



Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY

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Debt Ceiling Standoff Pushing Misguided 'Flight to Safety'

Regional bank stress in March, followed by the debt ceiling standoff over the past several weeks, has led some investors to recalibrate risk in the capital markets. The question is whether this recalibration is wise and informed, or whether it's a misguided response driven by worry and recency bias.¹

I'll make my case for the latter.

One area where we're seeing an unusual trend is in the spreads between some investment-grade corporate bonds and short-duration U.S. Treasuries. Normally, investors peg Treasury yields as the risk-free rate, which can be used as a minimum starting point for expected returns from other types of investments, whether they be other bonds, stocks, real estate, etc. Since every security is technically riskier than U.S. Treasuries – given Treasuries' status as the world's safest investment – one would expect investors to demand a higher return from other types of securities.²

But that's not the case right now for some investment-grade corporate bonds.

Indeed, in a rare occurrence, we're seeing some investment-grade corporate bonds trading at a yield *discount* to U.S. Treasuries. Two distinct examples are Microsoft bonds coming due in early August, along with Johnson & Johnson bonds that come due in November. The Microsoft bonds in recent days have been trading at yields slightly higher than 4%, which compares to the slightly higher than 5% yield on Treasuries coming due around the same time. The Johnson & Johnson bonds trade at a similar discount.

The unusual spread is largely driven by the debt ceiling standoff. There is fear that failing to reach an agreement on the debt ceiling would first affect the Treasury bonds coming due this summer, i.e., that these would be the first payments missed by the U.S. government. While this explains the elevated yields, I'm not sure it justifies labeling Microsoft corporate bonds as safer than U.S. Treasuries at this moment. I've made the argument before that the U.S. government can likely prioritize bond payments over other obligations, and also that the U.S. Treasury has adequate tax revenues to

avoid default. The market's treatment of some investment-grade corporate bonds relative to Treasuries looks like a short-term mispricing, in my view.

Another flight to 'safety' trend we're seeing is in current investor sentiment for gold versus stocks. In a recent Gallup poll, 26% of Americans ranked gold as the best *long-term* investment in 2023, up from 15% in 2022. Stocks moved in the opposite direction year-over-year: in early 2022, 24% of Americans saw stocks as the best long-term investment. In 2023, the figure had dropped to 18%.

What happened in the last year? For one, stocks and bonds delivered negative returns in 2022, which I think contributes heavily to investors experiencing 'recency bias.' The assumption becomes that since stocks did poorly last year, they are likely to do poorly again this year. But we know from history that's rarely the case.

The second thing to happen was the regional bank stress and currently, the debt ceiling standoff. To be fair, gold prices do tend to jump in the wake of major shocks or events. In the early days of the pandemic and Russia's invasion of Ukraine, for instance, gold prices rose. Investors may be viewing bank stress and the debt ceiling as the next iterations of the 'crises' of the U.S. economy, which I think will turn out to be wrong.

History suggests that favoring gold as a long-term investment is not a good mindset. From 1970 to 2022, the S&P 500 has delivered an average annual return of 10.43%. Over the same period, gold returned 7.7%. The reason I use 1970 is because that was the year the gold standard ended, meaning the price of gold was subject to market forces. The 3% difference in annualized returns over 50 years is very significant.

Bottom Line for Investors

Viewing investment grade corporate bonds as safer than Treasuries—or viewing gold as a

better long-term investment than stocks—seems more of a byproduct of fear and recency bias than it is grounded in fundamentals. Case in point: if we look beyond this summer and fall to Treasuries that mature beyond 2023, we see that they're trading at yields below AAA corporate bonds. Investors may be stuck thinking too short-term.

My base case assumption is that the U.S. government will reach a debt ceiling agreement and that no payments on U.S. Treasury bonds will be missed, as we've seen in many previous instances of this issue. I also think the regional bank stress is fading and that the effects on the U.S. banking system won't be severe, or permanent. In other words, there's no reason to make knee-jerk allocation decisions based on the perceived risks of the moment.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ CNBC. May 17, 2023.

<https://www.cnbc.com/2023/05/17/americans-think-gold-beats-stocks-as-a-long-term-investment.html>

² Wall Street Journal. May 23, 2023.

https://www.wsj.com/articles/debt-ceiling-fight-sends-investors-hunting-for-new-havens-45ea55e6?mod=djemMoneyBeat_us

Weekly Market Update

Important Market News We Think Worth Considering

STEADY INVESTOR WEEK

- **The main driver in the U.S. economy remains strong**
- **Status on Fed Rate hikes**
- **Strength in the housing market**

A Main Driver of U.S. Economic Growth Remains Strong

On a macro level, developed country economic activity is often framed in terms of services and manufacturing. In export-driven countries like China and Japan, manufacturing is generally considered the more important measure of the two. But in services- and consumption-based economy like the U.S., services activity matters far more than manufacturing. There's good news to report: the latest data from S&P Global shows service activity in the U.S. at a 13-month high. Overseas, Japan also showed strong services and manufacturing activity as did Europe, though the latter is still coping with high energy and food prices. According to the latest U.S. data, services activity was strong across travel, dining out, and other leisure activity. Manufacturing activity went in the opposite direction, as bloated inventories and weak new orders have dented growth. The composite purchasing managers index, which measures manufacturing and services together, rose to 54.5 in May from 53.4 in April, with any reading above 50 signaling expansion. This relatively robust measure of economic activity may complicate the Federal Reserve's plans for monetary tightening, as elevated services and spending activity will arguably keep some level of upward pressure on prices. Below, we discuss

whether that means the Federal Reserve's planned interest rate "pause" in June is still on the table.¹

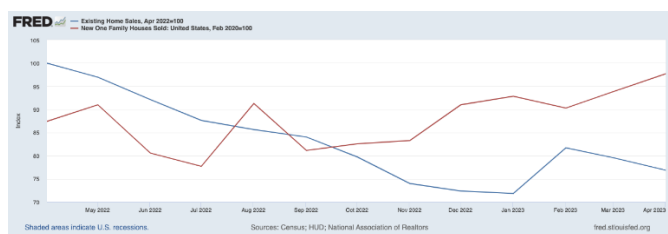
Is the Federal Reserve Actually Poised to Pause Rate Hikes in June?

The Federal Reserve has engaged in an aggressive rate hike campaign, pushing the benchmark fed funds rate from the zero bound to between 5% and 5.25%, a 16-year high. Chairman Jerome Powell has been sending signals that the Fed could pause rate hikes at the June meeting, as he recently said that "having come this far, we can afford to look at the data and the evolving outlook and make careful assessments." Powell also added that "the risks of doing too much versus doing too little are becoming more balanced," which was a break from earlier language suggesting that the real risk was in not raising rates enough. The market had all but priced in a pause in the tightening cycle – until this week. Now, a handful of Fed officials have indicated their decision to raise or hold rates at the next meeting could be a close call. Some have indicated that inflation does not seem to be slowing quickly enough and that the U.S. economy is still too strong – as evidenced by the services PMI referenced above and by the still-tight labor market. In Fed governor Neal Kashkari's words, "I would object to any kind of declaration that we're done [raising rates]."²

New Home Sales Post Strong Showing

The U.S. housing market is often characterized as being in a downturn, but a more nuanced view of the data suggests that pockets of weakness are also accompanied by pockets of strength. We have written in this space before about the geographic split in U.S. housing, where home sale activity in the South and East

has been holding up well relative to the West. But there is another ‘split’ in the data worth highlighting: the sale of *new* homes versus *existing* homes. Existing home sales have been under pressure, as homeowners with low mortgage rates are (understandably) reluctant to move – which could also mean swapping a low rate for a higher one. As such, the inventory of existing homes is low, which is driving weak sales activity. For new homes, however, the picture looks better. New home sales rose in April to a level not seen in over a year, up 4.1% from March and 11.8% year-over-year.³ The divergence between the two is clear in the chart below:



Source: *Federal Reserve Bank of St. Louis*⁴

Homebuilders understand that with interest rates likely to remain elevated, the supply of existing homes is likely to remain tight in the foreseeable future – which also means demand for new homes may remain firm as well. That has pulled forward new construction and is also adding to overall economic activity (since new home starts are the principal way real estate adds to GDP).

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¹ Wall Street Journal. May 23, 2023. https://www.wsj.com/articles/europes-economy-cools-down-as-interest-rate-rises-bite-2532af5c?mod=djemRTE_h

² Wall Street Journal. May 21, 2023. https://www.wsj.com/articles/fed-official-is-open-to-foregoing-june-rate-hike-ebb9c7c7?mod=economy_more_pos6

³ CNN. May 23, 2023. <https://www.cnn.com/2023/05/23/homes/new-home-sales-april/index.html>

⁴ Fred Economic Data. May 18, 2023. <https://fred.stlouisfed.org/series/EXHOSLUSM495S#>

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