ROBERTSON STEPHENS®

October 30, 2023 – Investment Commentary

Macro Developments

Last week, US stocks declined, and bonds appreciated (price up/yield down). The MSCI Emerging Markets and MSCI EAFE non-US developed indices outperformed the S&P 500. The S&P 500 is now up +8.7% year-to-date with the top five stocks by market cap up +8.2% making up 94% of the total return. As for fixed income, the 10-year treasury yield fell 9 bps on the week to 4.83% and the 2 year – 10-year treasury yield spread flattened to -19 bps. The best performing parts of the bond market included investment grade corporates and mortgage-backed securities. High yield bond spreads have been widening although were flat on the week at 434 bps, but still below their 20-year average of roughly 500 bps. The bond market is currently doing work for the Fed with higher longer-dated Treasury yields lifting borrowing costs (e.g., mortgages). We believe the tightening is going to eventually decrease liquidity.

Some Areas We Are Evaluating…

Earnings season better than expectations but…

We are now nearly 50% of the way S&P 500 earnings season with a 77% beat rate and surprising by on average +7.7% (Factset). The recent development is that the market is punishing both earnings beats and misses with negative stock returns around earnings announcements last week. The optimism which drove certain stocks to significant gains earlier this year appears to have been replaced by caution. Part of the reason for the caution is the result of persistent inflation. The outlook for Q4 earnings has been trimmed from +8% to +5% and 2024 earnings estimates have been trimmed modestly below +12%. We are cautious regarding 2024 earnings growth estimates. Approximately 30% of the S&P 500 companies are scheduled to report earnings this week, with the headline acts consisting of Apple, AMD semiconductor and Starbucks.

U.S. economic data holding up with a strong Q3 GDP >4.5%

Consumers are spending excess savings and increasing credit card expenditures to fuel spending as income is not keeping up with inflation. This does not seem sustainable to us and even though the labor market is still relatively tight, wage growth is softening, which is likely to slow down consumer spending.

China announces more stimulus

China announced 1 trillion yuan (~$137 billion) of stimulus with significant debt issuance to fund infrastructure projects with up-front spending in 2023, but this is mostly likely going to impact economic growth into 2024. Chinese equities were of the best performers last week, copper prices rose just over +2%, and materials stocks did of the best. Markets felt the China stimulus push this week.

European Central Bank (ECB) Pause

In addition, the ECB decided to hold interest rates steady at their meeting last week as economic data continues to come in relatively weak. Non-U.S. equities have held up remarkably well as of late given weaker earnings and growth than the U.S. China stimulus headlines just gave them a big week of relative performance.

Bank of Japan (BOJ) Monetary Policy Pivot?

The BOJ monetary policy meeting takes place this week. The recent surge in global interest rates has increased pressure on the BOJ to change its bond yield control policy (increase rates) making its debt more attractive to domestic investors and decreasing incremental demand for US Treasuries as a consequence (demand<supply may increase US yields).

US Treasury Borrowing Estimates

The US Treasury Department announces this week its expectations regarding the borrowing amounts in the fourth quarter of 2023. This “supply” guidance could impact bond markets which have been shaken by the high deficits. Treasury yields, especially longer dated securities (10 year +) , have risen with growing bond supply as the Treasury attempts to rebuild its cash balance drained by a debt ceiling standoff in Congress in the Spring. Approximately, 33% percent of US outstanding marketable sovereign debt matures in the next twelve months where the weighted average coupon and weighted average years to maturity are 2.12% and 6.1 years, respectively. Interestingly, S&P Global Ratings recently upgraded Greece's credit rating to investment grade for the first time since the country's debt crisis dating back to the Great Financial Crisis. Greece's bonds are now the best performers in the euro area. Its 10-year government bond is yielding less than the United States at 4.3% vs. US 10 year at 4.8%. By the way, back in 2012, that 10-year government yield, the government bond was at 41% back in 2012. Remember that bond prices and yields move inversely.

Fed meeting preview

The bond market is placing nearly a 100% chance of no rate hike this week followed by an 80% chance of no hike rate hike in December. The bond market is still pricing in a hold followed by the first rate cut in June of 2024. The Fed is likely still in wait-and-see mode to determine if another rate hike is warranted. The good news of strong economic data creates bad news of inflationary pressure and the need to keep rates high or higher for longer. It is too early for the Fed to declare victory over inflation, and the Fed needs to slow down the economy further to get inflation under control.

Three things that make this tightening cycle relatively unique as it relates to the bond market:

- We are potentially on our 3rd consecutive negative total return year in the bond market, which has never happened before.
- If July was the last rate hike of the cycle, it is very unusual for the 10-year treasury yield to rise to new highs for the cycle after the last rate hike, usually when the Fed funds rate peaks, the 10 yr. yield has already peaked or very close.
- After a yield curve inversion, it is rare to see a bear steepening occur (longer-dated yields rise more than shorter-dated yields). Usually a bull steepener happens next, as after yield curve inversions, typically the next move for the Fed is to cut rates.

<u>So What to Do With Credit</u>

The Fed's punch bowl of easy monetary policy is long gone—don't expect it to come back anytime soon. To date, the most severe drawdowns in high-quality bonds have been in the ultra-long end of the curve, which exhibits more sensitivity to technical supply/demand factors than pure macroeconomic factors. Volatility could remain elevated here, and we continue to exercise caution.

Instead, we still see value in the 1-10yr segment of public investment grade and municipal debt, as current yields and potential price appreciation upside may reverse recent drawdowns. It's worth noting that despite nearly 100bps of moves higher, the total return on a 5-year high-quality bond investment is essentially flat, demonstrating how higher outright yields levels can protect against mark-to-market volatility with potential upside.

We also believe there is a multi-year opportunity in private credit. There may or may not be a crash (e.g., High Yield spreads at 800bps vs. 500 long term average post GFC and ~450 bps Oct 2023) but the financing markets are increasing more difficult than the headline spreads indicate. In response, we have identified active managers who intentionally construct portfolios to capitalize on the ongoing supply of distressed, restructuring, special situation, and liquidation opportunities, while being cognizant of market valuations and macroeconomic risks. Based on these views, we believe there may be attractive opportunities to earn "equity like returns for debt like risk being focused high in the capital structure (i.e., first lien senior secured). We are focused on private fund managers who have experience leading negotiations on creditor committees, actively engage with companies to create positive catalysts, and improve companies with new boards and management teams. They typically also continue to work with companies to enhance balance sheets, which we believe will lead to increased free cash flow generation and create attractive exits at higher valuations for investors.

Ultimately, we believe that the Federal Reserve will need to keep rates high for longer to effectively slow inflation down to reach their target, which will likely result in further economic slowdown and continue to create attractive private credit investment opportunities to complement core public equity and credit holdings.

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