

## September 19, 2022 – Investment Commentary

### Market Update

The S&P500 index fell 4.8% last week while non-US developed and emerging equity markets were down ~ 2.5% as investors were troubled by a report of higher-than-expected US consumer price inflation in August as well as a profit warning by FedEx (Ticker FDX). More specifically, the S&P 500 Index dropped more than 4% last Tuesday, but the FANG+ Index of technology stocks dropped by more than 6.5%, underlining the vulnerability of interest rate-sensitive long duration equities. The S&P 500 Index has fallen 10% from its Aug 16<sup>th</sup> high and trades 6% above the June 16<sup>th</sup> low. Rising rates and widening credit spreads impacted investment grade US fixed income sectors generating negative returns and high yield bonds declined 2%. The 10Y-2Y is now -42bps, and the 10Y-3M at 25 bps still seems headed for signaling recession. Rates rose modestly in other developed markets. The Italian 10Y yield is above 4%, though Italian sovereign BTP-German sovereign Bund spread was down slightly at 2.28%.

The 2 Year treasury increased to 3.9%, its highest level since 2007, a stunning rate of change from 20bps 12 months ago. Outside of short term moves driven inflation headlines, we see headwinds for this market from both high valuations and high earnings expectations. We believe valuations at ~17x for the S&P 500 index are likely too high given the degree of tightening the Fed is doing (current level of 2 year yields, and level of 10 year real yields the 10Y real yield rose 19bps to positive 1.08%, its highest level since late 2018). In addition, Wall Street consensus earnings expectations are +8% for 2023 which we believe are too high given slowing leading indicators and Fed tightening. Maybe earnings warnings from companies like FDX last week are the wake-up call that analysts needed to recalibrate estimates.

### The BPS Question

The big (bps) question is when will the Fed reach its destination and ideally begin to drop rates. The implication of increasing rates as an allocator is that the hurdle rate is higher or in other words the cost of capital is higher. When we are constructing portfolios and recommending investments for clients it's not in a vacuum. The Investment Office also considers the risk-free rate and inflation expectations. During the last 10 years, investors benefited from a negligible risk-free rate and periods of negative real rates.

Today, the 2 year is knocking on the "4% door" and we believe it will likely walk through on its way to 4.5%. Investors are engaging in volatile price discovery to determine which valuation multiples and credit spreads they are willing to assign to unprofitable businesses, distant earnings streams, non-interest earning assets, etc. As a result, many are beginning to make two observations.

1. **Income.** There are now tax equivalent yields in 5-6 percent range in quality municipals.
2. **You can't run from beta.** However, you can be more deliberate in partnering with control investors via alternative strategies who can play offense when rest of the portfolio is in a "drop and roll" posture.

### Now What

We have a big "macro week" ahead of us with the Fed meeting on Wednesday and various home statistics. The Investment Office will focus on the Fed's three primary tools to deliver its monetary policy which include fed fund rate targets, balance sheet adjustments, and communication language. Additionally, the Investment Office is monitoring sticky shelter inflation and its material contribution to the consumer price index (CPI) via the "owners' equivalent rent calculation". This factor accounts for 24% of the index and is supposed to represent the rent a homeowner would pay if they rented rather than owned their home. Currently, we anticipate a material decline in home sale volumes but do not believe it will translate to a systemic catastrophic

decline in home prices. The reason is partly due to approximately 90% of US mortgages are under 5%, and around 80% are under 4%, according to housing sector analyst Ivy Zelman. Unless someone is compelled to move, looking at a potential 50% increase in borrowing costs could be a non-starter for many homeowners.

#### *Disclosures*

*Investment Commentary Sources: Bloomberg and Morningstar*

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