Market Update - Q4 2023

As we enter the final quarter of 2023, it would appear that rising interest rates may finally be catching up to equity markets. For much of the year, equities, primarily large-cap tech, and bond yields rose in tandem. On July 18th, the NASDAQ peaked at 14,353, up a resounding 37% on the year, and the 10-year Treasury note yielded 3.78%. Since then, the tech-heavy index has fallen -8%, while the 10-year note yield has climbed to 4.60%, its highest level in 16 years!

Higher interest rates are the byproduct of stubborn inflation, Fed rate hikes and Quantitative Tightening (QT). They are also reflective of a strong U.S. economy that is still struggling with a labor supply & demand problem. Historically (defined here as pre-QE, when markets actually determined the level of interest rates), the 10-year Treasury yield somewhat closely tracked nominal GDP. Over time, the U.S. economy has grown around 2.5% per year (Real GDP) and inflation has averaged around 2.5% per year, giving us Nominal GDP growth of 5%. It would not be unusual, therefore, to see the 10-year yield go back to or above 5%, barring a severe economic downturn in the offing.

Investors, primarily savers, should take heart now that QE is over and realistic investment returns can be had in traditional government and corporate bonds. Retirees especially, can now be rewarded for diversifying away from equity risk. Higher interest rates, however, can bring challenges to borrowers, especially those that perhaps bit off a little too much during the heady days of QE. Commercial real estate would appear to be the first casualty. After years of ultra-low interest rates and high occupancy, the double-whammy of materially higher refinancing rates and work-from-home policies, are driving landlords in major cities to mail in the keys, rather than face further economic losses.

Since the year began, we at Nottingham have migrated from the "no-landing" camp at the outset of the year, to more of the "soft-landing" side as the Fed appeared more hawkish mid-year. Should rates continue to rise here in Q4, the odds for a recession would appear to increase materially in our eyes. Higher interest rates should pressure corporate profit margins to the point that employment may begin to suffer. Should unemployment rise, and given that the consumer is 2/3 of the U.S. economy, we could see a measurable slowdown in GDP. Recession may follow.

What's the investor playbook should this come to pass? First off, I would lay the odds of this happening at maybe 40-50%. A coin toss, more or less. Given my lack of conviction on the potential outcome, altering portfolios a lot doesn't make too much sense to me. Staying diversified and leaning towards high-quality stocks and bonds has proven effective during past recessions, and may likely prove effective once again. Time, as we have mentioned often in the past, is a great diversifier. Recessions, as we've also mentioned before, are a normal part of the business cycle. They can bring investors discomfort as paper gains dissipate and paper losses mount; yet recessions tend to wring out excesses and lay the seeds for the next economic expansion. They should be disliked, but not feared.

Rather than fiddle with our core equity allocations, thereby triggering taxable gains, we've been more focused on the opportunities in the fixed income arena. These are generationally high yields that we are seeing, akin to when I was a bond trader decades ago. During the tech-fueled bull market of the late '90's, the 10-year Treasury note yield bounced around 6.0%. Over the past decade, the 10-year yield has averaged 2.26%. For bond investors today, times are good. As 1% and 2% yielding bonds mature, the replacement opportunity set now sports coupons of 4%, 5% and even 6%!

While interest rates were low, Nottingham generally opted for shorter-term bond exposures in our strategies, figuring investors were not rewarded enough for taking a lot of interest rate risk. Now that rates have moved higher, we are actively "extending duration", that's "CFA speak" for selling out of shorter-dated bonds and swapping into longer-term bonds. From focusing on maturities inside 5 years, we're now looking in the 10-15 year area for attractive yields that we can lock in for years to come. Moreover, if the Fed can successfully tame inflation and slow down the U.S. economy, interest rates should fall, sending the prices of longer-dated bonds higher – an added benefit! The key for us though, is to focus on investment-grade debt, forsaking high yield at this point.

I make this point because we think there may be some additional stress to come for lower-rated borrowers. Companies that were able to borrow a few years ago at low single-digit levels are facing refinancing rates of 10% or more in many cases. Default rates, which have been low for years, should begin to rise as the combination of economic slowdown and higher debt servicing costs bring trouble to marginally profitable businesses. Over the past 25 years, the additional spread over Treasuries for high-yield borrowers has averaged 502 basis points. Today that risk premium is only 432 bps. During recessions and times of acute economic stress, those spreads tend to widen considerably, usually presenting brave investors a compelling buying opportunity. We're content to be patient here.

The 4th quarter may indeed begin with a host of headwinds, including a federal government shutdown, continued UAW strike against the "Big 3", stress in the commercial real estate sector, the potential return of COVID, and Fed rate hike concerns. While all of these have potential repercussions for investors, none of them should be a reason not to stay the course. The various shades of gray that may describe the severity of any potential recession are indeterminable ahead of time. We are not willing to make that bet with client capital. 2023 has so far seen a nice recovery from the market declines of 2022. We remain optimistic that U.S. markets can weather the inevitable headwinds that come with economic slowdowns. Investors should remain patient, opportunistic and seek courage if indeed volatility spikes in the months ahead. As always, please reach out with your thoughts, questions and concerns.

Lastly, I want to take a minute and recognize the team here at Nottingham, especially our Client Services Manager Cara Bland, who led us through the recent custodial migration from TD Ameritrade to Charles Schwab. Countless hours were spent ensuring that our client's assets would successfully transition from the legacy TD platform over to Schwab. When Charles Schwab bought TD four years ago, we were admittedly a little chagrined, as we had worked with the Ameritrade folks for over 20 years. We are pleased to say, however, our experiences thus far with the new Schwab team have been excellent, and we look forward to growing that relationship further. Hats off to everyone at Nottingham who worked so hard to ensure this transition was successful. I'm proud of our team.

Sincerely,

Larry Whistler, CFA
President
September 2023