Are We There Yet?

I grew up in Boston. We'd spend summers on beautiful Lake Sunapee in New Hampshire. Driving up in the 1970s, the only game choices were "I Spy" and spotting out-of-state license plates to distract from the drive. Invariably, I asked my parents, "Are we there yet?"

When it comes to the markets, it feels like we're back in that car today. When are we going to get to the end of this Fed cycle as Chair Powell stands true to his vow to fight inflation, regardless of the impact on the markets? This quarter's letter has our view on when we get there and what it looks like when we finally arrive. I hope you find it helpful as we all wait together.

Interest Rate Spike Spoils Quiet Quarter

Markets this quarter looked a lot like a football player running toward the end zone, right until they tripped and face-planted yards from the goal line. Prior to the last two weeks, it was easy to sleep through this quarter as an equity investor, as stocks traded in a tight range after starting the year strong. Yet the market's complacency was tested by a sharp surge in long-term interest rates. The 10-year Treasury yield shot up 50 bps in September, rising to over 4.5%—a level not seen since before the Great Financial Crisis.

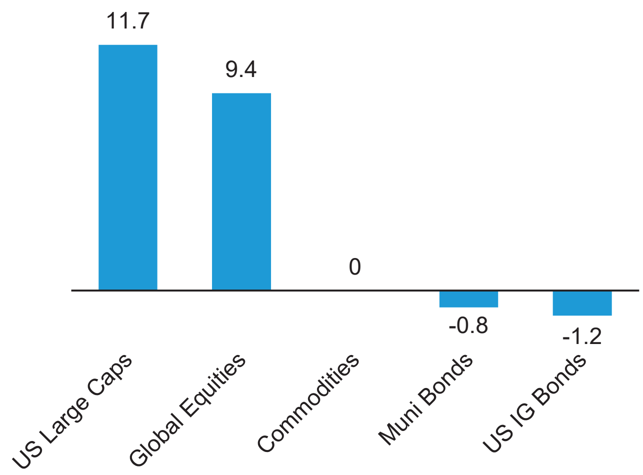
A move of that magnitude in such a short period is remarkable in its own right. Yet, this recent surge stands out for three other reasons. First, since market participants knew the US Treasury would flood the market with bonds after the June resolution of the debt ceiling, some of it was to be expected. But even that doesn't sufficiently explain such a large move. What's more, the action has unfolded almost entirely in longer-dated maturities, reflecting the market's expectations for long-term growth and the long-term Fed Funds rate. In other words, it's not about today's inflation or Fed policy, it's about the next economic cycle—and maybe even the one after that. Finally, the move has been almost entirely in real (after-inflation) yields, with the market's inflation expectations remaining well anchored. That represents a win for policymakers, who fear runaway inflation and a vicious pricing spiral if expectations get out of hand. Yet it's troublesome for asset owners, as rising real interest rates pose a headwind to the price of most assets.

Don't let this recent turbulence distract from the bigger picture. Zooming out to 2023 so far, stocks remain the story of the year. They may not have fluctuated much this quarter, but even after this past week, US large caps are up 11.7% and global equities are up 9.4% year-to-date.

Returns have been weaker for bond investors given that spike in Treasury yields. Diversified municipal bonds have fallen 0.8%, while US investment grade bonds have dropped 1.2%. In fact, returns have been more volatile and almost un-bond-like. And, after a tough quarter, diversified commodities have shown lackluster results as inflation has calmed down, returning -0.1% for the year so far. (**Display**)

YEAR-TO-DATE RETURNS OF MAJOR ASSET CLASSES

Percent



Past performance does not guarantee future results.
Source: Bloomberg and Bernstein analysis

What Happened to Rates?

As mentioned, the major market story of the quarter was the continued breakout of interest rates. That move came in the face of compelling evidence that central banks have likely completed their hiking cycles. The market is not expecting further hikes; rather it's pricing in rates staying higher for much longer. Other factors, such as a post-debt ceiling increase in Treasury supply, momentum, and investor positioning may also have played a role.

The Fed's forecasts appear to contain some wishful thinking, which makes sense as a more realistic assessment might spook economic participants. Despite saying they're looking for "below trend" growth to bring inflation back into line, the Fed's forecasts are roughly for on trend growth. Likewise, the Fed sees a long-run equilibrium unemployment rate of 4.0% and expects that to peak at only 4.1% this cycle, while bringing inflation back to target. We don't share quite that degree of optimism—our base case calls for growth to slow by more, and sooner. As that occurs, we expect the Fed to adjust to incoming data. That said, the silver lining to this rise in rates is that it's being driven by higher growth expectations. In fact, moves in Treasuries are now more correlated with growth surprises than with inflation surprises (**Display**). That higher growth should also cushion the downside risks to the economy and reduce the odds of outright recession.

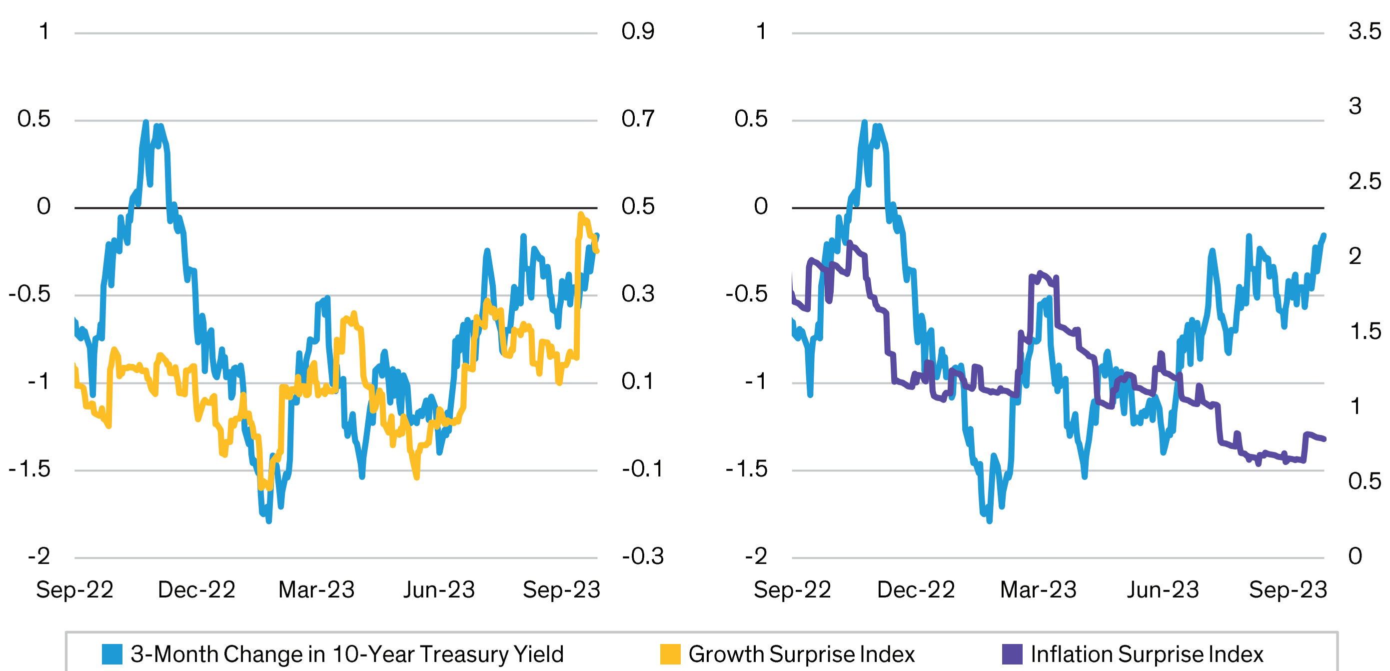
Despite remarkable economic resilience so far in this cycle, we expect diminishing household savings, tightening credit conditions, the resumption of student loan payments, and weakening corporate fundamentals to make the economy more vulnerable to shocks going forward. Those shocks may or may not upend the apple cart, but the longer higher rates persist, the greater the probability of a recession. As a result, we continue to believe that we've seen the final rate hike and that cuts will start earlier in 2024 than the Fed or the market expects. That should lead to a drop in rates and a flood of cash from the sidelines into bonds once rate hike fears finally dissipate. There are no guarantees, but the market tends to move quickly in situations like this, so we favor being early to being late.

China 2023: The Little Engine That Didn't

Outside the US, some of the most consequential news of the quarter came from China, where the post-pandemic economic boost has fallen flat, exports remain in retreat, and various property developers and local government financing vehicles appear overly indebted.

TREASURY YIELD MOVES ARE NOW MORE CORRELATED WITH GROWTH SURPRISES THAN INFLATION SURPRISES

Percent



Past performance does not guarantee future results.
Source: Bloomberg and Bernstein analysis

Many hoped that China's economy would rebound strongly after COVID lockdowns finally ended late last year. But that anticipated pop has been more of a puff, with exports facing a cyclical and secular challenge. The destinations for China's products are soft, as global manufacturing is arguably in a recession and global services experience a slowdown. In addition, China has lost half of its post-WTO market share gains in the US since the end of 2017, according to our colleagues at Bernstein Autonomous Research. Even in Europe, where the country continued to gain share during the pandemic, its share of trade has also peaked.

We received a considerable number of questions about China's systemic debt issues this quarter. One of the country's main financial institutions missed payments to investors, a large property developer missed payments to bondholders, and investigations continue into local government debt balances. So far, there is no sign of contagion in the Chinese financial system, but there does appear to be an increasing amount of fragility. The authorities seem to be shoring up the banks, but shadow credit providers and investment trusts could face greater risks. Ultimately, China's role as the growth engine of the global economy may be sputtering out.

Are Higher Oil Prices a Threat?

Over the course of the quarter, the price of oil quietly rose around 30%—from roughly $70/barrel to over $90/barrel—as OPEC+ pulled back supply. The Saudis cutting oil production by 1 million barrels/day put the oil markets into deficit, pressuring prices. Whether that pressure continues or eases in the coming months will depend largely on what they do next.

While strengthening oil prices haven't had a dramatic impact on inflation yet, it could become more consequential going forward, particularly if prices continue to climb. While this may not be reflected in the "core" measures that the Fed focuses on, it will still be crucial to their policy decisions as it will affect consumers' discretionary spending and inflation expectations. The Fed is currently working hard to keep inflation expectations under control and has no influence over the oil supply. For that reason, any further surge in oil prices could potentially impact their interest rate decisions in the upcoming quarters.

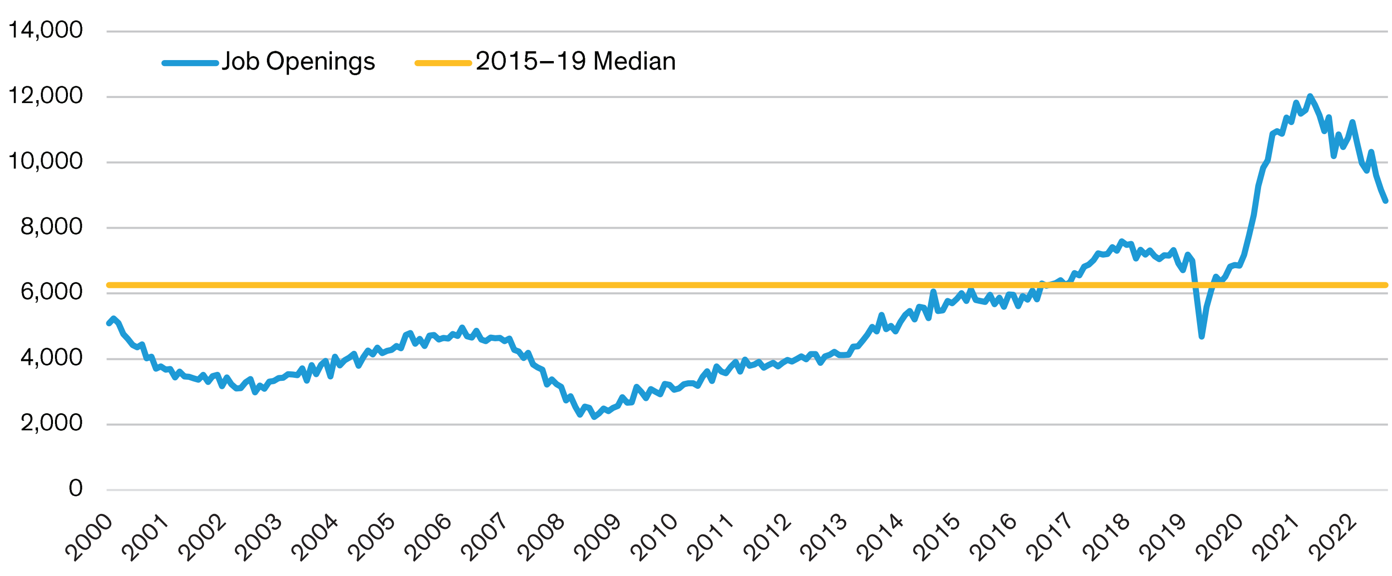
A Cooling Labor Market

So far, the Fed's efforts to bring down inflation without slamming employment appear successful. While overall employment continues to grow steadily and after-inflation average hourly earnings are rising again, labor market imbalances appear to be easing.

This can be seen most visibly in JOLTS data on job openings from the Bureau of Labor Statistics. At the peak last spring, US employers had around 12 million job openings—far outstripping levels seen in the prior two decades. Now having fallen to just shy of 9 million, job openings remain above both the long-term trend and the 2015–2019 median. Still elevated, but the progress is notable.

JOB OPENINGS ARE DECLINING AS THE LABOR MARKET COOLS

Thousands



Source: BLS, Bloomberg, and Bernstein analysis

The sharp decline in job openings and cooling labor market should help the Fed bring inflation back down to its 2% target. Yet there is still a risk that inflation could increase due to other factors, such as rising oil prices or another spike in house prices and rents due to low sales inventories. In such a scenario, the Fed may have to exert more pressure on the labor market. The Fed's current estimates seem quite optimistic about their ability to reduce inflation without a material rise in unemployment or decline in economic growth. Yet we can't help but wonder if part of this optimism stems from their reluctance to signal anything other than a soft landing to the general public.

To Q4 and Beyond

Beyond that, some pockets of the market stand out. To take advantage of the recent rise in rates—especially at longer maturities—we recommend investors extend duration in their core fixed-income portfolios. That will enable you to lock in the highest interest rates we've seen in nearly two decades while also putting a hedge in place should a harmful economic shock arise.

We also continue to find standout opportunities in private markets, as investors who can take on illiquidity are being paid a healthy premium by companies and other investors who need cash. We see a range of tactically attractive investments in various areas, such as commercial real estate where banks have taken a step back, private credit where we can lend to middle-market companies on highly appealing terms, and venture capital or other opportunistic private equity arenas where fundraising has slowed but capital needs remain high.

As always, we aim to be realistic in our assessment of the economy and the markets while stewarding your capital responsibly. Thank you again for trusting us with your investments and please enjoy these final months of 2023.

Alex Chaloff
Chief Investment Officer

Alex Chaloff is the Chief Investment Officer and Head of Investment and Wealth Strategies at Bernstein. In this role, he leads a national team of strategists across investments and wealth planning—including asset allocation advice, investment platform oversight, model portfolio construction, new product development, manager research, tax planning and solutions, and estate planning research—while remaining continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Alex has spent his Bernstein career refining our investment platform, listening to clients, and conducting deep research into investment and wealth planning topics that are critical to achieving clients' goals.

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