MONTHLY UPDATE

CARY STREET PARTNERS

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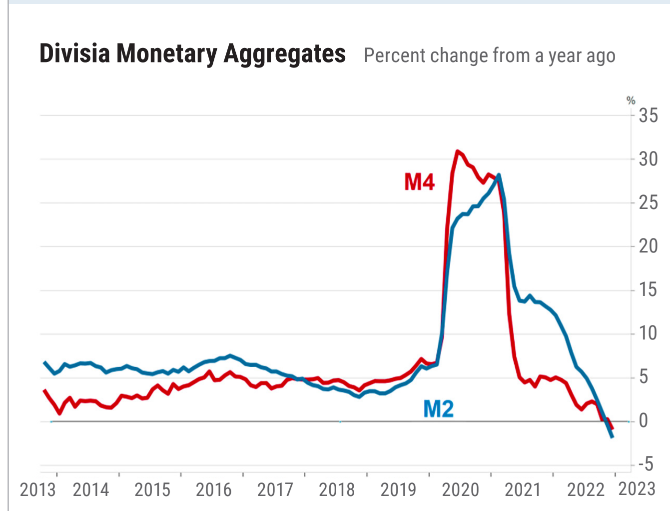
Last month we highlighted the strong relationship between calmer yields and better risk returns. That dynamic held in place from late October until approximately three weeks ago. Since that point, markets have been rattled as yields, measured by the 10-year Treasury bond, retraced higher from around 3.25% to a current 3.95%[1]. In other words, the opposite market backdrop: more volatile bond markets equaling poor risk asset performance. Both stocks and bonds have had a tough month, with the S&P 500 Index giving up about two-thirds of its YTD gain and the US Aggregate Bond Index giving up virtually all of its YTD gain. Within stocks, the mega-cap growth leaders in January have proven weakest. Those sectors (technology, consumer discretionary, and communications) are long-duration in nature and particularly sensitive to yields, benefiting when they decline and suffering when they move up. The best attribute of current market conditions is that the move in the 10-year Treasury yield has been very steep, which typically leads to exhaustion. That provides rationale for the 10 to at least consolidate around current levels. A move higher is also likely to be met with large, institutional buy-side pressure as those purchasers see value in long-duration bonds when real yields approach 2%, around trend GDP. The current 10-year real yield is a little over 1.5%, defining a potential top around 4.25 to 4.5%, much as we saw in October. Bond price and yield move opposite.

It's been decades since we've seen dramatic changes in the monetary aggregates.



Source: Macrobond

Yields have reacted to hotter-than-expected January inflation data released in February. While inflation is trending lower, this process will not be linear, and the pace and size of the decline are still up in the air. The S&P 500 Index is currently sitting at 3970, about 1.75% above initial support at 3900. This support level is not a major level. A successful break below that level results in a trading range that could reach down to 3500, the major support tested in October. Holding 3900 will be predicated a lot on the 10-year calming down short term. Additionally, sentiment remains complacent and has a great deal of room to get worse, adding to downside pressure. Sentiment is contrarian and inverse to equity returns.

Inflation was triggered by the Federal Reserve keeping the monetary spigots on far too long coming out of the pandemic. While the Fed should be commended for its approach early in the pandemic, continuing to print money well into last year was a huge mistake. Monetary aggregates are typically boring and not that meaningful, with money supply growing about 5% per year. But monetary expansion on the scale seen in 2020 until Q2 2022 leads to inflation. Related data to money supply are nominal GDP and excess savings, both skyrocketed. Good news — money supply growth has been zero since last March, recently even becoming negative. This ultimately brings inflation down. Nominal GDP is also much lower. Bad news — the scale of increase is so large that this will take some time. The consumer really is not reacting to inflation yet and continuing to spend the $2.5 trillion accumulated in excess savings during the money printing bonanza. This figure is now roughly half its peak, but it's estimated this cash hoard will last about another ten months assuming the consumer spends at current rates. Our base case for inflation is a dis-inflationary trend that reaches mid-single digits by mid-year.

We see a good case for risk assets to have a good 2023, especially the second half. The typical 60/40 stock/bond blend likely has a better year, but these assets are no longer non-correlated. This is still a higher volatility market. In 2022 we had 108 days of +/- 2% moves compared to an average of 38 over the preceding 33 years. This is why we have favored hedging strategies (often with high income) for over two years as an additional diversifier for portfolios. In a structurally higher inflation world dominated by yield movements, stocks and bonds move together. Everything is completely different from recent decades, especially the post-Great Financial Crisis period that ranged from 2009 to 2021.

[1] *Morningstar*

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