MARKET COMMENTARY

RATE SHOCK: HOW BAD IS IT?

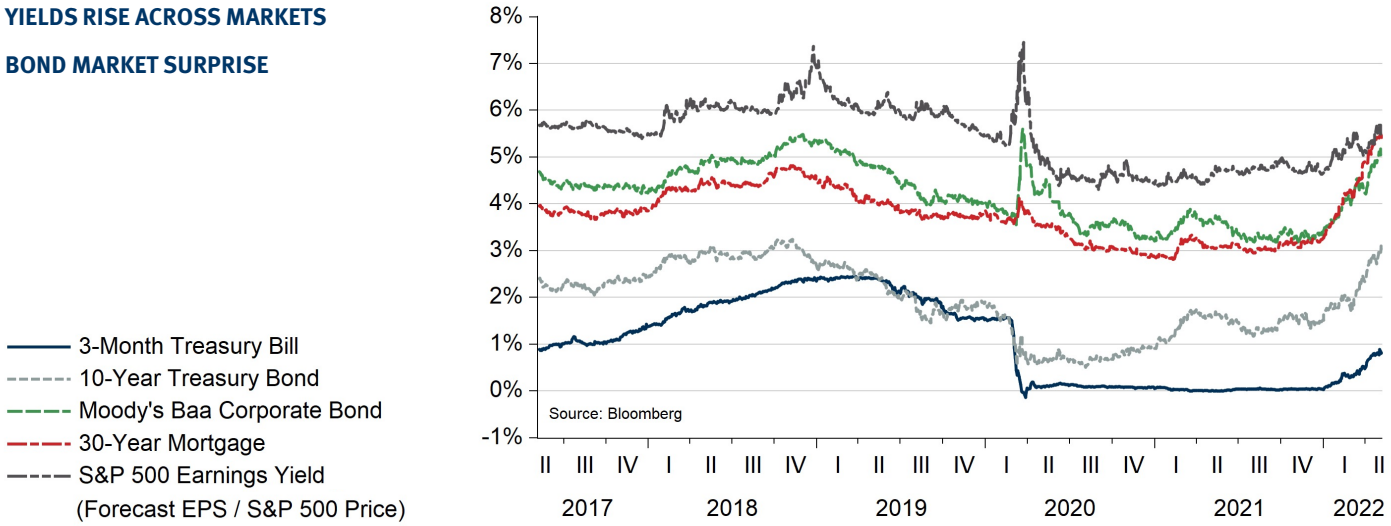
Rising interest rates are a challenge for the bull case. Rates are rising, not because real growth is picking up, but because inflation is forcing central banks to rethink policy. As the chart below shows, different yields across markets are making new highs. These increases are forcing a rethink of valuations and adding to volatility.

Since the start of the year:

- 3-Month Treasury Bill Yields are up to 0.9% from 0.0%;
- 10-Year Treasury Bond Yields doubled to 3% from 1.5%;
- 30-Year mortgages rose to early 5.5% from 3.25%;
- Baa Corporate Bond Yields are now 5.2% from 3.3%;
- The S&P 500 earnings yield (12-month forecast earnings divided by price) is up to 5.7% from 4.7%.

YIELDS RISE ACROSS MARKETS

BOND MARKET SURPRISE



These increases came as a surprise—even "sleepy" bonds like 5-year U.S. Treasury bonds lost 7% from January through April. This four-month decline ranks among the most considerable historical losses for the instrument. Even bond investors holding highly conservative, intermediate-term Treasuries experienced unusual pain. At the long end of the Treasury spectrum, holders of zero-coupon 30-year U.S. Treasury bonds lost about 25%.

The good news, of course, is that rising rates mean savers will be able to reinvest cash from coupons and maturing bonds at more attractive rates. The positive impact on wealth from higher reinvestment rates can be significant, especially for investors with a long horizon.

MORE COSTLY TO BORROW

Of course, not everyone benefits from higher rates. Consider a person borrowing for a home purchase. A $275,000 mortgage cost $1,088 per month at 3.25% back in January. Today's same mortgage costs $1,419 now that the average 30-year U.S. mortgage stands at 5.5%. That extra $419 per month comes when the average home price is up 35%, based on the S&P Case/Shiller National Home Price Index.

A similar rise can be seen for corporate borrowers. The average yield on a Baa issuer is now 5.2% versus 3.3% in January. Still, the increase was primarily due to a jump in Treasury yields, so there is no real sign markets are all that worried about corporate defaults. The "spread" or difference between Baa corporate bonds and a 10-year U.S. Treasury bond increased slightly. That spread increased to 2.2% today from 1.80% in January. Over the past five years, the spread ranged between 1.75% and 2.75%, leaving today's 2.2% near the center of the range.

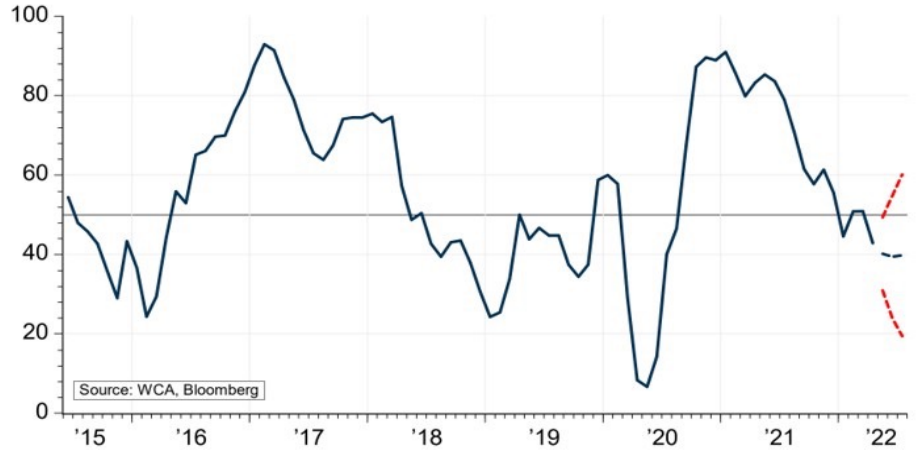
It should also be pointed out that earnings forecasts for the S&P 500 are still climbing, despite recent worries. Today, analysts expect $237 of operating earnings from the S&P 500 companies, a record that stands 33% above pre-pandemic levels. Moreover, the "earnings yield" is now 5.75%, roughly 2.6% above the 10-year U.S. Treasury yield. As you can see in the chart below, this is near the low end of the 5-year range and suggests room for a further move higher. Such a move could happen due to falling bond yields, rising earnings, falling stock prices, or a mix of all four factors.

S&P 500 EARNINGS YIELD MINUS

10-YEAR U.S. TREASURY YIELD

A TACTICAL SHIFT

WCA "BAROMETER"



As we wrote at the start of the year, and in our Q2 Tactical Asset Allocation quarterly, we believe a shorter duration posture makes sense. In our view, the ramp-up of inflation and response by central banks to contain it accelerated a much-needed adjustment to bond pricing. Beyond bonds, incoming data presents a mixed bag, especially compared with months ago.

The chart at the top shows the forecast path for the WCA "Barometer," (chart, below) which measures a variety of market-based and other inputs to our outlook. As you can see, the expected short-term path for the barometer is near 40, indicating some weakness.

Consequently, we reduced equity exposure at the start of the month to below neutral in the satellite portions of tactically-allocated portfolios (40% equity currently versus 50% last month and 70% a year ago). We will continue to monitor incoming data, update our forecasts at the start of each month, and make appropriate adjustments as warranted.

CONCLUSION

Higher interest rates have rattled markets of late. While higher rates convey benefits to some, it is too soon to conclude that the adjustment process is complete.

We can say that the pace of improvement in the outlook has clearly cooled, calling into question some lofty valuations and cutting growth forecasts. We continue to recommend a flexible approach to bond investing with a tactical focus on shorter duration and a strategic preference toward laddering. Stock portfolios should focus on fairly valued, higher quality, flexible businesses.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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