Four things for investors to remember in the second half of 2023

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Don't get distracted by the Fitch Ratings downgrade.

Fitch Ratings downgraded U.S. government credit in August, and financial media raced to document the change. However, it will have few practical effects on the financial system, according to James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management.

Institutional investors, credit agreements, and collateral requirements largely omit specific ratings information for U.S. Treasury debt. It's unlikely that a downgrade would result in market turmoil and the forced sale of assets.

In his Eagle quarterly webcast, Camp explained that the practical consequences of a U.S. credit downgrade had already played out in 2011. "None of the operational issues that could have shown up nearly a decade ago, when S&P Global downgraded U.S. debt, are going to emerge as a result of this downgrade," he said.

In Camp's opinion, investors should keep four other points in mind during the second half of the year:

- It's too early to say whether the U.S. economy is experiencing a "hard" or "soft" landing. "You cannot call 'all clear' on the economy just because we've had tightening and nothing bad has happened," Camp said. Changes in monetary policy take time to affect the entire financial system, and the real test happens after those policies have been in place for several months. "We are now just getting to tight in terms of monetary policy," Camp warned. If it takes 12 months for rate changes to permeate financial markets, then the economy has been operating at what is effectively a sub-1% federal funds rate for most of this year. The economy won't really start to "feel" more restrictive levels (i.e., a federal funds rate above 3%) until the fourth quarter.

- The inverted yield curve could still be signaling a recession ahead. After the previous eight times when the yield spread between the 10-year U.S. Treasury note and the 3-month U.S. Treasury bill (10s/3s) turned negative for at least 10 consecutive days, a recession followed – on average – just over 10 months later. "The jury is still out," Camp said, explaining that a recession in September, or even the first quarter of 2024, would still be within historical trends.

- Consumer spending may not be sustainable. In the first half of this year, consumer activity was supported by abnormally high levels of excess savings that may not be an enduring phenomenon. "People who expect their situation to get better will accumulate savings," Camp said, "and here's the key: The accumulated savings rate has completely collapsed." Plenty of data indicates that consumers more broadly are relying more on credit: U.S. credit card balances grew at their fastest pace in 20 years, and credit card delinquencies continue to increase. The recommencement of student loan payments, set to begin in October, is estimated to be equivalent to a 5% pay cut for borrowers, which will further pressure consumers to decrease spending or increase their reliance on credit.

- Inflation is still very much a concern. Camp warned that inflation is not in the rear-view mirror, and the rising costs of credit have the potential to slow activity in the housing market: Borrowers will be less willing to take out mortgages. He also noted that the costs of commodities and labor are creating inflationary pressures. "Until unemployment goes higher, and wages become subdued, the Fed will have to stay on the job," he said. June's consumer price index (CPI) data was likely the lowest print we will receive in the interim, and it is expected to see an uptick or trend sideways in the months ahead.

Overall, the current environment is not one where investors can get complacent. "It's nice to finally be getting a real return — or something close to a real return — on your cash and cash equivalents, but that is not a long-term investment," Camp said. "That is not asset allocation."

"History tells us that if the Fed continues to tighten, and it keeps its mandate as an inflation fighter, the only way to get the inflation genie back in the bottle is to have a recession," Camp said.

Camp's advice for long-term investors is to consider how previous Fed rate cycles played out: In the 1-, 3-, and 5-year periods that have followed each of the past five interest-rate tightening cycles, income assets have generally outperformed relative to cash and cash equivalents. Although some investors may currently find money market funds attractive, Camp said, "We believe that over a 12-month holding period, there are decidedly better investments for long-term asset allocation."

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Definitions:

A "soft landing" scenario is one where a central bank avoids making monetary policy decisions that cause a recession, and a "hard landing" scenario is one where a central bank fails to avoid a recession.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

Hawkish, dovish, and centrist are terms used to describe the monetary policy preferences of central bankers and others. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

Credit tightening is a decline in lending activity by financial institutions imposing stricter credit standards, usually in connection with a sudden shortage of funds.

The U.S. 3-month/10-year Curve is a bellwether indicator that measures the difference between the rates of the 3-month U.S. Treasury bill and the 10-year Treasury note. Measured in basis points, it is watched as an indicator of future economic activity and is considered to be a particularly close reflection of the effects of monetary policy on the broader economy.

The U.S. Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The U.S. Bureau of Labor Statistics bases the index on prices of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Prices are collected each month in 75 urban areas across the country from about 6,000 households and 22,000 retailers.