October 2023

# MONTHLY MARKET INSIGHTS

**Key takeaways:**

- Yields, especially long-dated yields, surged higher throughout September, and the trend in yields is biased upwards.
- The market's acceptance of a higher-for-longer interest rate environment will, in our view, continue to pressure valuations.
- Government shutdown was narrowly avoided; however, a dysfunctional Congress remains a risk.

September proved to be another challenging month for US stocks as the S&P 500 had a total return of -4.77% while the tech-heavy NASDAQ returned -5.77%.[1] Investors appear to be accepting the reality of a higher-for-longer interest rate environment after this month's perceived hawkish Federal Open Market Committee ("FOMC") meeting. The reality is that long-term treasury yields have been on the rise since the summer with a confluence of factors influencing the upward momentum in rates. As projections for 2024 rate cuts diminish, we believe already extended valuations will continue to be pressured, which should prove challenging for long-duration assets.

Yields on ten-year treasuries surged 46 basis points ("bps") in September, continuing the decisive breakout in rates that began this summer.[2] On August 1, Fitch Ratings downgraded the United States Sovereign Debt rating to AA+ from AAA, citing a large government debt burden, eroding governance, and expected fiscal deterioration as primary reasons for the downgrade.[3] Since then, ten-year yields have risen 67bps, reaching a intraday high of 4.69% on September 28 before closing the month at 4.57%.[4] Treasuries experienced headwinds this year as demand from the two largest foreign holders of treasuries, China and Japan, has abated. A declining exports environment has led to fewer dollars available for China to recycle into US government debt. At the same time, the Bank of Japan's exit from yield curve control has prompted Japanese investors to rotate money out of US treasuries.[5]

Simultaneously, a large stock of T-bills set to mature will force the Treasury to increase auction sizes for longer-dated bonds while the Federal Reserve ("Fed") continues its quantitative tightening program. Taken together, we believe that the treasury market should experience a growing supply-demand imbalance that will likely push yields higher. Furthermore, a tight labor market, combined with continuing worker strikes, should keep wage inflation elevated. As a result, we believe that the Fed will need to maintain restrictive interest rate policy for longer than expected in order to bring inflation down to its stated target. The September FOMC meeting reinforced this belief as projections for 2024 rate cuts were reduced from 100bps of cuts to 50bps of cuts, with another 25bps hike before year-end still on the table. In his post-meeting press conference, Chairman Powell suggested that the short-term neutral rate might be higher than what is currently being projected by dot plots, supporting the view of a higher-for-longer interest rate environment. While a soft-landing scenario appears to remain the consensus view among market participants, we believe the likeliest outcome is that the Fed will be forced to maintain restrictive monetary policy until they induce a recession, which may come as early as this year.

1. Bloomberg.
2. Id.
3. "Fitch Downgrades the United States' Long-Term Ratings to 'AA+' from 'AAA'; Outlook Stable." Fitch Ratings: Credit Ratings & Analysis for Financial Markets, 1 Aug. 2023, www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023?_gl=1%2Aei65vj%2A_ga%2AMjA4NTcwNTQ1Mi4xNjk2MDEyMzk3%2A_ga_E58YZGKRFB%2AMTY5NjM0MTY2My4yLjAuMTY5NjM0MTY2My42MC4wLjA.
4. Bloomberg.
5. Slok, Torsten. "Why Are Long Rates Going Up?" Apollo Academy, Apollo, 28 Sept. 2023, apolloacademy.com/the-daily-spark/.

We believe the movement in the 10-year yield will likely prove sticky, with yields anchoring towards a 5% rate from the below 2% range experienced over the past decade. Astonishingly, there are no sell-side economists who have a year-end 2023 or Q1 2024 ten-year yield forecast above 5%.[6] We anticipate that many economists will recalibrate their interest rate forecasts upwards over the coming weeks, which may pressure equity markets further. The most significant impact of this higher interest rate environment will be upon long-duration risk assets, which are historically negatively correlated to rate movements. Leadership within US equity indexes has already begun to rotate, with growth sectors like technology underperforming certain defensive sectors in September. Notably, many cyclical sectors have failed to outperform alongside last month's upward move in rates except for the energy sector where surging oil prices have proven beneficial for oil and gas producers. Normally, cyclical sectors tend to perform well in a rising interest environment, as upward movements in rates usually indicate expanding economic growth. We view the price action in cyclicals as a harbinger of trouble and of a possible economic slowdown in the fourth quarter, as declining consumer aid and rising oil prices weigh upon the consumer. Consequently, corporate earnings should continue to be pressured going into year-end, meaning equity multiples would need to remain extended to support current index levels.

On the political front, the month ended dramatically in Washington as lawmakers averted a government shutdown by passing legislation with bipartisan backing to extend funding through mid-November. House Speaker Kevin McCarthy unexpectedly reversed his previous opposition to a bipartisan package, after repeated attempts to pass legislation to avert a government shutdown failed over the past month. The deal provides Congress 45 days of runway to pass an alternative spending package; however, it is possible that Congress will find themselves in a similar position in mid-November. While McCarthy's capitulation prevented the government from going into shutdown, his actions may cost him the speakership.

Historically, shutdowns have had limited effects on GDP and equity markets; however, it appeared that investors were more concerned about a shutdown this time around. Investors appear particularly perturbed by Congress's dysfunction at a time when US debt servicing costs are rising for the first time in 35 years.[7] In our view, the most significant impact of a government shutdown would have been the Fed's inability to access crucial employment and inflation data prior to their next meeting at a pivotal point in their monetary policy regime. With shutdown averted, the Fed will have all the government data necessary to help guide their decision at the next Fed meeting. Government shutdown has been avoided for now, but risks still exist if Congress cannot come to a solution by mid-November. We maintain a watchful eye on developments in Washington as Congress works to find a solution.

An anticipated growth slowdown, stretched equity valuations, and rising interest rates have created an environment that we believe will prove challenging for risk assets. Further, continued government dysfunction and the lagged effects of monetary policy lead us to maintain a conservative investment thesis and a focus on capital preservation. We believe diversification into assets with mitigated interest rate risk remains prudent as we navigate through this period of uncertainty.

6. Verrone, Chris. Rate Unimpressed With D.C. Deal, Market Internals Still Weak, Strategas, 2 Oct. 2023, www.strategasrp.com/Document/Index?strResearchProductID=nnU6eBnMcrh81%2bYfn5Mwaw%3d%3d.

7. Clifton, Dan. Congress Averts a Shutdown, For Now, Strategas, 30 Sept. 2023, www.strategasrp.com/Document/Index?strResearchProductID=kKooK4kIxPKUgNcb5Ps0Yg%3d%3d.

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