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The Friday Memo:
The Great Repricing

10.06.23

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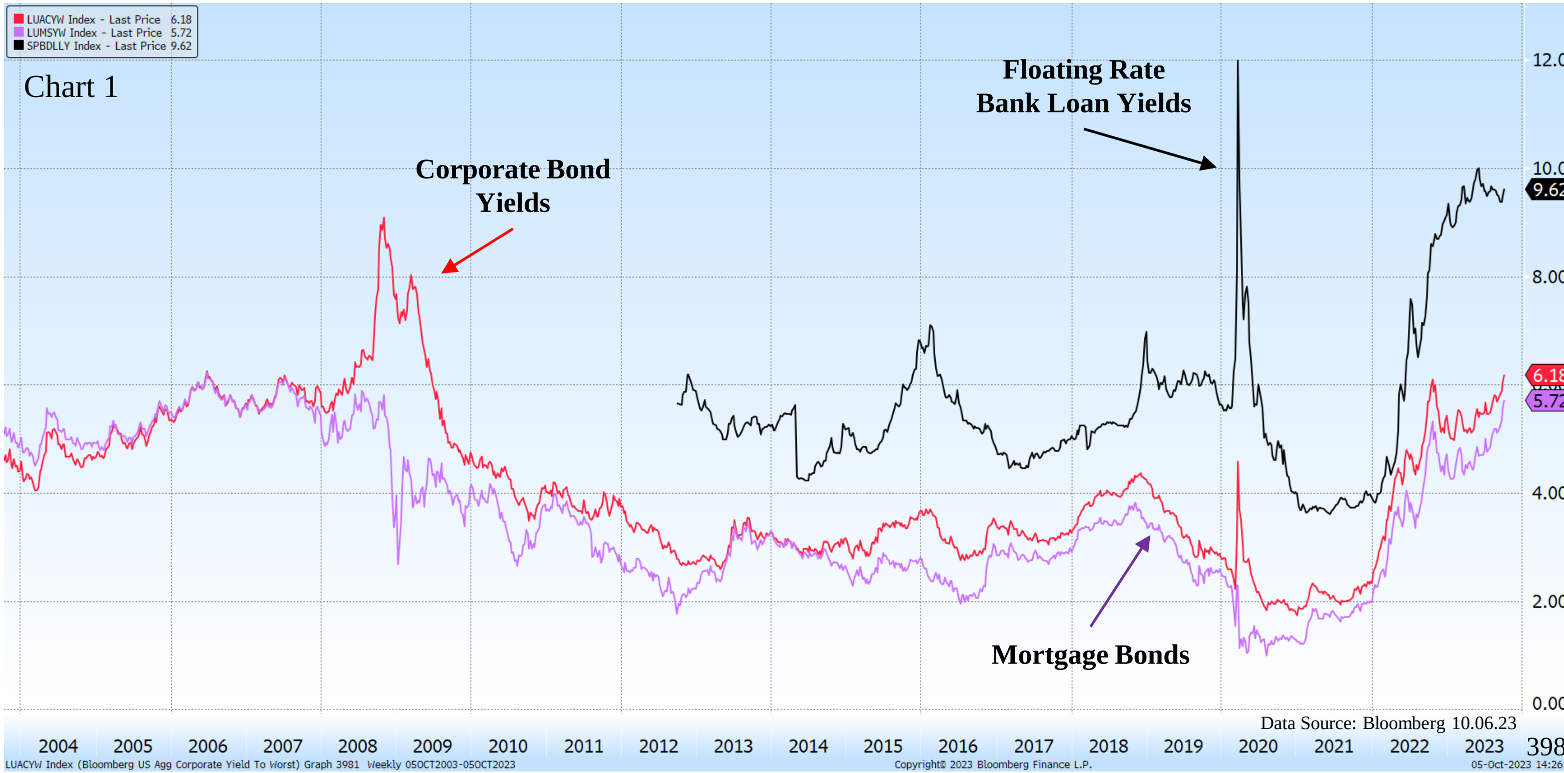
The Great Repricing: Bond Yields have Returned to pre-2008 Levels



- Fiscal and monetary policies during the past decade seem to have been unsustainable, contributing to a significant repricing of stocks and bonds.
- Bond yields moved much higher in 2022 and have recently moved to new highs. What is the “ceiling” for interest rates? We think bond yields will remain within a narrow “trading range” in coming months.
- This chart shows corporate and mortgage bond yields, as well as an increasingly popular category of the high yield bond market, floating rate bank loans.
- It seems logical to us that higher interest rates, meaning a higher cost for debt capital, will have a generally negative impact on corporate profitability, and lower demand for credit. It’s an uncomplicated narrative: slowing economic growth, reduced inflation, and lower demand for debt capital should enable bond yields to stabilize and possibly move lower.

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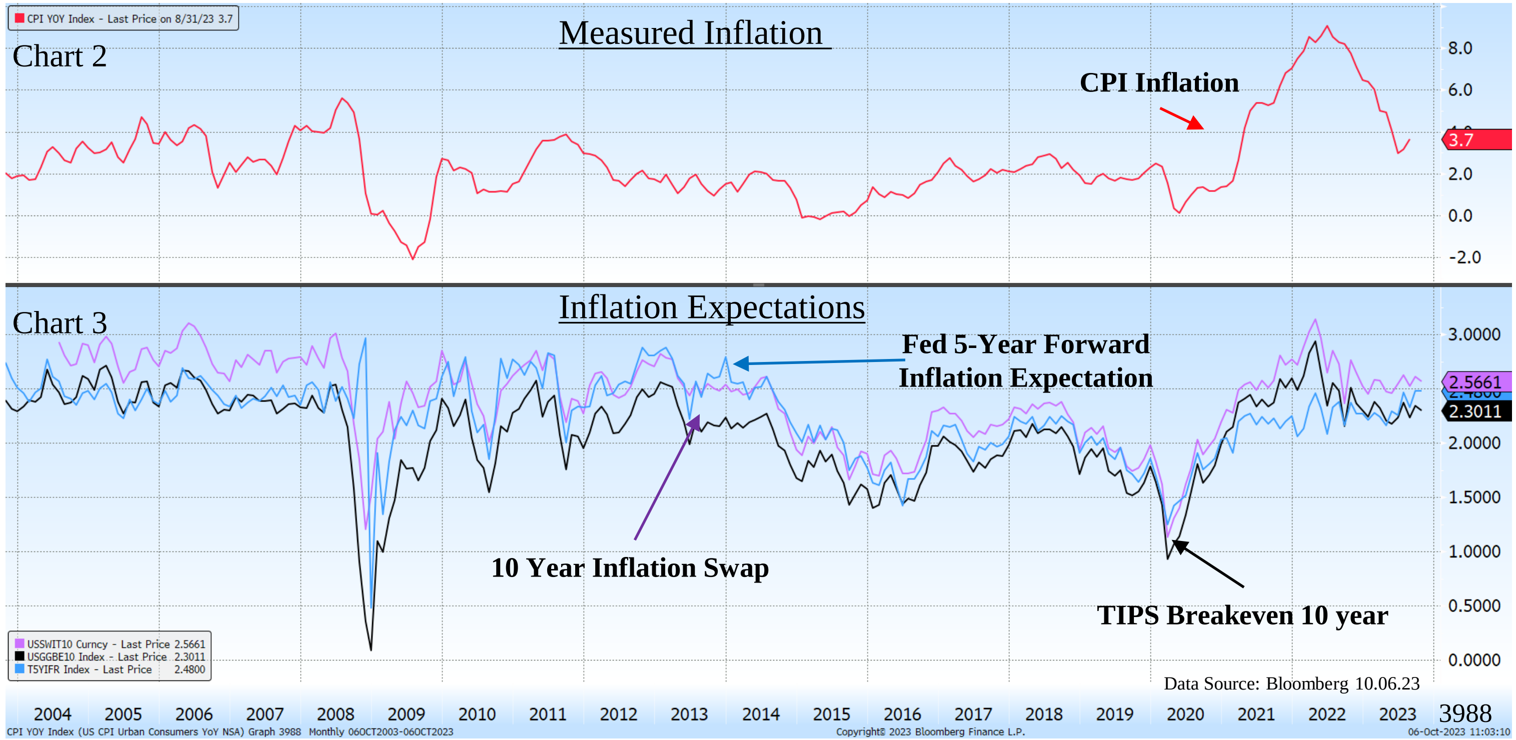
A Strange Development: Long Term Inflation Expectations Haven't Budged



- The outlook for interest rates is based largely on the outlook for inflation. To develop forecasts for inflation and interest rates, we differentiate between "measured" inflation, such as the reported CPI Inflation Index, and inflation expectations. Chart 2 shows reported year-over-year changes in the Consumer Price Index (CPI). Chart 3 shows measures of inflation expectations, including TIPS "breakeven yields", Inflation Swaps and Fed surveys.
- Although measured inflation has spiked recently, Chart 3 shows that long-term expectations of inflation haven't changed very much.
- The stability of inflation expectations provides evidence bond yields may not move higher.

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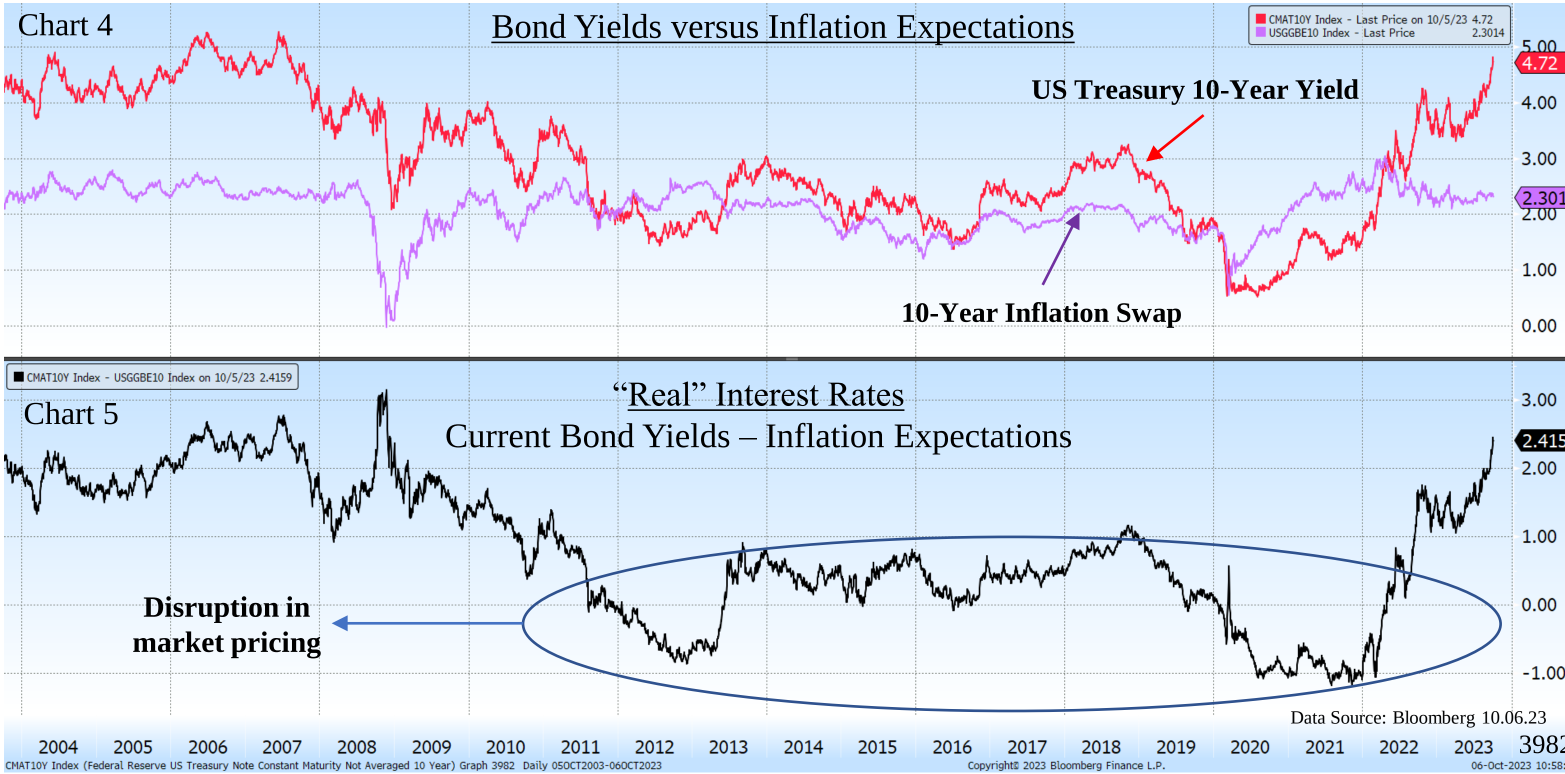
A Return to Market Pricing: Positive Real Interest Rates



- US Treasury 10-year notes have historically traded at a positive spread to inflation. In our view, US Treasury 10 year note yields have reached a "typical" spread to inflation.
- From 2010 to 2022, government fiscal and monetary policies disrupted the market process of setting interest rates. Recent events have led to a return of market forces determining interest rates, as apposed to "administered" rates.

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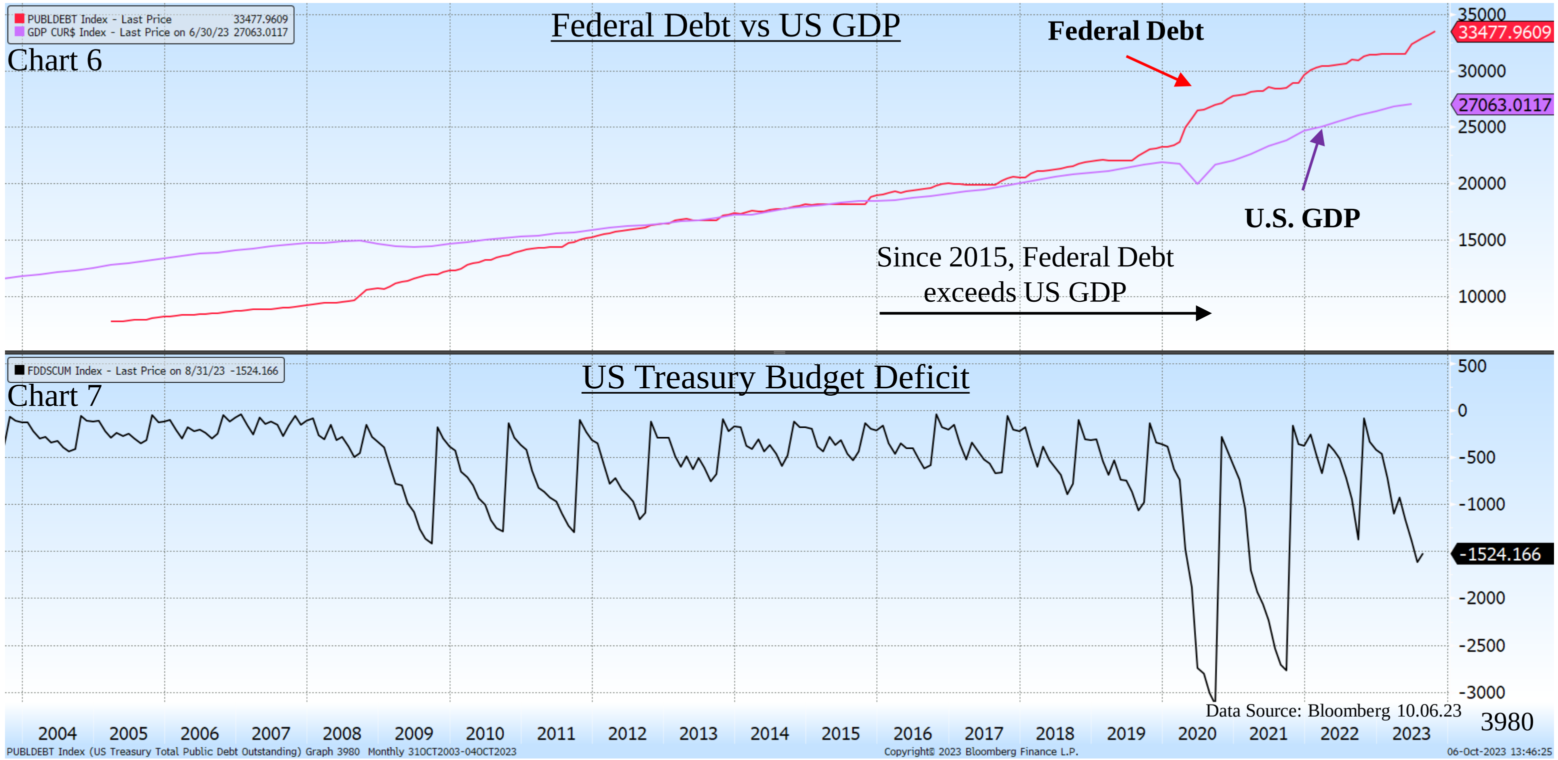
Will Government Debt Put Upward Pressure on Interest Rates ?



- We think important "new news" for interest rates is the pressure coming from high levels of US government debt, and the fact that the debt increase can largely be attributed to large annual federal budget deficits.
- The demand for funds by the US Government is substantial, relative to the size of the economy, and create a new dynamic in establishing an equilibrium level of interest rates.
- Markets will adapt to the new reality of federal debt, perhaps diminishing expectations of government support for markets during times of future economic stress.

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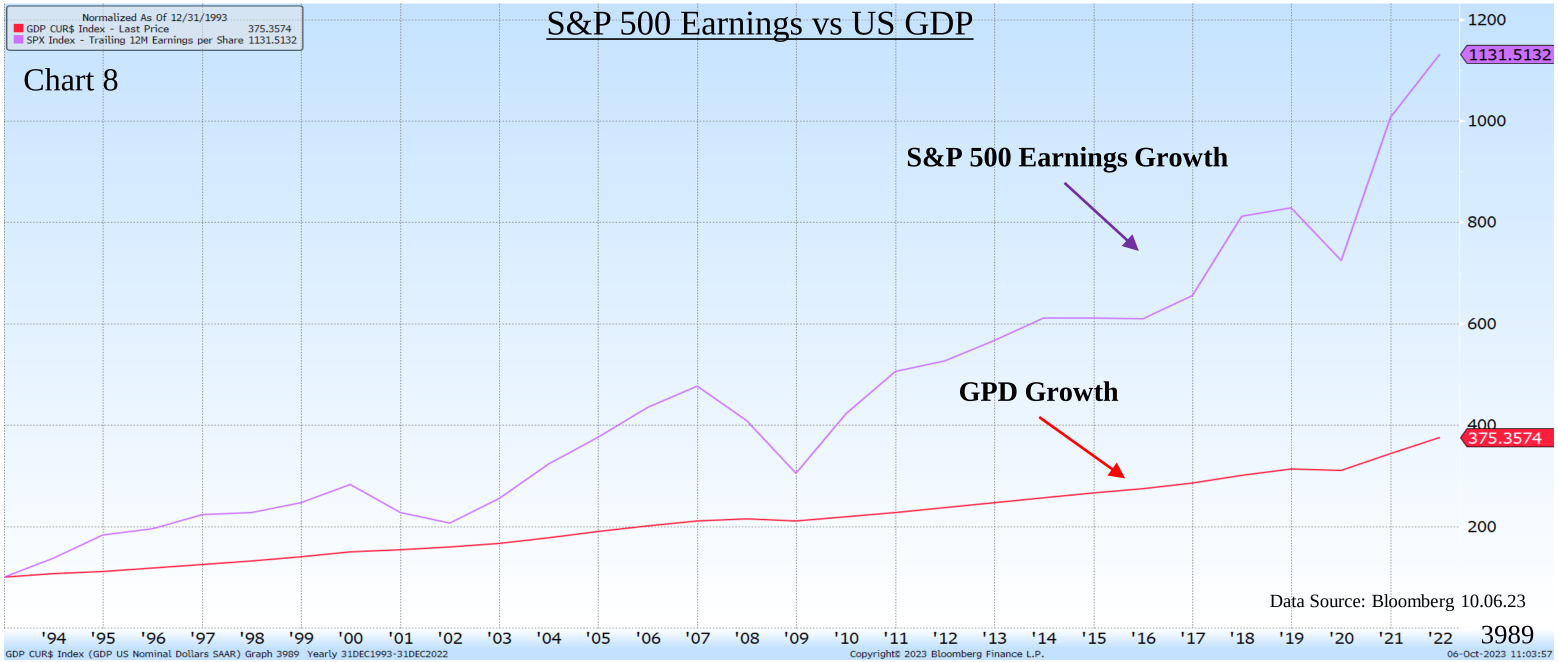
Will Higher Interest Rates Hurt S&P 500 Earning Growth ?



- Overall GDP growth and S&P 500 earnings growth are related, but are influenced by different factors.
- How will higher interest rates impact growth going forward? The S&P 500's net profit margin of 12.6% has benefitted in recent years from declining interest, energy and labor costs. Although a reversal of cost trends would have a negative impact on profitability, we don't think changes in these costs would be enough to significantly change long-term S&P 500 earnings growth of 6%.
- Our view is that higher interest costs will be more important for some industries and companies than others, but will not, in and of themselves, change the trajectory of S&P 500 earnings growth.

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Please note: Source of Data is Bloomberg as of 10.06.23

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