ROBERTSON STEPHENS®

October 9, 2023 – Investment Commentary

Market Movements

Last week, global equities fell 0.4% last week as interest rates continued to rise. While U.S. equities rose slightly, developed-market equities outside the U.S. fell 2.1%, and emerging market stocks declined 1.6%. The 10-year Treasury yield rose 0.23% to 4.8%, while the two-year Treasury yield increased to 5.08%. Intermediate to longer-term yields rose to the highest levels since 2007, resulting in a 1.2% loss for investment-grade bonds. High-yield bond spreads, or yields above comparable Treasury yields, rose 0.28% to 4.24%, an indicator of weakening credit.

Beyond the tragic loss of human life, investors must also contemplate what happens next in a world where heightened political risks and tight commodity markets represent a persistent threat to the global economy. Before the weekend invasion, inflation was expected to decline to 3.6% year-over-year in September from 3.7% in August, based on economists' estimates for the U.S. Consumer Price Index report scheduled for Thursday. Geopolitical concerns are driving some investor demand for "safety" in U.S. Treasuries (price up / yield down).

Over the past 15 months, investors have been pricing in higher interest rates and economic risk in the near term, lifting yields on the short end of the curve above the long end. We believe investors want to see clear evidence of an economic slowdown to be confident that yields have peaked. We expect those conditions to be met in Q4.
Inflation should also continue to fall. The strong headline job growth in the September payrolls report might belie that forecast. However, the continued moderation of average hourly earnings and the 18-month trend of labor market cooling both suggest that growth and inflation should fall.

<u>What could bend or break?</u>
There is likely a limit to how high rates can go before having a meaningful incremental drag on the economy or cause something to "break." Through 2026, roughly 25% of the high-yield (HY) bond market needs to be refinanced. However, there will be a wide set of outcomes within the HY market. Falling Treasury prices (yield up) may lead to more problems for certain banks complicated by certain commercial real estate challenges. However, the Fed created a new Bank Term Funding Program (BTFP), offering loans of up to one year in length to banks pledging U.S. Treasurys, agency debt and mortgage-backed securities, and other qualifying assets as collateral. Those assets will be valued at par while the "market value" is less than par. Therefore, financial market knock-on effects remain tail risks, not our base case absent further geopolitical developments.

While the U.S. housing market is holding up well, even more tightening is being put into the system, with 30-year fixed mortgage rates hitting a new 23-year high over the week and mortgage applications hitting a 27-year low. Housing has been amazingly resilient with prices, with the Case-Shiller house price index through July up +1% year-over-year but sitting at all-time highs national home price. In time, higher borrowing costs will likely weigh on housing and U.S. economic growth more broadly, especially in a world with elevated oil prices.

<u>What does it mean for stocks?</u>
Higher rates are a periodic drag on equity valuations – but this could be outweighed by the improving profit picture. While higher financing costs could impact earnings, the weighted average debt maturity for non-financial S&P 500 companies is over a decade – so the impact will be more prevalent in certain smaller companies and companies that have less durable operating margins.

What We Are Monitoring

<u>JPMorgan, Wells Fargo and Citigroup to Report Earnings and Provide Guidance</u>
JPMorgan, Wells Fargo and Citigroup are scheduled to report third-quarter earnings on Friday. The market will increasingly focus on the "E" (earnings) in the forward P/E ratio. Analysts are estimating that Q3 will be the last negative earnings growth quarter before we see 8-13% earnings growth for the next four quarters.

The U.S. economy continues to show strength into the fourth quarter (Q4). Beneath the optimism, growth comes at a cost—inflation, global policy uncertainty (U.S, Europe, Japan, China), and financial conditions tightening in the U.S. and Europe are all challenges markets will have to navigate in the near future. The labor market is fuel for economic resilience, and while the labor market is renormalizing after COVID disruptions, by virtually every metric, it remains strong.

This economic resilience has caused consensus expectations to evolve from concerns about recession to hope of a soft landing to optimism that growth will continue at a steady pace.

China Property Market

Country Garden, China's largest private property developer, has not defaulted so far, but has missed coupon payments on some dollar bonds since last month and faces the end of 30-day grace periods for making payments. Recently, Country Garden said that its available funds have continued to decrease.

We continue to closely monitor the Chinese government's new stimulus measures to offset these property pressures.