Market Update: Q3 2023

Many readers will recall the climactic scene in the 1982 movie *An Officer and a Gentleman* when the main character is pushed to his breaking point by a hardnosed drill instructor and screams out, "I got nowhere else to go… I got nowhere else to go." In 2021, that scene played out across the investment industry as portfolio managers surveyed the depressed yield on bonds and piled into stocks. It was jokingly referred to as a T.I.N.A. market: There Is No Alternative. Now, with historic interest rate hikes, the tide has turned. The benchmark 10-year treasury yield is approaching 5% for the first time since 2007, and money is flowing away from equities and toward bonds.

Key Takeaways

- Bonds 101 begins with the yield curve
- Bond yields and volatility are surging
- Our focus is on stability and liquidity
- REAL returns matter

INDEX	Q3 2023	YTD	TRAILING 12 MOS.
S&P 500	-3.3%	13.1%	21.6
Russell 2000 Small Cap	-5.1%	2.5%	8.9
MSCI EAFE - International	-4.1%	7.5%	26.2
MSCI Emerging Markets	-2.9%	2.0%	12.0
Bloomberg US Agg Bond	-3.2%	-1.2%	-0.6

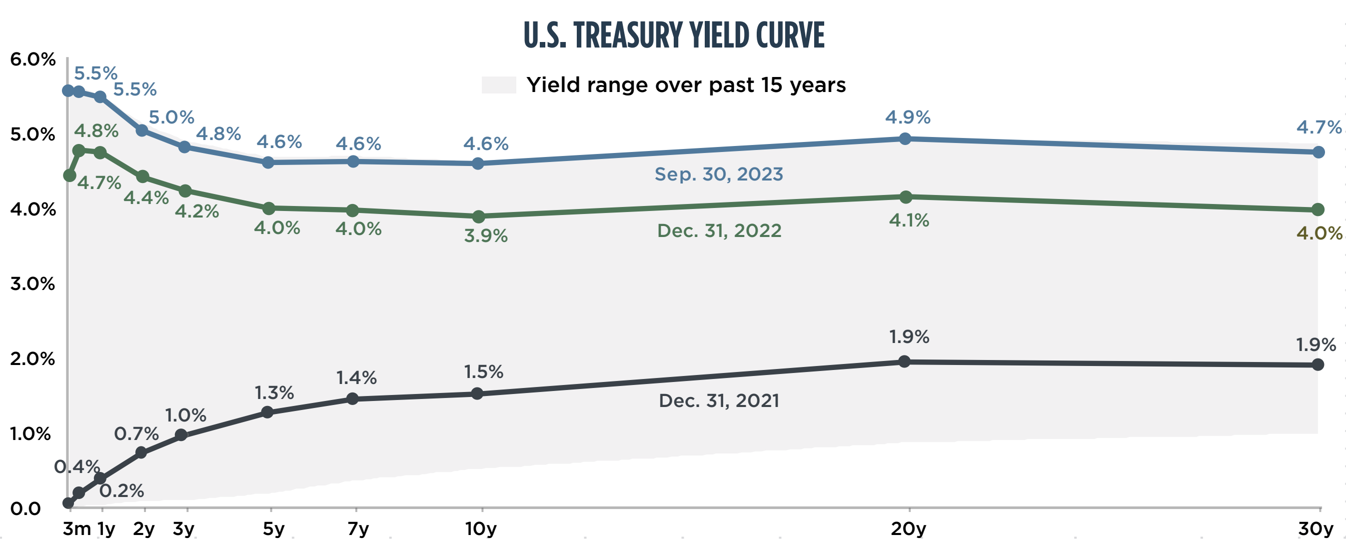
SOURCE: BLOOMBERG

Waking the Sleeping Giant

In these quarterly updates, we have not traditionally gone into great detail about the bond market — partly because of low bond yields, and also because of our liabilities-based asset allocation approach*. But since the global bond market is roughly three times the size of the global stock market, and global financial markets are more interconnected than ever, it helps to understand some bond market basics, including how bonds are currently impacting other asset classes.

The Yield Curve

The bond market's foundation is the U.S. Treasury-yield curve, which is a chart plotting a treasury bond's yield for different maturity dates at various points in time. Below is a yield curve showing three end dates: 12/31/21, 12/31/22, and 9/30/23. The x-axis shows various treasury bonds' maturities, starting with 3-month treasury bills and ending with 30-year treasury bonds. Dots on the curve depict that maturity's yield at the given point in time.



*See Asset Allocation note, Feb 2022 (https://hmpayson.com/asset-allocation)

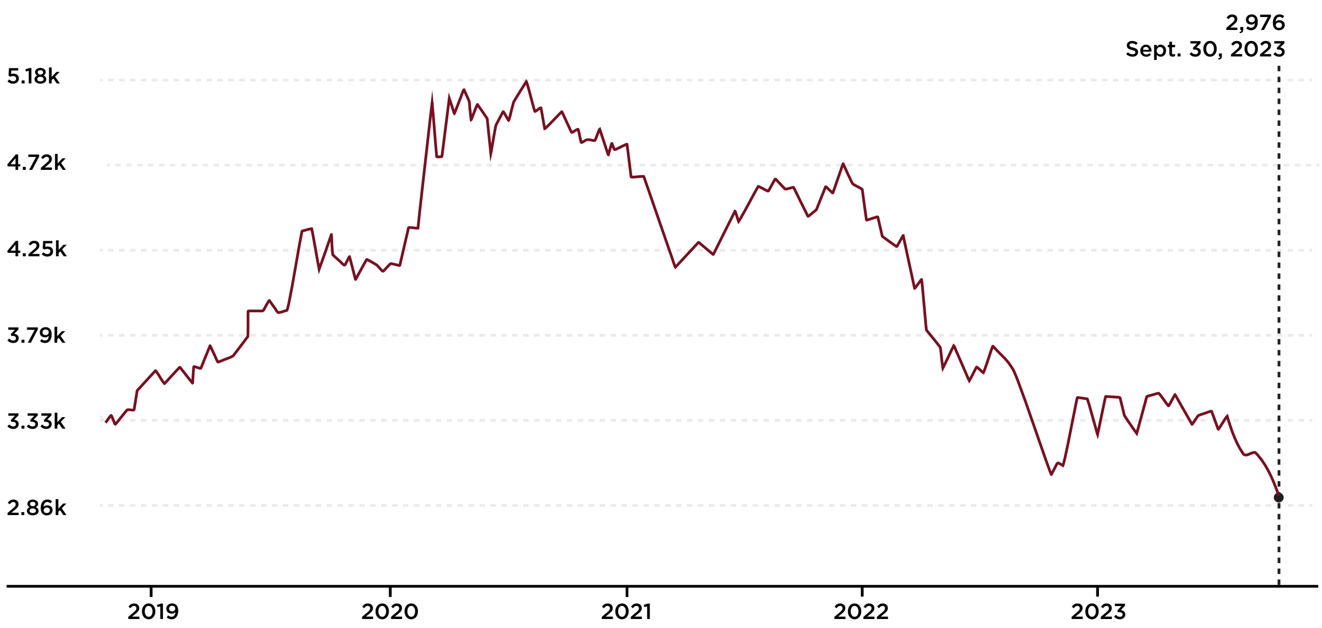
In a 'normal' yield curve, bonds that mature soon pay lower yields than those that mature years later. Intuitively, investors demand a higher interest rate in exchange for giving up their money longer and accepting the uncertainty that comes with time. For example, on 12/31/21, a 1-year treasury bond had a yield of 0.4%, while the longer-term treasuries paid 1.9%. Since 2021, the Federal Reserve has battled inflation by consistently raising interest rates. As a result, the treasury curve has moved higher at every maturity, with treasury bond yields reaching their highest levels in 15 years and dramatically changing the investing landscape. Because of the hikes' extraordinary pace, the most dramatic shift has been in short-term treasury yields, with the yield on a 1-year treasury bond rising from 0.4% in Dec 2021 to 5.5% today.

Aren't Bonds Less Risky?

Historically, bonds have been considered safe stock alternatives that also offer diversification to a portfolio. But bonds are not risk-free and not all bonds are created equal. Price volatility still occurs in the bond market, and it can be counter-intuitive to many investors: as bond yields move higher, existing bond prices move lower. The simple explanation for this dynamic is that bond investors can earn higher interest rates by investing in recently issued bonds. This causes a sell-off in existing bonds as buyers look to level the playing field for accepting a bond with a lower interest rate, or coupon. The longer the maturity of a bond, the greater the price volatility. The chart below shows that the Bloomberg US Long Treasury index* has declined 42.5% since its July 2020 peak. This decline is commensurate with the S&P 500's decline following the tech bubble in 2000.

Inflation is the enemy of both stocks and bonds. As the Fed has aggressively raised rates, the diversification benefits of bonds have been diluted with stock and bond prices reacting negatively. In 2022, sharp stock price declines were coupled with the bond market's worst annual return in history. And in the third quarter of 2023, stocks and bonds both lost value, with the broad bond market headed for another negative year in the aggregate. Over the past two decades, stock prices and treasury prices have been negatively correlated. In other words, bonds have been a cushion for portfolios when stock prices fall. Recently, only very short-term, high quality bonds have been a safe haven for price volatility.

BLOOMBERG U.S. LONG TREASURY INDEX



*The Bloomberg US Treasury: Long Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years or more to maturity.

Liquidity vs. Growth

At HM Payson, we view bonds as sources of stability and liquidity. We do not try to outsmart the bond market by investing in longer maturities or companies with suspect credit ratings. These areas of the bond market would expose clients to unwanted volatility ... not what we want from bond exposure. The focus of our bond allocations is to meet clients' spending needs over the next 3-5 years. Accordingly, we generally maintain bond portfolios of a similar maturity. In the current environment, we remain concentrated in very short-term (less than two years in maturity) treasury bonds which are currently yielding over 5%. This strategy has generated superior income and insulated client portfolios from volatility in the bond market.

While higher bond yields are great for portfolio income, they can also be a headwind for stocks. It is no longer a T.I.N.A market. The prevailing yield on U.S. money market funds is around 5%; and investors appear to have noticed. An Investment Company Institute analysis of mutual fund flows through August shows billions of dollars moving out of equity funds and into bond and money market funds.

IN $ MILLIONS, JANUARY THROUGH AUGUST 2023	
Domestic equity	-247,357
Global equity	-51,854
Balanced Funds	-65,514
Bond	39,841
Taxable bond	36,663
Municipal bond	3,178
Total money market	731,040

Higher yields may make bonds look like attractive alternatives to stocks, but only in the very short term. The Fed raised interest rates to slow economic growth and tame inflation, and emerging evidence suggests that the policy is working. If the Fed pivots to target lower short-term interest rates, the yield we would earn on those bonds would likely fall, too.

If inflation remains persistent and interest rates remain elevated, it will be important to maintain focus on REAL returns, i.e., returns over and above inflation. To build wealth in REAL terms, we need more than just income — we also need growth. Stocks are better positioned in the long term to generate REAL growth because there are multiple levers that contribute to the total return: dividend income, earnings yield, and price appreciation. Bonds provide current income, but any price appreciation is temporary and bond holders do not benefit from a consistent stream of earnings growth. By contrast, companies that consistently grow earnings are positioned to increase dividend income and are generally rewarded by the market over time via price appreciation.

Higher bond yields are a welcome change to a prolonged income drought. We position bond portfolios to limit volatility and protect our clients' liquidity needs in the short-term. Our primary focus remains identifying quality companies that can pull multiple levers to generate excess returns above inflation. In the long-term, investing in such stocks is the best way to build REAL wealth.