October 2023

INVESTMENT REVIEW AND OUTLOOK

The Price of Everything

The price of almost all financial and non-financial assets is related to the prevailing interest rate. In the United States, the prevailing interest rate takes many forms, but U.S. Treasury bonds are widely used as the benchmark index off of which loans to corporations, individuals, and state and local governments are made. Since bottoming in the spring of 2021, global interest rates have been climbing steadily, and we have written about this frequently in our quarterly letters. During the third quarter, the rise in intermediate and longer-term interest rates was particularly pronounced, as the yield on the 10-year U.S. Treasury bond rose from 3.8% to 4.6%. The rise in the 10-year yield is significant because it is the reference rate for the real estate sector and, more specifically, for residential mortgage lending. In addition, because stock market values are based on long-term earnings growth, the increase in rates had an impact on stock market returns in the third quarter.

The broad stock market, as measured by the S&P 500, had a total return of -3.3% in the third quarter. The sectors of the stock market that are most sensitive to interest rates fared less well; the real estate and utility sectors returned -8.9% and -9.2%, respectively. Similarly, higher long-term interest rates took a toll on bond returns: the Bloomberg Aggregate Bond Index had a total return of -3.3% during the quarter.

What were the causes of the sharp rise in the 10-year yield? An appropriate answer might be "all of the above." There have been a number of factors behind the increase in interest rates. Due to the high level of federal deficits, the amount of federal borrowing has increased significantly in recent months. According to the U.S. Treasury, borrowings were estimated to be $1 trillion in the third quarter, which is $274 billion greater than the government had forecasted as recently as May 2023. Another factor affecting interest rates is the resiliency of the U.S. economy. Despite many calls for a recession, U.S. real GDP for the third quarter is estimated to be 4.9%, according to the Federal Reserve Bank of Atlanta. Finally, the Federal Reserve, which has been a large purchaser of Treasury securities in recent years, has reduced its holdings of Treasury bonds by over $600 billion in the last 12 months.

Some Big Questions

As our clients know, we are reluctant to make forecasts about the economy, stock market, or interest rates. History demonstrates the difficulty of making consistently correct predictions. However, we recognize the importance of assessing the current economic and geopolitical environment. To that end, there are a number of consequential questions that are top of mind. The increase in interest rates over the last two years has been broadly felt across the economy, and the full impact of higher rates has yet to be known. On the positive side, short-term investments, such as money market funds, have seen yields increase from nearly 0% in 2021 to over 5% in 2023. The Investment Company Institute estimates the

current value of U.S. money market funds at $5.6 trillion, so the increase in yields on these funds on an annual basis is significant and can be conservatively estimated at over $200 billion. On the other hand, because bond prices move inversely in the direction of interest rates, the increase in rates has had a significant impact on the value of bonds, particularly longer-maturity bonds. To illustrate, the principal value of a 30-year U.S. Treasury bond issued in 2021 has fallen by approximately 50% as of October 2023. Borrowers across the economy including governments, businesses, and consumers are feeling the impact of higher interest rates. However, because much of the current debt is at a fixed rate, the impact of higher rates will take time to flow through the economy.

The Chinese economy is the second largest global economy after the U.S., and China has been an important driver of global growth for several decades. In recent years, the Chinese economy has experienced a noticeable deceleration in growth. According to the World Bank, the Chinese economy is expected to grow 4.4%, in real terms in 2024, while the country's annual growth averaged 6%–8% in the prior decade. There are myriad reasons for the slowdown in China's growth. Real estate and infrastructure development have been important drivers for decades, but a large amount of debt is associated with these projects. The recent loan defaults of several prominent real estate developers hint at the stresses building in the system. Since 2017, the U.S. and other Western nations have imposed new tariffs and other trade restrictions on imports from and exports to China. Finally, the business and investment community has begun to take notice of the Chinese government's greater influence on the private sector of the economy and curtailed personal freedoms, as exhibited by the National Security Law imposed in Hong Kong in 2020. A direct outcome of these changes has been a sharp fall-off in investment in China, as witnessed by the reduction in foreign direct investment, which declined over 50% between 2022 and 2023, according to Nikkei Asia. The ongoing tensions around Taiwan and the Chinese militarization of the South China Sea have served to further dampen Western business interest in China. We do not know whether China's economy will rebound and resume its previous trajectory. However, the headwinds above are significant.

The war in Ukraine will soon be entering its third year, and the resolution of this conflict is of concern to the entire global community. While it is not possible to predict the war's outcome, the strength of Ukrainian resistance and the coalescence of Western support are notable.

As we wrote last quarter, the subject of artificial intelligence (AI) has been very present in the news lately, and there have been manifold opinions and speculations about AI's impact on the economy and society in general. We can offer two relevant observations. First, AI is real, and as users of Microsoft or Google applications have already experienced, it is quickly being incorporated into everyday use. Second, we are in the very early days of AI adoption. Much like the advent of the internet 30 years ago, the implications of AI are likely to be far-reaching but perhaps difficult to fully appreciate today. In the same manner that online shopping has transformed the retail industry, we should expect some profound changes as AI capabilities grow and the rate of adoption increases.

Sticking to the Facts

In contemplating our investment decisions, we endeavor to be guided as much as possible by the facts that we know. Following a prolonged period of low interest rates, the recent increase in interest rates is having a drawn-out impact on the economy. The reason for this is that much of the private and public borrowing over the last decade has been made at low fixed rates. As these loans mature, there will be a "sticker shock," as new loans are made at significantly higher rates. For example, two-year U.S. Treasury bonds issued in October 2021 were priced to yield 0.3%. Refinancing that same bond today is costing the Treasury over 5%.

The strength of the U.S. economy has been noted, and we discussed some of the reasons for this strength in our second quarter letter. While higher interest rates will continue to impact the economy in the coming months, we should note that payroll growth remains healthy, and the unemployment rate was 3.8% for the month of August. Inflation, which had accelerated substantially in 2021–2022, has receded meaningfully in 2023, and the year-to-year change in the Consumer Price Index for the month of August was 3.7%.

Stock valuations, as measured by the price/earnings ratio for the S&P 500, appear around average compared to historical periods with similar levels of inflation, according to analysis by Strategas Research Partners. Short-term U.S. government bond, with yields averaging 5.3%, currently have an attractive real (after inflation) return.

We have discussed rising global tensions in past letters. Given the recent conflict in the Middle East, the war in Ukraine, and increased levels of friction between the U.S. and China and between China and its neighbors, it is worth emphasizing that the world is in a very different place today than in recent history.

Steady State

Our investment themes from the second quarter remain unchanged. We are continuing to emphasize short-term U.S. Treasury securities. Within equities, companies that generate free cash flow with low financial leverage look particularly attractive in a rising-interest-rate environment, and the healthcare and technology sectors are well represented. We retain a weighting in defense and aerospace equities.

As always, we welcome your comments and questions.