September 27,2023
Dow: 33,550

The Pause That Refreshes

We all know market corrections are normal. Look at a long-term chart of almost any stock or market index – they invariably look like some sort of a serrated knife held at an upwardly sloping angle. The ones with problems look like a knife held at a downwardly sloping angle. On many, the serrations look more severe and haphazard than normal. If the slope trends upward over time, things are going well and the company is executing its business plan properly. If the long-term trend is down, obviously there are business problems that need to be fixed.

The S&P 500 Index is down more than 5% since July 31st. The Index gained almost 20% in the prior four and one half months. Is this an ominous sign of problems to come? There is no indication that storm clouds are on the horizon. The slowdown in earnings appears to have turned, and the S&P 500 Index companies should show meaningful earnings growth for the year.

Nevertheless, there are hurdles for the markets to overcome. Treasury yields are at or near multi-decade highs, consumer purchasing power is still feeling the pinch from past inflation, and housing costs have increased, both in terms of housing prices and borrowing costs, a double whammy.

The current key driver of worry in the markets is interest rates, especially on the longer end of the curve. The ten year treasury has moved up to 4.50%, a sixteen year high. Paradoxically, treasury yields are rising while inflation is falling. Annualized inflation has fallen to below 4% from a high of 9% last summer, and it should continue to trend towards 3% or lower over the next few quarters. Higher treasury yields push borrowing costs higher across the economy. Credit card rates trend up, mortgage rates increase, and borrowing costs for companies go higher. This creates a drag on the economy, and the fact that it is happening now, more than a year after the Federal Reserve began increasing the Fed Funds rate, is evidence of the lagged effect of monetary policy. Part of the problem with Fed policy is they do not know if they have done too little, or too much, for months or years after they have made a change in monetary policy.

Government spending has played a part in this bout of inflation. The Federal deficit, or the amount spent minus total government receipts, will exceed eight trillion dollars for the past three fiscal years. When the real rate of interest is negative, i.e., treasury borrowing costs are below the rate of inflation, borrowing is

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a form of free lunch for the government. That has now changed as the rate of inflation moves below the cost of borrowing for the government. Decisions in Washington will be much more difficult without the low borrowing cost tailwind. We are not optimistic that most of the representatives in Washington are willing, or qualified, to make these difficult decisions. Politicians are well known for taking the path of least resistance. Federal borrowing costs will now be a drag on the economy that is greater than the stimulus benefit of Federal spending.

Who benefits from positive real interest rates? Bond investors. Bond investors will now receive an income return on their investment that is higher than the rate of inflation. As longer rates move up, there is less of an income disadvantage for choosing to lock in current yields for a longer period of time. Our portfolio managers are taking advantage of these opportunities in the market every day in every one of our fixed income strategies. For example, high-quality, short-term bonds now offer yields near 6%, the highest returns since 2007. Municipal bonds also offer excellent value for savers or entities in higher tax brackets.

Back to the stock market, it is difficult to see this move downward in equities as anything other than a garden variety market correction. Companies have proven they have varying degrees of pricing power, revenues have been resilient, and larger numbers of participants are rejoining the labor market. Earnings have rebounded, and the layoffs in the tech sector of the market have seemed to run their course. We will continue to be vigilant regarding the effect of higher interest rates. A Fed near the end of its tightening cycle and inflation trending lower are two key positives that we expect to provide support to equity prices.

Random Thought: "Theory is when you know everything and nothing works; practice is when everything works and nobody knows why." - Albert Einstein

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