ACIMA
PRIVATE WEALTH

ECONOMIC & INVESTMENT PERSPECTIVES

September 1, 2023

AUGUST: MARKET VOLATILITY RETURNS
BAD NEWS IS GOOD NEWS?

Figure 1: 8/31/2023 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.6%	1.6%	-1.1%	-4.4%	3.9%
Investment Grade Corp Bonds	LQD	-1.2%	3.0%	0.9%	-5.6%	7.9%
U.S. Treasury Bonds	GOVT	-0.5%	1.0%	-1.9%	-4.7%	2.1%
U.S. 20+ YR Treasuries	TLT	-3.1%	-1.1%	-11.0%	-14.7%	5.2%
Muni Bonds	MUB	-0.8%	1.5%	2.3%	-2.9%	4.1%
US High Yield	HYG	0.2%	5.8%	7.0%	-2.7%	6.9%
Non-US Corp Bonds	IBND	-1.2%	3.8%	8.3%	-3.9%	17.6%
Emerging Markets Bond LC	EMLC	-2.5%	7.3%	10.7%	-3.7%	12.3%
Global Equity						
ACWI Global Equity	ACWI	-2.9%	14.9%	14.4%	-3.0%	27.5%
ACWI Global Equity ex US	ACWX	-4.8%	8.8%	12.8%	-5.0%	25.5%
International Developed	EFA	-3.9%	11.0%	18.5%	-4.3%	31.0%
Emerging Markets	EEM	-6.6%	4.2%	1.6%	-7.9%	17.0%
Global Equity by Region						
United States	VTI	-1.9%	18.1%	14.7%	-2.2%	28.1%
Europe	IEUR	-3.9%	11.9%	22.4%	-5.2%	34.8%
Asia ex-Japan	AAXJ	-7.0%	1.8%	-0.3%	-10.0%	20.9%
China	MCHI	-9.8%	-4.6%	-7.4%	-19.9%	28.8%
Japan	BBJP	-2.7%	14.5%	16.6%	-3.7%	28.9%
Latin America	ILF	-8.3%	16.1%	18.2%	-8.6%	20.0%
US Equity						
US S&P 500	IVV	-1.6%	18.7%	15.9%	-2.0%	29.5%
NASDAQ 100 QQQ	QQQ	-1.5%	42.4%	27.2%	-2.6%	48.7%
US Large Growth	IWF	-1.0%	32.1%	21.7%	-1.8%	39.5%
US Large Value	IWD	-2.7%	5.8%	8.4%	-3.2%	18.6%
US Eqwt S&P 500	RSP	-3.2%	7.1%	8.4%	-3.8%	20.0%
US Mid Cap	IJH	-3.0%	10.0%	10.7%	-3.4%	21.6%
US Small Cap	VTWO	-5.1%	9.0%	4.7%	-5.2%	16.1%

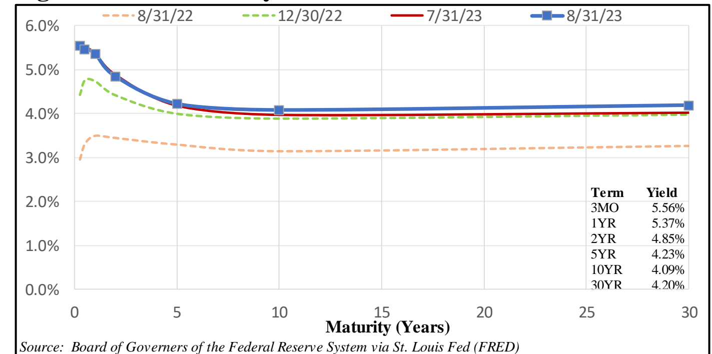
Volatility returned in August. Strong economic data initially led to fears of further interest rate hikes (negative for stock and bond prices), but markets rebounded after softer growth and employment data in the final week helped ease those fears. Performance highlights for the month and YTD are summarized below.

- Bonds: The US Aggregate index (AGG) was down 0.6% in August (+1.6% YTD) as interest rates ticked higher. Long-term Treasuries (TLT), which are highly sensitive to interest rate changes, lost 3.1% (-1.1% YTD). Corporate bonds (LQD) fell 1.2% (+3.0% YTD), but high yield bonds (HYG) rose 0.2% (+5.8% YTD). Non-U.S. bonds (IBND and EMLC) under-performed this month as the US dollar strengthened marginally.
- Global equities (ACWI) fell 2.9% in August (+14.9% YTD).
- U.S. Equity: The broad market (VTI) fell 1.9% (+18.1% YTD), and the S&P 500 (IVV) fell 1.6% (+18.7% YTD). Small (VTWO) and mid-cap stocks (IJH) under-performed in August and remain well behind large growth-oriented stocks this year; the Nasdaq 100 (QQQ) is still up 42.4% YTD! All sectors logged negative returns for the month except energy (XLE), which rose 1.6% as the price of oil spiked above $83 per barrel.
- Non-U.S. Equity: Developed market stocks (EFA) fell 3.9% (+11.0% YTD) with losses in Europe (IEUR) and Japan (BBJP). Emerging markets (EEM) fell 6.6% (+4.2% YTD); Chinese stocks (MCHI) lost 9.8% (-4.6% YTD) as their economic recovery falters, and Latin American stocks (ILF) lost 8.3%, giving back some of this year's gains (+16.1% YTD).

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. Interest rates crept higher in August on fears that continued economic strength (strong employment and GDP growth) increases the likelihood that rates will remain high for longer, but the inverted curve (short-term yields higher than long-term yields) continues to warn of recession. The 10-year Treasury now yields 4.09%.

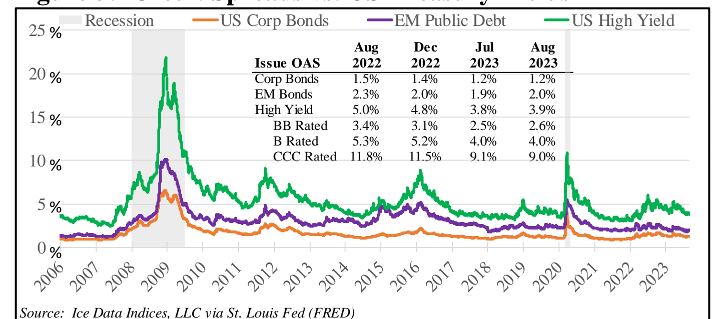
Figure 2: US Treasury Yield Curve



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads widened marginally in August but remain at historically low levels.

- Investment grade corporate bond spreads were stable at +1.2% but have marched incrementally lower over the past year.
- High yield (non-investment grade) spreads were widened to +3.9% this month but are well below year-ago spreads of +5.0%. The riskiest bonds (rated CCC & below) have declined over the past year and now yield +9.0% over Treasuries.
- Emerging market bond spreads have widened marginally, now yielding an average of +2.0% over US Treasuries. Returns on non-US bonds have been strong in 2023 as credit spreads fell and global currencies strengthened versus the US dollar.

Figure 3: Credit Spreads vs. US Treasury Yields



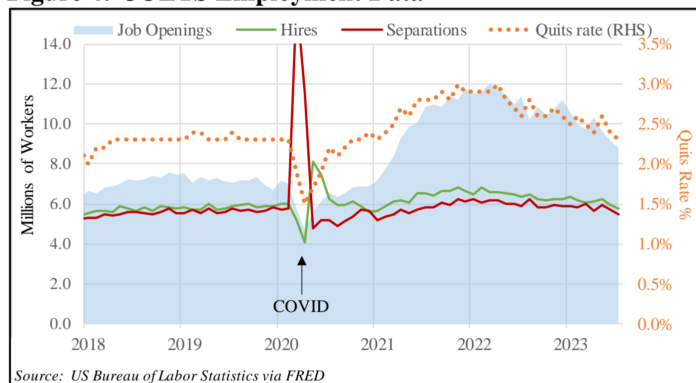
Bad News Is Good News

Volatility returned to the markets in August as investors continued to be hyper-focused on the path of interest rates going forward. While rising interest rates negatively impact bond prices directly (rising yields cause bond prices to fall), the impact on stocks includes the direct impact on valuations (decreasing the present value of future earnings) as well as the subjective concern that the Fed may go too far and push the economy into recession. Each new economic data point is viewed through the lens of how it influences the Fed's future interest rate decisions.

Perhaps counter-intuitively, good economic news has become bad news for the markets, because economic strength implies further Fed tightening (higher interest rates for a longer time). Data released in late July and early August indicated that the US economy continues to be strong and resilient, including stronger-than-expected growth (annualized real GDP growth of +2.4% in the second quarter) and continued strength in the labor market (strong job growth, low unemployment). Markets sold off as interest rates and expectations moved higher. Economic data turned weaker later in the month: Q2 real GDP growth was revised down to +2.1% (annualized), and various employment reports indicated a softening job market. Stocks and bonds began to rise again as interest rates and Fed expectations moved lower. Bad economic news is good news for the markets currently.

The Fed has stated that they will do whatever it takes to bring inflation back down to the 2% target, and significant progress has been made: Headline CPI (Consumer Price Index) inflation is now 3.3% year-over-year after peaking at 8.9% in June 2022. The Fed has also clearly stated that they need to see softening labor market conditions before they can be confident that inflation is under control. A tight job market (plentiful job openings, low unemployment) is inflationary due to rising wage pressures; higher wages lead to more consumer spending and higher prices. Recent data points to success on this front as well. The most recent JOLTS report (Job Openings and Labor Turnover Survey) from the Bureau of Labor Statistics is illustrated in Figure 4.

Figure 4: JOLTS Employment Data



Job Openings (shaded area in Figure 4): In the wake of the pandemic, employers have had a difficult time finding enough workers. Job openings spiked to an all-time high of 12 million in early 2022, roughly two job openings for every unemployed worker. An early signal of a softening labor market is a decline in advertised job openings as employers tend to scale back future hiring plans before actually laying off current workers. There are now 8.8 million job openings, a 27% decrease since March 2022.

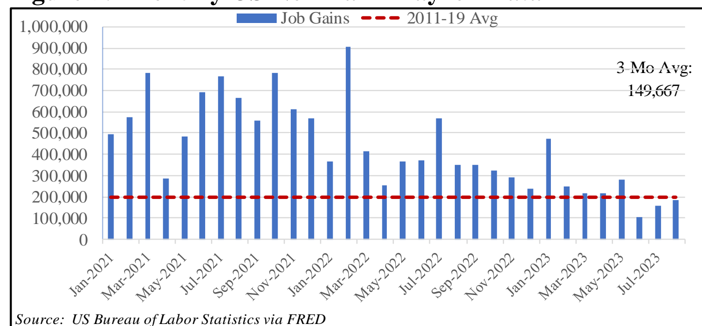
Hires (green line in Figure 4): After the massive layoffs and job losses during the pandemic, employers added workers back to their payrolls aggressively. The pace of hiring has slowed in 2023 and is now back to pre-pandemic levels.

Separations (red line in Figure 4): Separations (retirements, quits, terminations) have been well below the hiring pace, resulting in outsized job gains since 2020, but the gap is narrowing.

Quits Rate (dotted orange line in Figure 4, right-hand scale): This is the percentage of the workforce that voluntarily quit their jobs. A high Quits Rate implies that workers see plentiful job opportunities, a sign of a tight labor market. The rate has fallen to pre-COVID levels as the number of Job Openings has declined.

Today's jobs report offers further evidence that the labor market is softening. Unemployment increased to 3.8% even as 187,000 jobs were created in August, bringing the total to 1.9 million new jobs YTD. While still very positive, monthly job creation is now below pre-pandemic levels as illustrated in Figure 5.

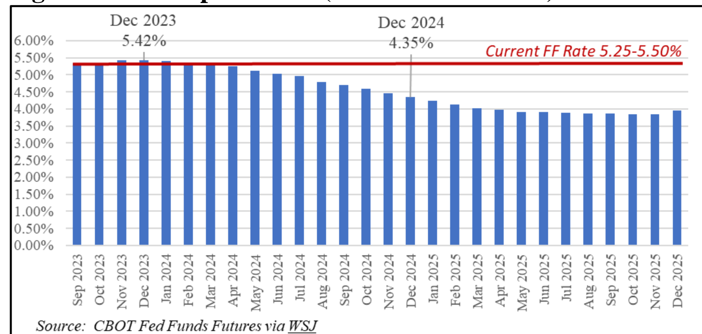
Figure 5: Monthly US Non-Farm Payroll Data



Bottom Line

Investors react to every new economic data point, trying to ascertain what the Fed (and their global counterparts) will do next. Bad news has become good news (and vice versa) because weak (strong) economic data implies lower (higher) interest rates going forward. Stock and bond markets are fueled by declining interest rates, and rising rates generally lead to negative returns. While it is impossible to predict the future, markets are highly efficient at processing currently available information. As illustrated in Figure 6, the futures markets currently reflect a small probability of one more rate hike and then rate cuts next year as the economy slows. Whether the eventual slowdown is in the form of a "soft landing" or a "hard landing" (i.e., recession) is impossible to predict. Diversification remains critical, with attractive bond and cash yields as viable alternatives to stocks as the story unfolds.

Figure 6: Fed Expectations (Fed Funds Futures)



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