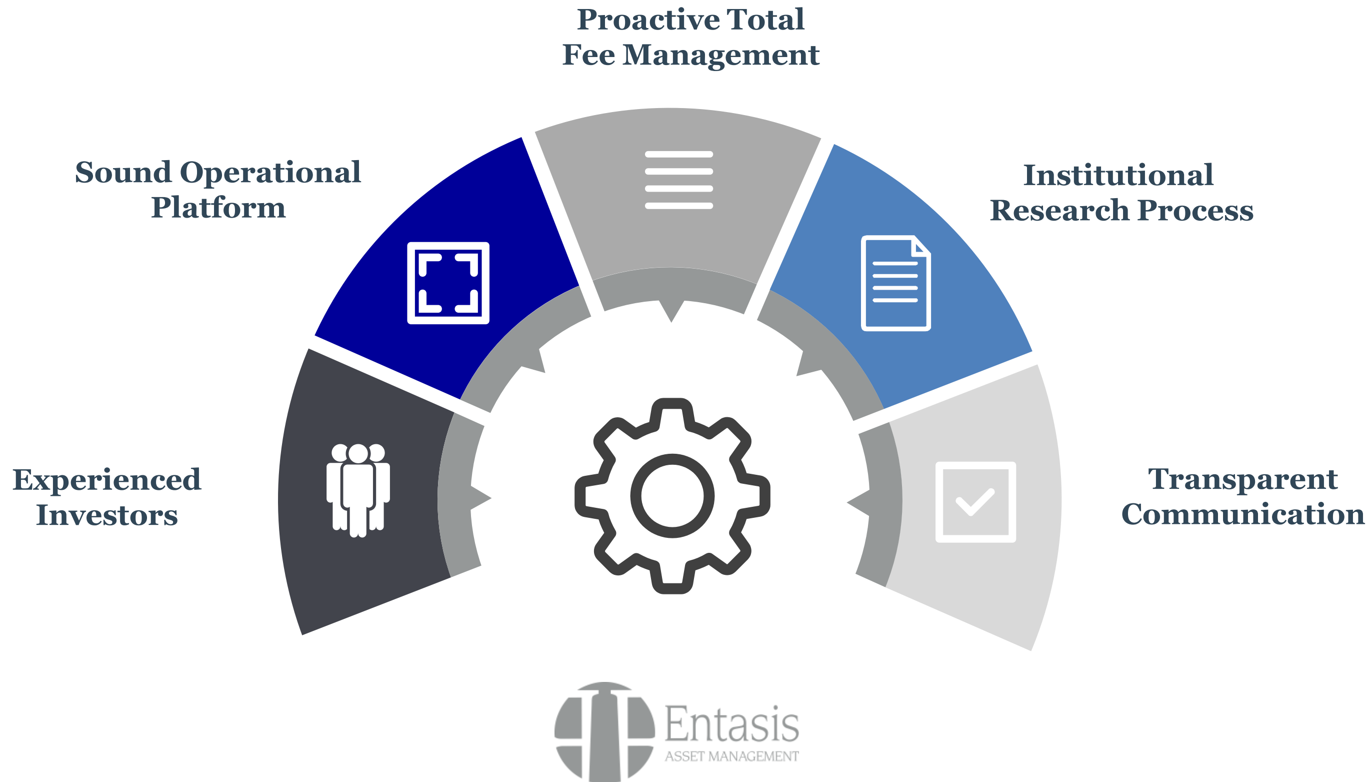
**Mike Peters, CFA®** is Co-Founder and Senior Wealth Advisor at Entasis Asset Management. Mike has 19 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as a voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

Mike holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. Mike is a member of the CFA Institute and CFA Society of Milwaukee.

**David LaCroix** is a Senior Wealth Advisor at Entasis Asset Management. David has more than 50 years of experience in the investment industry. Prior to joining Entasis, David worked at Cleary Gull Advisors, a Johnson Financial Group Company, and Cleary Gull Inc., a prior affiliate of Cleary Gull Advisors, where he most recently served as Vice President, Relationship Manager responsible for high net worth clients. Before Cleary Gull, David worked in a variety of portfolio management and client relationship management positions with A.G. Edwards and M&I Capital Markets Group.

David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

# The Entasis Difference



# Disclosure

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*Investment Terms*

**Valuation levels** are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100$^{th}$ of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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