

October 2, 2023 – Investment Commentary

Market Moves

Global equities declined 4.1% in September, led by a 4.8% loss in the U.S. Investment grade bonds lost 2.5% as the Treasury curve steepened on expectations that the Federal Reserve will keep rates higher for longer. High yield bonds fell 1.2% with a modest credit spread widening. Among real assets, natural resources performed the best with help from higher oil prices, while global real estate declined 6%, pressured by higher interest rates.

The preliminary reading for Europe's Consumer Price Index indicated that inflation's grip may be easing there as well. Europe's flash Consumer Price Index rose 4.3% year-over-year while core inflation rose 4.5%, below expectations and notably lower than prior levels. The late-week inflation releases provided some relief to rising global bond yields, especially in Europe.

The tech heavy Nasdaq ended September with a decline of 5.8%, bringing its third-quarter decline to 4.1%. It was the tech-heavy index's worst month since December. The S&P 500 was down 4.9% this month and 3.6% this quarter. It's fallen in four-straight weeks, its longest losing streak since the week that ended on Dec. 30, 2022.

Regarding inflation metrics, the Core PCE (personal consumption expenditures, which tracks changes in prices of goods and services excluding food and energy costs), rose 3.9% year over year in August, down from 4.3% in July. In contrast, the three-month Core PCE inflation rate fell to 2.2% annualized in August, the lowest core rate since December 2020. That is encouraging where the Fed's fight against inflation appears to be making progress towards its 2% target. The idea that lower long-dated bond yields make future profits more valuable and fast-growing tech companies are valued on the basis that most of their profits will come many years in the future.

However, the markets continue to face numerous challenges, including another funding bill in 45 days (November 17th deadline), higher-for-longer interest rates due to various "sticky inflation" metrics, elevated oil prices and further wage gains. The Investment Office is mindful of this week's labor market figures, particularly, with job openings, private payrolls, and September's jobs report all on tap. The reason is that we believe the Federal Reserve Bank likely needs to see the labor market cooling (implying weaker demand for a given level of goods and services) if it's going to alter its higher-for-longer narrative around interest rates. Some near term "equity traders" may be hopeful that historically October and November have been the second and third best performing months for the S&P 500 over the past 10 years, rising an average 2.3% and 3.2%, respectively. Maybe that statistic, plus a couple of the risks fading into the background, will be enough for the stock market to mount a tentative comeback.

Bonds

During the third quarter, high-quality investment grade bonds with an average duration of approximately six years have been under significant pressure (lower price/higher yield), and unsecured high yield bonds, with an average duration of four years, have been more resilient. The Fed has increased its hawkish rhetoric. They are no longer seeing a recession and are fully on the "higher for longer" train. This has pushed high quality bond yields to their highest levels in over 10 years. Investment grade corporate bonds are within basis points of their prior cycle high of 6.10% at 6.04%, mortgage backed securities (MBS) are now 5.57%, and municipals are now 4.32% (with higher tax bracket investors now looking at tax equivalent yields of 6-7%).

As we have highlighted in the past, your starting yield of a bond is the best predictor of forward 5-year returns, explaining nearly 90% of the total return. Given the continued increase in bond yields (price down/yield up), we are seeing investment grade bonds offer 5-6% income for years to come.

The market movements over the quarter are likely to weigh on economic growth as interest rates and oil/gas prices rise, and likely another form of tightening for consumers. Weakening economic growth was priced out over the quarter. However, in our view, the sale in high quality asset classes may be a suitable opportunity paired with short duration cash creating an income generating, more defensive fixed income solution for portfolios.

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