ROBERTSON STEPHENS®

October 16, 2023 – Investment Commentary

Macro Matters

At the start of 2023, recession concerns were top-of-mind for many investors. Since then, U.S. economic growth has been resilient, bolstered by strong corporate and consumer balance sheets, labor market strength, and fiscal support measures. Together with strong results for large tech companies and optimism over generative AI, this has helped to support risk assets throughout the year. The Federal Reserve has remained steadfast in its hawkish stance, and we've started to see evidence that Fed policy is finally slowing the economy. However, the markets are debating if the evidence supports the scenario that the Fed is successfully navigating a soft landing or kicking the can down the road toward a deeper recession as the lagged effects of monetary tightening continue to take hold.

Last week, stocks and bonds were up. The MSCI Emerging Markets and MSCI EAFE Non-U.S. Developed indices outperformed the S&P 500. The best performing sectors in the S&P 500 were energy and utilities. Across U.S. Russell style and market cap indices, large cap value did the best and the high dividend factor led more broadly. As for fixed income, the 10 yr. treasury yield fell 16 bps on the week to 4.63% and the 2-year – 10-year treasury yield spread flattened to -41 bps. The best performing parts of the bond market included investment grade corporates and municipals. High yield bond spreads were down on the week at 412 bps, but still well below their 20-year average of roughly 500 bps.

The major U.S. stock indices ended mixed last week as investors weighed inflation data against dovish signals from Federal Reserve officials as quarterly earnings season kicked off. Large-cap value stocks outperformed, helped by earnings beats from Citigroup, Wells Fargo, and JPMorgan Chase. The large U.S. banks kicked off the unofficial start to third-quarter earnings reporting season on a positive note, as their profits got a boost from higher interest rates and indications that provisions for future consumer credit delinquencies were lower than previously expected by investors.

The Wednesday release of the minutes from the Fed's September policy meeting seemed to confirm the shift in official thinking because of higher yields. While "all agreed that rates should stay restrictive for some time," Fed officials also agreed that the "Fed should shift communications from how high to raise rates to how long to hold rates." Fed Vice Chair Philip Jefferson told an economics conference in Dallas that he was mindful that the rise in long-term bond yields might affect the need for future rate hikes. He also acknowledged that policymakers "have to balance the risk of not having tightened enough against the risk of policy being too restrictive." By the end of the week, federal funds futures were pricing in only a 5.7% chance of a rate hike at the next Fed meeting in November versus 27.1% the previous week, according to the CME FedWatch Tool.

The pan-European STOXX Europe 600 Index ended last week higher, snapping three weeks of losses after dovish comments (indications to support lower rates) from Fed policymakers and reports that China was considering more economic stimulus measures. Major stock indices were mixed. Italy's FTSE MIB rose 1.53%, Germany's DAX slipped 0.28%, and France's CAC 40 Index fell 0.80%. The UK's FTSE 100 Index added 1.41%. European government bond yields broadly declined due to demand for safe-haven assets after last weekend's violence in the Middle East.

What Now?

We believe that the labor market must weaken in order to have a sustained shift down in inflation. It typically takes approximately 24 months for higher rates and tightening in bank lending standards to increase unemployment. We appreciate history may not be a good predictor of the future. However, we are approaching that milestone timeframe.

Prior to the decline in bond yields over the last week or so, the U.S. 10-year Treasury yield rose nearly 100 basis points (bps) in approximately three months. A rise in yields of this magnitude gives us pause to closely monitor economic and fundamental activity looking for something to bend or even break. For example, credit spreads have slightly increased since September providing a potential indication of future fundamental weakness. The small cap Russel 2000 continues to lag the large cap S&P500 Index where only 44% of the large cap index is trading above its 200-day moving average

ROBERTSON STEPHENS®

and the price performance of 493 stocks are only modestly positive year to date.

Portfolio Implications

Our investment posture continues to emphasize quality, with an increasing preference for larger companies in the United States. Stable to lower bond yields (price up = yield down) will help support equity prices. However, we believe the third quarter earnings announcements and guidance for Q4 and 2024 will prove fundamentals are increasingly important to investors' risk/reward assessment.