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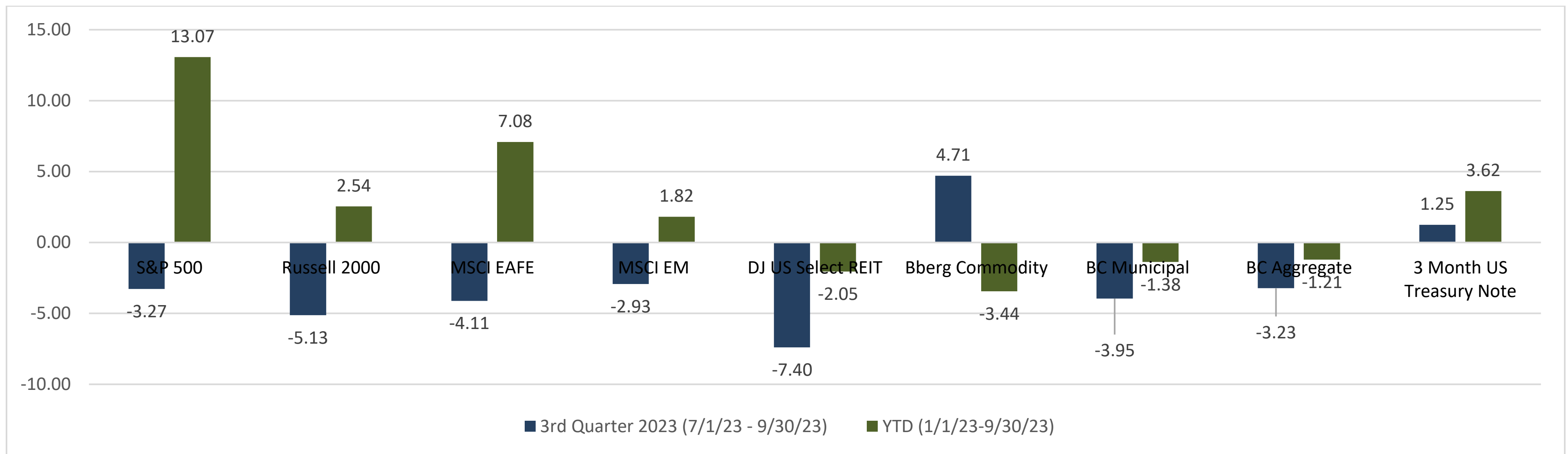
Interest Rates & Artificial Intelligence:
Two Competing Themes Driving Capital Markets

Schneider Downs Wealth Management Advisors, LP

Q3 2023 Market Commentary



It is hard to start this letter recapping the third quarter in capital markets without first addressing the heinous attack on Israel by the terrorist group, Hamas. While this event happened in early October, we would be remiss without opening this letter by sending our heartfelt thoughts and prayers to the Israeli people as they grieve the loss of loved ones and embark on a military mission to defend their country in response to this deadly attack.

Capital markets continued to grapple with what has become the dominant two-part question of the past 18 to 24 months: how much higher will the U.S. Federal Reserve raise interest rates, and how long will they keep them there? Market participants continued to struggle to price risk assets as incoming data points were often in conflict with one another. A prime example of the conflicting data that has flummoxed the market was the downward movement in the annualized inflation rate, which moved into the 3%-4% range, and the price of oil, which surged to a 52 week high of $95 a barrel in late September. The U.S. Federal Reserve's preferred measure of inflation excludes volatile items like food and energy; however, it is hard to ignore a surge in oil prices as the cost of energy reverberates through the entire economy. A combination of an interest rate hike in the summer[1] and investors demanding more compensation amid an uncertain macroeconomic environment led yields to sharply rise up across the maturity curve to 15-20 year highs. As the chart above illustrates, the only two major asset classes that had positive performance for the quarter were commodities (positive performance almost entirely attributed to energy prices) and short-term U.S. treasuries. Outside of commodities and U.S. treasury bills, every major asset class had a negative return for the quarter, with the most interest-rate-sensitive securities (REITs, Russell 2000, Municipal Bonds, and Barclays U.S. Aggregate Bonds) struggling the most.

In our opinion, playing the game of trying to construct portfolios and asset allocations to align with U.S. Federal Reserve decisions is a fools errand. For one, the eight members of the Federal Open Market Committee who have voting rights to set the level of interest rates, are not aligned on what to do with the level of interest rates. In some cases, they openly contradict one another within hours of speaking; in others, they reserve the right to

[1] https://www.forbes.com/advisor/investing/fed-funds-rate-history/

change their mind completely.[2][3][4] Second, the level of interest rates is subject to change based on exogenous events like we are seeing unfold in Israel that are impossible to predict. Short-term U.S. treasuries (and investments like money market funds that invest in short term debt instruments) offer higher yields that are attractive, especially in these uncertain times. However, zooming out to gain a bigger picture view of the backdrop, valuations[5] in the intermediate-term part of the yield curve (5-7 years) look especially attractive and lock in yields for significantly longer periods than shorter-term instruments like money market funds and treasury bills.

At SDWMA, we believe that core fixed income should be the ballast of our portfolios. Our belief in core fixed income is in part because it generates attractive yield (in the case of municiapls, tax-free yield), but also because core fixed income has the ability to appreciate when risk assets like stocks come under downward pressure. High-quality core fixed income works like a seesaw; when yields go up, prices go down, and vice versa. After the great yield reset in 2022, intermediate-term high-quality fixed income is now offering the most compelling yields in 15-20 years; if you look at the broad investment grade corporate bond universe, comprised entirely of bonds rated BBB or better, you can lock in an annual yield north of 6% for over eight years; compare that with U.S. treasuries where you can earn ~5% annualized for two years. Investors aren't wrong to consider taking the quick 5% annualized return for two years in the U.S. treasury bill and handle the reinvestment of interest and proceeds in 2025. However, we believe that the market is presenting an opportunity that comes around once or twice in a 15-20 year period in core fixed income, which is why we have maintained an allocation to short- and intermediate-term fixed income in client portfolios.

Transitioning from fixed income and interest rates, the second (and divergent) theme driving capital markets is artificial intelligence. As we discussed in the opening paragraphs, the pricing of risk assets was complicated by the rapid rise in yields in the third quarter. Almost every asset class has been negatively affected by interest rates: REITs (the amount of debt and value of real estate assets, especially office space, has weighed heavily), U.S. medium and small-cap stocks (a large population of banks and companies dependent on floating rate debt), and emerging market stocks and bonds (exposure to U.S. dollar and interest rate financing) with the exception of the S&P 500. To be more specific, seven stocks in the S&P 500 (Apple, Amazon, Google Class A and B, Nvidia, Meta/Facebook, and Tesla) have been deemed immune from concerns about interest rates, inflation, and an economic slowdown in the U.S. These seven stocks have generated virtually all of the gains in the S&P 500 through the first three quarters of the year. They represent, in the minds of a portion of the investment community, the most direct way to play the coming "artificial intelligence" boom. Despite increasingly expensive valuations, earnings reports that were good (beating expectations that were low coming off of 2022), and growing to over 31% of the S&P 500 index (despite contributing only 22% of S&P 500 Earnings),[6] these stocks have been mostly immune to the downward pressure on risk assets.

Given the very concentrated performance in the U.S. equity market, and keeping with the previous paragraph about zooming out for perspective, we believe another opportunity akin to high-quality fixed income is presenting itself in the equity markets. While the "Magnificent Seven" stocks are trading at historically expensive valuations, U.S. medium and small-sized stocks are trading at very attractive valuations relative to their respective histories. U.S. medium and small-sized companies do not have the same glitz and glamour of a Tesla or NVIDIA, but the forward looking returns

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[2] https://www.reuters.com/business/finance/feds-mester-not-ready-accept-recent-inflation-surge-meeting-central-banks-goal-2021-08-30/
[3] https://www.bloomberg.com/news/articles/2023-10-03/fed-s-mester-says-steady-economy-could-warrant-november-hike
[4] Loretta Mester, who is in charge of the Cleveland branch of the Federal Reserve that encompasses Ohio, Pittsburgh, and parts of Kentucky and West Virginia was the biggest dove in 2020 and 2021, seeing the need for only one interest rate hike in 2022. Now she is among the biggest hawks on interest rates, suggesting the need for future rate hikes as recently as last week.
[5] When we talk about valuations of fixed income, we are referring to the level of yield and amount of years we can earn that yield for.
[6] https://am.jpmorgan.com/us/en/asset-management/protected/adv/insights/market-insights/guide-to-the-markets/ September 30, 2023.

when an investor buys around twelve times forward earnings are very good. In addition, where the broad U.S. large cap market has taken only a modest step back, U.S. medium and small-sized markets are trading close to flat on the year, suggesting that a significant amount of the rerating in these asset classes has already occurred. Stepping outside of the U.S., international stocks are trading near twenty-year lows relative to their U.S. peers, despite showing surprisingly strong results amid a difficult macroecnomic background. Specifically, international developed stocks have generated the second best performance of the year in terms of major equity asset classes, but still trade well below their 25-year median valuation level.

The past 21 months have been a whipsaw for investors. On one hand, the time of this writing marks the one year anniversary when most broad stock markets hit bottom; a good thing for investors as the account balances of their portfolios has risen. On the other hand, there is significant uncertainty around the sustainability of U.S. economic growth, the level of inflation, the duration of time interest rates will stay elevated, and now the prospect of a prolonged war in the Middle East. Markets may now expect or demand that the "Magnificent 7" and other companies demonstrate that the prospect of gains from artificial intelligence are realized in the form of increased profitability and margins. In our view, the way forward will be for clients to maintain diversified portfolios; take advantage of the yields offered by high-quality fixed income, and that the next incremental dollar allocated toward risk assets go to attractively-valued securities like U.S. mid and small-cap stocks and non-U.S. dollar assets like international developed stocks. In the short term, it may seem prudent to throw in the towel, own seven mega cap technology stocks and short-term U.S. treasury bills, and call it a day. We think that strategy ignores the very compelling opportunities presented in areas of the market that aren't discussed on Bloomberg or CNBC, and history which suggests that such narrow leadership of markets has a finite shelf life.

As always we thank you for the trust you have placed in us to help guide your portfolio and investments through these interesting times we find ourselves in. Given the level of uncertainty in markets (and the world), it is normal to feel uneasy about your portfolio; the uneasy feeling you have is not uncommon or unwarranted. The SDWMA team wants to remind you that we are here to talk you through these difficult times in markets, to make sure you are still on track to achieve your goals and objectives, and help you remain calm amid the proverbial tumultous seas. We look forward to seeing you in person or over a Zoom/Teams screen soon. In the meantime, if you have any questions or concerns, please reach out to your SDWMA advisor. Thank you and have a wonderful start to fall!

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