Portfolio Commentary

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Will Growing Government and Corporate Debt Mean "Higher for Longer?"

Market Review

After an early year correction driven by the bank failures, impressive economic growth and a turnaround in earnings expectations drove an over 19% rally between the March 13th bottom and July 25th. By the end of July, the S&P 500 had nearly reached its December 2021 highs. Markets would not break higher, as not coincidentally, what was widely believed be one of the Fed's last interest rate hikes occurred on July 26th.

Soon after, it was good news that began to stoke investor selling, in the often counterintuitive fashion of the markets. Stronger-than-expected economic data – in particular, strong employment reports – drove interest rates higher and thus markets lower, resulting in an over 5% correction by the end of the quarter. Fixed income investors had become optimistic that not only was the Fed's hiking cycle over, but also that economic weakness would soon follow and a reversal into interest rate cuts was coming by late 2023 or in the first half of 2024.

For such a scenario to occur, we would expect to see unemployment begin to rise, and corporate earnings and overall economic growth slow. That never happened, nor did signs of a slowdown appear. Employment remains quite strong, despite higher interest rates driving up mortgage rates and corporate borrowing costs. So far, the economy has been able to absorb the Fed's 5.25% increase in short-term interest rates since March 2022.

Extreme concentration and a lack of breadth has driven the 2022 rally. While the S&P 500 is up 13.1% through the 3rd quarter, the NASDAQ 100 is up a remarkable 35.1%, driven by mega-cap names like Apple, Microsoft, Tesla, Google, and Meta. Meanwhile, mid-cap stocks are up only 4.3%, and small-caps are up only 0.9%. The willingness to concentrate in fewer and fewer dominant Technology sector leaders has proven to be one of the very few ways to discover outsized gains.

Third Quarter Portfolio Highlights

- The Global Risk Management portfolio tactically rotates its holdings between risk on equities and risk off Treasuries or cash equivalents, always maintaining a minimum of 5% in equities and Treasuries. It was a down quarter for equities, but it even was worse for Treasuries. While the S&P 500 declined 3.2%, the 7-10 Year Treasury ETF declined 4.5%. U.S. small-caps declined by 4.7%, while broad international equities fell 4.2% and international small-caps declined 3.4%. Cash equivalents were again king, with short-term Treasuries up 1.3%.

Past performance is not indicative of future results.
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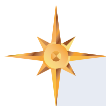

- When positive on equities, the portfolio baseline allocation is a 70-30 mix between U.S. large-cap and small-cap stocks and a 70-30 mix between U.S. and international equities. In May, we increased international equity exposure, moving to a 60% U.S. and 40% international mix. The change was driven by a large valuation gap between U.S. and international equities, and our belief that the Fed's eventual pause will create downward pressure on the dollar, boosting international equities. While we have been in a bull market since October 11th 2022, its gains have been concentrated. While the S&P 500 is up 21.4% over that time, small-caps are up only 6.9%. Broad international and international small-cap gained 21.2% and 20.0%, respectively. U.S. stock market gains have been extremely top heavy as the NASDAQ 100 is up 37.3% over that period. Market breadth has been quite poor and while many rightly point that out as a crack in the market's armor, we always keep in mind that markets can resolve this bullishly if value stocks and small-caps play catch up.
- For most of the third quarter, the pain caused by rising interest rates had a surprisingly small effect on credit spreads and our credit-based models were positive and only began to undergo weakness around early September. Since then, the models have gotten closer towards giving a risk-off indication. Given the pain and poor relative performance in Treasuries, our defensive vehicle of choice would be cash equivalents.

Positioning and Outlook

Let's again examine the four market segments important to the Global Risk Managed portfolios and their relative yields (as seen in the table below):

Market Segment and Yield	09/30/23
3-Month U.S. Treasury Bill Yield	5.4%
10-Year U.S. Treasury Yield	4.6%
Bloomberg High Yield Corporate Bond Index Yield	8.9%
S&P 500 Forward Earnings Yield	5.2%

Source: Ned Davis Research, Bloomberg. For illustrative purposes only. Past performance is not indicative of future results.

As of June 30th, T-Bills yielded 5.4%, while 10-Year U.S. Treasuries yielded only 4.6%, resulting in a 0.8% yield curve inversion. This has been reduced by surging Treasury yields. Cash stands out as a viable asset class, as its 5.4% yield exceeds the earnings yield of the S&P 500 itself (of course without the potential for earnings growth).

High yield corporate bonds offer what appears to be a compelling 9% yield, but with outsized credit risk. Cash now offers a compelling 5.4% yield on a risk-adjusted basis; equities offer a lower earnings yield and a forward price earnings ratio of 19.1, which is well above the 40-year average of 15.3, and only has been exceeded in the late 1990s and from 2018-2021. While we do not view valuations as predictive for market timing, we believe the relative competitiveness of cash and bonds versus stocks will present tactical opportunities amidst market volatility going forward.

Going forward, we believe that the levels of debt across the globe by both governments and corporations will be a crucial factor. We see a number of conditions that might force the higher for longer narrative on us. First and foremost, the U.S. government has been ineffective at addressing long-term problems and its finances are considerably stressed. As an example, the U.S. represents 4% of the world's population, yet its budget deficit is so large that it represents 40% of all global budget deficits. Moreover, the trade deficit is so large that it accounts for 60% of global trade deficits. As a result, the U.S. government's borrowing soaks up about half of the world's savings just in its funding needs.

While the dollar is the world's funding currency, U.S. structural debts could produce long-term upward pressure on interest rates. On the other hand, one would have to consider that a higher for longer narrative is fundamentally unsustainable for the simple reason that higher interest rates will restrict and constrain the robust economic growth that normally drives interest rates higher. We believe that these two conflicting forces and the overabundance of global debt will contribute to further volatility in the future, and we will continue to rely on our quantitative models that provide an objective assessment of the credit backdrop to drive our allocations.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

A Treasury Bill (T-Bill) is a short-term U.S. government debt obligation backed by the Treasury Department with a maturity of one year or less. Treasury bills are usually sold in denominations of $1,000.

The 3 Month Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 3 months.

The 10-year Treasury yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

The Bloomberg USD High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds

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