OBSERVATIONS: *Choppy markets to start Q4, slight improvement in manufacturing, labor market surprises to the upside.*

- The S&P 500 snapped a streak of four consecutive weekly declines after gaining +0.50% last week. Small cap stocks (Russell 2000) closed the week lower by -2.2% and the 10-Year US Treasury ended at 4.8% (+23bps on the week). *Global equity markets open this week on a negative tone amidst the conflict in Israel, US bond markets are closed today.*[1]
- Manufacturing sector: The ISM Manufacturing index ticked higher month-over-month from 47.6 in August to 49.0 in September indicating the US manufacturing economy continues to be in contraction, though modestly so after September's improvement. This marks the 11th consecutive month of contraction, following a 28-month period of growth post-Covid.[2]
- Services sector: The ISM Services index continued to expand, registering 53.6 (in-line with 53.5 expectations) and marking expansion for 39 of the last 40 months. Slowness was seen in the Employment and New Orders sub-indices, both of which declined from the prior month.[3]
- Initial unemployment claims remain very low, registering only 207k claims last week and signaling the labor market—despite the ongoing UAW strike—remains strong as we move into October.[1]
- Job openings reached 9.610 million in August (most recent survey period), well above the prior month's 8.827 million and estimates for 8.815 million. Despite the rise in openings, hires and quits—which tend to be more indicative of wages and labor growth—were generally unchanged from the prior month.[4]
- September registered another large-upside surprise for the US labor market. In September, 336k jobs were created—nearly double the consensus expectations—while the unemployment rate held steady, and the estimate of new jobs created in both July (+79k) and August (+40) were revised upwards.[1]

EXPECTATIONS: *Fourth quarter seasonal strength, McCarthy ouster sets stage for potential mid-November shutdown.*

- This fourth quarter got off to a choppy start but Q4 of the calendar year has historically been the best quarter of the year—gaining nearly 82% of the time since 1936 for the S&P 500. The average gain during Q4 over that period was +4.5% for the index with 68% of all quarters returning between -3.4% to +12.4%. In the last ten years the S&P 500 has experienced one negative fourth quarter, that was in 2018 when the index fell -13.5% (in that quarter the Fed Funds rate rose +25bps, while the 10-Yr UST fell from 3.08% to 2.69%).[1]
- House Speaker Kevin McCarthy was ousted last Tuesday by a vote of 216 to 210 with eight Republicans joining all Democrats in the House to vote him out of his job. McCarthy's downfall came after he allowed a vote in the final hours of September 30th to pass a stopgap funding bill to keep the government open until 17-November. The ouster of a sitting House Speaker has never occurred in the nation's history and all House business—including votes on any of the 12 appropriations bills needed to fund the government past mid-November—has stopped absent a new speaker. Republicans are set to meet this week to see if any of the three candidates to replace McCarthy can muster 218 votes out the Republican caucus of 221. These developments increase the odds of at least a partial government shutdown on November 18th.[5]

ONE MORE THOUGHT: *Do rising rates mean falling stocks?*[1]

Stock markets generally reached their respective 2023 peaks on July 31 and since then have been in retreat—mostly driven from a contraction in valuations (price-to-forward earnings). Small cap stocks (Russell 2000) have led

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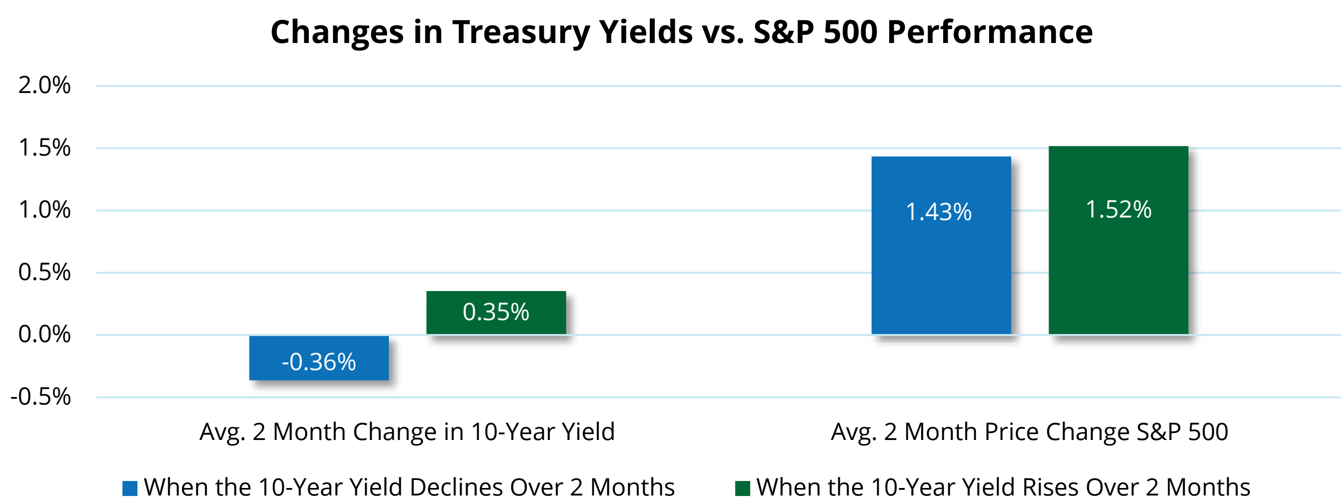
[1] *Bloomberg LP*
[2] *https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/september/, as of 10/3/2023*
[3] *https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/services/september/, as of 10/4/2023*
[4] *https://www.bls.gov/news.release/jolts.nr0.htm, a of 10/3/2023*
[5] *WSJ "Top Republicans Jump Into Speaker Race After McCarthy Ouster" 10/4/2023*

declines, having lost -12.6% from July 31 to date (October 6). The S&P 500 has lost -5.8% from its peak while the tech heavy Nasdaq is down -6.2% since July 31— with the exception of the energy sector, all sectors in the major indices have posted negative returns. Coincident with the drop in markets, interest rates have moved considerably higher, with the 10-Year US Treasury yield (UST) rising nearly 85bps from 3.96% to 4.80% over that period. Rising rates have had a more pronounced impact on interest rate sensitive sectors such as regional banks where unrealized losses of government securities on bank balance sheets continue to garner market attention (KBW Regional Bank index down -14.2% since July 31 to Oct 6)—Q3 earnings reports should shed more light on this specific concern. While the rise in interest rates takes much of the blame for recent market weakness, history has been less clear in illustrating the correlation between rising rates relative to changes in stocks over very short periods of time as we note here from July 31 to October 6 (i.e., 2 months). Over the last 50 years the average change in the 10-year yield over two-month windows is zero, interesting when you consider that period included a run up to nearly 16.0% in 1981 followed by a secular decline to less than 1.0% in 2020. Further, over two-month horizons the performance of the S&P 500 has been, on average, positive, regardless of whether the 10-Year rose or fell (Chart of the week). What now? In the very near term, volatility is likely to remain for both stocks and bonds as recent data complicates the Fed's next steps. That said, stocks enter a historically seasonally strong quarter, while for bonds interest rates are likely to continue to rise—with the 10-year UST eyeing 5.0%—becoming more attractive for long-term investors.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, monthly data as of 10/6/2023, Rolling two-month change in 10-Year US Treasury Yield and rolling two-month change in S&P 500 Price index, 9/30/1973 to 9/30/2023. Past performance is not an indicator of future results.

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