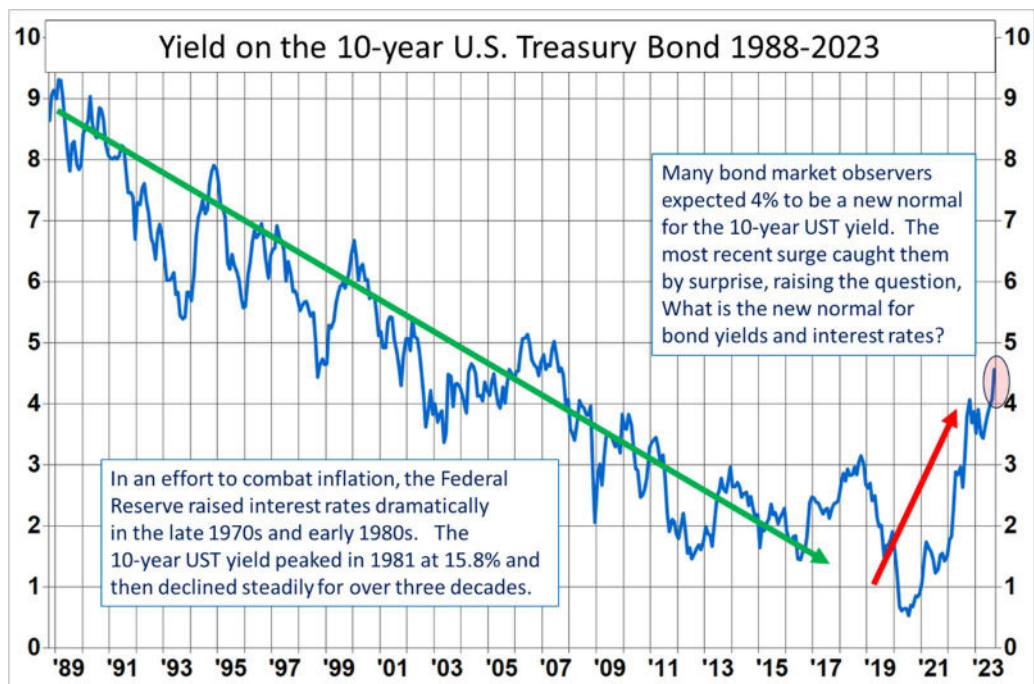


## Investment Commentary—October 2023

After ending July four percent off its all-time high, the S&P 500 index of U.S. stocks drifted lower in August (down 1.6%) and dropped more precipitously in September (down 4.8%). Although still up on the year, U.S. stocks closed the third quarter on a sour note.

Significant stock market swings can be driven by bond market activity and that is likely the case with the recent decline. Below is a chart of the yield on the 10-year U.S. Treasury bond. The 10-year Treasury is considered the benchmark for long-term bond yields. It drives the yields on other types of bonds, as well as the interest rate on fixed-rate mortgages and the rate paid on a great deal of corporate debt. (Bond yields and interest rates are very tightly correlated and move up and down in tandem.) After the economic shock of the Covid pandemic the Federal Reserve kept interest rates extraordinarily low for most of 2020 and all of 2021. With the 10-year Treasury yielding well below 2%, stocks offered the possibility of significantly better returns. Financial pundits introduced the acronym TINA—“There Is No Alternative (to stocks).”



When the Federal Reserve began to raise short-term interest rates in early 2022 in order to control inflation, bond yields began a rapid climb. The big question looming over financial markets was, where would bond yields and interest rates settle? In late 2022 and much of 2023, 4% seemed to represent a “new normal” for the 10-year Treasury. When the 10-year Treasury yield began to take off in late August and climbed steadily toward 4.5% and beyond, investors wondered whether the new normal could be 5% or

even higher. Most importantly for the stock market, the unexpected surge in bond yields convinced more investors that the era of TINA was finally over—there **is** an alternative to stocks.

What changed to account for this unexpected spike in long-term bond yields? One answer might be the striking resilience of the U.S. economy. Over the last twenty months the Federal Reserve has implemented the most rapid increase in interest rates in the last forty years. History suggests that such a rapid increase in interest rates will trigger a recession that then forces the Fed to lower rates. If, as many economists now anticipate, a recession is avoided (a “soft landing”), short-term interest rates will likely be “higher for longer.” The higher for longer thinking may have impacted longer-term bond yields a bit but not nearly enough to explain the size of the recent move.

A more plausible explanation could be a change in long-term inflation expectations. From late 2008 until early 2021 we lived in a low-inflation world. It may be hard to remember now but for many years the Federal Reserve struggled to get inflation **up to** its 2% target. In 2021 and 2022, inflation climbed rapidly due to supply-chain disruptions, fiscal stimulus that pumped more money into the economy than broken supply chains could handle, and spiking oil prices due to the war in Ukraine. Inflation has been settling down, but the question economists have been wrestling with is, what will happen with inflation over the next ten years and beyond? Will we go back to a low-inflation world, perhaps driven by productivity improvements from AI? Or will inflation become a nagging problem, perhaps because an aging population causes recurring labor shortages? If the Federal Reserve is forced to fend off inflation every few years, it may need to raise interest rates higher than it otherwise might. The bond market may be signaling that periodic bouts of inflation lie ahead.

An additional factor in the recent surge in bond yields may be supply and demand. The U.S. Treasury issues Treasury bonds to make up for budget deficits; the bigger the deficit, the more bonds it issues. Deficits skyrocketed during the Covid pandemic, causing bond issuance to soar. Fortunately, there was a ready buyer, with the Federal Reserve purchasing several trillion dollars of Treasury bonds during the first three years of Covid to stabilize the economy. In June, in order to normalize its balance sheet, the Fed suspended bond purchases. To make matters worse, commercial banks began avoiding long-term Treasuries this spring due to their role in the Silicon Valley Bank collapse. Higher yields have been needed to entice domestic non-bank investors to fill the gap. All of this was complicated by Congressional dithering a few months ago over increasing the government debt limit. As the limit approached, the Treasury had to slow down borrowing, creating a backlog of issuance that was followed by a surge of issuance later in the summer after the limit was increased.

The whys and wherefores of bond yields may be confusing but there are two important takeaways: (1) there is a lot of uncertainty over the new normal for long-term bond yields and long-term interest rates and that could impact the stock market and the bond market for a while, and (2) expected bond returns are significantly higher than they have been in nearly twenty years. The second point is especially welcome news for retirees who depend on bond holdings to provide stability in their portfolio and contribute to meeting their cash flow needs.

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Some readers may find it odd that the discussion above made virtually no reference to the major headlines of the last couple of months, whether the near-miss on a government shutdown (with a significant possibility that there will be a shutdown in November), the ongoing war in Ukraine, the immigration crisis, escalating tension between the U.S. and China, or the lack (as of this writing) of a Speaker in the House of Representatives. The reality is that the stock market cares almost exclusively about corporate profits and bond yields/interest rates. Some of the events that generate headlines can affect corporate profits and bond yields. For example, the recent horrific events in Israel may lead to a wider conflict and a surge in oil prices. That could have spillover consequences for inflation and economic activity that would impact the stock market. But most of the news doesn't have much of an effect on corporate profits or interest rates and therefore has much less of an impact on the stock market than most of us would expect. Even when today's headlines do have an effect on the stock market, it is usually short-term. Events with a lasting impact on stock market returns are uncommon.

It will be important to remember what does and what doesn't impact financial markets as we head into a presidential election year. It is a pretty safe bet that no matter who wins the next presidential election, some of you will be deeply dismayed by the result and believe that the country has taken a major turn for the worse. The reality, however, is that American capitalism—and global capitalism—are tremendously resilient. If your preferred candidate loses, you might disagree vehemently with the winner's policies or find some of his (or her) actions odious. You may also be frustrated by the long list of problems that Congress isn't addressing because of polarization and dysfunction. But the chances are very good that even in the face of unwelcome policies and unsolved problems, and despite the ongoing fraying of the social fabric, good companies will continue to grow their revenues and generate healthy profits for the benefit of shareholders.

We return now to the question of a soft landing for the U.S. economy. The odds of a soft landing have clearly increased over the last several months, but we're not fully sold on the idea. It takes awhile for higher interest rates to take their full toll on the economy. That is especially true now, as stimulus packages passed early in the Covid pandemic bolstered consumer income by around two trillion dollars and led to accumulated savings that have not been fully drawn down. (Estimates of remaining savings have recently been revised upward, which may explain why the economy has been so resilient.) However, banks have tightened lending considerably this year, mortgage rates are at twenty-year highs, and wage growth has slowed considerably. Further, the resumption of student loan payments and the ongoing UAW strikes could put additional pressure on the economy. There continues to be a significant probability of a recession toward the end of this year or early next year.

The good news is that there is still every reason to believe that if a recession comes it will be mild and would not have a dramatic impact on the stock market. Bond yields would go down, which would increase the value of bond holdings. While there seems to be uncertainty on many fronts, long-term investors who have been patient in the face of uncertainty have been rewarded in the past, and we expect the same going forward.

*Boston, MA  
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