Q3 MARKET INSIGHTS

BEAUMONT
FINANCIAL PARTNERS

Fall 2023

Investors spent the third quarter digesting the latest economic data as well as comments from the Federal Reserve (the "Fed") in an effort to determine the future path of interest rates. Since the Fed began raising interest rates in March of last year, investors have been closely watching to see if the Fed will be successful in taming inflation without causing a severe slowdown in economic activity. Surprisingly, economic data has been unexpectedly resilient. The Citigroup Economic Surprise Index, which measures how actual economic data compares to market expectations, hit a 28-month high in July as much of the data reported this year has come in stronger than expected. Refer to the chart below: a positive reading means that data releases have been stronger than expected and a negative reading means that the data releases have been worse than expected.

Given the better-than-expected data, some investors believe the likelihood of a recession occurring has declined, and that the U.S. economy will experience a soft landing. However, this has also raised concerns that continued growth in the U.S. could re-ignite inflation and prompt additional rate hikes by the Fed. In comments made after the Fed's September meeting, Chairman Jerome Powell did not rule out the possibility of another rate hike before the end of this year.

"In comments made after the Fed's September meeting, Chairman Jerome Powell did not rule out the possibility of another rate hike before the end of this year."

This rhetoric further confirmed that the central bank remains committed to its previous guidance of keeping interest rates much higher than expected well into 2024. This also pushed bond yields higher and pressured stock valuations lower during the third quarter. For the three months ended September 30th, the S&P 500® Index was down 3.27% and is now up 13.06% year-to-date. Internationally, foreign markets saw moderate declines as disappointing economic data in Europe and China bolstered regional recession fears. Foreign developed markets, represented by the MSCI EAFE Index, decreased 4.04% during the third quarter (+7.63% YTD), while emerging markets, represented by the MSCI Emerging Markets Index, finished the quarter down 2.85%

Citi Economic Surpise Index — U.S. Through September 2023

Source: Bloomberg

(+2.07% YTD). Switching to fixed income markets, the leading benchmark for bonds, the Bloomberg Barclays U.S. Aggregate Bond Index, declined for the second straight quarter as prospects for a prolonged period of higher interest rates caused the index to fall 3.23% for the quarter (-1.21% YTD).

THE ECONOMY GETS A BOOST

It is important to understand what has been driving this economic resilience to determine if it can continue. One explanation for this phenomenon has been the surge in Federal government expenditures since the end of 2022, stemming from President Biden's Inflation Reduction Act. This law authorized almost $900 billion of total spending, mostly dedicated to programs to bolster domestic manufacturing of electric cars and semiconductors, and to repair roads and bridges. Funding for these initiatives is paid for through additional borrowing, and as a result, the Congressional Budget Office expects the budget deficit to expand to 6.5% of GDP this year. For context, in the six plus decades between the aftermath of World War II and the 2008 Global Financial Crisis, the shortfall never reached that level. Since then, the only times the U.S. had bigger deficits was right after the Global Financial Crisis and during the COVID-19 pandemic. Historically, deficit spending is only intended to be used during a recessionary period and reversed to a surplus during the subsequent expansion. It is unprecedented to run a budget deficit this high while economic growth is positive (GDP grew 2.1% in the second quarter, and expectations are for growth of over 2% in the third quarter), and the unemployment rate is near multi-decade lows. This additional stimulus is likely a key reason why economic growth has been better than expected. A surge in the deficit this large can sometimes artificially maintain growth in the very short-term. But given higher interest rates on government debt, this kind of support cannot last.

"A surge in the deficit this large can sometimes artificially maintain growth in the very short-term. But given higher interest rates on government debt, this kind of support cannot last."

Taking a closer look at the income and expenditures of the U.S. government, you will see the negative impact higher interest costs are starting to have on government spending. But before we examine that, let's take a step back and explain the different categories that make up the U.S. government's income statement. The U.S. government generates revenue via taxes, a majority of which come from personal income taxes, payroll taxes, and corporate income taxes. Additional sources of tax revenue come from excise taxes, estate taxes, as well as customs duties and tariffs. On the expense side, government spending can be broken down into three categories: mandatory, discretionary, and interest expense. Mandatory spending is mandated by existing laws and includes expenditures on Social Security, Medicare, Medicaid, Welfare, as well as healthcare and benefits for government employees and veterans (the term "mandatory" is somewhat of a misnomer, as these "entitlement" expenditures can, in fact, be reduced through changes to existing laws). Discretionary spending is money formally approved by Congress and the President during the budget appropriations process each year. Generally, Congress allocates over half of the discretionary budget towards national defense and the rest to fund the administration of other agencies and programs. These programs range from transportation, education, housing, and social service programs, as well as science and environmental organizations. Lastly, there is the interest expense that the government pays on the debt the U.S. Treasury issues to the public via bonds. If the government spends more than it collects in revenue, then there is a budget deficit. If the government spends less than it collects in revenue, there is a budget surplus. The table on the following page summarizes the federal budget for fiscal year 2022 as well as the forecast for fiscal year 2023 (please note that the U.S. government has a September 30th fiscal year end - actual numbers for fiscal year 2023 will be released in October).

When looking at this data, a couple of items stand out. First, tax receipts are expected to fall about 6%, which in our opinion, is a more accurate reflection of economic activity. Considering that these receipts are generated by individual and corporate incomes, this decline better underscores the slowdown in growth we are likely experiencing. Second, you will observe that Other Mandatory spending is estimated to fall about 37%. This change can be attributed to a decrease in net outlays for student loan programs, largely due to the expiration of the student loan debt relief programs (as borrowers now have to repay their loans to the government). Finally, and most important, you can see that interest expenses have risen by 47%, due to higher interest rates.

Receipts and Outlays of the U.S. Government (in billions of dollars)

	FY 2022	FY 2023 (forecast)	% Change
Taxes	**4,900**	**4,600**	-6.1%
Mandatory Spending			
Social Security	1,200	1,400	16.7%
Medicare/Medicaid	1,339	1,600	19.5%
Other Mandatory	1,583	1,000	-36.8%
Total Mandatory Spending	**4,122**	**4,000**	-3.0%
Discretionary Spending			
Defense	751	800	6.5%
Other Discretionary	910	900	-1.1%
Total Discretionary Spending	**1,661**	**1,700**	2.3%
Interest Expense	**475**	**700**	47.4%
Total Spending	**6,258**	**6,400**	2.3%
Budget Surplus/(Deficit)	**(1,358)**	**(1,800)**	32.5%

Source: Congressional Budget Office; Center on Budget and Policy Priorities

Soaring interest rates have been a key driver of the deficit, with the Fed raising its benchmark interest rate by 5.25% since it embarked on its tightening campaign last year. This issue is only going to be exacerbated, as interest costs are expected to continue to rise unless interest rates reverse course. As lower-yielding securities continue to mature, the U.S. Government faces steady increases in the rates it pays on its outstanding debt. Maturities on Treasuries have gotten shorter in recent years which is not helping the matter. In fact, almost one-third of our national debt needs to be rolled over within the next 12 months, and that does not take into account additional issuance to finance additional deficits. For context, the weighted average interest rate for total U.S. Treasury debt outstanding, which was last reported at the end of June 2023, was 2.76%. That's up from 1.80% a year earlier, and if the Fed is adept at keeping rates "higher for longer", the blended rate on the debt is forecast to surpass 4% in one year. At that rate, assuming $33 trillion in national debt outstanding (which assumes no deficit next year), total interest payments could reach $1.3 trillion within 12 months. That means more than 26% of the total tax receipts will be used just to pay interest on debt (if you were to assume that tax receipts in fiscal year 2024 recover to the same level as fiscal year 2022).

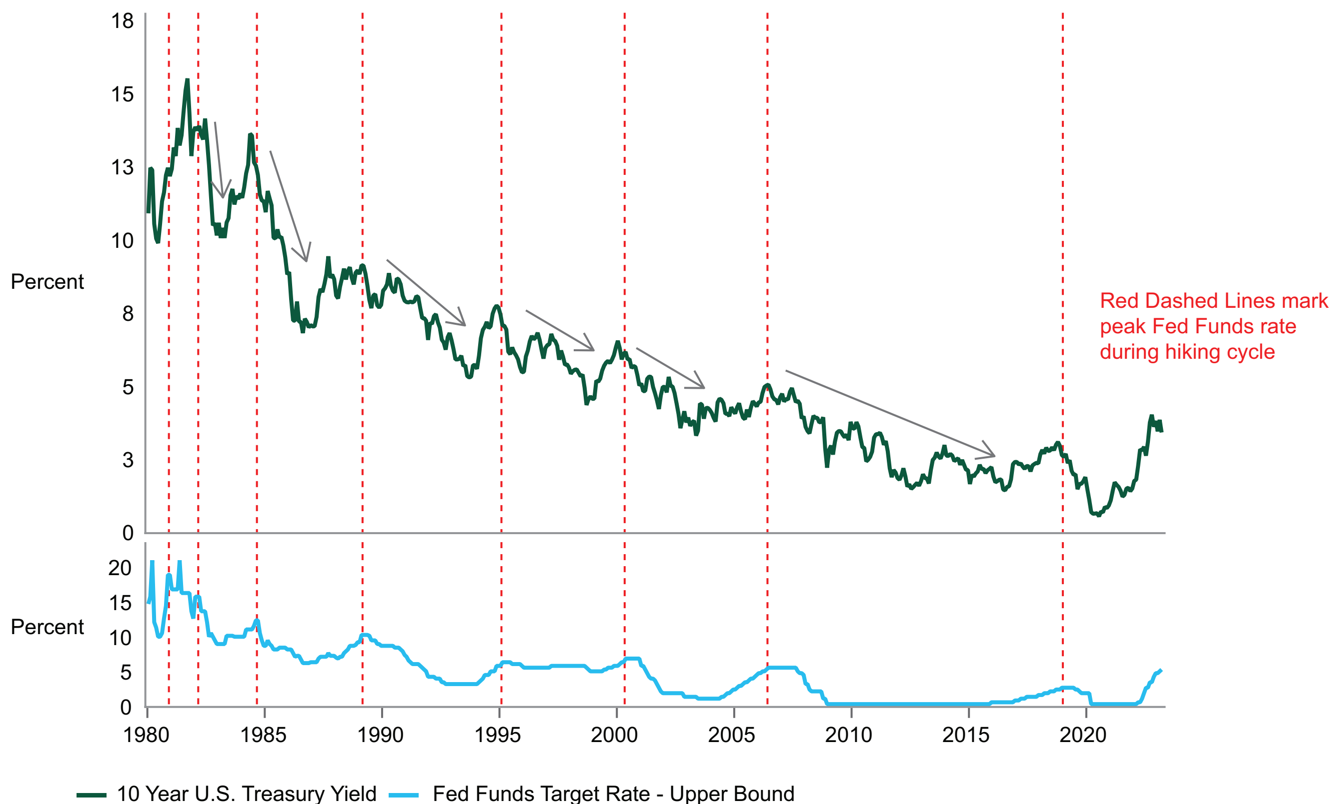
Having more and more of your revenue consumed to pay debt service costs is not a productive use of capital, as it takes resources away from parts of the economy that could use this capital for consumption and investment. In addition, it can restrict the government's ability to stimulate growth when it is really necessary (like during a recession). Therefore, we believe it is important that Congress and the White House take steps to reduce the deficit, as continuing on this path may become untenable.

In an effort to reduce the current budget deficit (and maybe balance the budget), lawmakers have a few options. Congress can cut spending, but given the federal budget's makeup, a significant portion of any cuts would likely need to come from popular social programs, which would be politically challenging especially with an upcoming election year. Alternatively, they can raise taxes, which is also unpopular, but in our opinion, is probably likely to occur at some point, but probably not until after the 2024 election. The only other alternative would be to pressure the Fed to lower interest rates. We believe that this option is the most tolerable as it allows lawmakers to avoid having to make unpopular decisions, thereby helping their chances to get re-elected next year. This solution does have some ramifications. Aside from helping reduce the deficit, cutting interest rates may lead to higher levels of inflation. However, there is a benefit to this as inflation would erode the real cost of those interest payments as well as the debt outstanding (as the interest and debt are paid off with cheaper dollars). While Chairman Powell has maintained that the Fed remains committed to bringing the inflation rate back down to a 2% run rate, we would not be surprised if the Fed became more "flexible" with its inflation target in order to contain interest costs.

PEAKING YIELDS AND OPPORTUNITIES IN FIXED INCOME

With less support from deficit spending, economic growth should begin to decelerate, especially as the lagged effects of tightening monetary policy permeate the economy. Numerous indicators that we highlighted in our last quarterly update such as the inverted yield curve, declining Leading Economic Indicators, contracting manufacturing activity, and tighter bank lending standards continue to suggest that the odds of a recession occurring in the future are high. Whether it is an effort to reduce interest costs, or changing policy in reaction to a recession, we believe we are near the peak of the Fed's rate hiking cycle, which has historically been a good time to extend duration in bonds. Remember that duration is a measurement of a bond's interest rate risk, and bonds with longer maturities and lower coupon payments have a higher duration than those with shorter maturities and higher coupons. The higher the duration of a fixed income portfolio, the more sensitive its value is to changes in interest rates. This means if you have two separate fixed income portfolios, the one with the higher duration will rise in value by a greater amount when interest rates fall (the opposite is true if rates rise, the portfolio with the higher duration will decline in value by a greater amount). After Fed policy rates peak, bond yields generally begin to trend lower (see chart below). The top chart displays the 10-year U.S. Treasury bond yield since 1980, while the bottom chart plots the Fed Funds target rate (which is set by the Fed) over the same time frame. The red dashed line in the chart marks the timing of the last rate hike during each tightening cycle. As you can see, yields trend lower after each peak which would lead to greater price appreciation in longer duration portfolios. In order to highlight this point, the table on the following page shows the 12-month performance of the Bloomberg U.S. Treasury 3-Month Total Return Index (which has a historical average duration of about 2.5 months) vs. the Bloomberg Barclays U.S. Aggregate Bond Index (which has had a historical average duration of about 4.9 years) after the final rate increase of each cycle. While the Bloomberg Barclays U.S. Aggregate Bond Index is subject to credit risk, as it also holds investment grade non-U.S. government bonds, the average return is more than double that of short-term U.S. Treasuries.

U.S. Treasury Yields After Policy Peak



Source: Macrobond, MNY Mellon Investment Management
BIS (The Bank for International Settlements), NBER (National Bureau of Economic Research), U.S. Department of Treasury Data as of Thursday, April 20, 2023

Fixed Income Index Performance After Policy Peak

	12-Month Performance After Last Hike	
Date of Last Rate Hike	Bloomberg U.S. Treasury 3-Month Total Return Index	Bloomberg Barclays U.S. Aggregate Bond Index
05/08/1981	13.9%	17.1%
01/04/1982	12.0%	32.6%
08/21/1984	9.7%	23.9%
02/24/1989	8.7%	12.9%
02/01/1995	6.0%	17.1%
05/16/2000	6.3%	13.7%
06/29/2006	5.3%	6.5%
12/19/2018	2.3%	8.8%
Average	**8.0%**	**16.6%**

Source: Bloomberg

Historical U.S. Government Shutdowns

Budget Authority Expiration (end of day)	Appropriation Act or Resolution	Number of Full Days Without Budget Authority	S&P 500 Return During Shutdown
11/20/1981	11/23/1981	2	0.0%
09/30/1982	10/02/1982	1	0.0%
12/17/1982	12/21/1982	3	-0.9%
11/10/1983	11/14/1983	3	1.1%
09/30/1984	10/03/1984	2	-1.5%
10/03/1984	10/05/1984	1	0.3%
10/16/1986	10/18/1986	1	0.0%
12/18/1987	12/20/1987	1	-2.5%
10/05/1990	10/09/1990	3	0.6%
11/13/1995	11/19/1995	5	0.9%
12/15/1995	01/06/1996	21	0.2%
09/30/2013	10/17/2013	16	2.4%
01/19/2018	01/22/2018	2	0.0%
12/21/2018	01/25/2019	34	9.3%

Source: BTIG Research

THE GOVERNMENT REMAINS OPEN…FOR NOW

At the end of the quarter, the U.S. government faced the possibility of a shutdown as Congress could not agree on a budget for fiscal year 2024, which started on October 1st (based on what we outlined earlier in this letter regarding the budget, the only thing Democrats and Republicans seem to be able to agree on is the lack of any need for fiscal discipline). At the last minute, Congress approved a stop-gap resolution that would keep the government operating until November 17th. Therefore, lawmakers must come together and agree on passing a long-term spending bill before that date, or risk shutting down again. While "government shutdown" sounds like an ominous term, like the dozens of government shutdowns before it, it won't have a material impact on equity markets or the economy (see the table above showing the S&P 500 returns during previous U.S. Government shutdowns). There are several reasons for this. First, the government doesn't actually shut down. Only parts of the government shutdown, and none of them are essential (meaning the military still gets paid, Social Security and Medicare still operate, etc.). Second, some Federal workers will be furloughed, and they will not get paid during the shutdown; however, they will get all the money they should have been paid via back pay once the government reopens. Third, government shutdowns don't last that long. The most recent one, which occurred in 2018 under President Trump, lasted 34 days and was the longest shutdown ever. The next longest was 21 days (under Clinton) and then 16 days (under Obama). The takeaway is that shutdowns don't impact enough people or last long enough to have a lasting macro-economic impact (although it may be disruptive for Federal workers furloughed and for certain services such as visiting a national park or wanting a passport renewed).

> "While "government shutdown" sounds like an ominous term, like the dozens of government shutdowns before it, it won't have a material impact on equity markets or the economy."

IN CLOSING

The unprecedented surge in the deficit has been a key reason for the better-than-expected economic growth we have experienced so far in 2023. In our opinion, this has helped to further delay the impact of the Fed's rate hiking campaign on slowing the economy (remember, monetary policy typically operates with a lag). That being said, many indicators still suggest that the odds of a recession occurring in the future are above average. However, additional fiscal supports could allow the economy to continue to muddle through. With an election year just around the corner, we would not be surprised if policy makers make every possible effort to keep the economy from entering a recession. Given these unknowns, it is important to maintain an asset allocation that fits with your long-term investment goals that can withstand any market surprises and related bouts of volatility.

We thank you for your ongoing confidence and trust. Please reach out to your relationship manager with any questions, or if you wish to discuss your portfolio allocation.

PERSONNEL UPDATE

We would like to share an important update regarding our long-time friend and Beaumont Partner, Larry Fiore. Larry encountered some health issues earlier this year. As you would expect, we want to be respectful of Larry's privacy but wanted to let you know that he will be out for an extended period of time, although it remains unclear as to how long at this point. Our focus continues to be on Larry's health and his family. We all want the best positive outcome.

In the interim, the entire Beaumont team continues to be committed to delivering the highest level of service that our clients have come to expect. Our Relationship Managers, Tax Department, along with our Client Service Team, remain available for any investment-related questions, tax issues, or support.

Please contact us with any questions.

Best regards,
Tom & Phil

BEAUMONT
FINANCIAL PARTNERS

TRUST | TRANSPARENCY | TEAMWORK

Definitions:

S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used to create indices or financial products. This correspondence is not approved or produced by MSCI.

The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Leading Economic Indicators (LEI), a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association working in the public interest.

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance [been] beating consensus. The indices are calculated daily in a rolling three-month window.

The Bloomberg U.S. Treasury 3-Month Total Return Index is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of 3 months.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.

Disclosures:

This material is provided for informational purposes only and does not in any sense constitute a solicitation or offer for the purchase or sale of securities nor does it constitute investment advice for any person. Investment themes and individual securities mentioned may or may not be held in any or all client accounts.

The material may contain forward or backward-looking statements regarding intent, beliefs regarding current or past expectations. The views expressed are also subject to change based on market and other conditions.

The information presented in this report is based on data obtained from third party sources. Although believed to be accurate, no representation or warranty is made as to its accuracy or completeness. Past performance is no guarantee of future results.

All performance data is as of 9/30/2023 unless otherwise stated. Diversification does not ensure a profit or guarantee against loss. An investment cannot be made directly in an index. As with all investments, there are associated inherent risks, including loss of principal. Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments include risks such as exposure to interest rate fluctuation, credit changes and inflation. Positions held in cash are subject to inflation risk.

Past performance is no indication of future results

Beaumont Financial Partners

250 1st Ave, Suite 101
Needham, MA 02494