ON THE RADAR

FAQs on the Markets and Economy

August 10, 2023

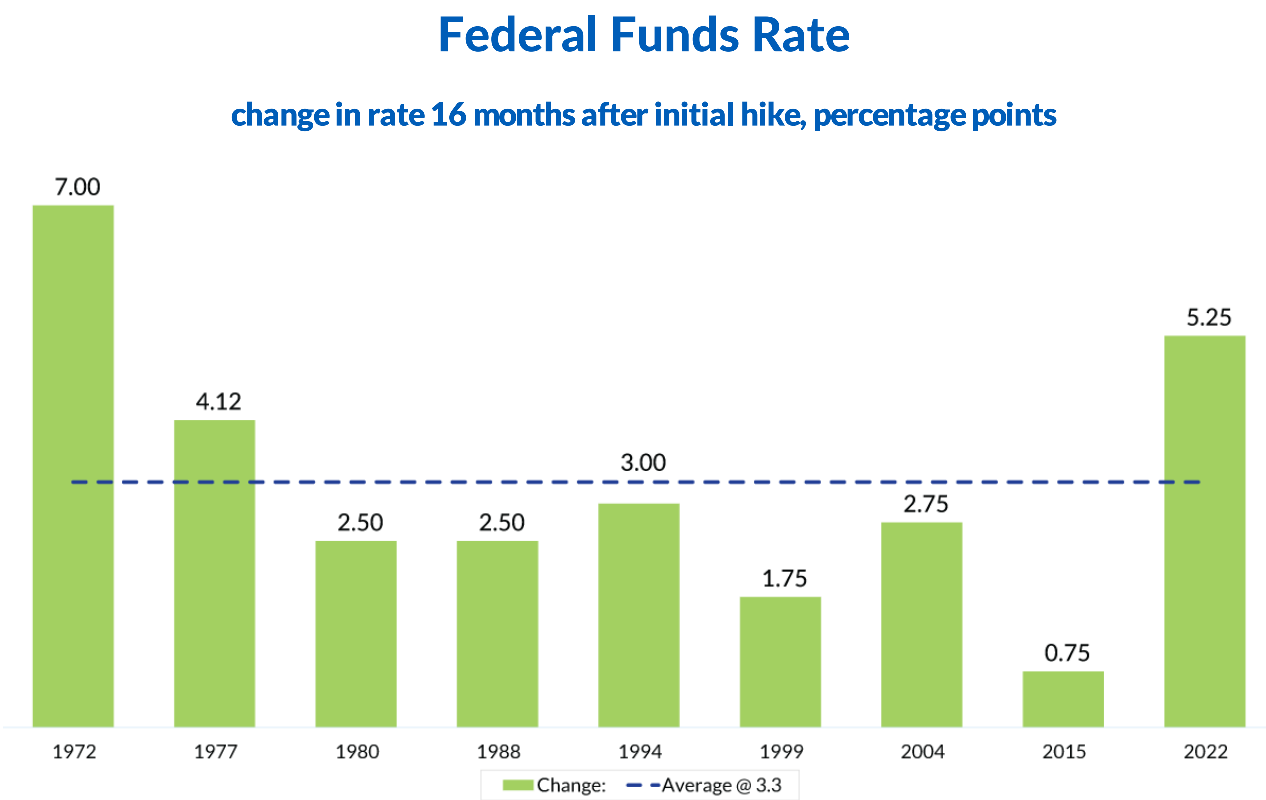
Has the Fed stopped raising interest rates?

Last month, the Federal Reserve (Fed) raised the federal funds rate by 25 basis points to the median rate of 5.375%. It was the 11th hike in the past 12 policy meetings, and now stands at the highest rate in 22 years.

The Fed is in a "fine-tuning" phase of monetary policy, and policy changes will be dependent upon incoming data, unlike most of the past year, when the goal was to bring the funds rate high enough into restrictive territory. The Fed wants time to observe how the cumulative increases in interest rates (525 basis points) will impact economic activity and inflation. They know there are lags to the impact of higher interest rates on the economy, which can vary in length. Economists refer to not committing to a direction on interest rates and making decisions on a meeting-by-meeting basis as "data dependent."

Being data-dependent means the Fed does not want to overreact. Policymakers will not have a firm view on what to do with interest rates until they get close to the next meeting – they want to maximize the optionality of their interest rate decisions based on the incoming data. The next Federal Open Market Committee (FOMC) meeting is almost two months away (September 20), and economic activity and inflation could evolve in many ways.

We think there is a high probability this may have been the last hike in this cycle. After 16 months of raising interest rates, the federal funds rate is much higher than in recent cycles (see chart). It was higher only in the 1970s, when high oil prices kept inflation elevated for an extended period. The higher interest rates will continue to slow growth.



Source: Federal Reserve as of July, 2023

Information is subject to change and is not a guarantee of future results.

Is U.S. government debt still safe after the Fitch downgrade of the credit?

Fitch downgraded the U.S. credit rating to AA+, from the top tier AAA, sighting the “erosion of governance” in the U.S. relative to other top-tier economies. The repeated political standoffs regarding the debt ceiling and the last-minute resolutions have eroded confidence in fiscal management.

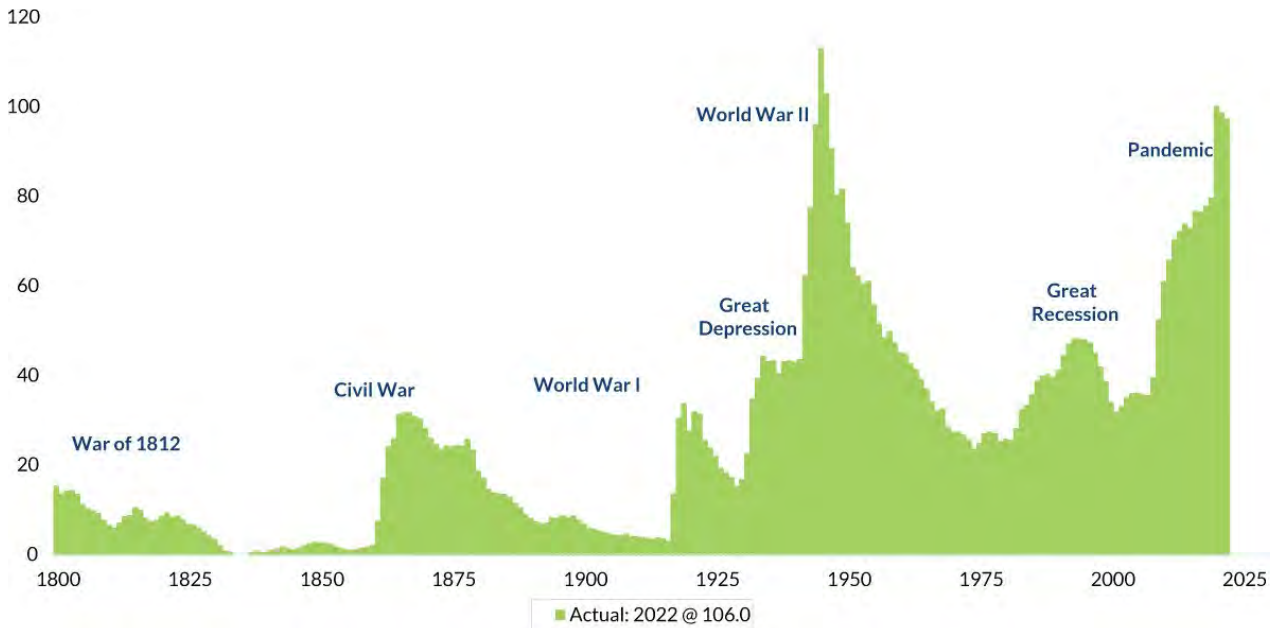
There is also a concern that expenditures are rising faster than revenue, especially with an aging population. U.S. debt, as a percent of the economy, is on track to surpass the level from World War II (see chart).

Fitch is one of three major credit rating agencies, and it, along with Standard and Poor’s, has assigned an AA+ rating to U.S. government debt. Standard and Poor’s downgraded the credit rating in 2011, following a tense debt-ceiling standoff in Congress. Moody's, the third major credit rating agency, continues to give the U.S. its strongest assessment of AAA.

The Fitch statement does not change what we already know: Investors still consider U.S. government debt to be safe, and it is the largest and most liquid market in the world.

Federal Debt

percent of Gross Domestic Product (GDP)



Source: Congressional Budget Office as of 2022

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Is this year's municipal bond performance a bright spot in the fixed-income markets?

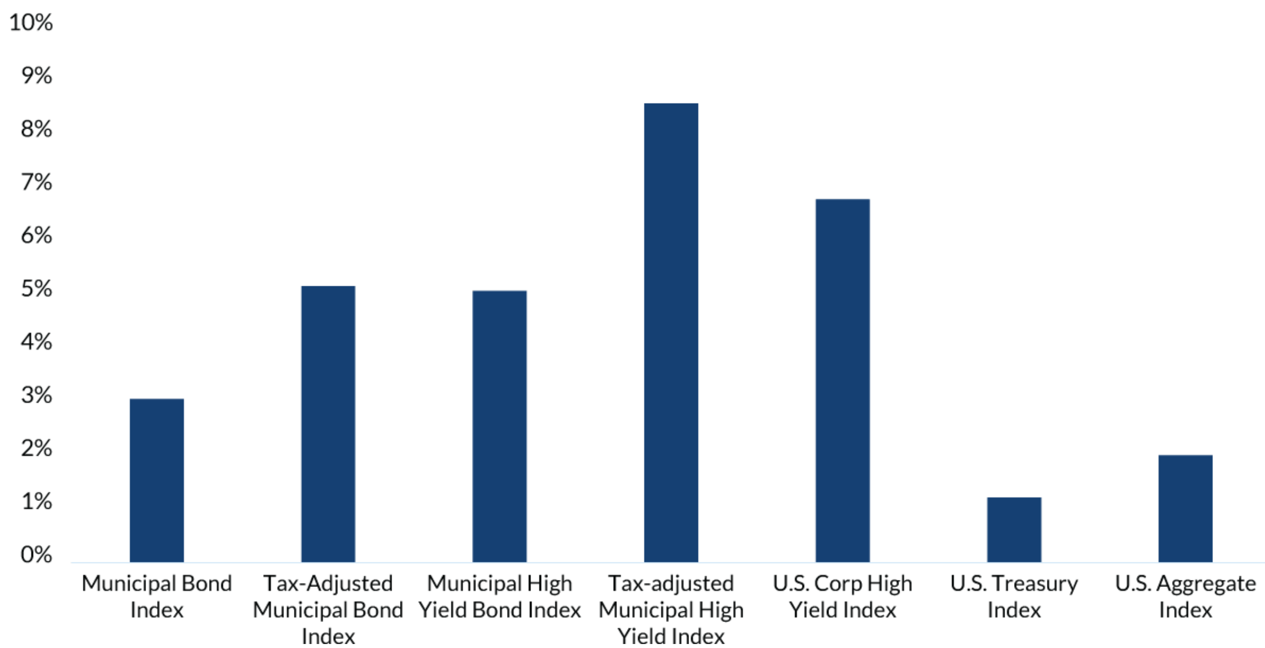
Investment grade (IG) and high-yield municipal (HYM) bonds have captured increasing attention, as their total return performance year-to-date (YTD) through July is eye-catching on an absolute and tax-adjusted basis. According to Bloomberg data, the IG broad municipal index and the HYM index increased approximately 3% and 5% YTD, respectively, with robust performance during June and July.

On a tax-adjusted basis (top federal tax + Medicare surtax), the IG and HYM Bloomberg indices' YTD performance exceeds 5% and 8%, respectively, which compares favorably versus U.S. Treasuries, U.S. Corporate High Yield and the U.S. Aggregate indices. According to index attribution, the yield income, or coupon "carry," contributed about 200 bps to the overall YTD performance (versus ~100 basis points [bps] from price movement) of IG municipal bonds.

The cushion provided by the attractive nominal yields of municipal bonds could mitigate potential rate volatility over the near term. With the yield to worst on IG and HYM indices remaining at their highest levels in at least several years, municipal investors can benefit from staying engaged in the market as income accrual has demonstrated its importance to long-term total return, based on historical data. The changes in yields along the curve vary by maturity, with shorter tenors having experienced a sharper increase in their rates (more sensitive to monetary policy) than longer-term maturities since the Fed tightening campaign started. However, with municipal market technical strength vis-à-vis constrained supply YTD, where gross issuance is lower by 15% YoY and municipal bond mutual funds have experienced more encouraging trends with more episodic inflows in recent weeks, municipal bond price support has improved.

Credit spreads have somewhat contracted, while longer-duration municipal bonds have generally outperformed. These observations are evident when looking at the components of the municipal indices (e.g., 1-5-year and 1-10-year bonds and lower quality versus higher quality). Nevertheless, with the Fed policy and the potential impact on economic conditions, municipal investors should remain cautious in security and sector selection amid moderation in fundamentals. From a seasonal standpoint, municipal bonds typically gain from heavy maturities/cash flows during summer months (e.g., August is expected to return about $48 billion to municipal investors) that could mitigate fluctuations in the rate market and help insulate performance over the short run. Municipal bonds continue to offer compelling value for long-term investors.

Fixed Income Asset Class Performance
YTD through July 2023



Source: Bloomberg as of July 31, 2023
Please see the index descriptions for more information on the indices referenced above. An index is unmanaged and is not available for direct investment.

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Is the rally in the S&P 500 sustainable?

U.S. equities continue to build on their strong first half-year performance with the S&P 500 now up 20% for the year. Fear of missing out on a new bull market has replaced caution amongst investors, despite a large number of historically reliable recession indicators still flashing warning signs.

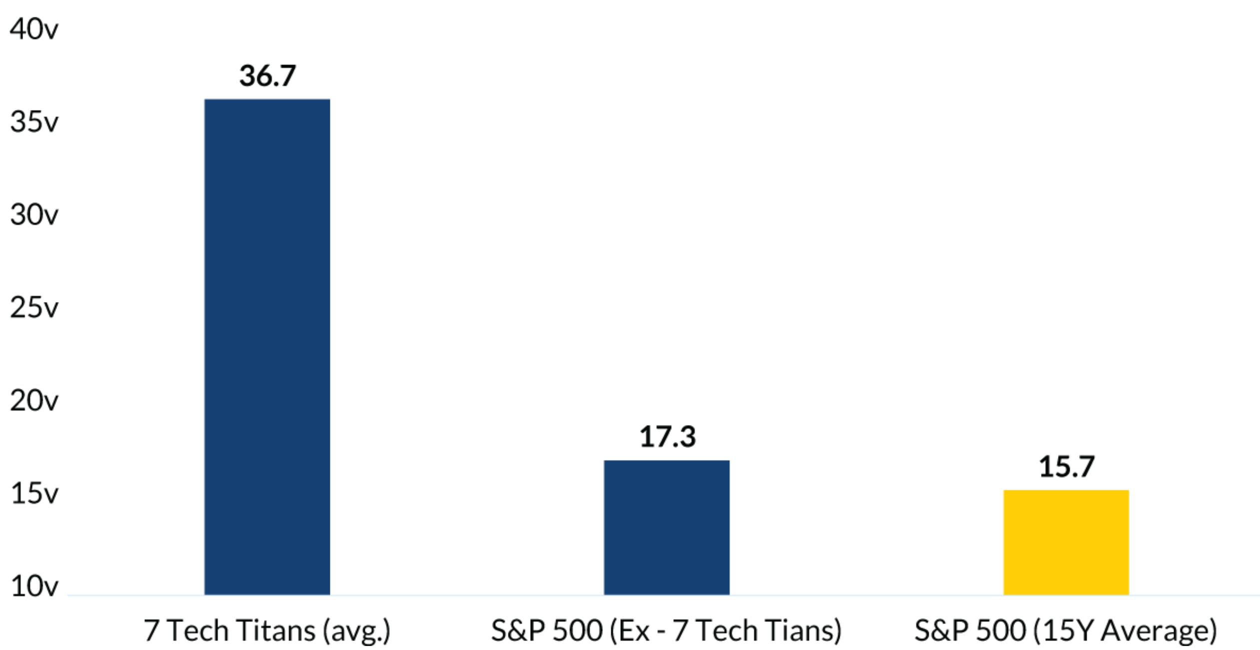
While the strength of the stock market rally so far this year has been notable, we believe talk of a new bull market is premature and that it remains too early to increase equity exposure. Overly optimistic sentiment about economic growth prospects and the future path of interest rates leaves stock prices vulnerable to a correction or pullback, and we expect a less supportive environment to develop over the second half of 2023, as the Fed keeps rates higher for longer, recessionary pressures build and earnings estimates are revised lower.

Investors' sentiment has been encouraged recently by an improvement in market breadth relative to the extreme concentration that characterized equity returns over the first half of the year. While the performance of a handful of mega-cap tech names still accounts for the lion's share of market returns so far in 2023, economically sensitive parts of the market, including small-cap stocks and cyclical sectors, have outperformed in recent weeks.

However, this broadening in participation has been accompanied by frothier investor sentiment and valuations that even outside the seven tech titans are now no longer as reasonable as they were just six months ago when compared to the historical long-term averages. Higher valuations alone do not impede future market gains, but they do create a higher perch from which to fall, should earnings results fail to meet expectations. Indeed, with consensus estimates now projecting a reacceleration in corporate growth in Q4, a slowing economy and earnings misses could be a key source of market weakness ahead.

Valuations

12 month forward P/E multiple



Sources: FactSet, CNR Research, as of July 31, 2023
The "7 Tech Titans" are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla.

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

CPI: A consumer price index (CPI) is a price index; i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated investment grade by Standard & Poor's, Moody's and/or Fitch. Bloomberg Municipal Bond Index: The Bloomberg Municipal Index covers the USD denominated long-term tax-exempt bond market.

The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. Dollar-denominated, high-yield, fixed-rate corporate bond market.

Bloomberg U.S. Municipal High-Yield Index: covers the U.S.-dollar denominated, non-investment grade, fixed-rate, municipal bond market and includes securities with ratings by Moody's, Fitch and S&P of Ba1/BB+/BB+ or below.

Bloomberg U.S. Corporate High-Yield Index: covers the U.S.-dollar denominated, non-investment grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch and S&P of Ba1/BB+/BB+ or below.

Bloomberg U.S. Treasury Index: includes all publicly issued, U.S. Treasury securities that are rated investment grade, and have $250 million or more of outstanding face value.

Bloomberg Aggregate Bond Index: comprised of U.S. government, mortgage-backed, asset-backed, and corporate fixed income securities with maturities of one year or more.