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2023 Outlook Theme #1: Markets Come to Terms with the "Hold" in "Raise and Hold"

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The most significant driver to Q3'23 markets was the continued rise in interest rates. Investors continue to wrestle with the Fed's "raise and hold" mantra, of not only raising rates to around 5%, but then holding them there for the rest of 2023 and into 2024. This was evident in the 10yr Treasury rising 76 bps to 4.57%, much more than the 2yr's 17 bps rise to 5.04%. While there has been much talk of the inverted yield curve (the 2yr yielding more than the 10yr), this past quarter saw the 2-10yr inversion fall by 59 bps, even as interest rates were rising overall. Typically, an inverted yield curve resolves itself when interest rates fall across the board, and the short end falls more, as was the case in 2000, 2006, and 2018. In those three instances, once the 2yr and 10yr were equal, both subsequently declined, with the 2yr dropping more. In 2023, not only are rates still rising, but the gap is now narrowing because the 10yr is rising faster than the 2yr.

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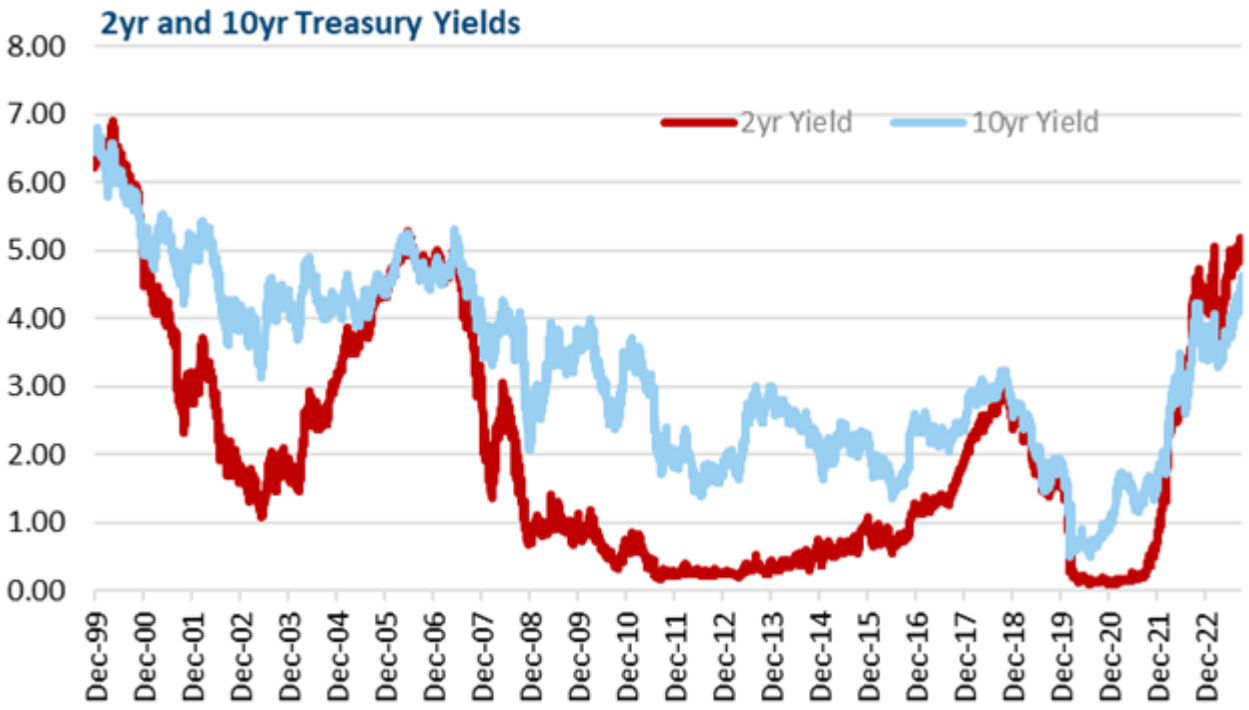

Chart 1

Driving this interest rate move is the markets finally believing the Fed's plans to "raise and hold" to slow the pace of inflation. Since the Fed's first rate hike on 3/16/22, it has pursued its fastest ever rate increase campaign (reflected in the surge in the 1yr Treasury from 0% to 5.39%) to combat the surge in inflation (Core CPI). Inflation has eased from its recent peak and, thanks to the rate hikes, the markets believe inflation will continue to fall, as reflected in the TIPS implied inflation rate of just 2.20%. The question is how much the economy will be impacted by this rapid shift. Ironically, it has been the recent strength in the economic data that has kept the Fed toeing its "raise and hold" line. Interest rates have had to adjust.

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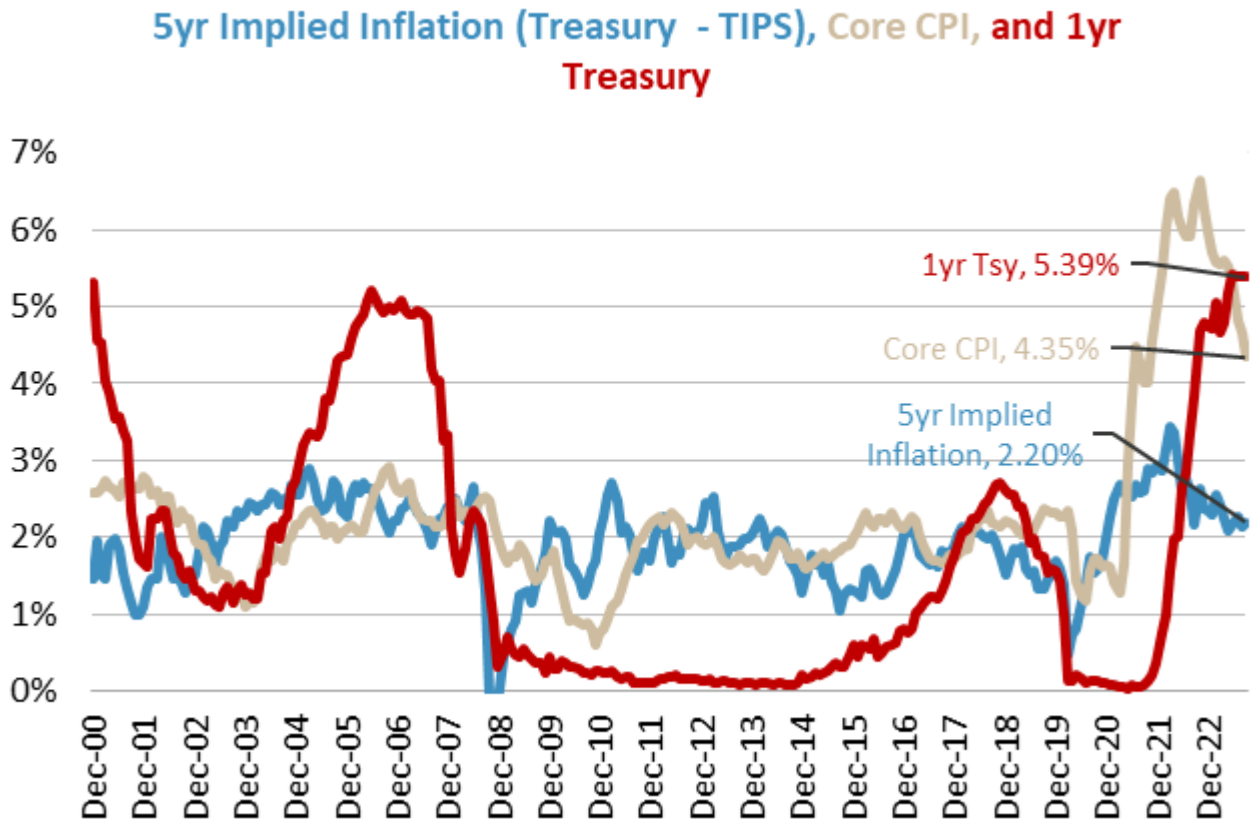

Chart 2

The continued strength of the economy in Q3'23 has kept the Fed's (and market) hopes for a soft landing alive. Yet this optimism has caused interest rates to rise, as *Markets Come to Terms with the "Hold" in "Raise and Hold".* This threatens both valuation (higher interest rates put downward pressure on PE ratios) and fundamentals (higher rates slow economic growth). This paradoxical back and forth that has caused the interest rate ups and downs and will likely persist. Going forward, the impact of interest rates on valuation, for both Equity and Fixed Income, remains a key question.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.

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