ALL ABOUT RATES

Global markets were weak over the past month, with both stocks and bonds posting negative returns. The catalyst was principally the material rise in interest rates over the course of the month – driving losses in fixed income and pressuring equity valuations. Until recently, the increase in long-term rates off of the regional banking crisis-induced lows in March had been largely driven by increased odds of a "soft landing" and the more hawkish reaction function from the Federal Reserve. The most recent increase, however, shows less fundamental support – meaning it has not been driven by changing expectations for inflation or the Fed. Instead, we believe the required term premium has increased – given economic uncertainty and interest rate volatility – perhaps exacerbated by elevated Treasury supply amid a shift toward more price-sensitive demand as the Fed continues its quantitative tightening. Given the slight divorce from fundamentals, we would anticipate some interest rate rollover in the months ahead.

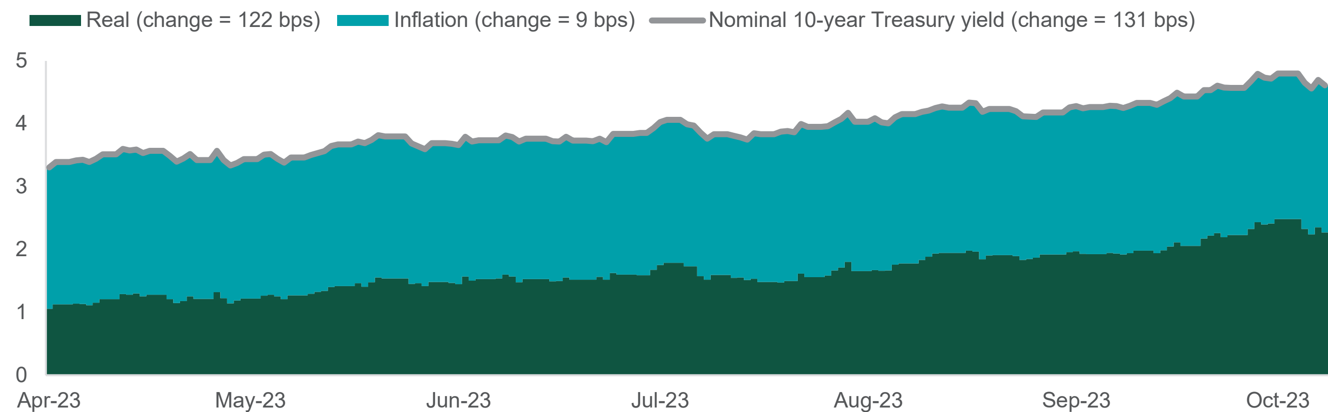
We believe investors are somewhat complacent about accumulating economic headwinds. Yes, U.S. labor markets were strong and consumer spending has remained durable – but we see headwinds going forward in the capacity to spend from depleted excess savings, as credit card balances move higher and student loan payments resume. Higher rates will also impact the pace of activity in the economy. Several Fed officials have noted the tighter financial conditions from the move higher in interest rates – a clear sign they wish to telegraph to the markets that the out-the-curve rate increase has finished the Fed's rate hiking campaign for them.

We have a new risk case this month relating to the Middle East conflict. Beyond the human tragedy unfolding, we acknowledge the risk of escalation in the region and what it could mean for oil prices. Oil supplies out of the Persian Gulf could be significantly disrupted should Iran be brought into the fight. We (and we believe central banks) will be less concerned with the inflationary impact of the resulting rise in oil prices – and more worried over the impact on growth. Demand destruction from materially higher oil prices would negatively impact global growth.

We made no changes to our Global Policy Model this month, maintaining our relatively modest underweight to risk. Equity valuations became more attractive the past month, but we continue to prefer high yield bonds to developed market equities, natural resources to emerging market equities, and maintain an overweight to cash.

A REAL RISE

Rising real yields have driven the bulk of the increase in longer-term government bond yields this year.



Source: Northern Trust Asset Management, Bloomberg. Data from 4/6/2023 through 10/13/2023. Inflation component (breakeven yield) is measured by the 10-year breakeven rate. Real component is the nominal yield minus the inflation component.

BASE CASE EXPECTATIONS

Complacency Concerns

While off the equity highs, investors are still taking too much comfort in the increased possibility of an economic soft landing (lower inflation without recession), not appreciating long(er) monetary policy lags and geopolitical risks. TAA expects flattish growth with downside risk, endorsing credit markets over equities.

A Steady Fed

Recent Fed rhetoric suggests the rate hike cycle that started in early 2022 may have finished – prompting a favorable narrative around an upcoming rate cut cycle. Market expectations call for rate cuts beginning mid-2024. We think investors seeking rate cuts without material economic weakness will be disappointed as the Fed shows resolve.

RISK CASE SCENARIOS

Oil Ends the Expansion

The war in Israel expands into a broader Middle East conflict that draws in Iran, putting global oil supply at risk. Central banks would look through the near-term inflation spike anticipating the economic fallout.

Sticking the Landing

Market expectations and the Fed's own forecasts are calling for rate cuts in 2024. Should those cuts happen amidst an orderly disinflation process and economic durability, TAA is too underweight risk.

Prepared by Northern Trust Asset Management for United Bank.

UNLESS NOTED OTHERWISE, DATA IN THIS PIECE IS SOURCED FROM BLOOMBERG AS OF OCTOBER 2023.

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