Third Quarter 2023 Investor Letter

After a strong first half of the year, equity and bond markets fell in the third quarter. Overall, the S&P 500 Total Return Index fell 3.3% during the quarter. Stocks remain higher by 13.1% for the year. The Bloomberg Aggregate Bond Index fell by 3.2% during the quarter. Long-term US treasury bonds fell 11.9% during the quarter. Growth stocks, which led the market higher in the first half of the year, fell the most in the quarter, declining 5.9%. Value stocks declined 1.9% and dividend stocks fell 2.5%.

The biggest news event for financial markets was the press conference by Fed Chair Jay Powell following the Fed's interest rate decision on September 20. After explaining the Fed's reasoning for not raising interest rates, Powell went to great lengths to explain that the Fed's war against inflation was not over, and that rates could still rise further and that they were not likely to fall anytime soon. These statements were followed by similar hawkish statements by other Fed officials. Following these statements, stocks and especially bonds declined sharply, with the decline carrying into the beginning of the third quarter. The decline in bonds contributed to one of the biggest declines in this asset class of all time (see section below).

While the decline in equity and fixed income prices was widely reported, an important positive that received less attention is that the US economy's performance has been much stronger than anticipated. This strength should be a positive for corporate earnings in the second half of this year.

The End of the Bond Bubble

The decline in bonds this year combined with last year's drop have brought the total losses in long-term bonds to nearly 50%. As a recent Bloomberg article points out, these losses are of a similar magnitude to losses experienced by equity investors in the tech bubble in the early 2000s, or the financial crisis in 2008. (So far, the fallout from the decline has been relatively modest, mostly contained to some regional banks such as Silicon Valley Bank which made bad bets on the bond market.) To put it in perspective, the total return on 10-year Treasury bonds is now worse than any other 20-year period in history.

Investors might reasonably ask how losses of this magnitude could be experienced in bonds, which are supposed to be relatively safe investments. The simple answer is that almost any investment can become overvalued and at risk of loss. (The only exception to this rule would be cash and short-term bonds.) It is true that historically speculation has been more common among instruments such as growth stocks, real estate, cryptocurrencies, etc., but so called "safe" investments are not immune to speculation. In fact, their perceived safety can lead investors to ignore the risks of over-valuation.

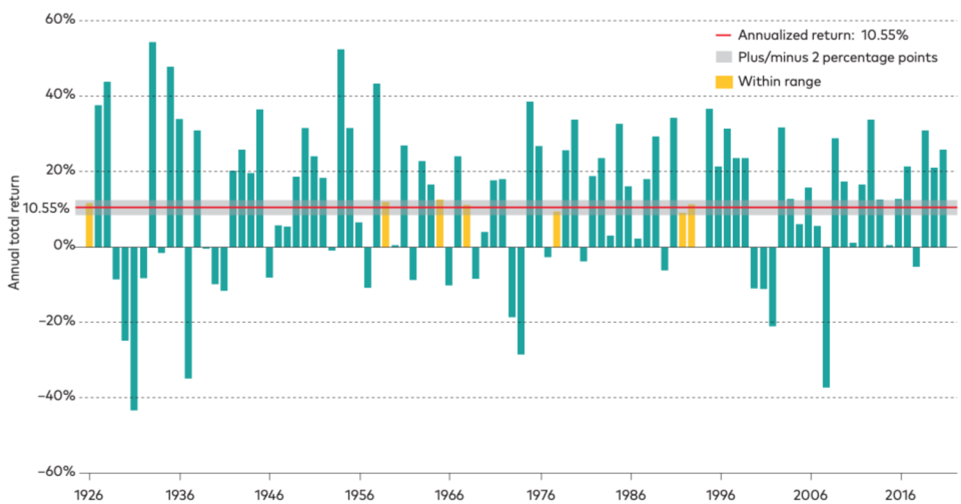
Historically bonds were purchased in order to earn a return greater than inflation. If the inflation rate was expected to be 2-3% then it was not uncommon for bonds to yield 5-6%. This relationship was broken in the past 20 years for various reasons including disinflation, quantitative easing, and the bond bubble. For reasons that can't really be explained, in recent years investors regularly purchased long term bonds with yields lower than the expected inflation rate. As Warren Buffet said at the time, these bonds could be said to offer "return free risk." It would be reasonable to expect that in the future, bonds would again offer yields in excess of inflation.

To be clear, the dramatic losses experienced by investors were on long-term bonds, not on the short-term treasury securities held in Western Pacific portfolios. We have followed a philosophy of holding either short term treasury securities (which have the lowest level of risk of which we are aware) or equities. That said, now that bonds have fallen dramatically, we are researching potential opportunities for our clients to selectively invest in this area.

Financial Market Returns are Somewhat Predicable in Long Run but not in the Short Run.

A common question/frustration investors express is, if equities are supposed to average returns of about 10% per year, why does this almost never happen in practice. We recently received a chart from Vanguard that addresses this issue. The chart, which is reproduced with permission below, shows equity market returns going back to 1926. As you can see, the average return over that period was 10.55%. But the more interesting thing is that for the 96 years covered in this chart the return only fell within 2 percentage points of the average in 7 years, or about 8% of the time. So, for someone who invests over a 50-year time frame, they might only expect "average" returns in about four of those years. Every other year (92% of the time) will be either an overreaction or under reaction to some economic or geopolitical event. Another observation from this chart is that since the Great Depression, there have only been two periods where the market was down more than one year at a time. Once was during the bear market of the 1973-1974, and the other time was following the tech bubble in 2000. In most cases, a down year in the market was followed by a number of positive years of market returns.

U.S. stock market 1926–2021
Returns fell within 2 percentage points of the annualized return of 10.55% in only 7 out of 96 years.



U.S. stock market returns based on Standard & Poor's 90 Index from 1926 to March 3, 1957; S&P 500 Index from March 4, 1957, through 1974; Dow Jones Wilshire 5000 Index from 1975 to April 22, 2005; MSCI US Broad Market Index from April 23, 2005, to June 2, 2013; and CRSP US Total Market Index thereafter. Assumes all distributions were reinvested. Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Vanguard.

Thank you as always for being a client. Please feel free to reach out to Roger or me should you wish to discuss any topic.

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