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Member SIPC

Investment Insights Quarterly

From The Investment Strategy Committee

October 2023

Higher Yields Matter

In 2008, central banks responded to the Global Financial Crisis in an aggressive and unprecedented manner, lowering interest rates to (and sometimes through) the zero bound and launching bond-buying programs (referred to as quantitative easing). Many of these policies were later revived in response to the Covid-19 shutdowns and resulting dislocation to wide swaths of the economy. These policies had a profound effect on global fixed-income markets, with yields remaining "low" and generally below the rate of inflation for an extended period, and in some countries sovereign bonds periodically traded with negative yields. In the United States, the 10-year Treasury yield touched a low of 0.51% after the pandemic but stayed persistently low relative to long-term averages for an extended period before and after that date.

The 10-year Treasury traded with a yield of less than 4% from July 2008 until August 2023 and averaged (using monthly data) 2.43%. To put that in perspective, during the decade from 2000 through 2010, the benchmark 10-year note averaged 4.35%. That prolonged period of low nominal rates also featured low real (after inflation) rates and long stretches of negative real rates, and the impact on asset prices was pronounced. Home prices, collectibles, commercial real estate and equities are some of the asset classes that benefited. From the March 2009 lows through the end of the third quarter of 2023, the S&P 500 and NASDAQ posted annualized returns of 15.7% and 18.6%, respectively, well in excess of historical averages.

An extended period of low nominal and negative real yields (often referred to as financial repression) had multiple impacts on a variety of financial assets and markets. These included a dramatic narrowing of risk premiums across all types of credit, cheap financing for commercial and residential real estate resulting in strong price appreciation, inexpensive leverage for private markets, and a broad move by all types of investors to riskier assets to generate higher returns. Equity markets benefited broadly as many investors embraced the concept of TINA or "there is no alternative."

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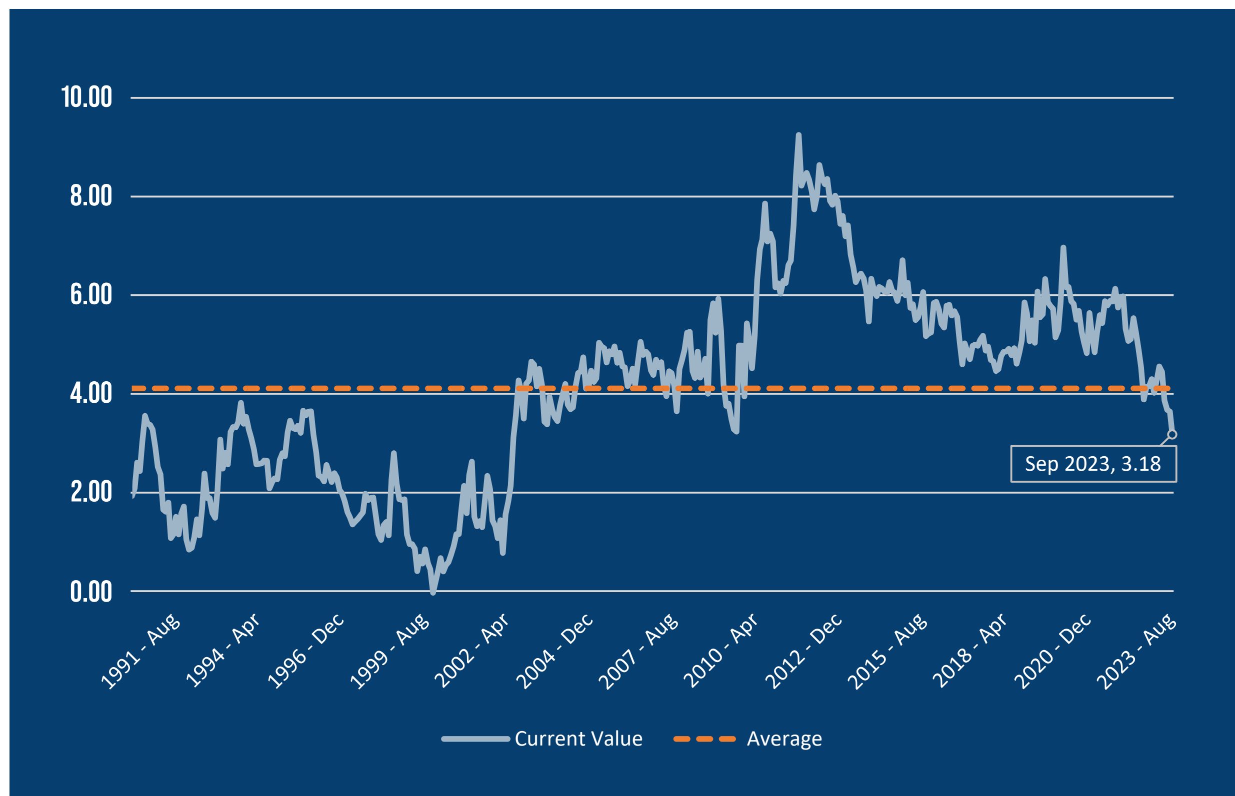
After that long period of low rates, the markets entered a new interest-rate regime that began in March 2022 with the first of multiple interest-rate increases by the Federal Open Market Committee. On that date, the U.S. Federal Reserve (Fed) embarked on the most aggressive tightening cycle on record, increasing the target federal funds rate above the rate of inflation, shrinking the size of its balance sheet (quantitative tightening). Bond yields have also risen, and financial conditions have generally tightened.

While higher bond yields are generally "good" for savers (more on that in a moment), they have other ramifications for investors in risk assets such as equities. One of the things that we track monthly is the equity-market risk premium, which is defined by Investopedia as the additional return that's expected on an index or portfolio of investments above the given risk-free rate. Since Treasuries are backed by the full faith and credit of the U.S. government, their yields are used as a proxy for the risk-free rate.

We have a simple model that we use to compare the earnings yield of the S&P 500 to a real or inflation-adjusted 10-year Treasury. We use the inverse of the price/earnings ratio as our earnings yield and the 10-year Treasury less long-term inflation expectations, as defined by the University of Michigan consumer sentiment survey, and then subtract the risk-free rate from the earnings yield. As you can see in the chart, higher yields combined with the current earnings yield have resulted in the equity-market risk premium falling below its long-term average.

Equity Risk Premium

Earnings Yield (1/S&P 500 PE ratio) less Real 10-Year Yield (10-Year-Expected Inflation)



Source: Benjamin F. Edwards

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This is just one of the many inputs into our thoughts on the markets and is subject to a variety of interpretations. We tend to have an intermediate to longer time horizon. Within that context, when equities are more richly valued, we expect lower forward returns (which is different than negative returns), and the opposite is also true. Lower valuations lead us to forecast higher returns. Our 2023 capital market assumption for domestic large-cap equities (10-year projected compounded annualized return) is 5.8%, in large part due to valuations.

Another factor to consider is from an asset-allocation perspective. Projected bond returns are now more attractive due to higher beginning yields, and flows into fixed-income securities have greatly increased across the industry, with many trading desks posting records in terms of number of trades and par value traded. With yields normalizing and offering some return for the risk, many investors are tweaking their allocations and reducing equities slightly. The inverted yield curve and short rates at levels not seen in more than two decades have many investors allocating to cash-type instruments with maturities less than six months. We would strongly advocate investors push out the yield curve and accept slightly lower current yields but locking them in a for a longer period. At some point, monetary policy will reverse course, and those shorter maturities are at risk of being reinvested at subsequently lower yields.

We are of the opinion that the Fed is nearing the end of the current tightening cycle. However, with inflation still showing signs of stickiness, we don't believe that bond yields are going to revisit the levels experienced over the last decade and a half. For many investors, this will be a very different investing environment, where fixed-income securities and allocations can be additive to returns as opposed to just an expensive equity-market risk mitigator. Higher yields make bonds a more attractive investment but also can be a headwind for risk assets. In that environment, we are of the opinion that active management and asset allocation are going to be increasingly important to returns.

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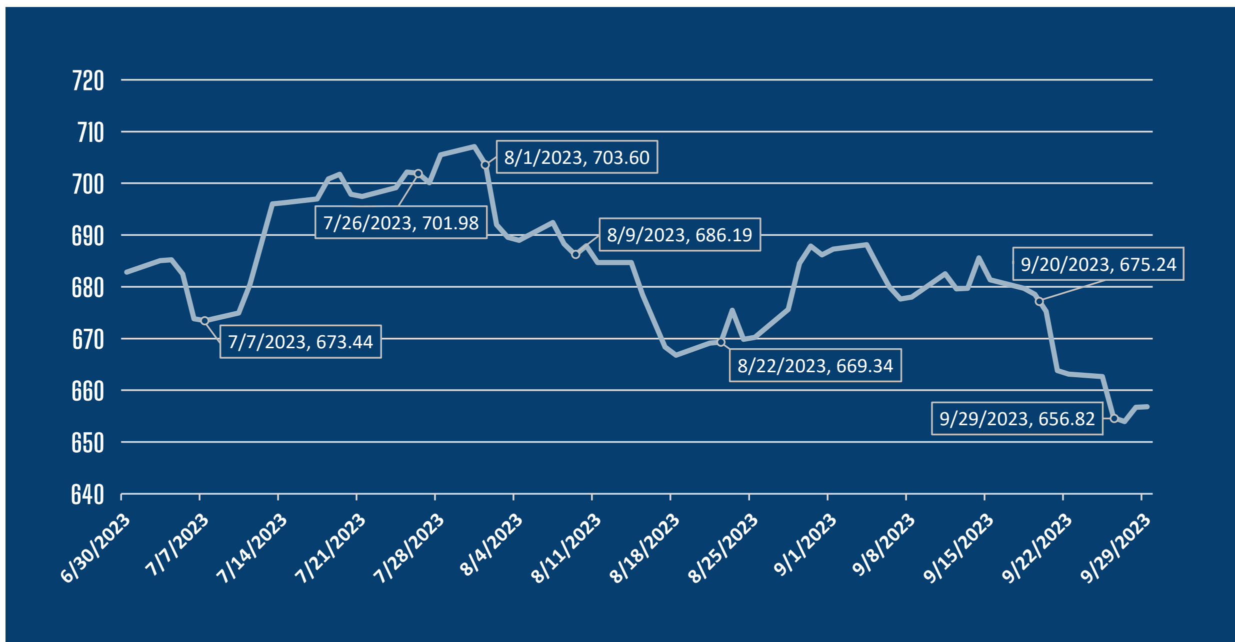
Key Q3 Dates

- July 7 – The Strategic Petroleum Reserve remained at levels last seen in 1983 with 347.5 million barrels on hand, approximately 40 days supply.
- July 26 – Fed raised interest rates after leaving them unchanged in June after 10 consecutive meetings with increases.
- August 1 – Fitch downgraded its U.S. sovereign credit rating because of expected fiscal deterioration over the coming years and an erosion of confidence in governance.
- August 9 – Moody's downgraded the credit ratings of 10 small- to mid-sized banks, citing growing financial risks and strains that could erode their profitability.
- August 22 – Standard & Poor's downgraded the ratings of five banks, including some of the nation's largest lenders.
- September 20 – Fed left interest rates unchanged for the second time this year.
- September 29 – Personal consumption expenditures (PCE), the Fed's preferred inflation gauge, increased 0.4% in August or 3.5% over the past year. Core PCE increased 0.1% in August or 3.9% year-over-year.

Global Stock Market
MSCI ACWI in USD



Source: Bloomberg

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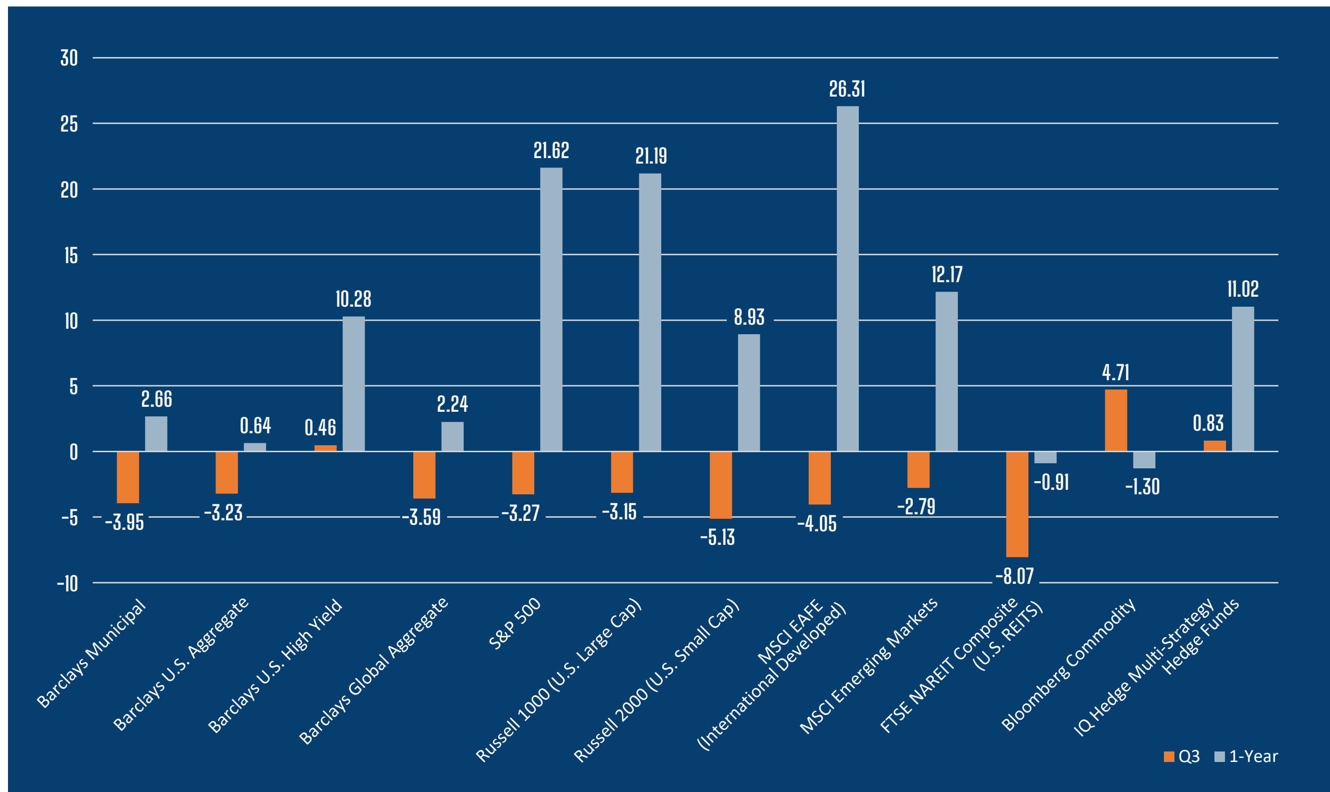
Asset Class Returns
Q3 2023



Source: Conway

Fixed Income

- Core fixed income and municipal bonds posted losses last month in the face of rising rates. Treasuries, sovereign bonds and municipals are now all negative year-to-date.
- Loans bucked the trend in September, but high yield and emerging-market debt fell in value. Higher carry in credit has helped offset the impact of higher rates.
- Bonds outside the U.S. were also hurt by the strong rebound in the U.S. dollar.

Equities

- September was a weak month for U.S. equities, particularly growth/tech stocks that are considered long duration assets.
- Value outperformed growth across all market caps and small caps broadly lagged large caps.
- Growth continues to lead value by a wide margin in 2023.
- Non-U.S. equities posted negative absolute returns last month but provided some modest relative outperformance versus U.S. equities.
- Value sharply beat growth, and small caps lagged large caps in September.
- U.S. dollar strength was a sharp headwind with a 234 basis points impact on the EAFE Index and 82 bps on the emerging-market index.

Alternatives

- Real estate had a particularly poor quarter on a combination of higher rates and concerns over the general economic outlook and impact on occupancy rates.
- Hedge funds were able to eke out small gains for the quarter aided by the tailwind of higher rates and greater dispersion in the stock market.
- Energy master limited partnerships (MLPs) responded positively to higher energy costs.

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Rates on the Rise

Global Bond Yields

Meeting Date	Central Bank Rate	2-Year	10-Year	Yield Curve
United States	5.50%	5.04%	4.57%	Inverted
Great Britain	5.25%	4.87%	4.44%	Inverted
Japan	-0.10%	0.022%	0.75%	Positive
Germany	4.50%	3.19%	2.84%	Inverted
China	4.35%	2.33%*	2.65%	Positive

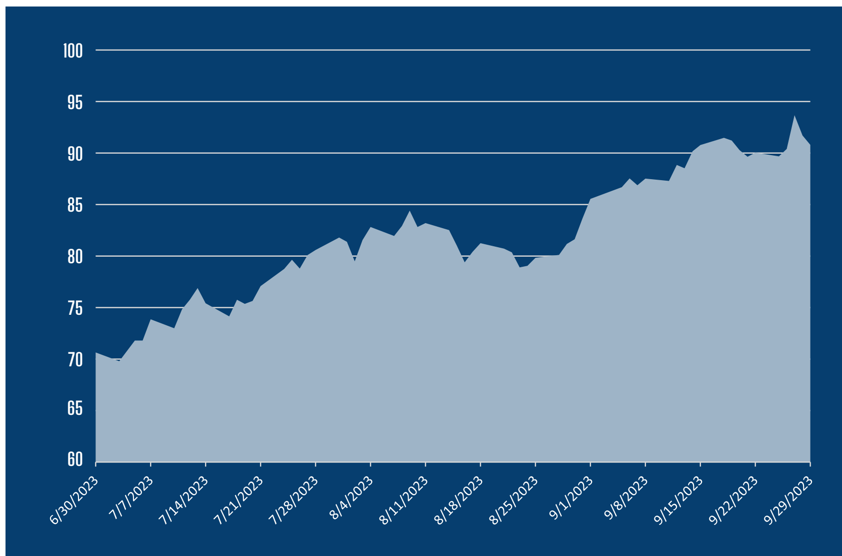
Source: Bloomberg
** 3-Year Note*

- Bond yields continue to increase on a global basis.
- U.S. Treasury yields are at the highest levels since the 2006-2007 timeframe.
- Yields are responding to higher inflation and rhetoric from central banks suggesting “higher for longer” monetary policy.
- Higher yields weighed on global equities and are impacting the consumer.
- In the U.S., mortgage rates are touching levels last seen in the early 2000s.

Energy Concerns

Crude Oil

Q3 2023



Source: Bloomberg

- Crude oil prices increased almost 30% during the quarter.
- The increase in energy prices stoked concerns about inflation and the negative impact on consumers.
- Perhaps the single biggest driver of rising oil prices has been supply cuts by Russia and the Organization of Petroleum Exporting Countries (OPEC).
- On September 5, Saudi Arabia announced that it will be extending its 1 million-barrel-per-day production cuts through at least the end of the year. Russia announced that it will be cutting production by 300,000 barrels per day through December 31 as well.

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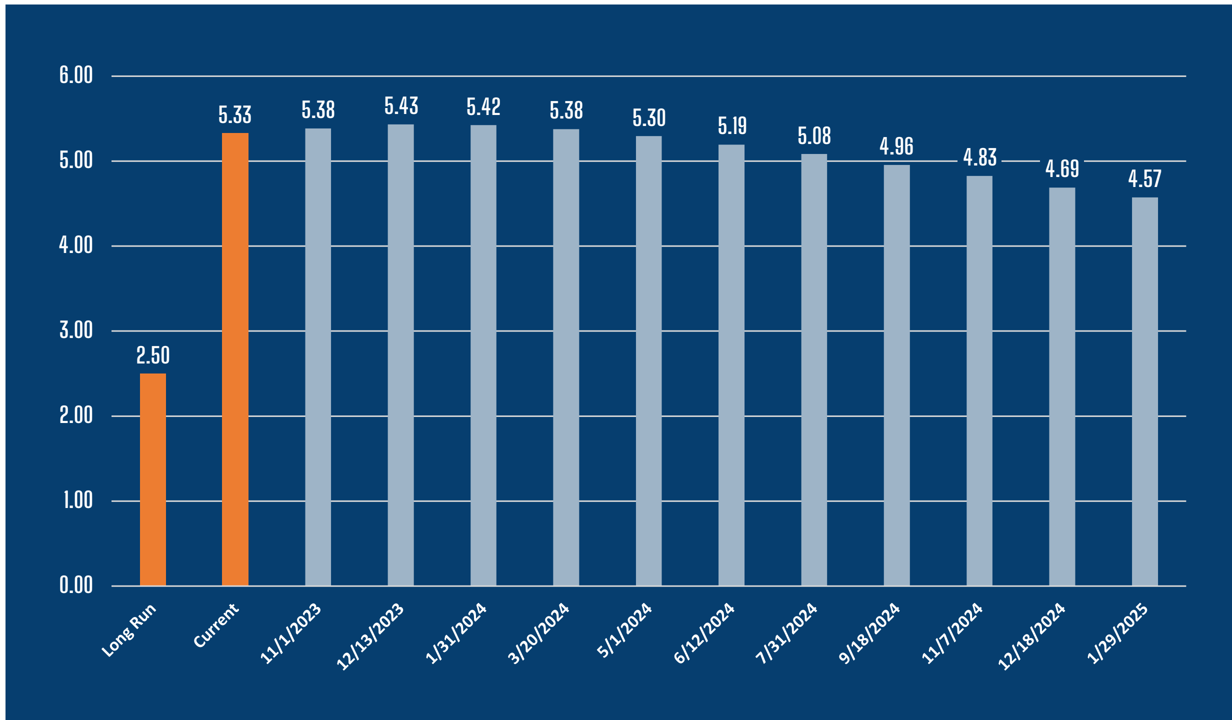
Monetary Policy

Implied Policy Rate (%)



Source: Bloomberg

- The Fed's recent narrative has indicated rate increases are nearing an end, but rates will remain "higher for longer."
- Fed funds futures indicate policy will remain "restrictive" through 2024.
- The Fed's long-term equilibrium rate target is 2.5%, and rates are currently expected to remain above that for several more years, as priced by the futures markets.

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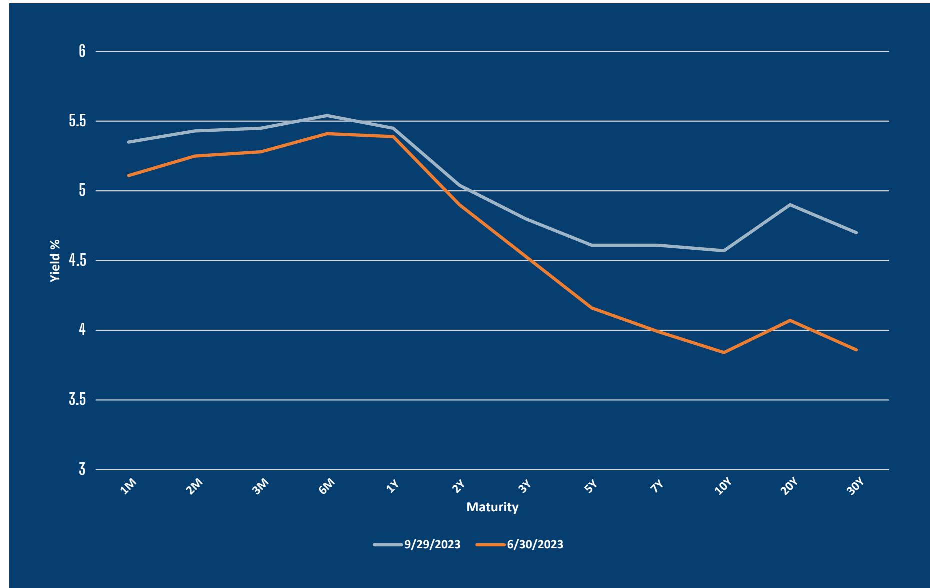
U.S. Treasury Curve

Yields moved higher across the maturity spectrum during the third quarter, and the yield curve remains inverted. In recent sessions, the 30-year bond yield has moved above 5%.

U.S. Treasury Yield Curve



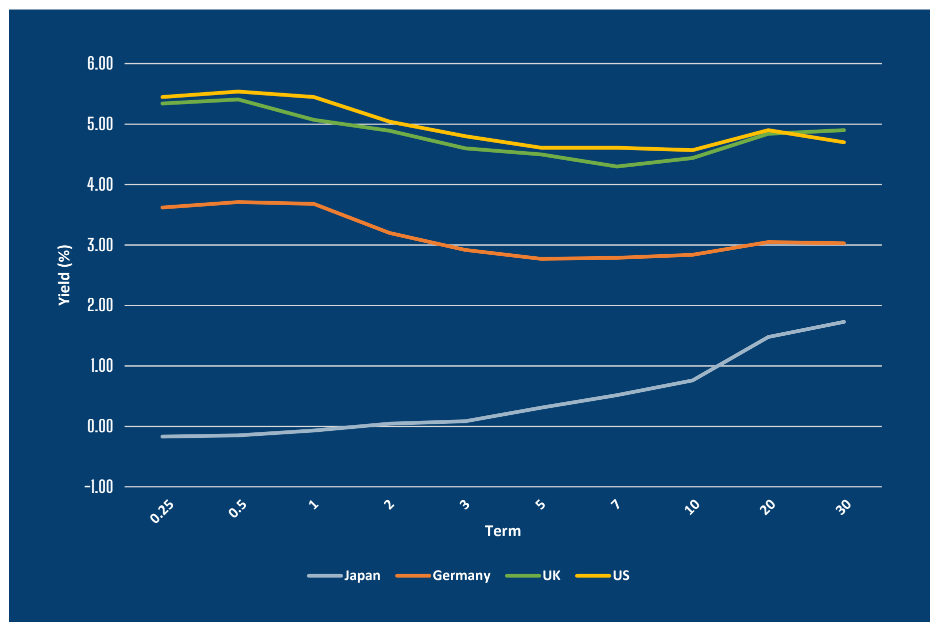
Source: Bloomberg

Government Bond Curves

Yields generally moved higher across the globe in Q3, and many sovereign yield curves remain inverted.

Government Bond Yield Curves

End of Q3 2023



Source: Bloomberg

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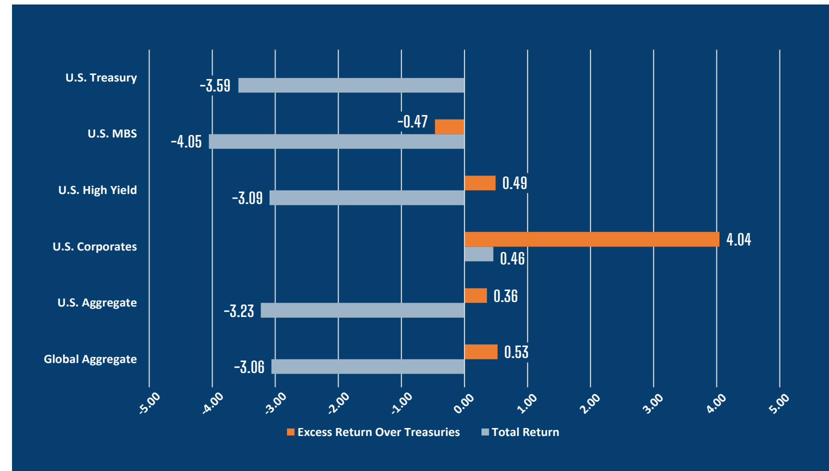
Fixed Income Performance

Yields continued to move higher, hurting bond prices. The added carry from credit and structure led to better performance vs. Treasuries. High yield was the only sector that managed to eke out a small gain.

Fixed Income Performance
Q3 2023

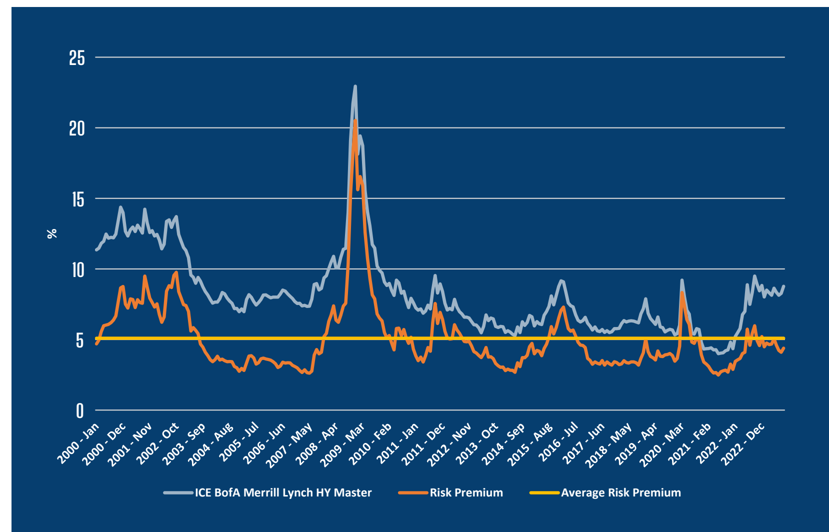


Source: Bloomberg

Credit

Higher-benchmark Treasury yields have resulted in higher yields across the fixed-income spectrum. However, credit spreads remain relatively narrow. High-yield spreads remain below their long-term average despite yields approaching 9%.

Junk Bond Yields vs. Junk Bond Spreads
ICE BofA Merrill Lynch High Yield Master less 10-Year Treasury



Source: Haver

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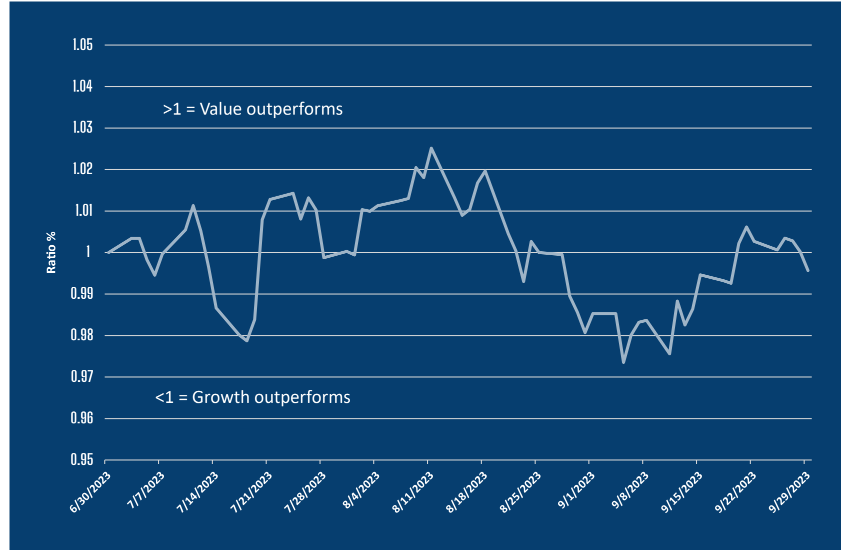
Equity – Value vs. Growth

Large-cap growth and value had similar performance in Q3, while small-cap value significantly underperformed small-cap growth.

Large-Cap Value/Large-Cap Growth – Q3 2023

Russell 1000 Value/Russell 1000 Growth



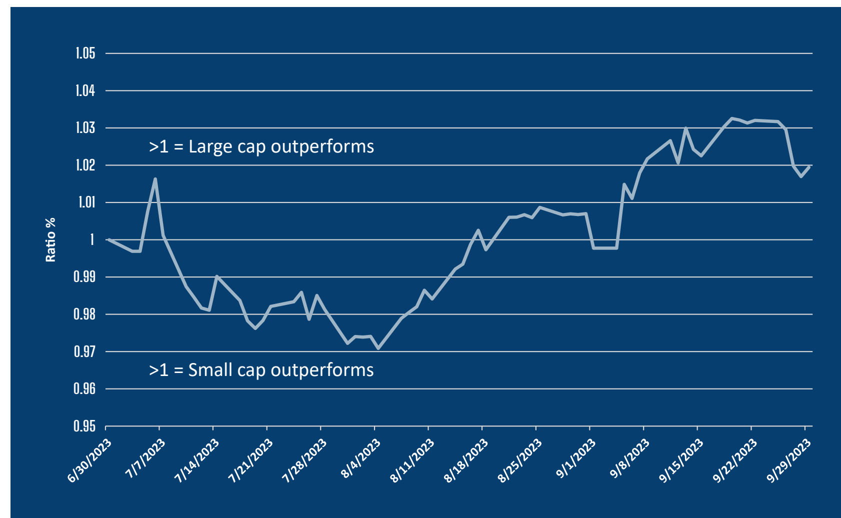
Source: Bloomberg

Equity – Large vs. Small

Large cap outperformed small cap during Q3, particularly late in the quarter as equity markets weakened and investors looked for relative safety.

Large-Cap/Small-Cap – Q3 2023

S&P 500/Russell 2000



Source: Bloomberg

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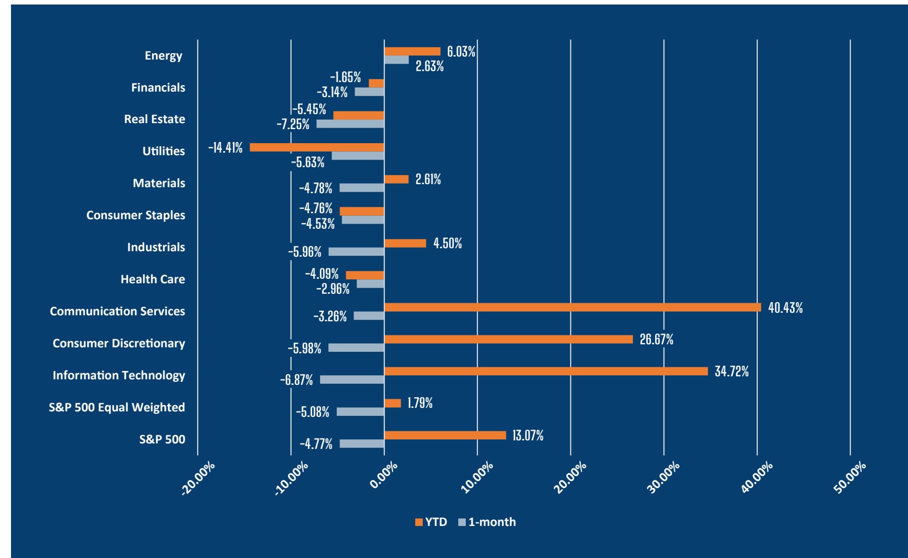
U.S. Equities – Return by Sector

Q3 was difficult for equities, with all sectors but energy lower. Market breadth remains very narrow as evidenced by the dramatic underperformance of the equal-weighted S&P 500 vs. the cap-weighted index.

S&P 500 Sector Returns

Q3 2023

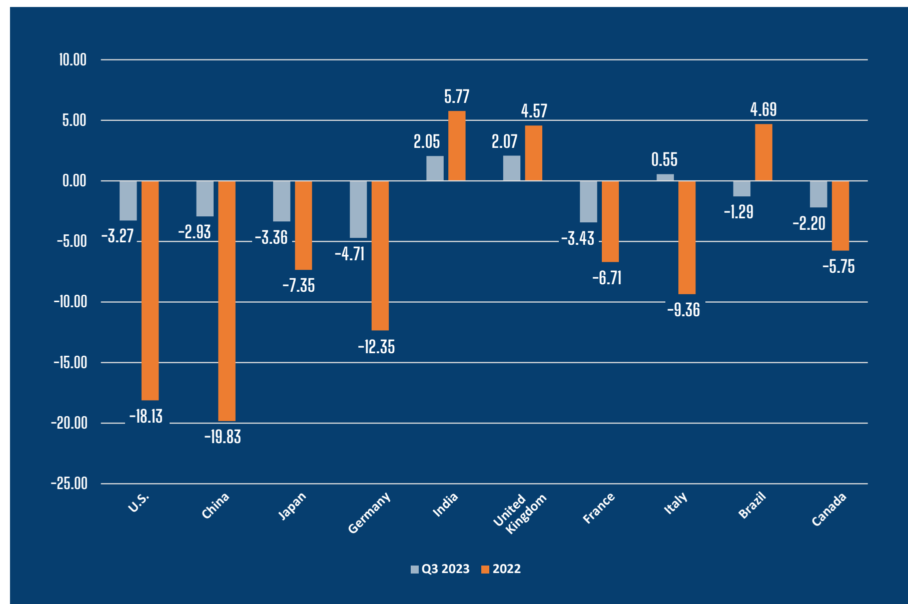


Source: Conway

Country Total Returns (%) – 10 Largest Economies

Global equities were generally lower in the third quarter. The U.S. currency was stronger point to point for the quarter, providing a headwind for U.S. investors in international equities.

Country Total Equity-Market Returns



Source: Bloomberg

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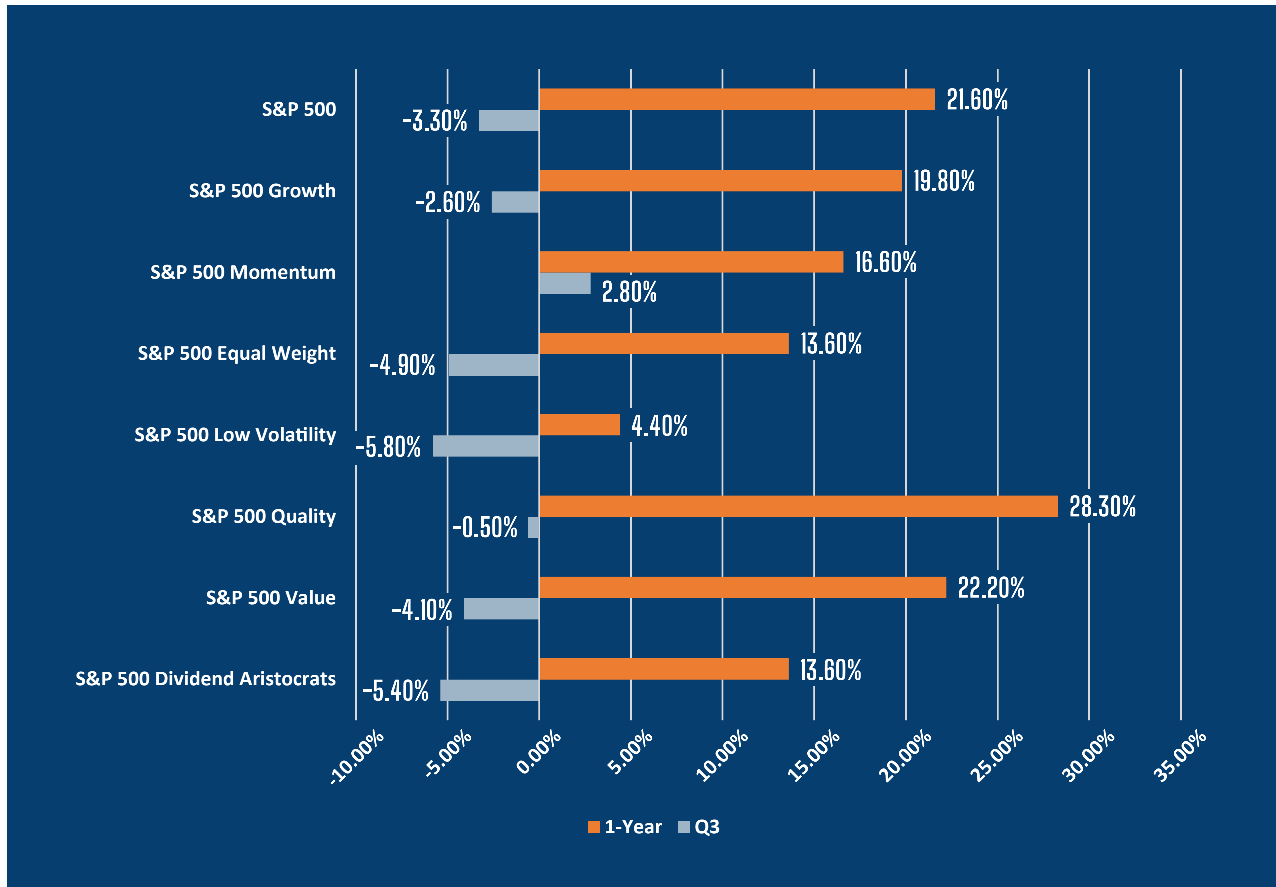
U.S. Equity Factors – Total Return Q3

Consistent with the broader markets, most of the core factors were lower in Q3. Dividend-focused strategies generally underperformed in Q3, as higher bond yields weighed on them.

Total Return: Core Factors
Q3 2023



Source: S&P

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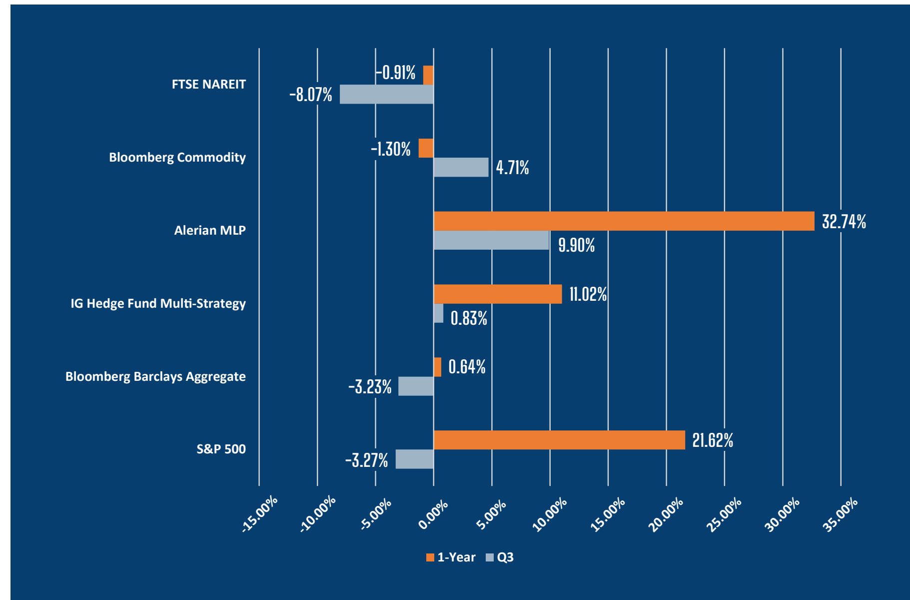
Alternative Returns

Alternative strategies and asset classes were mixed in Q3. Higher bond yields and large dispersion among equity returns were beneficial to hedge funds.

Alternative Returns

Q3 2023



Source: Conway

REITs vs. MLPs

Real Estate Investment Trusts (REITs) and energy have diverged in recent months as higher yields and higher oil prices are impacting them differently.

REITs vs. MLPs

FTSE Nareit All Equity REIT vs. Alerian MLP
2023 YTD

Source: Bloomberg

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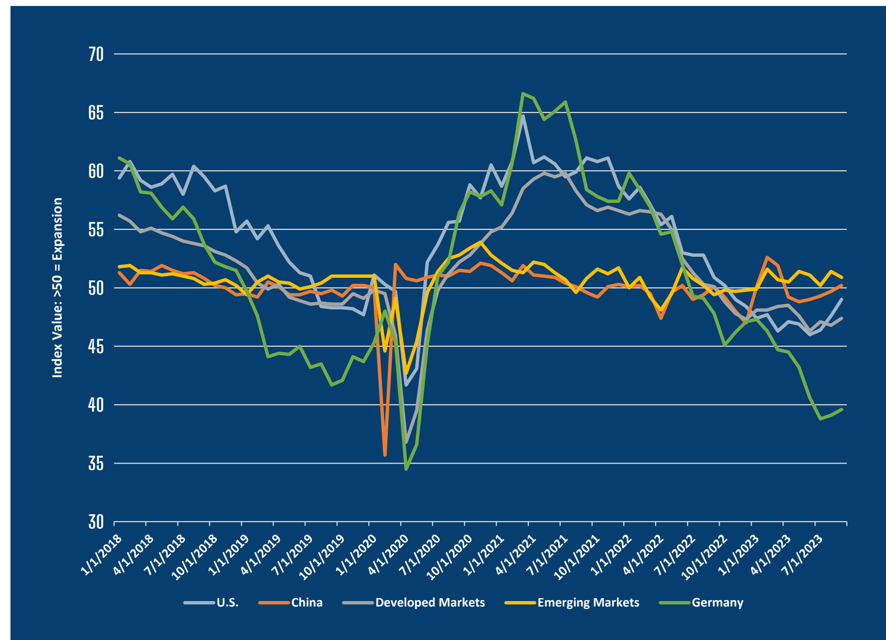
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. Global economies have been generally soft while emerging markets (including China) have shown more resiliency.

Global Manufacturing Surveys



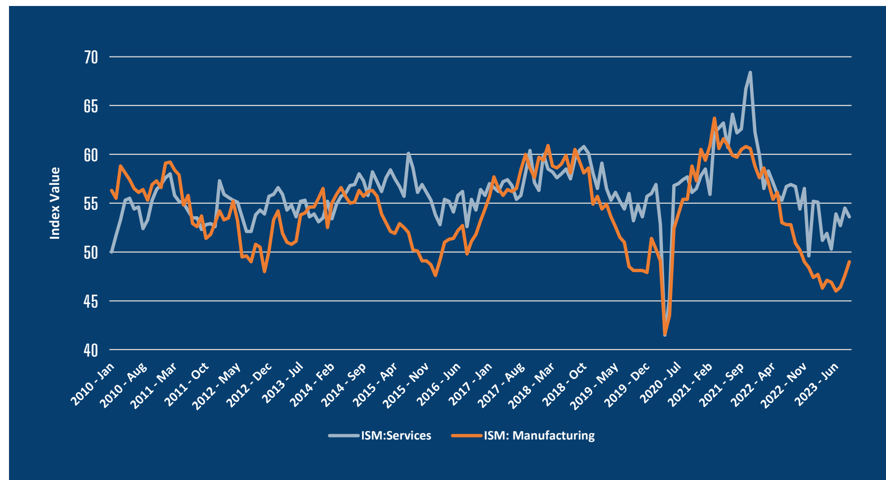
Source: Bloomberg, Haver

Manufacturing vs. Services

In the U.S., the service side of the economy remains in expansion mode vs. the manufacturing sector. According to the ISM surveys, manufacturing has been contracting for 11 consecutive months while the service sector strengthened this summer.

Institute for Supply Management Service and Manufacturing Surveys

>50=Expansion, <50=Contraction



Source: Bloomberg, Haver

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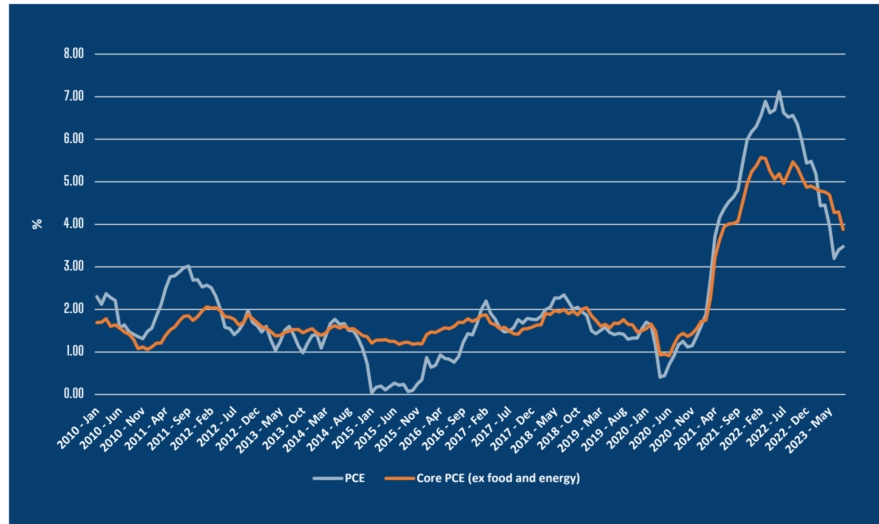
Inflation

Inflation continued to decline in Q3, with core personal consumption expenditures falling below 4% for the first time since mid-2021. The Fed targets 2% core PCE averaged over a cycle.

Inflation vs. Core Inflation

Personal Consumption Expenditures

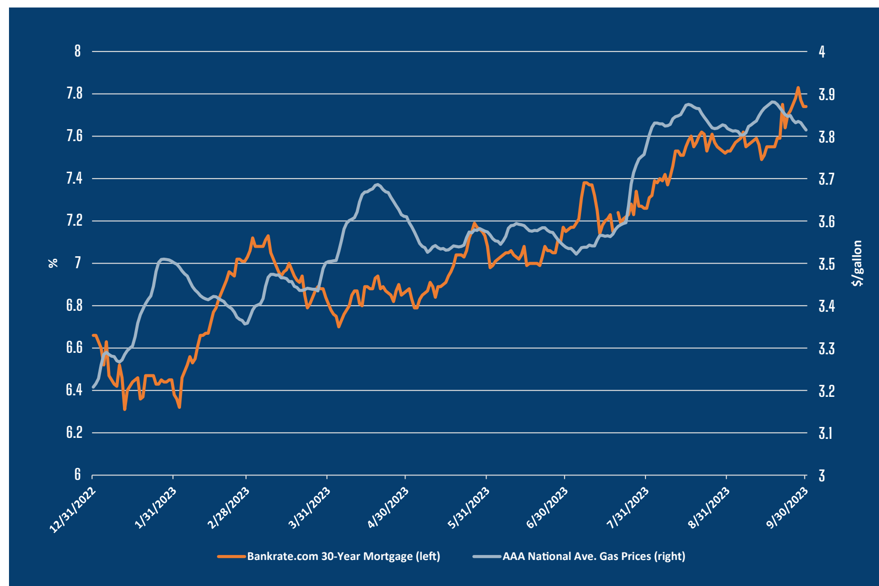


Source: Haver

The Consumer

The consumer is facing twin headwinds from high mortgage rates and rising gas prices.

Gas Prices and Mortgage Rates



Source: Bloomberg

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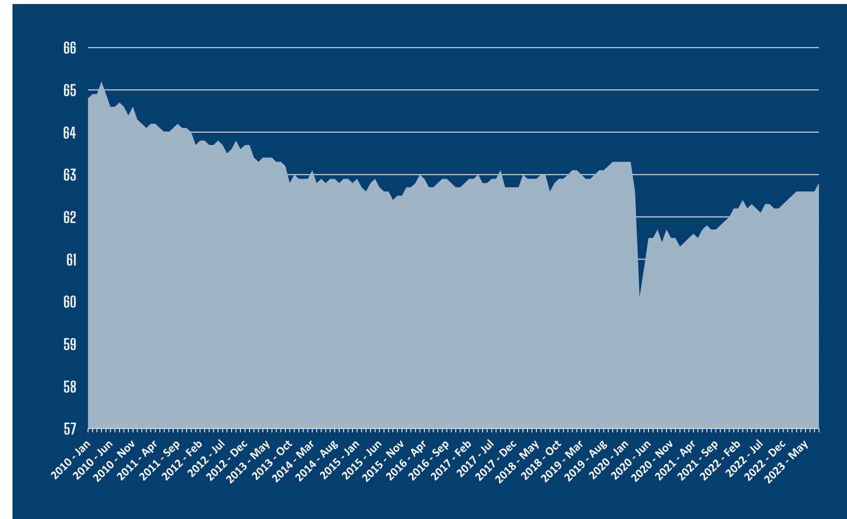
Employment

After a sharp fall in the pandemic shutdown, the number of people in the labor force has rebounded. This, coupled with a low unemployment rate, is a sign of a continued strong labor market.

Labor Force Participation Rate: 16 Yr+

%

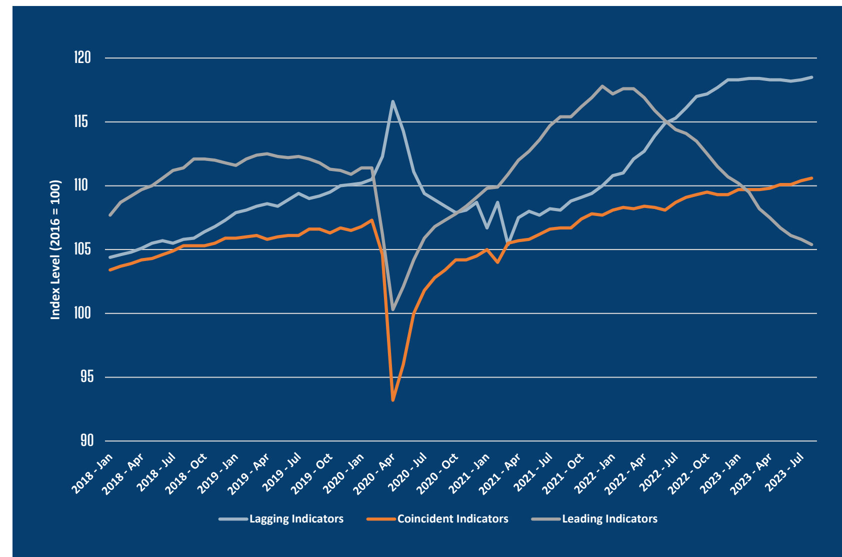


Source: Haver

Leading Indicators

Coincident and lagging indicators are still rising while leading indicators (down 17 consecutive months) paint a picture of a slowing economy. Leading indicators are consistent with what has been previously observed in recessionary environments, and this level of protracted weakness was last experienced during the Global Financial Crisis.

Leading, Lagging and Coincident Indicators



Source: Haver

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Economic Forecast

The consensus forecast from Bloomberg reflects the belief that the Fed will be able to engineer a soft landing. This forecast assumes 2024 will be the softest year and that inflation and interest rates will slowly decline from current levels.

Economic Activity	2022	2023	2024	2025
Real GDP (YoY%)	1.9	2.1	0.9	1.9
Core PCE (YoY%)	5.2	4.1	2.7	2.2
Housing Starts (000s)	1,556	1,410	1,395	1,432
Unemployment (%)	3.6	3.7	4.3	4.3
Central Bank Rate (%)	4.50	5.55	4.25	3.25
10-year note (%)	3.88	4.05	3.59	3.44
Euro/USD	1.07	1.08	1.13	1.16

Source: Bloomberg

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September 29, 2023	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.44%	1.34%	3.71%	4.63%	1.75%	1.71%	1.09%
Barclays Municipal	-2.93%	-3.95%	-1.38%	2.66%	-2.30%	1.05%	2.29%
BBgBarc U.S. Govt/Credit Intermediate	-0.05%	0.73%	1.87%	2.77%	-0.72%	1.21%	1.02%
Barclays U.S. Aggregate	-2.54%	-3.23%	-1.21%	0.64%	-5.21%	0.10%	1.13%
Barclays U.S. High Yield	-1.18%	0.46%	5.86%	10.28%	1.76%	2.96%	4.24%
S&P/LSTA Leveraged Loan	0.03%	0.03%	10.19%	13.06%	6.07%	4.46%	4.30%
Barclays Global Aggregate	-2.92%	-3.59%	-2.21%	2.24%	-6.93%	-1.62%	-0.44%
JPM GBI EM Global Diversified	3.26%	2.51%	7.79%	11.38%	-1.42%	0.29%	-0.56%
U.S. Equity Indices							
DJ Industrial Average	-3.42%	-2.10%	2.73%	19.18%	8.62%	7.14%	10.79%
S&P 500	-4.77%	-3.27%	13.07%	21.62%	10.15%	9.92%	11.91%
NASDAQ Composite (Price)	-5.81%	-4.12%	26.30%	25.00%	5.78%	10.44%	13.36%
Russell 1000	-4.70%	-3.15%	13.01%	21.19%	9.53%	9.63%	11.63%
Russell 1000 Growth	-5.44%	-3.13%	24.98%	27.72%	7.97%	12.42%	14.48%
Russell 1000 Value	-3.86%	-3.16%	1.79%	14.44%	11.05%	6.23%	8.45%
Russell Mid Cap	-5.02%	-4.68%	3.91%	13.45%	8.09%	6.38%	8.98%
Russell 2500	-5.58%	-4.78%	3.59%	11.28%	8.39%	4.55%	7.90%
Russell 2000	-5.89%	-5.13%	2.54%	8.93%	7.16%	2.40%	6.65%
Russell 2000 Growth	-6.60%	-7.32%	5.24%	9.59%	1.09%	1.55%	6.72%
Russell 2000 Value	-5.21%	-2.96%	-0.53%	7.84%	13.32%	2.59%	6.19%
Non-U.S. Equity Indices							
MSCI World	-4.28%	-3.36%	11.55%	22.58%	8.60%	7.80%	8.84%
MSCI ACWI	-4.10%	-3.30%	10.49%	21.41%	7.39%	6.99%	8.11%
MSCI ACWI Ex-U.S.	-3.11%	-3.68%	5.82%	21.02%	4.24%	3.07%	3.83%
MSCI EAFE	-3.37%	-4.05%	7.59%	26.31%	6.28%	3.74%	4.32%
MSCI EAFE Growth	-5.96%	-8.60%	4.63%	20.41%	0.70%	3.59%	4.80%
MSCI EAFE Value	-0.79%	0.68%	10.63%	32.46%	11.85%	3.47%	3.59%
MSCI Europe	-3.96%	-4.91%	8.60%	29.69%	7.89%	4.58%	4.44%
MSCI Japan	-1.97%	-1.45%	11.60%	26.40%	3.19%	2.44%	4.75%
MSCI AC Asia	-2.39%	-2.55%	4.05%	16.62%	-0.80%	1.36%	4.14%
MSCI EAFE Small Cap	-4.37%	-3.42%	2.27%	18.48%	1.54%	1.18%	4.70%
MSCI ACWI Ex-U.S. Small Cap	-3.72%	-1.58%	5.48%	19.60%	4.49%	3.03%	4.76%
MSCI Emerging Markets	-2.57%	-2.79%	2.16%	12.17%	-1.34%	0.94%	2.45%
MSCI EM Asia	-2.55%	-2.76%	1.31%	12.37%	-3.13%	1.34%	4.18%
MSCI China	-2.74%	-1.83%	-7.13%	5.44%	-14.14%	-4.02%	1.85%
MSCI EM Eastern Europe	-9.08%	-8.17%	15.08%	59.45%	-33.09%	-22.73%	-11.81%
MSCI EM Latin America	-2.27%	-4.64%	13.40%	20.15%	15.63%	3.25%	0.62%
MSCI EM Small Cap	-2.04%	3.10%	14.16%	23.67%	11.16%	6.93%	4.96%
MSCI Frontier Markets	-3.77%	2.14%	7.82%	7.01%	2.12%	1.96%	2.61%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	-0.73%	0.83%	6.27%	11.02%	1.06%	1.79%	2.49%
Real Assets Indices							
FTSE NAREIT Composite	-6.93%	-8.07%	-5.17%	-0.91%	2.75%	2.43%	5.98%
Alerian MLP	3.24%	9.90%	20.56%	32.74%	43.10%	6.81%	1.93%
Bloomberg Commodity	-0.69%	4.71%	-3.44%	-1.30%	16.23%	6.13%	-0.75%
S&P Global Infrastructure	-4.67%	-7.28%	-3.74%	6.88%	7.33%	4.07%	5.10%
Other							
Oil Price Brent Crude	9.73%	27.25%	10.94%	8.36%	32.52%	2.87%	-1.30%
CBOE Market Volitility (VIX)	29.11%	28.92%	-19.15%	-44.59%	-12.74%	7.65%	0.54%

Source: Morningstar

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