Are Higher Interest Rates Beginning to Impact Growth Expectations?

HOBBS GROUP ADVISORS
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October Scares Markets

Although US economic growth was stronger than expected, equities were down in October amid geopolitical conflict, rising longer-term US bond yields, and mixed earnings takeaways. All three major US stock market indices were down for the third straight month. Both the S&P 500 and the Dow Jones Industrial Average had their worst October since 2020 while the Nasdaq Composite had its worst October since 2018. US small-caps (-5.8%) were among the worst performers, followed by US mid-caps (-5.3%) and broad-based emerging markets (-3.5%). Bonds were also down as investment grade corporates fell 2.4%, 7-10 year US Treasuries declined 1.9%, and the US Aggregate Bond Index decreased 1.6%. Aside from crude oil (-7.2%), commodities produced positive returns as gold was up 7.4%, silver gained 3.2%, and broad-based commodities increased 0.4%.

Exhibit 1: Trailing Returns as of October 31, 2023

	Index/ETF	1-Mo	3-Mo	YTD	1-Y	3-Y	5-Y
Equities	US Small-Caps (SPSM)	-5.77%	-15.10%	-4.99%	-7.67%	8.90%	4.81%
	US Mid-Caps (SPMD)	-5.30%	-12.90%	-1.25%	-1.06%	9.20%	6.67%
	Broad-based Emerging Markets (IEMG)	-3.47%	-12.04%	-0.66%	11.07%	-2.46%	2.20%
	International Developed Equities (IEFA)	-3.09%	-10.34%	3.13%	14.70%	5.38%	4.20%
	US Growth (IVW)	-2.41%	-7.81%	15.11%	11.73%	6.79%	11.57%
	US Large-Caps (SPY)	-2.17%	-8.32%	10.58%	10.01%	10.23%	10.95%
	US Value (IVE)	-1.82%	-8.93%	5.56%	7.45%	13.27%	9.04%
US Fixed Income	Investment Grade Corporate Bonds (LQD)	-2.41%	-7.03%	-3.01%	1.82%	-6.71%	0.65%
	US Treasury 7-10 Year (IEF)	-1.93%	-5.70%	-4.47%	-2.49%	-7.78%	-0.61%
	US Aggregate Bond Index (AGG)	-1.57%	-4.72%	-2.58%	0.25%	-5.53%	-0.11%
	Municipal Bonds (MUB)	-1.25%	-4.52%	-2.34%	2.12%	-2.21%	1.06%
	High Yield Credit (HYG)	-1.04%	-2.46%	3.05%	4.72%	0.09%	2.04%
	Treasury Inflation Protected Notes (TIP)	-0.72%	-3.41%	-1.39%	-0.91%	-2.19%	2.10%
Commodities	Crude Oil (USO)	-7.22%	2.53%	7.00%	4.88%	43.75%	-7.42%
	Broad-based Commodities (BCI)	0.38%	-1.44%	-3.94%	-3.02%	14.92%	6.15%
	Silver (SLV)	3.15%	-7.54%	-4.72%	19.08%	-1.55%	9.37%
	Gold (GLD)	7.37%	0.95%	8.52%	21.20%	1.47%	9.84%

Source: FactSet. Data as of October 31, 2023.

Fed to Hold Steady, But More Hikes Possible

At the upcoming October/November FOMC meeting, the Federal Reserve is expected to keep interest rates unchanged, leaving the fed funds rate to remain at the 5.25–5.50% range. In his speech at the Economic Club of New York earlier in October, Fed Chairman Jerome Powell signaled rates would likely be held steady. This was in line with recent comments from Fed officials who expressed the increase in longer-dated yields has done some of the tightening for the Fed. However, Powell did leave the door open for additional increases with his comment, "Additional evidence of persistently above-trend growth, or that tightness in the labor market is no longer easing, could put further progress on inflation at risk and could warrant further tightening of monetary policy." He acknowledged that progress has been made towards reducing inflation, but he also reiterated that "inflation is still too high" as both annualized core CPI and PCE for September are still above the 2% target (4.1% and 3.7%, respectively). Powell and officials also stressed they will proceed carefully as the lagged impacts of rate hikes take effect.

Rising Bond Term Premium

The bond term premium, the additional return investors expect for owning longer-dated Treasuries, has increased recently as seen by the rise of the 10-year yield versus the 2-year yield. Its rise can likely be attributed to to limited future fiscal support given the deficit, monetary policy uncertainty with higher for longer interest rates, and less foreign US bond demand coupled with large Treasury issuance.

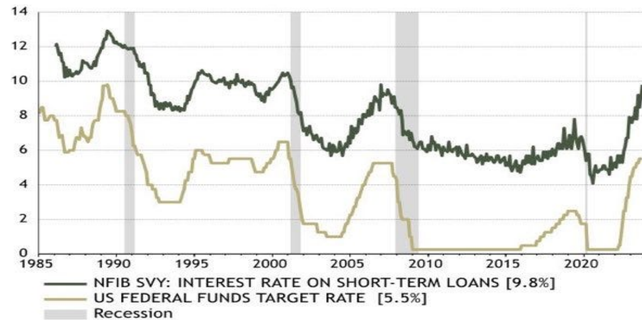
Exhibit 2: 2s10s Treasury Yield Curve — United States

Source: FactSet, Astoria Portfolio Advisors. Data as of October 31, 2023.

Small Companies Face High Interest Rates

Small companies in the US, often referred to as the backbone of the economy, are facing high borrowing costs as a result of the Fed's tightening efforts. Per the NFIB, such companies are being quoted a 9.8% interest rate on short-term loans. This will likely make refinancing existing debt more challenging, decrease capital expenditures, and slow hiring.

Exhibit 3: Interest Rates Paid by US Small Companies

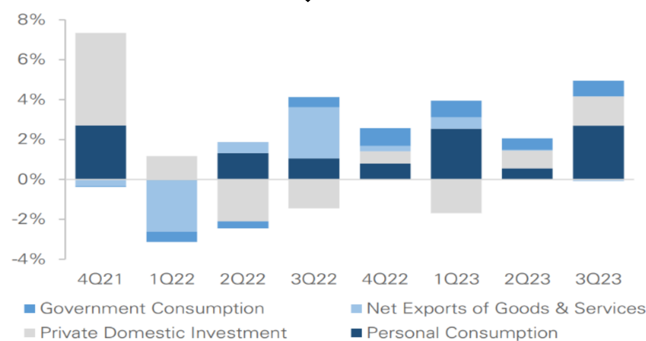


Source: ASR Ltd., NFIB, LSEG Datastream, Callum Thomas

Is Strong GDP Growth Sustainable?

US GDP grew by 4.9% in Q3 2023, its fastest pace since late 2021. More than half of the growth can be attributed to consumer spending, which rose 4.0% versus a gain of 0.8% in Q2 2023. However, Americans saved less than their incomes, with consumer spending increasing over the past quarter and incomes falling over the same period. This, along with excess pandemic savings running out, relying on debt with higher interest rates, the resumption of student loan payments, and materialization of lagged tightening effects imply that such growth may not be sustainable.

Exhibit 4: Contribution to Q3 2023 GDP Growth



Source: MarketDesk, Bureau of Economic Analysis. Seasonally adjusted.

How to Navigate Market Shifts as Higher Interest Rates Begin to Impact Growth Expectations, Consumer Health, and Spending

Over the past year, we have made several adjustments to our ETF model portfolios. We've strategically doubled our duration (from approximately 3 years to 6 years) as longer dated bonds can act as a safeguard against potential recessions. With the accumulation of concentration risk in market-cap weighted approaches, we've employed equal-weighted strategies, strongly promoting diversification across our portfolios while still owning but reducing our exposures to the "Magnificent 7". We are also barbelling our portfolio risk by owning real assets for elevated and sustained levels of inflation, tilting slightly towards international developed equities, and investing in high quality US stocks, as well as strategies that capture stocks with attractive valuations and appealing growth characteristics (growth at a reasonable price). We believe Inflation and interest rates are to stay higher for longer, and portfolios should be re-adjusted to reflect higher real rates. With a recession looming, equal weight over market cap weight can be used to mitigate outsized risks. The bond market is likely to struggle with elevated levels of inflation, the potential for another rate hike, and non-stop Treasury issuance. Warnings of the recession are making themselves known as the yield curve has started to uninvert, but don't forget that the recession already started with the selloff in cryptocurrency and long duration, unprofitable technology stocks in 2022. The recession has now moved to the 20-year part of the Treasury curve with such longer-dated bonds down approximately 40% since the end of 2021. We think commercial real estate and the housing market may be next. How should portfolios be positioned for the recession? We advocate holding more cash than normal but getting ready to extend duration, owning more alternative investments, increasing exposure to real and inflation-fighting assets, and diversifying portfolios away from pure market beta.

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