MARKET COMMENTARY

INVESTING IN THE AGE OF RISING RATES

As 2023 comes to a close and investors look back over the past two years, one can't ignore the paradigm shift in rising interest rates and its far-reaching effects on markets and the economy. After all, investment portfolios, mortgages, savings accounts, and auto loans, to name a few, have been drastically impacted by rising interest rates, which stand at 5.25% today.

To put it into perspective, we have not seen a Fed Funds Rate this high, achieved in such a short period, in over 35 years (see Chart A on page 3). Against a backdrop of high rates, risk, and recession uncertainty, it seems prudent to revisit how we got here and how Washington Crossing Advisors considers these challenges when choosing investments in our equity portfolios.

THE SEEDS OF INFLATION

Nearly four years ago, Americans learned about the COVID-19 pandemic. Looking beyond the tragic loss of life, the U.S. government had to quickly intervene to keep the economy functioning and provide relief for millions of Americans who suddenly lost their jobs. The Paycheck Protection Program and other financial assistance programs took effect later in 2020 and beyond.

More recently, two significant pieces of legislation were signed into law in 2021 that would drastically increase government spending in subsequent years. The timeline and impact on government spending for the $1.9 trillion American Rescue Plan Act and $1 trillion Infrastructure, Investment, and Jobs Act are depicted in Chart B on page 3. It was also around this time that inflation warning signs first appeared in the spring/summer of 2021.

As fiscal policy became more expansionary, monetary policy remained extremely accommodative, and the Fed Funds Rate hovered near 0%. With both fiscal and monetary policies firmly on the accelerator, inflation followed, which we warned about in a May 2021 market commentary piece titled “A Discussion Worth Having.” In particular, Chart C on page 4 examined expected inflation and rates expectations. Essentially, the Treasury TIPS market (green line) expected 4+% inflation into 2022, followed by a slight moderation, but still ahead of the Federal Reserve’s (Fed) stated 2% target. The forwards rate markets (orange line), looking at short-term rates, and Federal Reserve forecasts (blue line), both expected near-zero policy rates for several more years. As it would turn out, the Federal Reserve and forwards markets significantly underestimated the historic rise in rates we’ve lived through the past two years.

WHERE’S THE RECESSION?

After brutal declines in equity and bond prices in 2022, many forecasters expected 2023 to be a most challenging year. For example, in a Bloomberg Survey of Professional Investors in December 2022, 60% of those surveyed predicted a recession in 2023. Another firm forecasted “the worst downturn in decades.” As of 10 November 2023, this feared downturn has yet to materialize. The job market remains solid, disinflationary trends persist, and corporate earnings indicate a resilient consumer. Indeed, credit spreads and the equity risk premium are both at 20-year low levels, meaning a “risk on” sentiment that flies in the face of a recessionary environment (see Chart D on page 4).

Having dodged an imminent recession this year, risky stocks have been the best-performing equities, as measured by their beta, underscoring the above attitudes favoring risk. However, looking at the whole rising rate period tells a very different story. On page 5, Table A shows how less risky stocks have outperformed riskier stocks as interest rates unexpectedly soared.

CHART A | PAST POLICY TIGHTENING CYCLES / INCREASE IN FED FUNDS RATES Source: WCA, Bloomberg

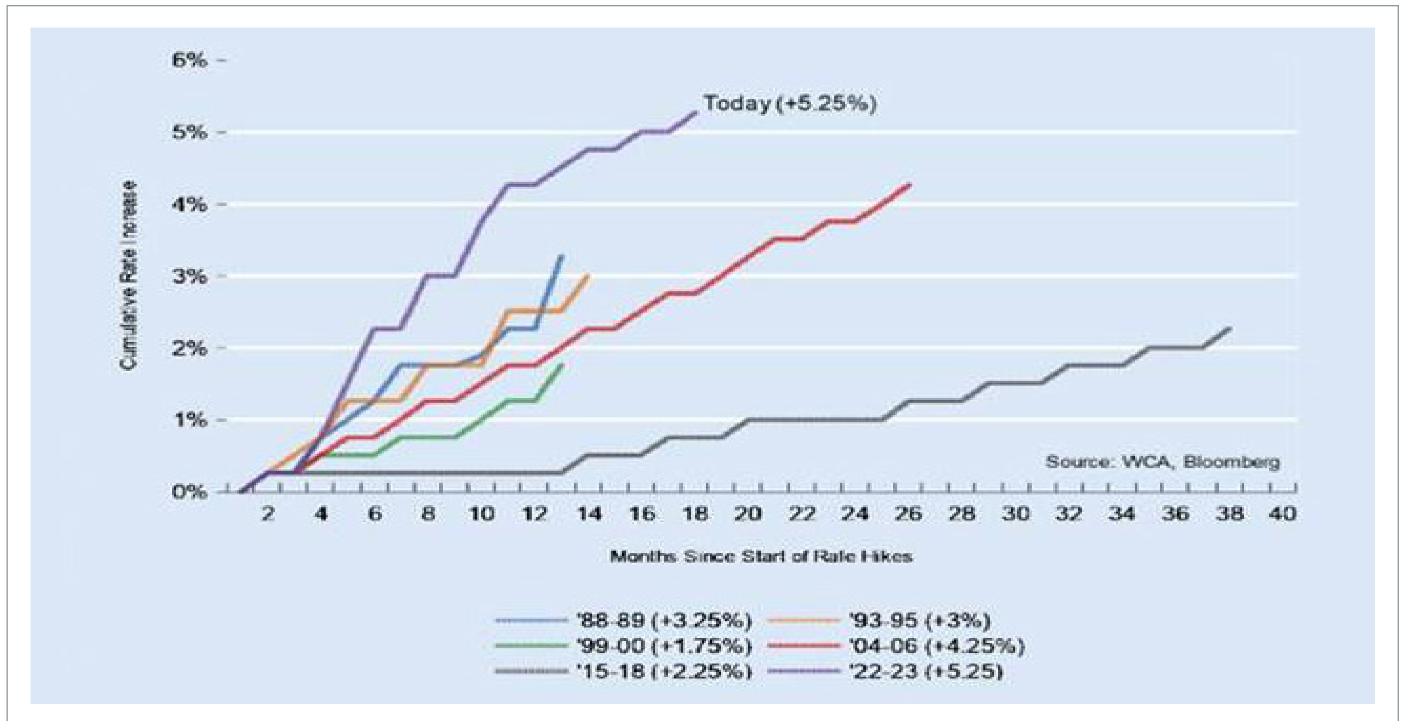

CHART B | CHANGES IN U.S. GOVERNMENT SPENDING Source: U.S. Treasury

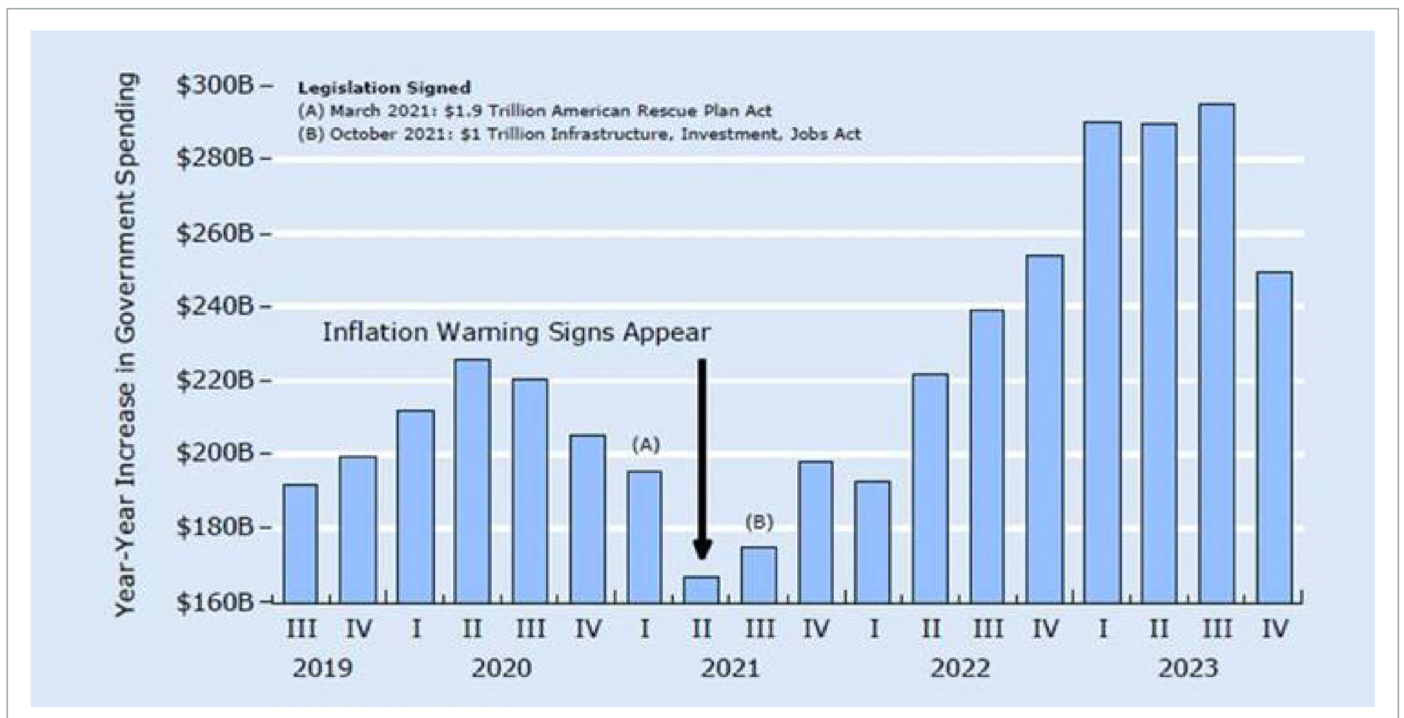

CHART C | INFLATION AND SHORT-TERM RATE EXPECTATIONS (AS OF MAY 2021) Source: Bloomberg

CHART D | CREDIT SPREAD (Baa-10yr UST) / EQUITY RISK PREMIUM Source: Bloomberg

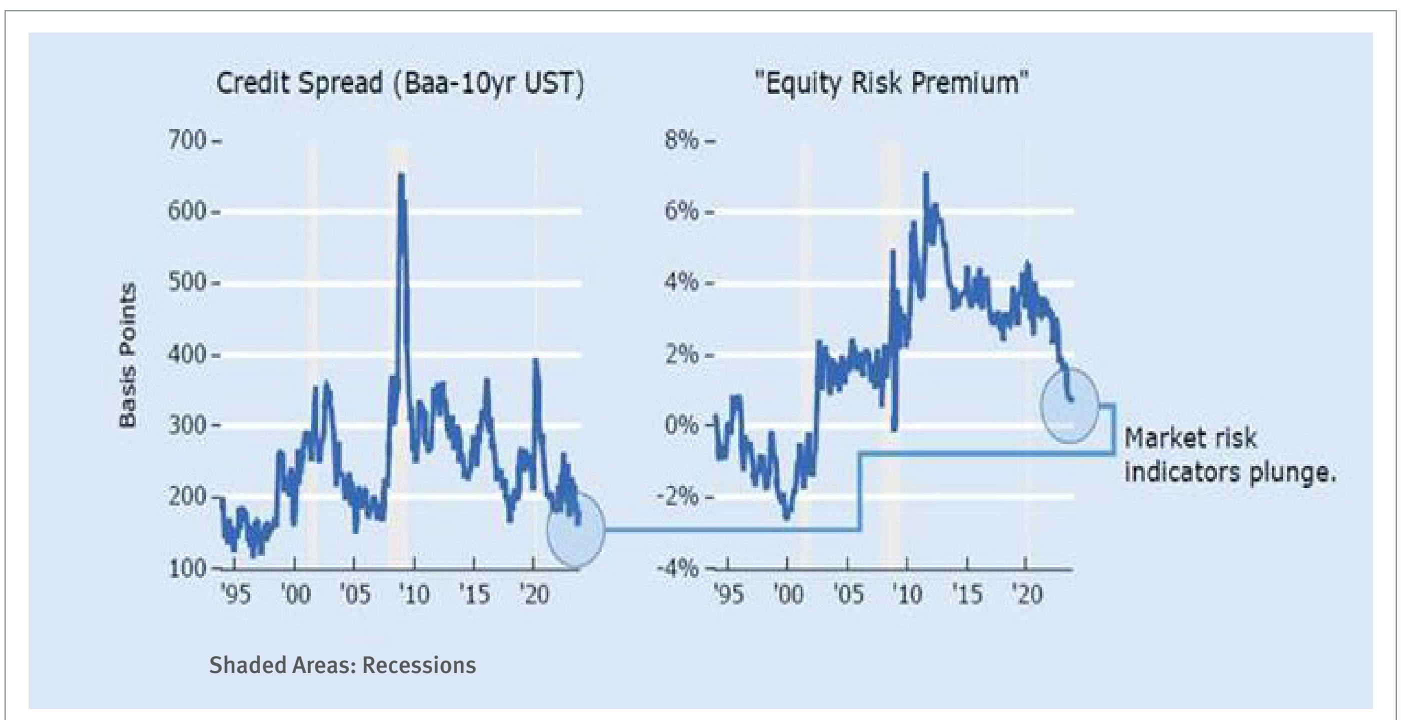

TABLE A | S&P PERFORMANCE BREAKDOWN BY RISKINESS* OF STOCK (AS OF OCT 31, 2023) Source:WCA,Bloomberg

Riskiness of Stock	2022	2023 YTD	Whole Period
Top Quintile (MOST RISKY)	-40%	+24%	-26%
2nd Quintile	-25%	+19%	-11%
3rd Quintile	-22%	+20%	-6%
4th Quintile	-4%	-8%	-13%
Bottom Quintile (LEAST RISKY)	+2%	-4%	-2%

* Riskiness measured as stock beta

CONCLUSION

We believe basing investing decisions on interest rate predictions or recession probabilities is a fool's errand. Events of the past two years, as discussed above, prove that it is tough to correctly estimate or model the path of interest rates and understand when or if a recession will ever materialize. Instead, at Washington Crossing Advisors, we construct our equity portfolios with high-quality companies that have had low debt levels, profitable assets, and consistent earnings. Additionally, our strategies maintain lower betas (risk) than the broader averages. Focusing on high-quality, lower-risk stocks helped insulate portfolios from outsized risk since interest rates started a historic rise early in 2022.

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.

Index Descriptions: WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

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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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher-quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark. A forward contract is a type of customizable derivative contract that involves two parties who agree to buy or sell a specific asset at a set price by a certain date in the future. Forwards are similar to futures contracts, but they are made over the counter (OTC) and settle only once, on their expiration date.

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About Washington Crossing Advisors | Washington Crossing Advisors a wholly owned subsidiary of Stifel Financial Corp. (NYSE-SF). The WCA team has been helping individual and institutional investors build wealth for more than 25 years.

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