



**Artemis**  
FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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## Executive Summary

- After a strong start to the year, markets continued to initially churn higher this quarter as inflation data continued to show a downward trend, and economic data and labor markets held up nicely. This continued until mid-August when bond yields surged and markets gave up their quarterly gains, tipping into negative territory.
- For the quarter, the U.S. market ended down -3.3%, developed international equities declined -4.9%, and emerging markets lost -4.1%. Most bond segments were negative for the quarter as well, with losses ranging from ~-2.0 to -3.0%. Within the U.S., large value and growth stocks both fell by around -3.3% while small companies (-5.2%) underperformed large companies (-3.2%).
- In this report, we take a close look at ESG investment performance over the last decade and ask whether this style of investing is in trouble as some headline news articles might suggest. We review three recent studies, two of which are notable in that they ensure that any out or underperformance of ESG returns is not simply due to different sector allocations or risk exposures. A third study examines whether more sustainable companies trade at higher valuations, thus acting as a direct incentive for companies to become more sustainable. Overall, the results are encouraging, although they do point to some speedbumps in ESG performance of late.
- **Artemis Strategy.** We are remaining defensive with a balanced exposure to both large value and growth stocks, with an overall tilt toward quality. We are also remaining somewhat cautious in fixed income, although we think some investors should start moving out of cash and into bonds.



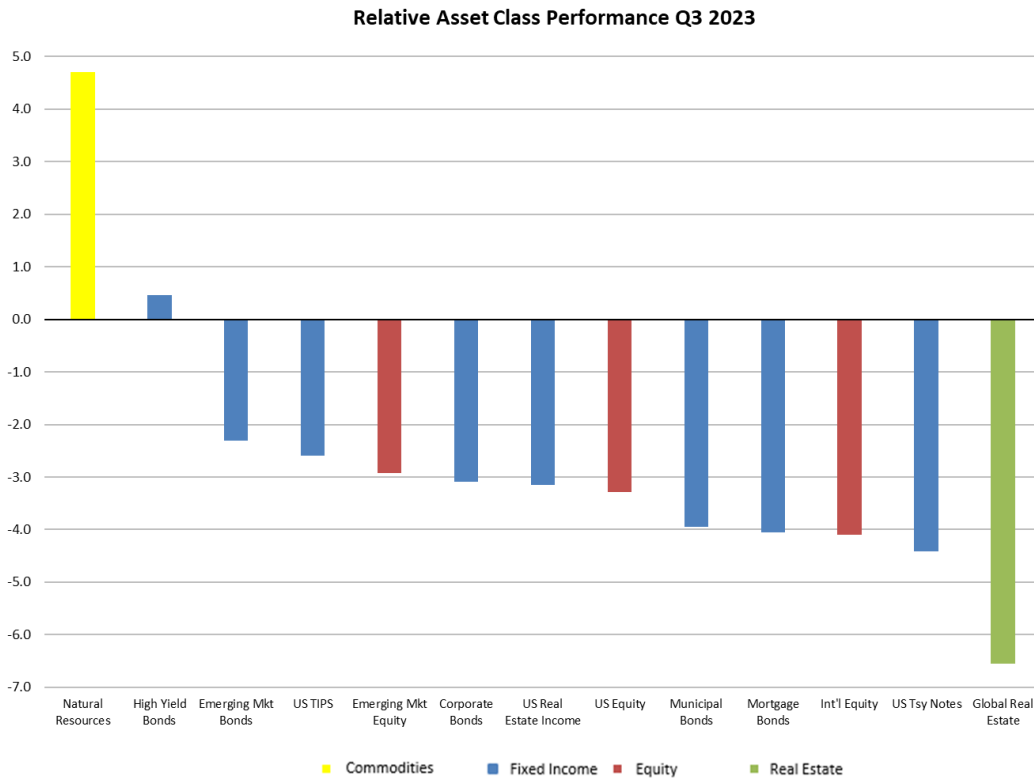
**Markets in Review – Q3**

After a strong start to the year, markets initially churned higher this quarter as inflation data continued to show a downward trend, and economic data and labor markets held up nicely. This continued until mid-August when bond yields surged and markets gave up their quarterly gains, tipping into negative territory.

For the quarter, the U.S. market ended down -3.3%, developed international equities were down -4.9%, and emerging market equities lost -4.1%. International markets were hit hard in September as surging bond yields in the U.S. caused the U.S. dollars to rise by over 5% between mid-July and the end of the quarter. Most bond returns were negative for the quarter, with most losses ranging from ~-2.0 to -3.0%.

Within the U.S. market segments, large-cap value and growth both fell by -3.2% while small companies (-5.2%) underperformed large companies (-3.2%). Real estate, a classic bond proxy, was the biggest detractor this quarter, falling -6.6%, while commodities rose +4.7%, led by increases in oil prices. See figure 1.

Figure 1. Asset Class Returns in USD for Q3 2023 (%) (Source: YCharts)





Markets became unsettled in July when government bond yields started climbing after a flurry of stronger-than-expected data persuaded investors that the Fed would have to keep interest rates elevated longer to cool the economy. At the same time, the government said it would sell many more Treasuries in the coming months than investors expected, which pushed up yields on longer-maturity bonds.

This “higher-[interest rates] for-longer” thesis took the shine off of the so-called “Magnificent Seven” stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta), which up until September, had accounted for over 90% of the gains in the S&P 500 year-to-date. Shares of Nvidia fell 12% in September, Apple slid 8.9%, and Amazon dropped 7.9%. Only Meta notched a gain. Yet by the end of September this same basket of stocks still accounted for over 70% of the total gain in the S&P 500 for the year. Indeed, if the S&P 500 stocks were all equally-weighted versus weighted by size, the S&P 500 would show a 0% gain for the year by the end of September.

A strong economy and a tight labor market imply that interest rates might stay higher because they are supported by that good economy. While we anticipate inflation will fall, a strong economy may prevent it from falling enough, and the added risk of rising oil prices and geopolitical conflict could add a wrench to those expectations. Hence, the “higher for longer” thesis.

Higher rates by themselves do not cause a recession, but the longer rates stay above what would be considered a normal or “neutral” level, the more stress is created. This stress presents itself in different ways and with delays (as not everyone is affected right away), but as companies and consumers are forced to take on more strain from paying higher interest rates, the bigger an impact it will have.

Oil prices are also a key risk in the coming months because a harsh winter, escalating conflict in the Middle East, a more assertive Russia, and an opportunistic Saudi Arabia, could potentially trigger oil prices to surpass \$100 per barrel. If this high price is reached and persists, it would filter down to both core and headline inflation, possibly leading to a more prolonged period of elevated interest rates. As shown in Figure 2, oil prices spiked in 2022 when Russia invaded Ukraine. These prices came down over the past year until this July when they began rising again.



Figure 2. Crude Oil Prices 2020-2023 (\$)



Source: Bloomberg

While the U.S. economy continues to exceed expectations, the situation overseas is more mixed. The Eurozone is contending with more stubborn inflation and some slowing business activity. China is struggling with structural issues, low consumer activity/confidence, and a deflating real estate market. Japan and India remain the bright spots as they have showed stronger growth and economic resilience.

### *Our Take*

Our outlook remains consistent with our thoughts last quarter, which is that the global economy is heading toward a period of more sluggish growth rather than a steep downturn. That said, the risk is that higher interest rates cause a 'breakpoint' somewhere unexpected that pushes us more rapidly into a deeper recession. If a few bank failures have taught us anything, it is that the economy is more susceptible to negative surprises in this type of environment.

Risks aside, there are many positives that make this a more balanced environment for investors. The strength of the labor market and consumer income are compelling forces, interest rates are peaking (or have peaked), and the innovation cycle born from the AI boom should provide some positive upside as productivity and new opportunities emerge.



### ***Trouble in ESG Land?***

As most of you know, Artemis believes that it is becoming industry best practice to incorporate environmental, social and governance (ESG) risk factors into the investment process, and we offer clients the option (not the obligation) to do so. For those of you who have not expressed a strong opinion, in recent years we have been defaulting to using more ESG-aligned funds in our portfolios. As such, it behooves us to periodically let you know what's happening in the world of ESG investing, especially due to the increasing news that sustainable investing principles seem to be facing some backlash. Is ESG in trouble? In this section, we want to share with you some new research on ESG investment performance over the last decade in both the U.S. and in Europe.

The short answer is that ESG investing is not in trouble but it is facing a few speedbumps:

#### *Political Backlash*

Some of you will have read about the conservative politicians in the U.S. who have begun arguing against ESG tenets as “woke” investing that sacrifices profits for principles. Last January, for example, 25 conservative states, led by Texas, came together and sued the Department of Labor to block its so-called “ESG rule,” which states that investment companies that manage employer-sponsored retirement plans could consider ESG risk factors alongside traditional financial metrics when evaluating which companies to invest a 401(k) plan in. And in May of this year, more than a dozen conservative states petitioned the Federal Energy Regulatory Commission to challenge the legality of BlackRock's (Blackrock is a huge U.S. asset management firm) ability to invest more than a certain amount in certain fossil fuel emitting firms, while potentially requiring those energy providers to follow ESG priorities. Rulings on both have not yet come out.

Yet other states are taking the opposite view. In June of this year, New Jersey became the first state to require that climate change be taught in all classes from kindergarten through 12<sup>th</sup> grade. And just a few weeks ago, Gov. Gavin Newsom of California signed a new law requiring all large businesses in the state to disclose a wide range of planet-warming emissions. The SEC is in the midst of finalizing a similar rule for all large U.S.-based companies.

In brief, ESG investing is currently getting caught up in the broader ‘culture wars’ underway in the U.S. Will ESG survive? Yes, but just like abortion and teaching your children that some folks have same-sex preferences, it's getting harder, not easier.



### *ESG Investment Performance*

Debates have raged for years over whether ESG strategies and funds have lagging or superior performance compared to funds that do not incorporate these risk factors. Not surprisingly, different studies claim they prove one side or the other, in part because assessing the realized impact of ESG factors on performance is actually very difficult due to the existence of disparate approaches to define and capture sustainability. However, there are a few newer studies out we find noteworthy.

A brand new study titled “Sustainability Alpha in the Real World”<sup>1</sup> analyzes the performance of U.S. exchange-traded funds (ETFs) that incorporate ESG principles over the last decade. Their findings are notable because the authors measure the performance of investment products actually available to investors versus the relative performance of what they call stylized strategies. An example of the latter might be measuring the relative performance of companies that receive high employee satisfaction scores. As the study’s authors point out, ‘real world’ ESG investment products rarely draw on such simple and publicly available categorizations, alone.

The key finding in this study is that on the whole, ESG-focused funds have not outperformed non ESG-focused funds in the U.S. over the last decade (through December 31, 2022). Specifically, the study finds that average annual returns for U.S. ESG ETFs were 0.2% lower than for comparable non-ESG ETFs. The underperformance falls to 0.1% percentage points when returns are adjusted for the market risk exposure of portfolios. However, the average annual underperformance increases to 0.7% when industry factors’ contributions are removed, balancing the sector weights between the two universes (e.g., ESG funds are typically underweight energy).

The overall (negative 0.1%) finding is shown in Figure 3. Of note is the period between October 2018 and November 2021, when ESG investing outperformed, coinciding with a period of growth and popularity for ESG investing. However, that outperformance all but evaporated in 2022.

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<sup>1</sup> Bruno Giovanni and Felix Goltz. “Sustainability Alpha in the Real World: Evidence from Exchange Traded Funds.” Scientific Beta Publication. May 2023.



Figure 3. Cumulative Risk-Adjusted Out/Underperformance of ESG ETFs - 2012-2022\*



Source: Scientific Beta.

A second study worth mentioning was conducted by Barclays bank in 2021. While their approach differs from the above study, they, too, focus on ensuring that any outperformance or underperformance is not simply due to different sector allocations and risk exposures. In this study, the authors build two individual stock portfolios (both for the U.S. and for Europe) that are identically matched for risk and sector weightings to their non-ESG benchmarks (S&P 500 for the U.S. and Stoxx600 for Europe). The authors find that the high ESG-scored portfolios outperform their non-ESG benchmarks over the entire period from (January 2014 – April 2023). But similar to the ETF study, they also find that outperformance in the U.S. shrank by half in the last 2.5 years but not in Europe. See figure 4.





Figure 4. Cumulative ESG Return Premiums for the U.S. and European Equity Markets.



Source: Barclays Research

A third recent study<sup>2</sup> takes a different tack and asks the question of whether firms with sustainable practices trade at higher valuations. The basic idea is that if good companies trade on higher valuation, companies have an incentive to become better. Investors who support companies who are trying to become better, will make money from their rising valuations (assuming the market hasn't already priced in their better behavior).

The answer is encouraging for ESG proponents as the study's author finds that bad companies (based on Schroders Bank's SustainEx ESG rating system) are valued at 17x their last 12 month earnings, whereas good companies are valued at 25x. This relationship holds when examining companies within sectors. For example, the author finds that the most

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<sup>2</sup> Lamont, Duncan. "Are More Sustainable Companies More Expensive?" Schroders Bank. May 11, 2022.



sustainably run materials companies are valued at 23x their last 12-month earnings, compared to 13x for the least.

### *Conclusions*

While ESG returns have been lackluster of late, we are encouraged by the overall findings of these studies. The first study suggests to us that one does need to carefully research the ESG index-like products on the market today, given the disparate (and sometime contradictory) methodologies and rating systems used to create them. At Artemis, we favor products from Calvert Research, a company known for really looking under the hood at what companies are actually doing or not doing, versus solely relying on quantitative rating systems. We also like Calvert because they back up their research by actively engaging with companies (e.g., by filing shareholder resolutions) to become more sustainable.

The other two studies seem to suggest that good rating systems can separate the “wheat from the chafe” with companies who score higher (largely on environmental versus social and governance risk factors) outperforming and commanding higher valuations. This is good news for sustainability investors.

### ***Artemis Strategy***

For those of you who follow along, you will know that our overarching approach to the markets this year has been to be defensive, focusing on higher quality stocks, creating a better balance between high-growth stocks and more defensive value-based stocks. We have also been cautious with fixed income, leaning more toward lower maturity securities, and holding a good slug of U.S. Treasuries for the first time in years. Our cautious approach to the markets was predicated on the view that the Federal Reserve was very determined to reduce inflation and, in so doing, was likely to increase interest rates aggressively and cause economic growth to stall, if not contract. In such an environment, playing it safe seemed the sensible approach.

As we all know by now, this outcome has not come to pass. In fact, the U.S. and even most European economies (Germany is the exception) have shown resiliency, good growth, virtually no increase in unemployment, with company profits and margins holding up impressively.

But resiliency to date doesn't necessarily mean resiliency going forward, especially if the Federal Reserve does keep interest rates higher for longer as the market now seems to believe. Moreover, we are concerned by growing war in the Middle East and its potential impact on oil prices, the resumption of student loan payments in the U.S., and another potential government shutdown before year end.

As such, we are remaining cautious for now.