# AMR INVESTMENT INSIGHTS

**September 27, 2023 | Brian J. Regan**

As we navigate through a complex and dynamic economic landscape, allow me to offer some insights and perspectives on the current state of the financial markets and the potential implications for our investment strategies moving forward.

## Surging 10-year Rates

The persistent upward pressure on 10-year Treasury rates has captured investors' attention. This phenomenon is largely driven by the market's growing acceptance of the Federal Reserve's commitment to maintaining a higher interest rate environment for an extended period but seems to be rising further than the Fed's expectations. The anticipation of above-trend third-quarter economic growth has solidified this belief. This trend is the number one data point I am watching when considering portfolio allocation decisions.

## Rate Ceiling?

We are likely to see a continued decrease in inflation rates in the coming months. One significant contributing factor to this expectation is the large measurement lag in housing related inflation. As the housing market data catches up to the current realities, we will see a more subdued inflationary picture. Energy will be front of mind again as we have seen a rally in prices. It is important to note that OPEC cut production so drastically (1.3M) because they fear a significant slowdown in the Chinese economy which has not yet hit Chinese oil demand. Energy prices will likely be cyclical while we are currently in an upswing. The EIA expects prices to normalize in 2024. All this inflation data is in sharp contrast to the treasury market which has sold off. The market is assuming the Federal Reserve will stay high for much longer.

Despite the negative hiring trends reported in NFIB small business surveys, longer term treasury rates continue to soar. These surveys provide valuable insights into the health and sentiment of the small business sector, which is typically a good predictor of rates. We will continue to monitor these trends closely to gauge their potential impact on our investment strategies primarily when it comes to more rate sensitive assets.

The Federal Reserve plans to have only one more increase in the Fed Funds rate in 2023, with the median rate projections coming down in in 2024-2026 and beyond to a 2.5% long term rate. These projections are "higher for longer" compared to the June projections but do not justify a significantly higher 10-year treasury rate from here. If rates move along the trajectory the Fed is predicting it will likely be a tailwind for equities.

## Debt, Uncertainty and Optimism

It is crucial to address the looming risks associated with the refinancing of risky debt over the next couple of years. The specter of higher interest rates has been a topic of concern and discussion among investors, and it is not unfounded. Whether we are talking about private credit, unsecured high yield debt, or commercial real estate, the prospect of higher borrowing costs could pose significant challenges for many businesses and borrowers. I have been told by Private Credit investors that it is a good time to be a lender and not a borrower. To me, that sounds like an unsustainable situation. We are heavily allocated to high quality, low duration fixed income positions for these reasons (JPST, DODIX, SPTI, THIFX).

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One of the key dynamics we are observing in the current economic landscape is the divergence between discretionary goods and discretionary services. During the pandemic, we witnessed a rapid boom in discretionary goods, driven by shutdowns and stimulus checks. However, we are now in a cyclical trough for discretionary goods, while discretionary services are experiencing a significant uptick in demand. These fast-moving cycles make it difficult to identify trends and require a more conservative allocation that focuses on high quality stocks.

Earnings are expected to begin to grow again in Q4 2023 for the S&P 500. In 2024, they are expected to grow by more than 12% and the projections in 2025 are similarly bullish. These rates are significant not only because they are positive but also because the growth rate is greater than the long-term average. There is a lot of economic activity around reshoring of supply chains, building out of semiconductor foundries, investing in AI, and rebuilding American infrastructure. To this end, we have seen significant investment in heavy machinery and computer engineering.

## Is the Market Pricing the Risks?

Equity market prices are a function of interest rates and earnings expectations. To justify a stock market valuation near where it is today, we need to hope for the earnings scenarios to play out as expected or for rates to tick down. A best-case scenario would mean high earnings and static rates. We know earnings expectations are typically optimistic. We also know that there may be dynamics in the market that could cause treasury rates to rise further before they fall or stagnate (deficits, QT, Foreign buyers). This makes for a continued volatile market with less upside at the current price. Given that, we will continue to allocate to the portfolios cautiously while keeping an eye toward long term optimism. That means positioning underweight stock, overweight cash-like funds, neutral to underweight beta.

In conclusion, the post-pandemic landscape continues to offer fast moving risks and opportunities. In time, as has been the case throughout history, the equity markets will march higher. The fixed income markets are more attractive for the future as yields are higher. Our commitment to disciplined allocation and a continued flexible investment approach will be instrumental in navigating these complexities. We remain focused on our long-term investment objectives and aspire to provide superior results for our valued investors.

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