

High Interest Rates (for Longer)

The S&P 500 peaked at the end of July, up 19.5% by the 31st. This performance is remarkable given the S&P 500 was up less than 1% on the Friday before Silicon Valley Bank failed in March.

Reasons for the rally include:

- The liquidity infusion by the U.S. government (\$550 billion from the Treasury's General Account and \$300 billion from the Federal Reserve's Bank Term Funding Program)
- The draining of oil reserves from the Strategic Petroleum Reserve which helped keep a lid on oil prices
- The potential power of artificial intelligence and the recognition of the new technology's economies of scale
- Ongoing strength of the job market and therefore the consumer

As we said in our 2Q investment letter and our podcast associated with "Trees Don't Grow to the Sky", having a small number of technology related stocks drive the entire market was unlikely to continue. Either the 'Magnificent Seven' stocks would fall or other sectors, particularly energy, would rise. In fact, both occurred. In the 3rd quarter, the S&P 500 total return was negative (down 3.3%) while energy was the best performing sector (up 12.2%) and only one of two sectors that were positive for the quarter. By the end of the 3rd quarter, the overall market had retreated 6.6% from the July highs.

Why Did the Market Turn Negative in the 3rd Quarter? Higher interest rates!

The 10-year Treasury yield increased from 3.8% to 4.6% in the quarter, sending the U.S. Aggregate Bond Index into negative territory once again. (Bond prices fall as yields rise.) As the U.S. deficit continues to grow, the government must issue more bonds to finance that deficit. As the supply of bonds increases, buyers are unwilling to continue purchasing unless they are rewarded with higher interest rates. At the same time, certain foreign buyers (lenders) have either been selling U.S. Treasuries or reducing the amount they purchase, putting further pressure on prices.

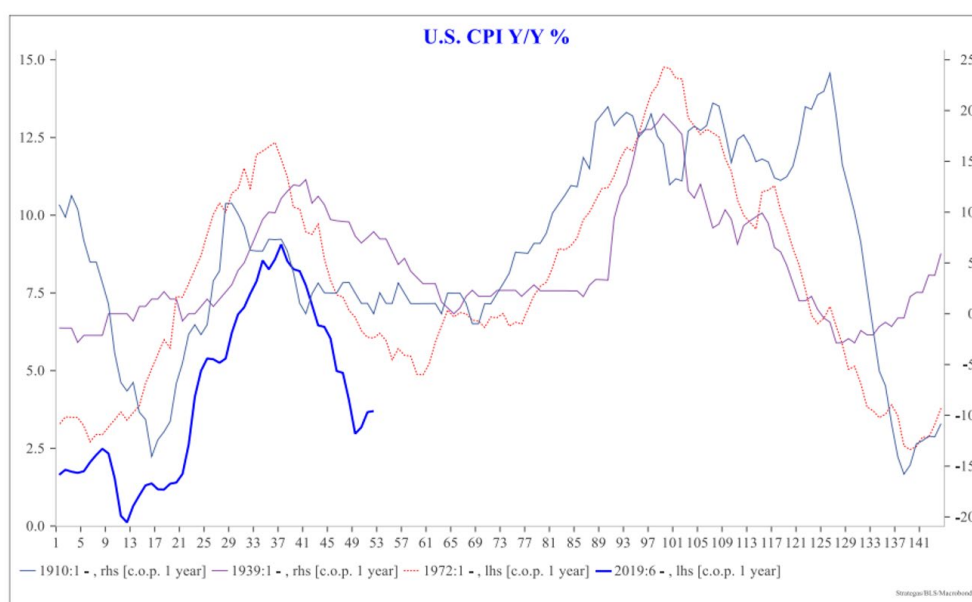
When bond yields rise substantially, they often cause equity prices to fall, partly because higher bond yields offer better competition against equities. In evaluating the attractiveness of equities versus bonds, investors often look at the 'equity risk premium', which is the S&P earnings yield minus 10-year bond yields. The equity risk premium recently fell well below historical averages, making stocks look less attractive. Continued inflationary fears may be at work also, driven by aggressive wage increases and higher energy prices. If inflation persists, the Federal Reserve is likely to keep rates higher for longer, raising fears of an economic slowdown or recession.

The last mile can be the hardest for policy. Most of the easy work has been done on inflation. Now, there are intractable issues that the Fed cannot control:

- Energy prices
- Wage pressures (particularly from unions)
- Historically high Federal debt levels
- Geopolitical risk

The chart below explains why the Federal Reserve has adopted a higher for longer policy. They don't want to risk a rebound.

INFLATION HAS TENDED TO COME IN MULTIPLE WAVES HISTORICALLY



Strategas Research 10/12/23

As we write this, the market has once again reversed course with the large cap tech and communication stocks rising while energy stocks fell (despite the weekend bombing of Israel by Hamas). Markets don't move in straight lines, and we remain cautious. Interest rates are restrictive. Equity valuations are not cheap, and geopolitical risks are increasing. The effect of Fed tightening is taking longer to slow the economy than usual, and we think most of the negative effects are still ahead.

As we have said for more than a year, we believe this recession will be different than other recessions because Americans will remain employed due to population demographics. Inflation will remain sticky. Financing of U.S. debt may be a problem as foreigners have been reluctant to hold, much less buy more of our debt, and U.S. investors may grow weary of holding fixed income instruments in the face of falling prices. As markets correct, expect us to take advantage of adding to equity, with an eye to companies whose margins will not be hurt by rising input prices.

These are challenging times. To paraphrase Jamie Diamond, CEO of JP Morgan, this may be the 'most dangerous time' the world has seen in decades. We have a war in Ukraine, war in Israel and paralysis in our own government.

And as famed investor Howard Marks writes in "Sea Change", we have now come to the end of a 15-year low period in interest rates. Investors, whose life expectancy is likely to be longer, are just beginning to realize what that means for returns and asset allocations. Returns will likely be lower and asset allocations will need to change.

Please reach out with any questions or comments. At times like these, it is important to have experienced advisors by your side.

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