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# The Hudson River Group at Morgan Stanley

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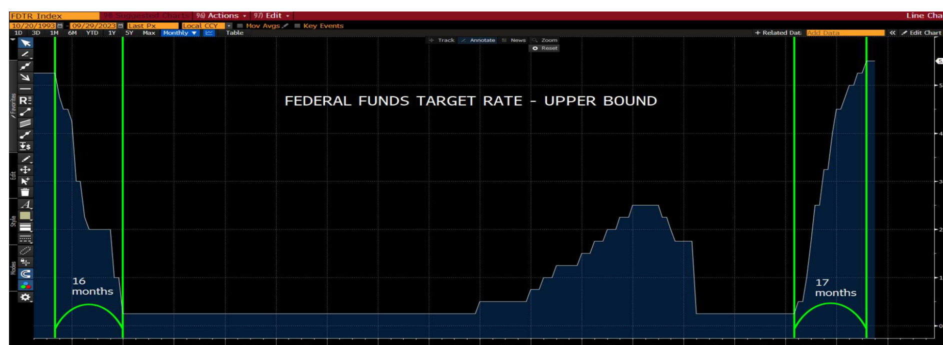
And another one gone, and another one gone
Another one bites the dust (yeah)
Hey, I'm gonna get you too
Another one bites the dust

-Queen

Though the major averages are in the green year to date the internals tell a very different story. For the first three quarters of 2023 the S&P 500 is +13.1% however the median return for the stocks in the index is just 2%[1]. In our prior letter we discussed the "Magnificent Seven" and its impact to the major index, so we see no point to repeat ourselves. Instead, we want to discuss two trends that have had and may continue to have signification ramification for the markets: higher interest rates and weight loss drugs. Both have caused some sectors and sub sectors to "bite the dust".

Fifteen years ago, Quantitate Easing (QE) was born in the United States. The world was in the throes of the worst financial crisis since the Great Depression. In 16 months, the Federal Reserve dropped the Fed funds rate from 5.25% to near zero with a string of announcements in the months/years to follow that we now know as QE1, QE2 and operation twist. For seven-years Fed Funds sat at near zero, followed by a gradual move higher until Covid brought QE back in vogue. In total from 2009 to 2020 nine out of thirteen years (70%) saw close to zero short end rates as well as below average longer rates (10yr UST averaged roughly 2.25% per Bloomberg). While it was a dream scenario for borrowers both big (debt fueled buybacks, leveraged buyouts etc.) and small (mortgage, auto loans); it was an awful time for savers and bond buyers. This all changed in early 2022 when the Fed started raising rates. Ironically it took around 17 months to hike short term rates from near zero to 5.5% and ripples were surely to be felt aside from of the regional bank crisis that happened earlier this year. Those ripples have turned into waves for the bond market and sectors leveraged to it.




*Source: Bloomberg*

As of the end of Q3 the US Aggregate Bond index is down a bit over 1%[2]. This is on top of a negative year in 2021 and 2022. We have looked at many different historical records on the bond market and believe that if 2023 were to end negative again it would be the first time in history to see three straight down years. To make matters worse the drawdown in price on the long end of the treasury curve is ranking up there with some of the greatest losses in in modern finance. Since May 2020 the ICE US Treasury 20+ Year Bond index is down close to 45% in price[3]. To compare, the S&P lost roughly 56%[4] during the Great Financial Crisis. After a decade plus of recommending being underweight fixed income, we have and continue to recommend adding exposure and not just on the short end of the curve.

On August 16, 2022, the Inflation Reduction Act of 2022 (IRA) was signed into law. It is the largest investment into addressing climate change in the US history with nearly $400b in federal funding being directly to clean energy. Since the bill was signed the WilderHill Clean Energy Index, an index comprised of publicly traded companies whose business's stand to benefit substantially from societal transition toward the use of cleaner energy and conversation is down over 50% while Fed Funds have doubled (chart below – top WilderHill Index, bottom Fed Funds Rate). Clean energy companies tend to be smaller and their projects are capital intensive. The industry has always been speculative. Though the IRA was created to aid in these business's, high financing costs are outweighing the benefit creating a quandary for the companies as well as the goals of the IRA. Can the US shift more to clean energy in a "higher for longer" environment (no pun intended)? From an investment standpoint we do however believe the risk/reward is interesting for the clean energy space for those with a higher risk tolerance.

*Source: Bloomberg*

Shifting from a speculative space to ones that are considered “defensive”: Utilities and Telecom. Both highly regulated businesses with leveraged balance sheets (i.e., more debt), high capital expenditures, attractive dividends and historically stable revenue and earnings. Thanks to higher interest rates/funding costs along with some stock specific news both sectors have seen better days. In the past twelve months the S&P 500 Utility Index and S&P 500 Telecommunication Services Index are down 7% and 3% respectively (total return – including dividends) lagging the S&P 500 by roughly 25%+[5]. Though we believe funding costs may stay elevated we see value emerging from both spaces.

Higher interest rates are not a surprise. After a decade of low rates, a reversion to the mean was inevitable with the timing and impact difficult to gauge. The current weight loss drug (GLP-1) trend is far different. It was relatively unknown years ago outside of the medical world and Wall Street is still trying to predict its future impact. Mizuho said it best when the research shop wrote “The GLP-1 trade..could be the single greatest story-line we have ever followed, and damage done to equity values within and outside of Healthcare historic”[6]. The destruction done in the short term is frankly stunning. Thanks to algorithms & fast money Wall Street assigned the losers very quickly!

| 04/28/2023 – 10/12/2023 | |
|---|---|
| Sector | Price Change |
| S&P 500 Packaged Food | -25.7% |
| S&P 500 Beverage | -16.0% |
| Dow Jones US Select Medical Equipment | -20.7% |

*Source: Blooomberg*

Like any major groundbreaking product/trend, the future is murky at best. Momentum will mostly likely win in the short term for both those going up as well as down while many questions will continue to go unanswered.

The ripples/waves discussed in this letter have may have negatively impacted parts of your portfolios. Baron Rothchild famously said, “Buy when there’s blood in the street, even if the blood is your own”. We believe it is more prudent to do your homework when there is blood in the street and that is what we are doing in all the sectors mentioned above.

Enjoy the upcoming holiday season with food, family and of course Wall Street tossing out its “guess” to what happens in 2024.

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For index, indicator and survey definition referenced in this report please visit the following:
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[1] Source: Bloomberg
[2] Source: Bloomberg. 12/30/22 – 9/23/23 Bloomberg US Agg Index -1.21%
[3] Source: Bloomberg. 05/25/20 – 10/06/23 ICE US Treasury 20+ Bond Index -44.8%
[4] Source: Bloomberg. 10/11/07 – 03/06/09 S&P 500 Index -56%
[5] Source: Bloomberg. 09/30/22 – 09/29/23 S&P 500 Index +21.6%, S&P 500 Utility Index -7.0%, S&P 500 Telecommunication Services Industry -3.0%
[6] Source: X: Carl Quintanilla 10/13/23

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