September 25, 2023 – Investment Commentary

Macro Matters

The S&P 500 is down approximately 6% from its July 31 market recent peak. We believe that's mostly because the bond yield has been climbing above 4.00% since then. The S&P 500 sectors and industries have all declined since the July 31 peak: Energy and Health Care have declined ~3%, Financials ~4%, Utilities ~5%), Consumer Staples and Consumer Discretionary ~6%, Industrials ~7%, Materials ~8%, Information Technology ~8%, and Real Estate ~9%.

For the first time this year, a tighter Fed message last week has become a headwind for markets (all year Fed rate forecasts have moved higher while valuations expanded sharply). But now, after reaching 20x forward for the S&P and 33x for Growth areas like the Tech sector (returning to its 2021 peak PE) at the end of July. Investors are increasingly questioning valuations without incremental Fed liquidity, fiscal stimulus and strong fundamental earnings per share (EPS) growth. For now, better EPS forecasts for 2023 and 2024 (already at +12% 2024 vs. 2023 EPS growth) do help and could even help stabilize markets, but we will continue to watch earnings revisions for signs that EPS revisions could begin to move lower.

Lucky Number 7? "I'm not sure the world is ready for 7%" interest rates– Jaime Dimon, CEO of JPMorgan

Last week's Fed's decision to hold interest rates steady wasn't a surprise, but its hawkish tone and indication that another rate hike may be in store before the end of the year wasn't what the market was hoping for. U.S. stocks retreated nearly 3% post-meeting, but it's the bond market that's sending the real warning signals. The 10-year yield briefly touched 4.6% for the first time since 2007 and has now risen nearly 120 basis points just since the beginning of May. These kinds of sharp increases in real rates (nominal interest rates less inflation expectations) tend to happen right before something breaks in the bond market, where the U.S. bank industry stumbled in February 2023. If inflation remains around the 3-4% level over the next 6-12 months, that means we could be looking at a stagflation scenario of persistent inflation and slow/low growth. However, if the full impact of material rate increases and tighter financial conditions accelerate the recent increases in consumer credit and corporate delinquencies, then a Treasury rally (price up / yield down) may be coming sooner than currently anticipated.

In a recent interview, Dimon said the worst case would be 7% interest rates with stagflation. "If they are going to have lower volumes and higher rates, there will be stress in the system." However, stop any person in the street and ask them to choose an odd number between 1 and 10. We believe, more often than not, they will say the number 7. There are seven days of the week, seven colors of the rainbow, seven notes on a musical scale, seven seas and seven continents. Snow White ran off to live with seven dwarves. There were seven brides for seven brothers and Shakespeare described the seven ages of man. Finally, Ian Fleming was looking for a code for James Bond, and he didn't go for 006 or 008.

Risk on? Mixed Signals

The hawkish interpretation (rates will be higher for longer) of the Fed meeting takeaways was also reflected in weaker risk asset markets, with U.S. equities falling and high-yield credit spreads rising by 10 basis points. Importantly, high-yield bond spreads (unsecured loans to leveraged companies) have risen but remain quite well contained at below 400 basis points (well below the long-term average of ~500bps) and are certainly not reflecting concern about the economic outlook while small-cap stocks remain ignored reflecting potential economic concerns.

We believe the macro and bottom-up fundamentals domestically and abroad are at an uncertain inflection point with a dynamic shifting of macro scenario expectations amongst a benign landing, hard landing and stagflation regime. These outcomes are complicated by recent Department of Justice and Federal Trade Commission inquiries into Google and Amazon, which have helped push market index returns year to date, plus China's struggling economy. As a result, we remain underweight benchmark high-quality fixed income duration and deliberately allocate portfolios to include equity long-term growth assets with quality, durable business model characteristics.

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