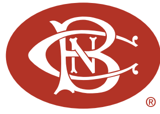

Wealth Management

QUARTERLY PERSPECTIVE

FALL 2023

An Interest in Interest Rates

If money is the lifeblood of an economy (a debatable point), then interest rates are its blood pressure, providing a broad measure of economic health and a general gauge of financial stress and concern. Generally, low interest rates reflect a sanguine economic environment while high interest rates may be a sign of trouble – and interest rates have been rising.

The Economy

For the past two years, the rise in interest rates has been driven by rising inflation. Interest rates rise to compensate lenders for expected future inflation, but the Fed also raises short-term interest rates to slow economic growth and to curtail the supply of money and credit that is a key cause of sustained inflation.

For most of the past two years, as the Fed hiked interest rates to fight inflation, the largest impact has been on yields with the shortest maturities. The Fed's hope was that aggressive rate hikes would slow inflation rapidly, even though this policy would risk an increased probability of a near-term recession.

As figure 1 shows, headline inflation peaked in 2021 at an annualized rate of about 9% and is currently trending around 4%. The Fed's tightened monetary policy seems to be working. However the sustained resilience of the US economy, buoyed by low unemployment and healthy consumer spending, has recently shifted market expectations about future interest rates. While the Fed may have made its last rate hike for the current inflation cycle in early July of this year, short-term rates have been stalled near 5.5% since May. Yet, yields on longer maturities have risen about a full percentage point over the same period (see figure 2). In the third quarter alone, the yield on 10-year treasuries rose roughly 75 basis points to about 4.6% — its highest rate since the onset of the financial crisis in 2007. Thus, the new expectation is that interest rates will be "higher for longer" than previously thought.

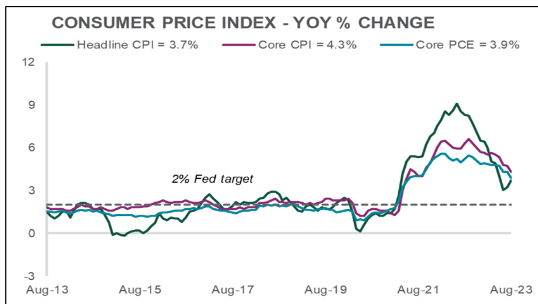

Figure 1- Source: Northern Trust Asset Management

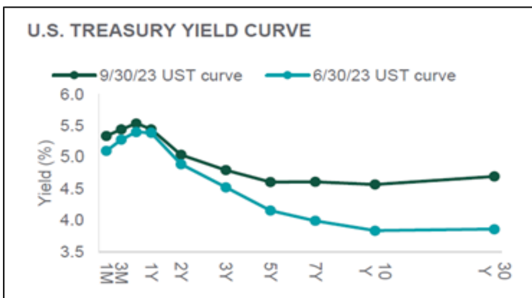

Figure 2- Source: Northern Trust Asset Management

This market action comes with a conundrum: longer-term interest rates are rising because the economy is doing better than expected, and the expected near-term impact of those higher-for-longer interest rates is to slow credit-financed spending on such things as personal consumption, new homes, and capital investments – all of which drive economic growth. It's a classic case of "good news is bad news" and it spilled over into equity markets during the third quarter.

Since late last year, stock valuations surged in part on the notion that the Fed was nearly finished raising interest rates, paving the way for renewed optimism. Broken supply chains were being mended, artificial intelligence was revitalizing stalled technology investments and the spike in interest rates was expected to be temporary. The rise in rates across the yield curve caused equity investors to shift their focus once again and renew their worries about rising longer-term rates. As shown in figure 3, the surge in longer-term yields precipitated a loss of roughly 4-5% on S&P 500 and growth stocks from their recent highs.

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Mark has over 30 years of experience in the financial services industry. As Senior Wealth Advisor, he participates in setting investment policy standards and strategies within the group. Mark manages portfolios for high-net-worth, trust, and institutional clients, guiding them through the process of identifying personal objectives for wealth management, and developing appropriate investment portfolios and strategies to help meet those goals.

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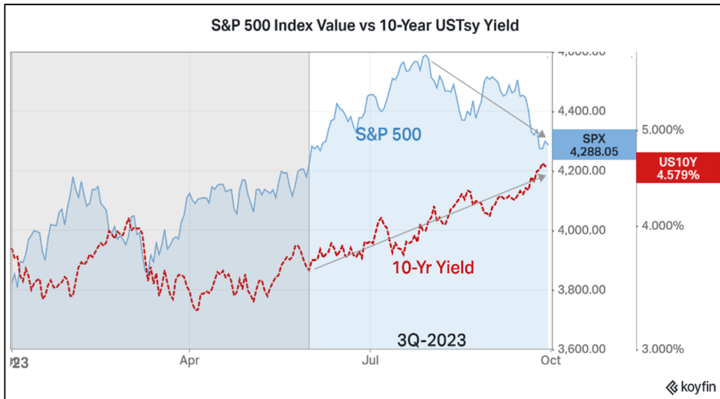

Figure 3 - Source: Koyfin

But it isn't all bad news. The very forces causing a rise in longer-term interest rates also makes it more likely that the economy will moderate without falling into recession – the ever sought after "soft landing." Furthermore, the rise in longer-term rates may help to mitigate the impact of a sharply inverted yield curve on the banking industry, parts of which are still recovering from a small number of bank failures this past spring. In addition, the recent decline in equity prices should be seen in the broader context of a secular bull market in which we cannot call US equities cheap. Similarly, the rise in bond yields reflect a relative normalization of interest rates after being held artificially low for more than a decade in the Fed's response to the Great Recession and the COVID pandemic.

The Markets

Given all that is happening among interest rates, one might think that financial markets are in disarray. That is hardly the case. From a broad perspective, major segments of the global financial markets are performing well or very well. Even after their third quarter declines, US equities have performed admirably. The S&P 500 gained over 13% year-to-date and the NASDAQ Composite, about 8% off its highs, leapt 27% for the first 9 months of the year.

One of the biggest qualitative differences among equities during the third quarter compared to the rest of the year is the relative consistency of performance across equity capitalizations and styles. Growth stocks far outpaced value companies during the first six months, and large companies generally outperformed their smaller counterparts. But for the third quarter there was relative parity (albeit to the downside): large-cap stocks, small-cap value, and international stocks generally declined 3-4% in the recent quarter. Small-growth and real estate were the laggards, falling about 7-8% respectively.

Index Returns as of 9/30/2023	Q3 2023	YTD
S&P 500	-3.27%	13.07%
Russell 1000 Value	-3.16%	1.79%
Russell 1000 Growth	-3.13%	24.98%
Russell 2000 Value	-2.96%	-0.53%
Russell 2000 Growth	-7.32%	5.24%
DJ US Real Estate	-8.56%	-4.86%
MSCI EAFE (net)	-4.11%	7.08%
MSCI Emerging Market (net)	-2.93%	1.82%
Bloomberg U.S. Aggregate Bond	-3.23%	-1.21%
Bloomberg Global Treasury ex. US	-4.70%	-4.62%
Bloomberg U.S. High Yield Bond	0.46%	5.86%

Figure 4 - Source: Northern Trust Asset Management

In a minor repeat of last year's unwanted synchronicity between bond and stock returns, the Bloomberg Aggregate Bond Index and the Bloomberg Global Treasury Index both declined in near-lockstep with equities – a violation of the intended purpose of the classic 60-40 stock-bond allocation. High yield bonds were the outlier among the wide range of market segments, posting a half-percent gain for the quarter.

Another market group worth addressing is the so-called Magnificent Seven – the seven largest components (by market capitalization) of the S&P 500. These seven stocks (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla and Meta), comprising a combined 29% of the S&P 500's capitalization, posted year-to-date total returns ranging from 32% to 200% – well in excess of the S&P's aggregate total return of 13%, and a whopping disparity relative to the other 493 stocks in the index taken as a whole. For the third quarter, their performance was more diverse: four were down and three were up; Apple lost 12% while Alphabet gained 9%. A key fact to remember about these companies is that they are all heavily oriented to the technology sector, thus lacking significant diversification, and their heavy representation in the S&P 500 exposes that large index to the influence of a mere handful of companies along with the significant volatility that comes with them (they were all down significantly more than the S&P 500 last year).

Moderating Expectations Ahead

As we enter the final stretch of the year, the market's "blood pressure gauge" may appear to be warning of stresses ahead, but it may also be reflecting a degree of healthy activity. Vigorous exercise that lifts our blood pressure is one of the ways our bodies accommodate increased activity. The same is true with the economy; a rise in interest rates can be the market's means of self-regulating economic growth to better allocate resources across time and market sectors. This may be only a temporary downshift in equity valuations, and maybe one that precipitates broader participation among a larger segment of companies. We can hope that's the case. Meanwhile, the strong performance in some sectors is a signal to rebalance allocations for optimal risk-return benefits.

As always, we encourage you to seek out the guidance of your CNB Wealth Management team to better maintain a stress-free financial future.

Data as of 9/30/2023. Not intended to be construed as tailored fiduciary advice. Investments are not FDIC insured, not bank deposits, not obligations of, or guaranteed by Canandaigua National Bank & Trust or any of its affiliates. Investments are subject to investment risks, including possible loss of principal amount invested. Past performance is not indicative of future investment results. Before making any investment decision, please consult your legal, tax or financial advisor. Investments and services may be offered through affiliate companies.