CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q3 2023

"We naturally fear the unknown, and the future is always unknown."
Peter Bernstein

It's October, and based on our local Home Depot, preparation for Halloween is well underway. In fact, by the time you read this, you are likely far too late to purchase one of the 12-foot skeletons. Halloween makes us think about horror movies and the "jump scare." First used in 1942's "Cat People," the jump scare is intended to shock an audience with a jarring change in image and sound. When you go to a horror movie, it's what you expect. Once the score starts to rise in intensity, you know it's only a matter of time before Jack Torrance starts beating down the bathroom door in "The Shining," or Jason Vorhees emerges from the lake in "Friday the 13th," but it's scary just the same. It is that uncertainty that attracts people to horror films in the first place, the Schrodinger's cat-like balance of comfort and fear existing simultaneously, and there are some waiting for this market's jump scare. **Because of that uncertainty, it is periods like today that can provide unique opportunities for active management, particularly value-oriented stocks.**

Much of the last two years has been turbulent for stocks, and the third quarter was no different. Like watching a horror movie, investors have been thrown around between fear and exuberance. The primary debate continues to be focused on the macroeconomic picture, with hopes for a soft landing balanced against fears of a hard landing. As some concerns have eased, new ones have taken their place. The Federal Reserve is in a tricky spot as it tries to navigate reducing inflation without crushing economic growth. **The latest moves in the bond market have been nothing short of massive, with the long end of the curve rising dramatically. This has started to create turmoil as the quarter comes to a close.** While this can be frustrating, volatility and uncertainty can create opportunities to buy great companies at inexpensive prices and trade around positions.

Given the litany of concerns today, it makes sense to highlight a few of the most prominent ones. First, the health of the consumer is up for debate. Many companies have pointed to a strong consumer, but there is evidence that those days may be fading, and others, perhaps those that are less promotional, have said the exact opposite. During COVID, there was a massive fiscal transfer to consumers, which resulted in a considerable increase in the savings rate and high levels of excess savings, which J.P. Morgan had estimated at over $2.1 trillion at the peak. However, as those transfers slowed or stopped, consumers continued to spend at an elevated rate and rapidly depleted those savings, with estimates of a remaining buffer of only around $0.2 trillion by the end of the third quarter. This will make the fourth quarter one to watch more closely as those excess savings dwindle, coinciding with a period where many will need to start making student loan repayments. We will be watching early indicators of credit deterioration, such as auto and credit card loans.

Another concern remains inflation. While inflation has come down significantly from the peak, it is still running above trend. With wage growth remaining strong (the latest reading from the Atlanta Fed Wage Growth Tracker in August was 5.3%) and labor markets remaining tight, it continues to put an upward bias to inflation. Additionally, oil prices have moved significantly higher of late, which will lift inflation measures. The U.S. already drew down on the Strategic Petroleum Reserve., making any relief on that front less likely. Lastly, while Congress narrowly avoided a government shutdown, the can has merely been kicked down the road for 45 days, and more aggressive parts of the majority party in the House of Representatives have proved with the vacating of Speaker McCarthy's seat that they will be in the room next time. That uncertainty still remains and can scare some investors. However, we would point out that this last concern is not likely to have a meaningful impact on the market, as prior government shutdowns have shown a negligible impact on equities.

In response to this uncertainty, there was some weakness in the market, as the S&P 500 and Russell 1000 Value indices were both down 3% for the quarter and 6-7% from their July peaks. Small cap stocks were more impacted, with the Russell 2000 down 11% from its peak. However, it reminds us of our philosophy that stock prices are more volatile than the fundamentals that determine value. Volatility has risen, even if it is nowhere near panic levels, with the large cap VIX up to 18 and the small cap RVZ over 20. **We continue to hunt for opportunities where we believe fear is excessively in the price. Periods of higher volatility, combined with a large spread between the cheapest and most expensive securities, drive an even more exciting opportunity to identify attractively valued securities.**

The non-magnificent seven stocks in the S&P 500 now trade below their 10-year median on a P/E basis, and value stocks broadly continue to trade as cheaply as they have been since the Tech Bubble. **While we need to be prudent and focus on companies that can weather a downturn and/or higher rates, were those situations to occur, we believe our current holdings are well-positioned and broadly demonstrate strong fundamentals, and we are seeing more (and different) unique opportunities to compare them to.**

We don't know what the next month, quarter, or year has in store for the market, and certainly hope that the fear of a jump scare will be just that, a fear. But if it is not, we will be prepared. **We continue to manage our portfolios and positions in the same steady way, and it is an environment that we believe will favor discipline. We look for mispriced opportunities at companies with strongly embedded characteristics. We remain laser-focused on fundamentals to ensure that we are confident our companies can thrive during good periods and withstand weaker ones. We continually examine our portfolio and our convictions to ensure that we hold stocks trading at attractive discounts to our conservative assessments of their worth.** We remain very excited about the absolute return potential of our stocks over a multi-year time horizon.

Sincerely,

The Cornerstone Investment Team

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.