What the rapid rise in interest rates means for investors

And why the Fitch downgrade in a non-event in the bigger picture

August 2023

The rapid rise in interest rates spooked markets to start the month, coinciding with the Fitch Ratings downgrade of U.S. government debt, but that doesn't mean the downgrade is what's driving the rise.

Ten-year U.S. Treasury yields jumped more than 22 basis points (bps) the first few days of August and broke though some critical resistance levels around 4.09%, likely signaling more upside in the short term, said Matt Orton, CFA, Chief Market Strategist at Raymond James Investment Management. The U.S. 2/10 Curve, known as the 2s/10s, also jumped from -105.1 bps on July 24 to -70.8 bps on Aug. 3. That's a nearly 33% move in less than two trading weeks, and Orton said it has raised questions about the implications for risk assets.

First, let's start with what Orton said he believes to be a non-event. On Tuesday, Aug. 2, Fitch downgraded the U.S.'s long-term credit rating by one notch from AAA to AA+, citing its:

- Expected fiscal deterioration over the next three years;
- High and growing government debt burden; and
- Erosion of governance relative to peers over the last two decades as exemplified by the repeated last-minute debt limit standoffs.

"This sounds scarier than it is," Orton said. "Given that Fitch put the U.S. on watch during the debt ceiling standoff, this has been a 'when, not if' outcome in my opinion. I wouldn't expect any meaningful long-term market implications."

He is not alone in seeing the jump in rates having little to do with the Fitch downgrade.

"There are other things driving the Treasury market that we think are more important," said James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management, the largest of Raymond James Investment Management's boutique investment managers.

"Remember back in 2011, we had the first downgrade by S&P Global," Camp said. That triggered changes to contract language and other operational issues that had to be addressed in the wake of the downgrade, so those won't need to be done again now.

"The downgrade should be attention-grabbing for members of Congress, but from a practical standpoint it will not have any direct effect on what happens with the Treasury market," Camp said. He did note that the downgrade signals that any kind of additional fiscal policy that Congress might try to deliver in response to an economic slowdown or recession would face a "very difficult environment."

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Next, Orton said it's important to consider the context in which the downgrade occurred. Last week the Bank of Japan essentially announced the beginning of the end of its yield curve control efforts and the U.S. Treasury also announced nearly $500 billion more in issuance than expected in the third and fourth quarters. Additionally, the U.S. deficit totaled approximately $1.4 trillion in the first nine months of the current fiscal year, up 170% from the prior year. The Treasury's estimate seems to imply a deficit nearly $1.9 trillion for the full 2023 fiscal year: well above the Congressional Budget Office's estimate in May of $1.5 trillion.

"This increases the odds that we get larger (or longer) issuance into the end of the year," Orton said. "All of this adds to headwinds for rates. Add in a stronger than expected ADP® National Employment Report™ on Wednesday that showed continued robust hiring among small firms, which is seemingly at odds with regional banks pulling back on credit provision. This was a cocktail for rates to jump higher, which is exactly what we saw."

In this context, it's not surprising to see some consolidation in equities given the yield curve's degree of bear steepening, which was led by the rise of longer-maturity real rates, coupled with overextended equity sentiment and momentum.

"It's worth emphasizing that *real* rates have been increasing, and all things equal, higher real rates imply lower equity market valuations,"

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Orton said. The concern about the moves this week is that high-velocity increases in real rates tend to lead to risk-off shocks, many of which have historically been associated with monetary policy normalization as in 1994, 2004, 2010, 2011, the 2013 "taper tantrum," 2018, and 2022.

"I do not expect any prolonged equity market weakness from what we've seen thus far, especially as earnings have generally continued to come in strong, but these big moves in rates simply reinforce why we shouldn't be chasing the market higher," Orton said. "I also wouldn't be surprised if we saw a bit more weakness before the market starts to grind higher again. The S&P 500 Index is down less than 2% and is overdue for some healthy consolidation, especially as we head into a weaker seasonal period."

The forward price to earnings (P/E) ratio is 21x, which is elevated historically, especially considering where real rates are. Orton said this is all just another reason for prudent risk management: Now is a time to mind the position sizes of big winners and to cycle into higher-quality areas of the market where valuations remain attractive.

"We're seeing these companies outperform as the market of stocks catches up to the stock market, fueled by enthusiasm around earnings results," he said. And if the market does provide some much-needed consolidation, he said he would expect profitable, high free-cash-flow companies with stable earnings growth to outperform. At some point, he said, higher real rates will impact the highest-duration areas of the market where valuations have moved meaningfully over the past few months.

Yields for U.S. 30-year Treasury Inflation-Protected Securities

U.S. 2-year/10-year Yield Curve

The last time the 2s/10s curve saw such a massive steepening was during the regional banking turmoil in March. This was also the last time we had a drawdown of more than 5% in equities. Orton said he wouldn't be surprised to see a similar move if the steepening trend continues.

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Definitions

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

A resistance level represents a price point that an asset has had trouble exceeding in the time period being considered.

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.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

The U.S. 2/10 Curve, known as the 2s/10s, is a bellwether indicator that measures the difference between the rates of the 10-year U.S. Treasury bond and the 2-year Treasury note. Measured in basis points, it is watched as an indicator of where the U.S. economy is in the business cycle, as the spread typically narrows as the economy moves through the cycle, reaches a low point and may go negative near the onset of a recession, then widens again during and after a recession.

Yield curve control occurs when a central bank targets a longer-term interest rate and then buys or sells as many bonds as necessary to hit that targeted rate.

The ADP® National Employment Report™ is published monthly by the ADP Research Institute® in close collaboration with Moody's Analytics. The ADP® National Employment Report™ provides a monthly snapshot of U.S. nonfarm private sector Employment based on actual transactional payroll data.

Bear steepening takes place when long-term interest rates rise faster than short-term rates and cause the yield curve to widen.

A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor. A real interest rate reflects the rate of time preference for current goods over future goods. For an investment, a real interest rate is calculated as the difference between the nominal interest rate, which is not adjusted for inflation, and the inflation rate.

Consolidation is a term used in technical analysis to describe when stocks reverse previous gains (or losses) to stay within well-defined trading levels.

Price-to-earnings (P/E) ratios measure a company's current share price relative to its earnings per share. The ratio is used to help assess a company's value and is sometimes referred to as the price multiple or earnings multiple.

Bond Ratings: Ratings are by Moody's, S&P, and/or Fitch. Ratings provided by nationally recognized statistical rating organizations, also called ratings agencies, are appraisals of a particular issuer's creditworthiness, including the possibility that the issuer will not be able to pay interest or repay principal. Ratings are not recommendations to buy, sell or hold a security, nor do ratings remove market risk. Securities with the same rating can actually trade at significantly different prices. In addition, ratings are subject to review, revision, suspension, reduction or withdrawal at any time, and a rating agency may place an issuer under review or credit watch. Additionally, Fitch reports are available for municipal bonds. More about ratings is available at moodys.com, standardandpoors.com, and fitchratings.com.

Equity duration is the cash-flow weighted average time at which investors can expect to receive the cash flows from their investment in a company's stock. Long-duration stocks include fast-growing technology companies, including those that may not pay any dividends in their early years, while short-duration stocks tend to be more mature companies with higher ratios to dividend to price.

U.S. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The principal of a TIPS instrument increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, investors are paid the adjusted principal or original principal, whichever is greater.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

Contact us at **800.521.1195** or visit **RJInvestmentManagement.com** for more investment insights.

RAYMOND JAMES | INVESTMENT MANAGEMENT

880 Carillon Parkway | St. Petersburg, FL 33716 | 1.800.521.1195 | RJInvestmentManagement.com

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