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August 21, 2023 – Investment Commentary

Market Movements

Last week, both stocks and bonds declined (price down/yield up). The S&P 500 outperformed the MSCI EAFE (non-US developed) and MSCI Emerging Markets indices. The best performing sectors in the S&P 500 were technology, energy, and healthcare. Across market cap indices, large cap growth did the best.

The S&P 500 index is on course for its biggest monthly loss of 2023, impacted by rising Treasury yields as investors face the prospect of the Federal Reserve keeping interest rates higher for longer. The S&P 500 is down 5% from its July 31st high. In August, the yield on the 10-year Treasury note broke out of the 3.5% – 4% lane in which it had been trading, lowering valuations in the stock market as it climbed. In sum, recent developments challenge the investment paradigm that has been in place for much of this year, that rates will likely be cut later in 2023.

Last week, the 10 year treasury yield rose 8 bps on the week to 4.25% and the 2 year – 10 year treasury yield spread steepened to -68 bps which typically indicates an economic slowdown. High yield bond spreads were up on the week to 392 bps, but still well below their 20-year average of roughly 500 bps, suggesting a belief in the "soft landing" scenario where inflation pressures will continue to decrease while the economy will avoid a recession.

Credit risk has been rewarded so far this year with high-yield spreads over Treasuries starting the year at 4.69 bps and has since fallen to 392 bps. Overall, CCC bonds (the lowest rated across the credit quality spectrum) have been the best performers generating a +12% total return. The income that bonds generate for investors through periodic coupon payments has been a helpful contributor to year-to-date returns, as the Bloomberg U.S. Aggregate Bond Index yield starting the year at 4.68% and investors will still receive roughly half that income as the year goes on. Duration—a measure of how much a bond's price is likely to change given a corresponding change in interest rates—has been a headwind thus far, with the 10-year U.S. Treasury bond yield climbing to just over 4.20% after starting the year at 3.88%.

Right now, the biggest headline in markets is the 10-year yield above 4.25%, which is its highest level since November 2007. By historical standards, the number isn't all that high. However, it feels high to investors given their experience over the last decade since the Great Financial Crisis, where the Fed set its target short-term interest rate close to 0% to spur economic growth by encouraging low-cost borrowing. Meanwhile, the cost of a 30-year fixed mortgage is up to 7.55%, according to Bankrate, which is the highest level since the year 2000.

What We Are Watching

Artificial Intelligence/NVIDIA Earnings Announcement Wednesday

Nvidia (ticker NVDA), a substantial supplier of artificial intelligence hardware and software, reports this Wednesday. If it reports weakness, investor confidence in big tech may be challenged. We believe investors expect the chip designer to forecast quarterly revenue above estimates when it reports results on Wednesday. As you have heard me say before, "expectation management is risk management." In this case, expectations are very high, leaving little room for any earnings-related or guidance disappointment.

Jackson Hole Fed Meeting Friday

The U.S. stock market is declining this month as investors brace for comments this week from Fed Chair Jerome Powell at the Jackson Hole Economic Symposium in Wyoming on Friday. Investors are struggling with an increase in yields in August while also monitoring possible knock-on effects from the weak China economic activity (the world's second largest economy), Fitch lowering the U.S. credit rating, the increased supply of U.S. Treasury issuance to reestablish government funds used during the debt ceiling debt and Japan indicating flexibility to tolerate higher yields.

The probability of an additional Fed rate hike this year rose to approximately 40% (from single digits) after the recently released Fed minutes. In the minutes, officials felt the "potential need for higher rates" still exists. The core inflation reported figure above 2% likely decreases the chance the Fed lowers rates even early next year unless the Fed decides to "move the goalpost" and revise its target to something greater than 2% or something begins to break, such as the labor market or economy.

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Implication of Higher Treasury Yields

The Investment Office wants to take an opportunity to remind investors there is more than one way to interpret the impact that Treasury yields can have on U.S. stocks. Investors often default to a narrative that rising Treasury yields are bad for stocks overall as the cost of capital to conduct economic activity may impact profit outlooks and fixed income risk adjusted investment opportunities become more competitive with equities.

However, higher yields, which occur when investors sell off the underlying fixed income holdings (price down/yield up), may be consistent with risk-on sentiment in equities. Rising yields may be a sign that the economy is proving to be more resilient than expected and investors want to own stocks to participate in that growth.

The Investment Office is mindful of the Fed triggering a recession when the full impact arrives of its policy to rapidly hike rates and reduce its balance sheet to tame high inflation. Before a potential slowdown unfolds, we would be patient in holding higher quality fixed income and maintain our view to invest in quality equities.