HIGHLAND

Multi-Asset Solutions Weekly Commentary

October 23, 2023

Key Observations

- Stocks fell across the board last week as solid, albeit underwhelming earnings results and the continued rise in Treasury yields weighed on investor risk appetite. U.S. equity indices outperformed developed and emerging markets abroad by a meaningful margin, but there were few places to hide.

- Two areas that delivered a positive absolute return were energy stocks and gold, both of which have been beneficiaries of the unrest in the Middle East. Consumer staples stocks were also a strong relative performer, driven by better than feared earnings results out of some bellwether names as forward guidance on profit margins proved better than feared.

- Treasury yields rose sharply last week, with the 10-year and 30-year yield each ending the week at levels last seen in 2007. The unsettling jump in Treasury yields weighed heavily on investment-grade corporate bonds while lower quality, high yield corporates fared much better.

What We're Watching

- U.S. Purchasing Managers Index (PMI) for October is released Tuesday with a Composite reading of 50.0 expected, a modest fall from 50.2 in September. Manufacturing PMI is expected to fall to 49.5 from 49.8 in September, while the Services PMI is expected to drop from 50.1 the prior month to 49.9. A reading above 50 implies growth/expansion, below 50 contraction.

- Eurozone PMI for October is released on Tuesday and the Composite reading is expected to rise slightly to 47.4 from 47.2 the prior month. Manufacturing PMI is expected to rise to 43.7 from 43.4 in September, while Services PMI is expected to rise to 48.8 from 48.7. A 'less bad' Eurozone PMI reading for October could be enough to stem the tide of selling across the pond.

- September Personal Consumption Expenditure (PCE), the FOMC's preferred inflation gauge, is slated for release Friday and volatility in U.S. Treasury yields is likely to persist as a result. PCE Deflator is expected to have risen 3.4% year over year in September, just below the 3.5% reading from August, while core PCE Deflator is expected to show a 3.7% year over year increase, down from 3.9% in August. If the core PCE Deflator comes in below 3.7%, yields on long dated U.S. Treasuries could retrace some of the recent move higher in short order.

	Price/Yield			Total Return (%)			
	10/20/23	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	33127.28	-1.57	-3.72	1.70	11.61	7.54	7.83
S&P 500	4224.16	-2.38	-3.94	11.90	17.15	8.72	10.79
NASDAQ	12983.81	-3.16	-3.57	25.82	23.42	4.92	12.71
Russell 2000 Index	1680.79	-2.25	-7.03	-2.86	0.13	2.57	3.12
MSCI World ex US	279.96	-2.58	-6.11	1.98	15.74	2.19	3.82
MSCI EM	925.58	-2.69	-4.59	-0.77	10.26	-3.86	1.60
Bloomberg US Aggregate	5.67	-1.73	-3.19	-3.48	1.25	-5.74	-0.12
Bloomberg Global Aggregate	4.38	-1.01	-2.72	-3.82	3.04	-7.52	-1.71
Bloomberg US Corporate	6.37	-2.06	-3.75	-2.58	3.93	-5.72	0.71
Bloomberg 10-Year Muni	4.48	-1.42	-3.24	-2.32	1.13	-2.46	1.01
Bloomberg High Yield	9.44	-1.17	-2.72	3.38	7.57	0.62	2.77
				Price/Yield			
	10/20/23	1 Week Ago	1 Month Ago	12/31/22	1 Year Ago	3 Years Ago	5 Years Ago
SOFR (yield)	5.30	5.31	5.30	4.30	3.03	0.08	2.19
30 Year Mortgage (average rate)	8.01	7.80	7.59	6.66	7.32	3.04	4.75
2 Year Treasury (yield)	5.11	5.05	5.18	4.43	4.61	0.14	2.90
10 Year Treasury (yield)	4.96	4.61	4.41	3.87	4.23	0.79	3.19
30 Year Treasury (yield)	5.12	4.75	4.44	3.96	4.22	1.59	3.38
WTI Crude (closing price)	88.75	87.69	90.28	80.26	85.89	41.46	69.12
Brent Crude (closing price)	92.16	90.89	93.53	85.91	92.38	43.16	79.78
Gold (NYM $/oz)	1982.50	1927.40	1948.60	1826.20	1630.80	1910.40	1225.30

Source: Bloomberg (3- and 5-Year Returns Annualized)

What Happened Last Week:

▲ Stocks: Equal Weight S&P 500 (Narrowly) Outperforms On The Week, Despite Defensive Market Tone; Developed Markets Abroad Dinged By Higher Interest Rates, Stubborn Inflation; Gold: The Current Safe Haven Of Choice.

Equally Weighted S&P 500 (Narrowly) Outpaces The Cap-Weighted Version On The Week. It's no secret that the S&P 500 has been buoyed by its top 7 to 10 holdings year-to-date, generating sizable outperformance relative to the equal-weighted S&P 500 which puts each stock in the index, independent of market capitalization, on equal footing. Last week the market-cap weighted index, perhaps surprisingly given the more defensive market tone, lagged its equal weighted counterpart. Looking back, the market cap-weighted S&P 500 underperformed during other recent periods of stress, including back in March when interest rates fell as SVB and Signature Bank failed. In fact, the S&P 500 has now generated a negative weekly return 19 times this calendar year, and the equal-weighted index outperformed in 14 of the 19 instances, a notable display of the benefits of diversification despite what is a wide gap in performance year-to-date. With small cap stocks performing poorly year-to-date, it's safe to say the bias toward smaller capitalization companies has been working against the S&P Equal Weight index, and given our expectation that the U.S. economy will weaken over coming quarters, we doubt that outperformance out of the equal weight index will prove durable as capital is likely to find its way back into mega-cap growth stocks with strong balance sheets at the expense of everything else.

Defensive Leadership Tone Continues. Traditionally defensive sectors, specifically, consumer staples, health care, and utilities, outperformed the S&P 500 last week, but only one out of the three – health care, has also outperformed month-to-date. Individual company debt burdens and refinancing risks should be top-of mind for investors, particularly if interest rates hold at/near higher levels as utilities, and biotechnology companies in the health care sector, specifically, often rely on debt financing to fund operations, and the rising cost of that debt will weigh on free cash flow, profitability, and likely the return of capital to investors moving forward, which will likely increase the importance of security/stock selection in these sectors.

Developed Markets Abroad Dinged By Rising Rates, Stubborn Inflation. Equity markets abroad faced headwinds on multiple fronts last week as interest rates continued to rise sharply, with U.S. Treasuries leading the way, while fears of inflation reaccelerating in the U.K. and Eurozone came closer to being realized. The MSCI EAFE developed markets index ended the week lower by 2.6% with a hotter than expected U.K. consumer price index (CPI) for September the primary culprit as the 6.7% year-over-year reading was in-line with August and above the 6.5% expected, which pointed toward inflation remaining sticky at a time when the Bank of England is believed to be done tightening monetary policy. The U.K. CPI reading increases the odds of stagflation taking root in the U.K., and perhaps the Eurozone at-large over coming months and limits investor demand for Eurozone and U.K. equities. Weakness out of Eurozone and U.K. indices are nothing new, but last week's pullback in Japanese equities, which have been an outperformer year-to-date is more noteworthy. The Nikkei225 index ended the week lower by 3.2% as core CPI came in modestly above estimates for September and the Bank of Japan (BoJ) intervened, buying government bonds to prevent a spike in yields and to support the yen. We expect market participants to continue challenging the BoJ on this front, which could lead to a readjustment to yield curve control around year-end, which would likely put downward pressure on investor risk appetite and Japanese equities in the process.

Almost All That Glittered Last Week Was Gold. Gold has been on an incredible run with the price per ounce rising 2.7% last week and 8.8% just since October 5. The traditional safe haven asset has benefitted from investors shunning the bond market due to rising yields and as a preferred port in the geopolitical storm due to Hamas' attack on Israel. While gold has been a great place to have capital allocated of late, it isn't without its tradeoffs as the precious metal doesn't generate income and can be costly to store, among its less attractive traits, and with real, or after inflation yields on U.S. Treasuries north of 2% on most maturities, at some point, capital will shift out of gold and find its way back into high quality bonds. With that said, if held through more liquid instruments such as exchange traded funds (ETFs) that track the price of gold, and sized appropriately at 2% to 3% of assets, an allocation may make sense as an inflation diversification tool, but we would not advocate for larger allocations as heightened volatility, the lack of income generation, and limited total return potential must be considered.

▲ Bonds: "Sell First, Ask Questions Later" Remains The Mantra For Fixed Income Investors; "Strong" September Retail Sales Less Than Meets The Eye; Market Spurs The Bank Of Japan To Intervene Again.

Retail Sales, Powell Remarks Push 10-Year Treasury Yield To Within A Stone's Throw Of 5%. On the heels of the September retail sales release on Tuesday, yields on long-term U.S. Treasuries rose sharply, with the 10-year yield, specifically, rising 12 basis points on the day to 4.83% as rate hike expectations rose modestly for both December and January. FOMC Chair Jerome Powell's remarks at the Economic Club of New York on Thursday served to put additional upward pressure on Treasury yields with the 10-year yield touching 4.99% as he left the Committee's options open and stated that "inflation remains too high and that it will take more than a few months of good data to build confidence that it is moving sustainably toward 2%." Recent comments made by FOMC members pointing to the rise in long-term Treasury yields doing the Committee's job for it implies to us that a hike in November is unlikely and Fed funds futures agree with that assessment as they price in a less than 10% chance of a hike early next month. However, in the wake of the retail sales data and Chair Powell's remarks last week, the odds of a quarter-point rate hike in December or January rose and as of the end of last week were around a coin-flip. The FOMC is keeping markets guessing as to whether it will or won't hike further, but with the 10-year Treasury yield ending last week at 4.95%, we believe the Committee is done, barring a sharp drop in Treasury yields leading up to the FOMC's December meeting.

The Devil Is In The Details On Retail Sales. September retail sales were released last Tuesday and, on the surface, surprised to the upside in a big way, rising 0.7% month over month, well above the 0.3% estimate. Excluding motor vehicle sales, retail sales still rose 0.6% month over month, easily surpassing the 0.2% estimate. The September retail sales data does point toward a resilient U.S. consumer, but the devil is in the details and seasonal adjustment effects were a major contributor to the beat relative to consensus. Seasonal adjustment noise aside, the U.S. consumer continues to spend, keeping upward pressure on prices of both goods and services, and presenting the Federal Open Market Committee (FOMC) with questions surrounding whether monetary policy is as sufficiently restrictive as some Committee members believe.

Bank Of Japan Forced To Intervene Again, Buys Bonds To Stem Rising Yields. Yields on Japanese Government Bonds (JGBs) were again on the rise last week, with the yield on 5-year JGBs, specifically, rising to its highest level in a decade before the BoJ stepped in with an unscheduled bond-purchase operation that forced yields across the curve lower. The BoJ is consistently being challenged by the market to keep a lid on rates and wants to make further adjustments to its yield curve control program on its own time without market participants forcing it to do so before it is ready. Yield curve control will likely be tweaked again in the coming months, and with Japan's central bank allowing yields to move higher still, there will likely be continued upward pressure on global sovereign bond yields as a result.

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