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January 22, 2024 – Investment Commentary

Market Moves

Last week, stock performance was mixed and bonds down. The S&P 500 outperformed the MSCI EAFE (non-US Developed) and the MSCI Emerging Markets indices. The best performing sectors in the S&P 500 were technology, communication services, and financials. As for fixed income, the 10 year treasury yield rose 18 bps on the week to 4.14% and the 2 year - 10 year treasury yield spread flattened to -25 bps.

What's Happening

Economic data in December continued to impress with strong retail sales, consumer sentiment, and consumer inflation expectations fell. Consumer sentiment also improved with one year ahead of inflation expectations now under 3%, falling to the lowest since September 2020. Q4 earnings season continued to roll-on with 10% of S&P 500 companies reported without any noticeable trend.

Expectations for rate cuts in 2024 fell sharply last week, with futures markets pricing only a 13.1% chance of seven or more rate cuts in 2024 as of the close of trading on Friday versus 61.5% the week before, according to the CME FedWatch Tool. Chances of a rate cut in March fell from 81.0% to 47.4%. The decline appeared due in part to comments Tuesday by Fed Governor Christopher Waller, who told a virtual conference that "I see no reason to move as quickly or cut as rapidly as in the past" given the healthy state of the economy. Waller's comments appeared to be one factor driving the yield on the benchmark 10-year U.S. Treasury note sharply higher for the week and to its highest intraday level since December 12. (Bond prices and yields move in opposite directions.)

Germany, the world's fourth largest economy, avoided a technical recession but did shrink by 0.3% over the whole of 2023. Much of Germany is now expected to grind to a halt this week when train drivers begin a six-day strike – the longest industrial action in the national railway's history. Six out of 10 of Europe's freight corridors go through Germany, so a considerable knock-on effect across mainland Europe is also inevitable. This strike is an extension of the government's recent farmer's strike on the cuts to diesel subsidies and farming vehicle tax breaks.

Portfolio Insights

We continue to prefer investment grade corporate bonds to high yield. The current investment grade corporate index yield is just over 5%. At the peak of the last 15 years in 2009 they were yielding just under 8% and the recent highs in 2022 were just over 6%. Comparing investment grade corporate relative value to high yield, the current additional yield for high yield vs. investment grade corporates is roughly a 50% premium, near the lowest premium since 2007. The average premium over the last 15 years has been more like 100% or nearly double the yield in high yield vs. investment grade corporate bonds.

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