

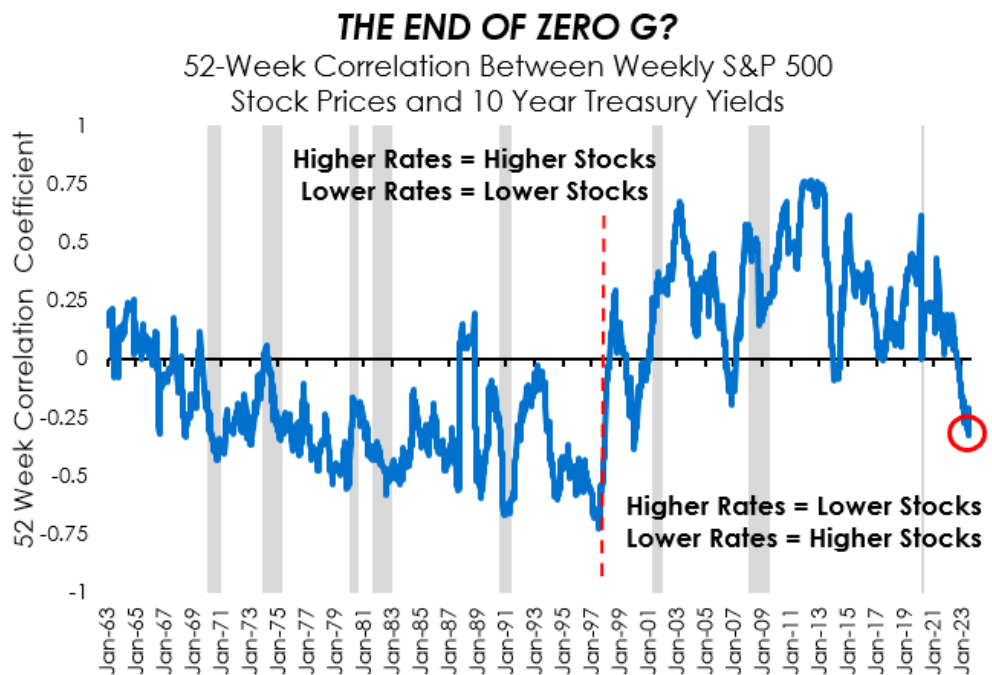
The End of Zero G?

“Interest rates are to asset prices like gravity is to the apple. They power everything in the economic universe.” – Warran Buffett (2013)

Becoming the first US astronaut to orbit the earth back in 1962, legendary space traveler John Glenn quipped, “Zero G and I feel fine”. In a way, investors have operated in a Zero G environment for more than two decades. In fact, for most investment professionals’ careers, it seems we’ve been in an environment where interest rates have not had the gravitational effect on stock prices they once did. Investors of a longer vintage have a different perspective. Warren Buffett always seems to have a knack for saying it best.

Because of the discounting effect that interest rates have on determining the present value of future cash flows, they’ve always had an influence on asset prices like stocks. However, the degree of that influence has proven to change materially with time and in both directions. The chart below shows the rolling one year correlation between weekly Stock Prices and the 10 Year Treasury Yield. Readings above zero indicate a positive relationship between

Rates and Stocks (Higher Rates / Higher Stocks and vice versa) while readings below zero indicate a negative relationship between Rates and Stocks (Higher Rates / Lower Stocks and vice versa). Note the choppiness of the line suggests there are lots of varying degrees here but the big picture is that the relationship recently looks to have materially changed from the experience over the past



Source: Factset



quarter of a century (1998-2022). While no one can be entirely sure, today's move might be a pivot back to the negative correlation regime (1963-1997) that ironically began around John Glenn's "Zero G" voyage.

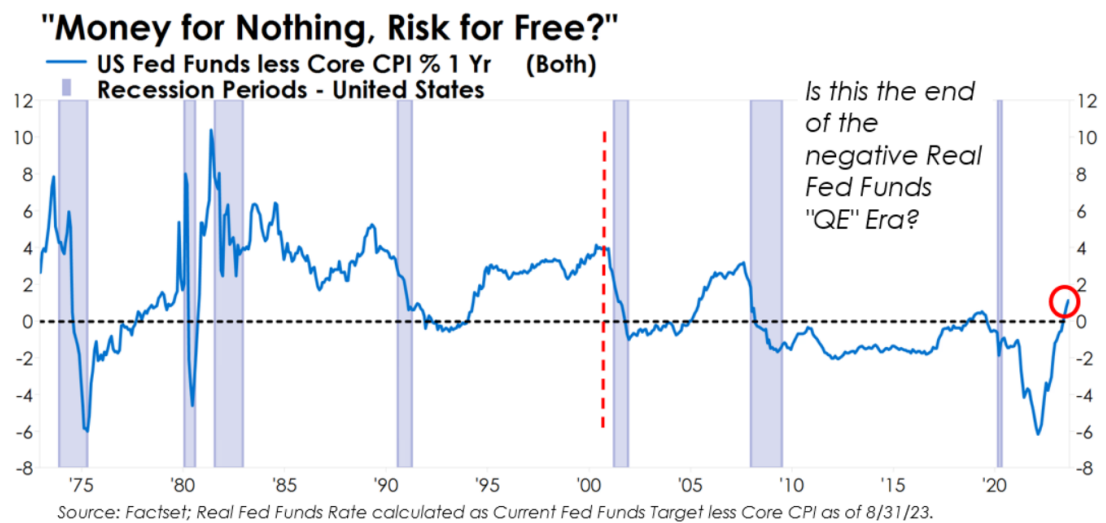
Perhaps it's not until rates and inflation move to critically high levels in a sustainable way that leads to a certain degree of gravitational pull on stock prices (i.e. bonds begin to offer greater competition). Conversely, when rates and inflation move below critical levels in a sustainable way, a zero gravity influence might kick in (i.e. bonds begin to offer less competition).

	Gravity 1963-1997	ZERO G 1998-2022	Current
10 Year Yield	7.8	3.4	4.6
CPI	4.9	2.4	3.7
P/E	15.7	22.7	21.8

Source: Factset; 10 Year Treasury Yield and CPI measures are averages over the respective time periods. P/E is a trailing twelve month median calculation based on company reported earnings. Historical earnings are taken from Robert Shiller's U.S. Stock Markets 1871-Present and CAPE Ratio (<http://www.econ.yale.edu/~shiller/data.htm>). Current 10 Year Yield and P/E as of 9/30/23, Current CPI as of 8/31/23.

As can be seen in the table, when rates and stock prices were negatively correlated (1963-1997), the 10 Year Treasury Yield and CPI Inflation Rate tended to be higher (and more volatile). Consequently, when rates and stock prices were positively correlated (1998-2022), the 10 Year Treasury Yield and CPI Inflation Rate tended to be lower (and less volatile). The impact on stock valuations should also be noted. A lower median Price to Earnings ratio (P/E) was observed in the "Gravity" regime while a much higher median P/E occurred in the more recent "Zero G" regime. We also

find it interesting that this regime shift occurred concurrent to when the Fed predominately moved to an easy money policy – associated with the negative real Fed Funds rate era (see chart at right).



The correlation between Rates and Stocks is ever changing and the move witnessed over the last twelve months is something we've not seen in quite some time. Investors' attitudes appear to be shifting back to an environment where gravity matters again. The market's changing relationship might imply a differing view for rates, inflation and stock multiples as well. Only time will tell, of course, but it's worth pondering whether investors may be swapping their space suits for parachutes.



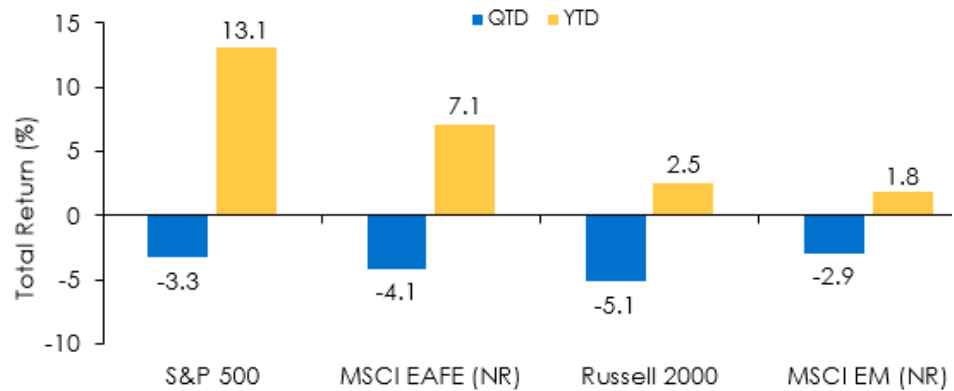
Market returns were weak in September with Commodities, Bonds, and Stocks all posting negative, low-single digit returns, with REITs down high single digits. Profit taking amid higher rates and oil prices likely contributed to the weakness. Meanwhile, major Stock indices remain solidly positive for the year. Conversely, Commodities, REITs, and most Bond indices are now negative for the year.

Stocks

Year-to-date equity performance remains strong with U.S. Large Caps (S&P 500) leading. Conversely, US Small Caps (Russell 2000) have lagged given their interest rate sensitivity.

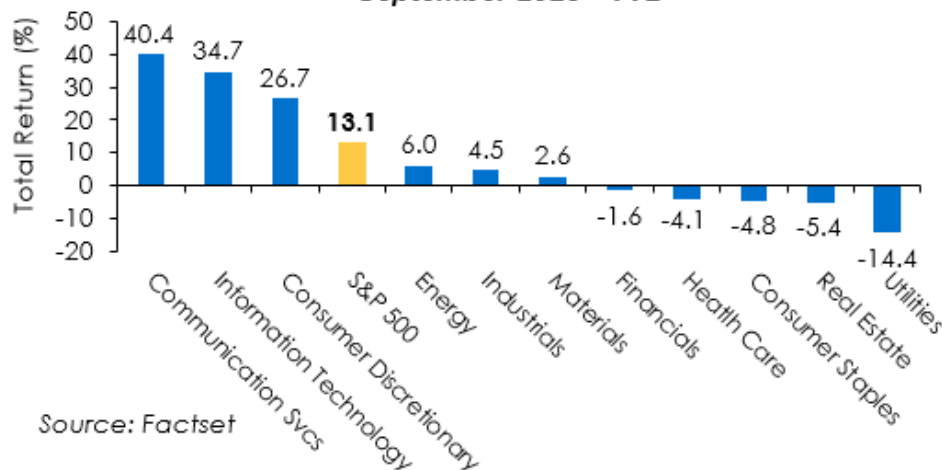
Overseas, equity performance in International Developed Markets (MSCI EAFE) has been solid – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis in Europe along with better economic data out of Japan. Finally, Emerging Markets (MSCI EM) posted “less negative” returns in September, closing the gap somewhat with Developed Markets. Meanwhile, sector outperformance has favored the higher priced “Magnificent 7” within the cyclical growth sectors (Technology, Discretionary and Communication Services). Conversely, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed despite the former group continuing to exhibit relative strength in the quarter.

Global Equity Returns
September 2023



Source: Factset

S&P 500 Sector Returns
September 2023 - YTD



Source: Factset



Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 525 basis points (to 5.25-5.50%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer-term rates have broken out to the upside with 10 Year U.S. Treasury yields increasing roughly 50 bps in September. The Fed has indicated they are likely to leave rates higher for longer in their fight with (still sticky) inflation. Meanwhile, the yield curve remains inverted (albeit less so) – an indication of macro stress as monetary policy restricts lending to the point of deteriorating growth prospects. The year-to-date upward move in rates, has now offset the solid carry and tightening of credit spreads resulting in slightly negative returns in aggregate (US Agg).

Corporate bonds (High Yield, Investment Grade) and Emerging Market debt (JPM EMBI) outperformed.

Conversely, duration based returns represented by Long-Term Treasuries (Govt Tsy Long) fell deeper into negative territory year-to-date as long rates increased again in September.

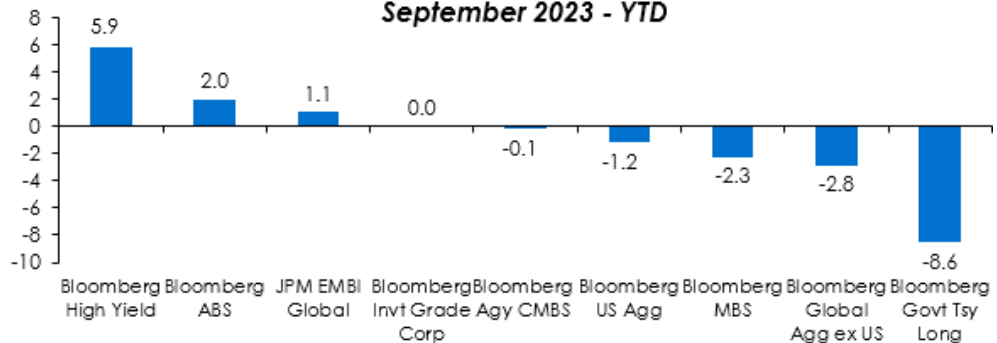
Alternatives

Commodities traded lower year-to-date with negative returns in Agriculture, Precious Metals, Industrial Metals and Energy (notwithstanding the latter’s big reversal QTD). Meanwhile, publicly traded

Real Estate (REIT’s) remained weak resulting in year-to-date returns that have materially lagged relative to equities. Finally, Treasury inflation protected securities (TIPs) – in comparison to nominal Treasuries – benefited from the positive carry in bonds year-to-date along with a bottoming in inflation expectations.

Global Fixed Income Returns

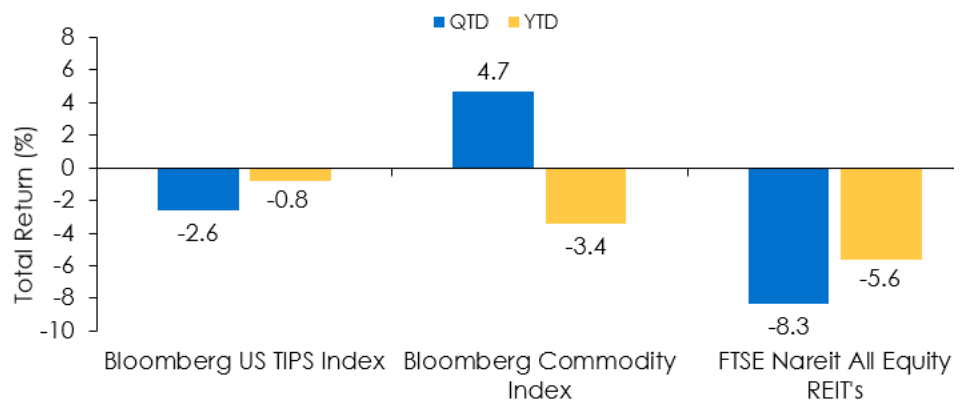
September 2023 - YTD



Source: Factset

Alternative Market Returns

September 2023



Source: Factset



Market Outlook

“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”

– Bill Bryson, *A Walk in the Woods* (1998)

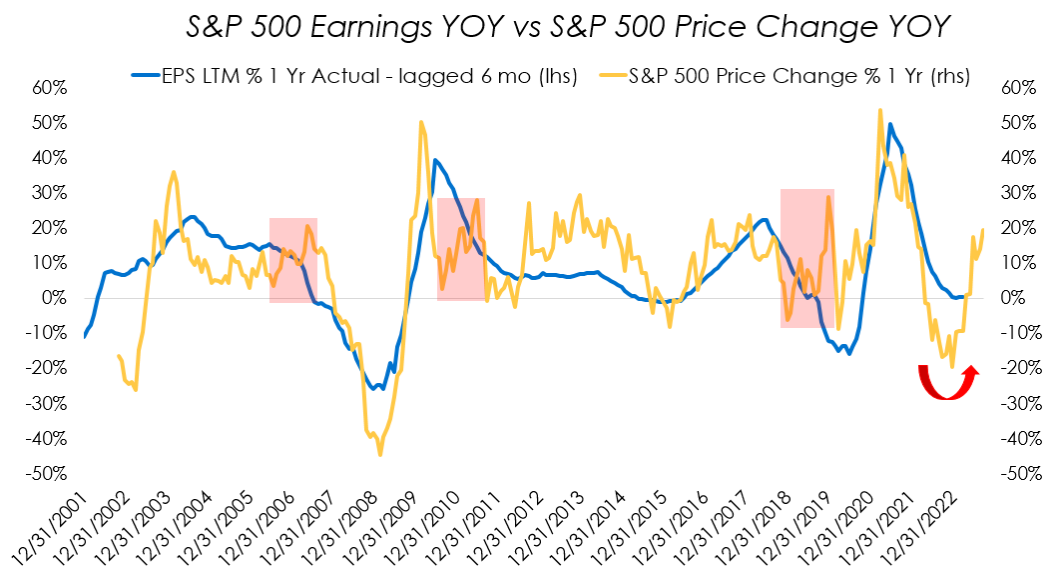
We’ve dubbed our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there

are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

At the other end of the spectrum is the

cyclical perspective, which has recently shown some improvement in the Fundamental data. The chart above suggests the S&P 500 has been anticipating an acceleration in corporate profit growth – which now looks like it may be bottoming. The two lines above (EPS growth and the S&P 500) tend to be correlated through time



Source: Factset; EPS Growth LTM actual earnings based on iShares S&P 500 (IVV) from Factset.

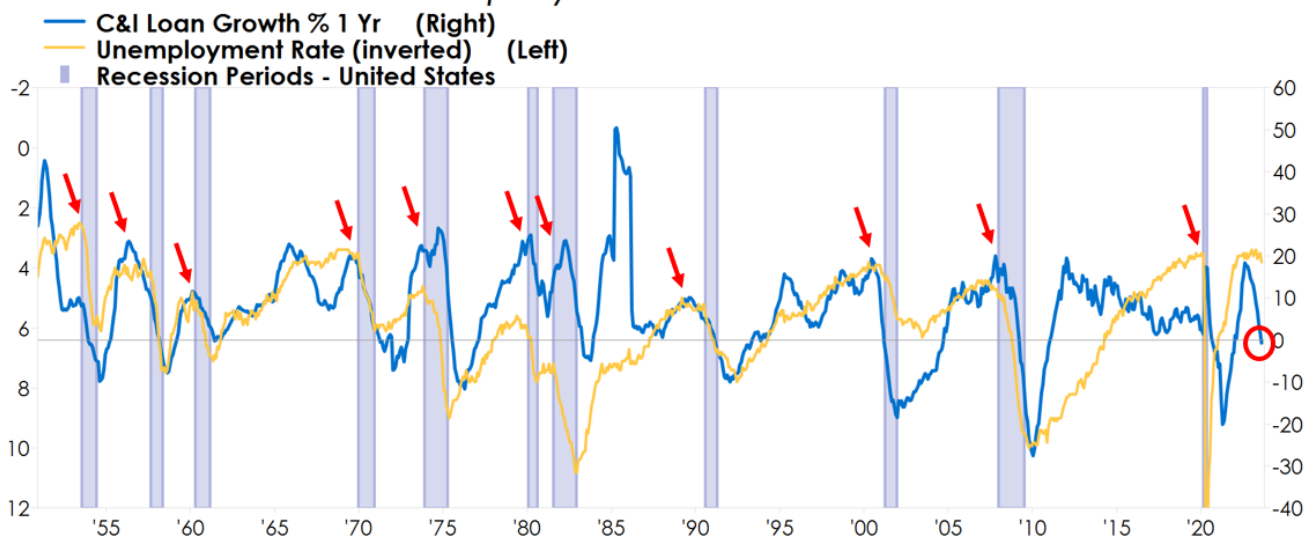


– not without some notable disconnects along the way including 2006-07, 2010-11 and 2018-19 (red shaded regions – so this is not necessarily a given). Nonetheless, the broadening improvement in the Fundamental data has been supportive of the market’s positive view on earnings.

The caveat – things can be good for a time but the question remains around such sustainability if a bottoming in growth also comes with a bottoming in inflation. As such, we continue to focus on the following set of conditions:

- We remain in the latter stages of the business cycle. What inning we’re in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle. Perhaps the simplest measure is a 3.4% unemployment rate – a record low level reached earlier this year only seen in one other period over the last sixty years (in the late ‘60’s)!
- Liquidity is being drained from the economy. Lots of data support this notion including a dramatic decline in the savings rate, negative year on year money supply growth (more than \$800b off the peak), the continued Fed tightening policy (including 525 bps of rate hikes), a deeply inverted yield curve and credit standards that are the tightest since 1Q09 (ex Covid) – which have continued to worsen. As can be seen in the chart below, loan growth has now fallen into negative territory – a consequence of the above. Eighty years of history would suggest that, more often than not, precipitous drops in loan growth (into negative territory) have spelled trouble for the unemployment rate. It will be interesting to observe whether today’s structurally tight labor market dampens this effect. Ultimately, we believe that if businesses find it difficult to get financing for their marginal operations, they might respond with a round of belt tightening.

Loan Growth vs Unemployment Rate



Source: Factset; 2020 unemployment rate truncated due to COVID.



- Growth sustainability is unclear. While improving Fundamental data and market price action suggest the potential for improvement in underlying profit growth, the combination of the above can act as a governor on growth. If growth does lift off with an inflation follow through, central banks might have to respond with additional actions or their credibility might be called into question. This might set up the “Good News is Bad News” dynamic until a significant enough reset of the business cycle can take place.
- Valuations are elevated. With flat earnings growth so far this year, strong stock market returns have resulted in a partial reversal of the valuation compression seen last year (15X P/E NTM). The S&P 500 is now trading back in line with long-term forward valuation levels (18X P/E NTM) and well above where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X). Of course, this has been most acute at the top of the market where the mega-cap growth stocks have seen more dramatic multiple expansion. This begs the question, will multiples begin to compress under the weight of the back up in rates especially at a time where there’s now a real alternative to stocks (i.e. skinny equity risk premium)? While stocks are increasingly feeling the gravitational pull from higher rates, the valuation compression, so far, has been limited relative to the rise in real yields (especially in the mega-caps relative to the average stock).

From our lens, stock valuations have priced in a soft landing scenario with greater risk in the most cyclical and growth oriented names should this not come to fruition. The most expensive stocks might be doubly at risk if the secular view results in perennially higher rates and a more volatile inflation backdrop. The bottom line is that real yields at these levels imply lower P/E’s than where we are today.

Ultimately, late cycle backdrops are especially tricky as things are often good until they’re not when at these inflection points. This doesn’t mean that risk taking has to be completely absent though we find that it does mean that clear heads tend to prevail. As a result, to us, it still doesn’t appear to be a great setup for significant risk taking – particularly in areas where there’s a limited margin of safety.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to believe that it’s important to “See both the Forest AND the Trees”. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). While we entered this year with an UW to risk assets, we’ve let that UW lessen amid the year-to-date market rally as Fundamentals appear to be bottoming. Still, our composition within US Equities, US Core Fixed Income and Diversified Alternative managers remains more conservative in nature for the reasons cited above. Our overall portfolio bias has generally been to have more exposure to less expensive areas while maintaining conservative leanings.



Within equities, our positioning continues to favor a tilt toward the more traditionally defensive sectors (Staples, Health Care, Utilities) with a lesser lean toward cyclical value (Energy, Industrials, Materials) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a “Heads I Win, Tails You Lose” mentality with speculative fervor.

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we’ve previously moved up in credit quality by adding some Treasuries and lengthening duration (along with the more recent adjustment from barbell to belly approach) – consistent with a downshifting of risk in portfolios.

Within alternatives, we’re slightly OW in aggregate with a bit more defensive skew. We remain OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there’s lower correlations between stocks and bonds). We’re slightly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we’re slightly UW Real Estate as a way to further reduce overall portfolio risk.

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