MJM INVESTMENT ADVISORS, INC.

Fourth Quarter 2023 Investment Outlook

You Dropped The Bond On Me, Baby

"Inflation has moderated somewhat since the middle of last year, and longer-term inflation expectations appear to remain well anchored as reflected in a broad range of surveys of households, businesses, and forecasters as well as measures from financial markets. Nevertheless, the process of getting inflation sustainably down to 2% has a long way to go."

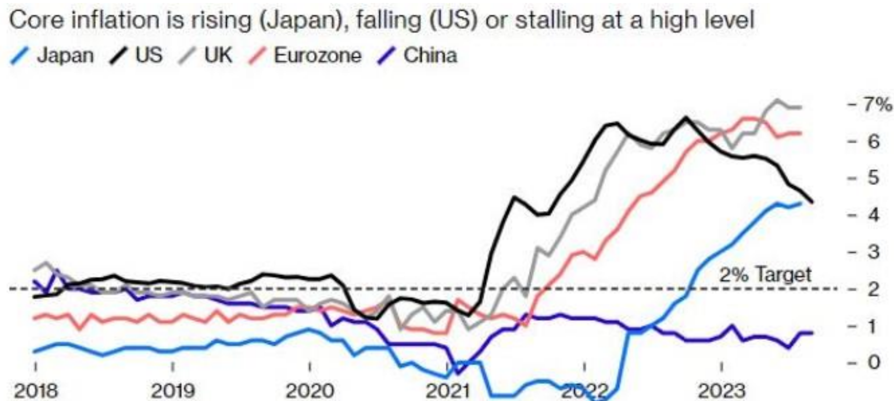
– Jerome Powell - U.S. Federal Reserve Chairman

"We are watching the tightening of financial conditions and the sharp increase in long-term real yields, and these developments are doing some of the hard work for us, and as such, we believe we have reached that fabled sufficiently restrictive level."

– Philip Jefferson – U.S. Federal Reserve Vice Chairman

Surging bond yields was the major story during the third quarter, which unsettled investors and caused both stock and bond markets to generate negative returns. In addition, the labor market and associated wage gains, while softening from the strong reports earlier this year, remained strong enough to keep the Fed in hawkish mode and in a position to potentially raise interest rates another 0.25% either in early November or mid-December. After the Fed's September meeting, the main message Chairman Jerome Powell and other Fed officials delivered to financial markets was to expect Higher For Longer, meaning that even if they move to the sidelines and stop raising interest rates, the Fed intends to keep interest rates at higher levels for a longer period of time. Fed officials want additional confirmation that inflation is moving back towards its 2.0% annual target before considering changes to its current monetary policy stance.

Starting in March 2022, the Fed reacted to high and persistent levels of inflation by aggressively raising interest rates from 0% to the current Fed Funds target range of 5.25% to 5.50%. The Fed's policy actions appear to finally be making some progress, as noted in the chart below, which captures inflation trends for five major global economic regions. Of the five, the U.S. is seeing the largest decline in its core inflation rate since the middle of 2022 but inflation remains well above the Fed's 2% target.



Real yields are the difference between the yield on a bond minus the current rate of inflation. As shown in the next chart, as inflation receded but bond yields continued to increase, real yields have surged higher. The line in the chart below represents the change in real yields for bonds since 1997 using the 10-year Treasury Inflation Protected bond (TIPS) as a proxy. With bond yields now above 5% and the rate of inflation declining, investors purchasing TIPS today can now earn over a 2% real yield, a level last seen in 2008.

The last time real yields surged rapidly higher was in 2013. As bond yields surged higher that year (because bond prices fell), the Ishares 20+ year U.S. Treasury ETF (TLT) returned -14%. In 2023 through mid-October, the TLT returned -12%, another ugly return outcome, especially when considering the TLT returned -31% in 2022. Since 1/1/22, longer maturity Treasury bonds have declined over 40%. If you think that's bad, the Austrian 100 year bond issued in 2017 when longer maturity bonds in Europe were yielding close to 0% has declined 75% in price! Both cases show the high degree of price risk in longer maturity bonds when interest rates increase rapidly higher from very low levels.

As shown in the next table, investment returns for U.S. bond investors the past decade has been one of the worst on record. As of 9/30/23, the Bloomberg Aggregate Bond Index (AGG in the table) had a trailing 3 year annualized return of -5.5%, 0% for the trailing 5 years, and earned a measly 1% annualized over the last 10 years. These figures are nominal returns or before the impact of inflation. In real return terms, bond investors suffered even worse negative returns given the elevated inflation levels over the past three years.

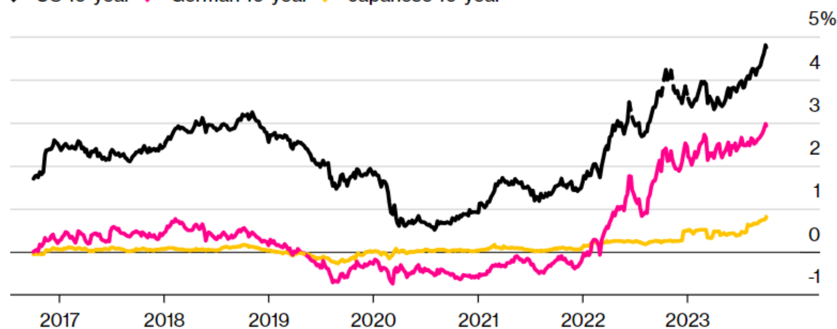
Bond ETFs: Durations, Yields and Returns

Data Source: YCharts as of 10/6/23				Total Returns (>1 Year = Ann.)				
Category	Ticker	Duration (Years)	30-Day SEC Yield	2023	1-Year	3-Year	5-Year	10-Year
Leveraged Loans	BKLN	0.1	8.2%	8.7%	10.0%	3.8%	2.9%	2.8%
Floating Rate IG	FLOT	0.0	6.0%	5.0%	6.5%	2.3%	2.2%	1.7%
Short Duration IG	GSY	0.8	5.5%	3.9%	5.0%	1.4%	1.9%	1.7%
1-3 Month Treasury	BIL	0.1	5.3%	3.7%	4.5%	1.6%	1.6%	1.0%
US High Yield	HYG	3.6	8.6%	3.2%	5.5%	0.0%	1.8%	2.9%
1-3 Year Treasury	SHY	1.9	5.0%	1.7%	2.3%	-1.0%	0.9%	0.7%
International	BNDX	7.3	3.4%	1.5%	1.5%	-4.4%	0.0%	1.7%
EM High Yield	HYEM	3.3	8.6%	1.4%	10.1%	-2.4%	0.9%	2.6%
EM Local Currency	EMLC	4.8	6.8%	0.7%	7.8%	-3.9%	-0.8%	-1.8%
3-7 Year Treasury	IEI	4.4	4.6%	-0.6%	0.5%	-4.3%	0.5%	0.7%
Commercial Mortgage	CMBS	4.3	4.2%	-0.7%	0.7%	-4.4%	0.6%	1.1%
EM Sovereign (USD)	EMB	7.1	7.7%	-1.0%	5.7%	-5.9%	-0.8%	1.7%
Municipal	MUB	6.3	3.9%	-1.8%	0.8%	-2.1%	1.2%	2.1%
Inflation Protected	TIP	6.7	5.2%	-2.0%	-0.7%	-2.5%	1.9%	1.5%
US Aggregate	AGG	6.2	4.7%	-2.1%	-0.7%	-5.5%	0.0%	1.0%
US Investment Grade	LQD	8.4	6.0%	-2.2%	0.6%	-6.6%	0.7%	2.0%
Mortgage Backed	MBB	6.1	3.5%	-3.4%	-1.5%	-5.6%	-0.9%	0.4%
7-10 Year Treasury	IEF	7.5	4.5%	-4.0%	-3.3%	-7.9%	-0.3%	0.6%
20+ Year Treasury	TLT	17.1	4.9%	-12.7%	-14.2%	-17.3%	-3.5%	0.2%
25+ Zeros	ZROZ	26.2	4.6%	-20.9%	-24.3%	-24.3%	-5.9%	0.0%

CREATIVE PLANNING @CharlieBilello

As weak as bond returns have been over the last decade, the Fed's interest rate policy actions and the financial market's reaction to them over the past 18 months has led to a complete reversal in the prospective return setup for bond investors. Back in March 2022, cash earned 0% and the Bloomberg Aggregate Bond Index was yielding around 2.5%. For fixed income investors, it was a highly unattractive setup, especially since inflation was accelerating and real yields available on bonds were negative. The low interest rate environment created by central banks forced investors to take on much higher levels of investment risk in bonds in order to capture higher bond yields.

Today, the setup for bonds is the complete opposite, with inflation declining while bond yields are surging higher and real yields are positive. Money market funds now yield around 5.25% and an intermediate investment grade bond fund has a yield to maturity of around 5.5%. The dramatic change in the yield setup for U.S. government bonds are captured by the next chart, which shows the 10-year U.S. Treasury bond yield approaching 5%, the highest level in 15 years.



Importantly, the relative attractiveness of bonds versus stocks has also improved dramatically since the Fed began hiking interest rates in March 2022 and as bond yields have surged higher. Intuitively, it makes sense that when the real yields on bonds are low or negative then stocks offer a more attractive investment option. Who wants to own an asset that offers negative real returns? When this setup occurs, investors become more biased towards stocks and stock valuations increase as defined by the price/earnings (PE) ratio.

The next chart shows the relationship between real bond yields and U.S. stock valuations since 2016 using the forward (next 12 months) PE multiple. After C-19 hit in March 2020 and the Fed was forced to cut interest rates to zero, real bond yields eventually went into negative territory for two years (blue line, right hand scale, inverted) while stock valuations concurrently went higher (black line, left hand scale). As the Fed raised interest rates over 5% the past 18 months, real bond yields moved out of negative territory and are now over 2%. Stock valuations peaked at around 22X in early 2021 and have now declined to around 18X as real yields climbed higher. If the Fed maintains its Higher For Longer policy bias and bond yields stay at current levels and the inflation rate continues to move lower, then real bond yields will expand even further and most likely will cause the stock market's PE level to further contract. As such, it is a much better risk/reward setup for bonds now than it has been for quite some time.

GOLDMAN SACHS GROUP

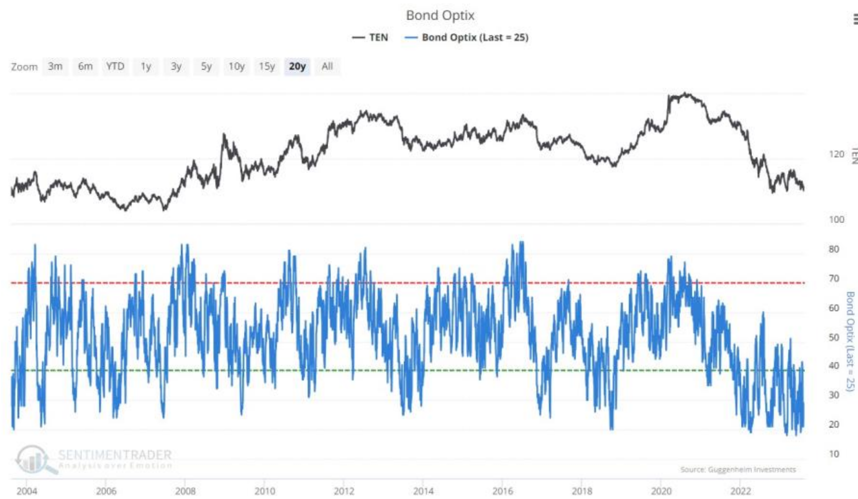
Let's review the potential bond return setup for investors today after this sizable increase in interest rates and surge in bond yields over the past 18 months. Let's assume that the Fed is done raising interest rates and bond yields are close to peak and don't change much from current levels. Investors can now capture a 5.5% yield to maturity from a diversified portfolio of investment grade bonds that includes Treasuries, corporates, and mortgage-backed bonds. In early 2022, investors would have earned an annual yield of 2.5% from a similar investment if bond yields had stayed stable. However, that did not happen because inflation soared and the Fed was forced to aggressively raise interest rates, which caused the broad U.S. bond market to suffer its largest annual decline since the 1970s.

However, the prospective risk/return setup for bonds now is significantly better. The next chart shows the yield on the 10-year U.S. Treasury bond since 1992. The 10-year U.S. Treasury yield peaked at just over 8% in 1994 and declined all the way to 1% in early 2020. This chart is from mid-July when the 10-year yield was 4.79%, which is the same level it is at in mid-October. The table in the upper right shows how the total return on a 10-year U.S. Treasury bond is impacted at different yield level changes. Let's use the most extreme moves of +/- 100 basis points (+/- 1.0%) in bond yields from the 4.79% level. If the yield increases 1.0% from 4.79% to 5.79%, over the next 12 months an investor would get a -1.5% total return. The return is a combination of the higher yield and income earned on the bond offset by the negative price impact. From current yield levels, it would take a sizable 1% move higher in yields for an investor to earn a negative return over the next 12 months. Now let's consider the opposite scenario or if the 10-year Treasury yield decreases 1.0%, declining from 4.79% to 3.79%. In that case, the 10-year U.S. Treasury would have a total return of +11.1% over the next 12 months from the combination of the yield plus the price appreciation of the bond.

This example shows how the risk/reward setup in bonds has become more attractive for investors. The total return of a +/- 1.0% move in bond yields from the 4.79% level is -1.5% of potential negative total return if bond yields rise 1.0% but +11.1% of potential total return if bond yields fall 1.0% from the current yield level. Note in the table that all other yield moves between +/- 1% result in positive returns for the 10-year U.S. Treasury bond. As such, at current yield levels, returns are skewed heavily towards positive return outcomes.

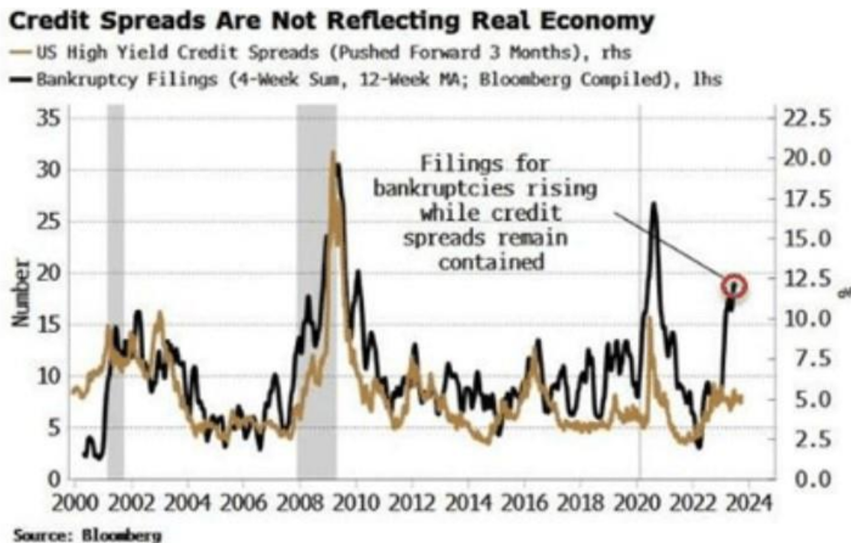
10-Year Treasury Yield Change (bps)	Agg Index Yield (%)	12-Month Return
100	5.79	-1.5%
75	5.54	0.1%
50	5.29	1.6%
25	5.04	3.2%
0	4.79	4.8%
-25	4.54	6.4%
-50	4.29	7.9%
-75	4.04	9.5%
-100	3.79	11.1%

After a period of very negative returns from bonds, it is not surprising that investor sentiment towards bonds has turned extremely negative. The next chart from SentimentTrader captures investor sentiment trends towards bonds going back to 2004 or 20 years. Over that time period, investor sentiment towards bonds has never been as deeply negative as it is today. However, whenever investor sentiment leans heavily in one direction, it is often a rewarding opportunity to lean in the other direction. There is an old stock market saying related to a good risk/reward setup that said to buy when there is blood in the streets (a reference to coup attempts). Bonds seemed to have reached that "buy when there is blood in the streets" status given the negative bond returns over the past several years combined with very negative investor sentiment levels.



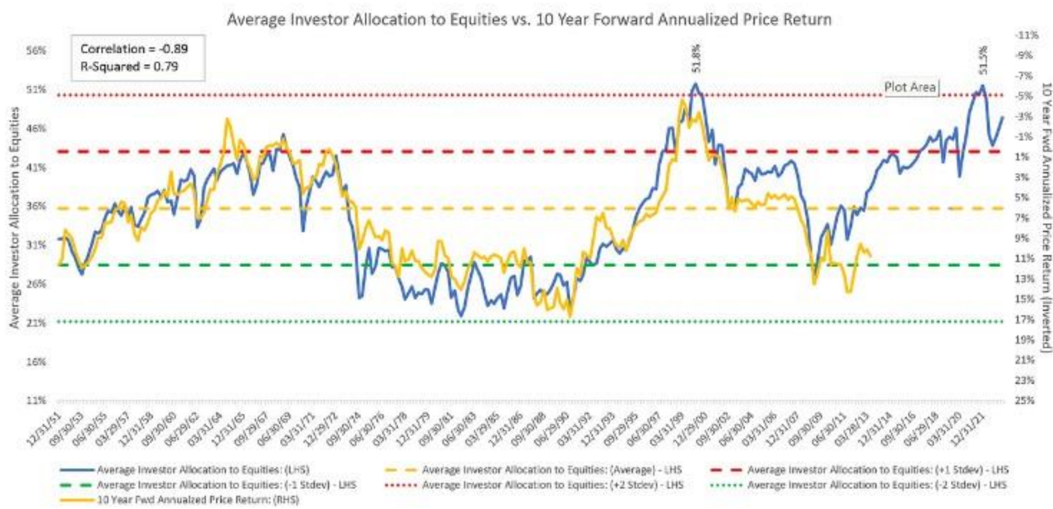
That being said, not all bonds are created equal. In times of rising economic uncertainty or a recession, it is better to stick with higher quality bonds to avoid capital losses. Lower quality credits often get hit harder and decline during recessionary periods. In addition, credit spreads, or the extra yield an investor earns above a Treasury bond yield for taking on credit risk, remain surprisingly low given the growing risk of a recession given the Fed's Higher For Longer mentality.

The chart below compares U.S. bankruptcy filings with the high yield (below investment grade bonds) credit spread. As bankruptcy filings increase, the risk of owning higher risk debt also increases and credit spreads typically widen as shown in the grey areas of the chart which are recessionary periods. However, that has not been the case this economic cycle to date even as bankruptcy filings have moved substantially higher. If the Fed maintains its Higher For Longer interest rate policy well into 2024, it seems highly likely that credit spreads will widen from today's levels. How much credit spreads widen will depend upon the severity of any potential recession. Right now, the high yield bond market seems to be ignoring recession risk. Given that a bond investor can own higher quality bonds and earn positive real yields with yields over 5%, it doesn't make much sense to stretch for yield at this stage of the economic cycle as the risk in lower quality credits does not seem to be properly priced into high yield bonds.



For balanced portfolio investors, the attractiveness of bond investments has improved dramatically over the past two years. Whereas bonds in early 2022 offered high interest rate risk and low yields, bonds in October 2023 now offer much higher yields and there is a low probability of negative returns from bonds over a 12 month or longer time horizon. For balanced portfolios that include bonds, the bond portion of the portfolio offers a high probability of generating 5% annualized returns going forward. In addition, given that bond price volatility is much lower than stock price volatility, bonds once again offer an attractive risk reduction and diversification benefit to balanced portfolios. This is true even for more aggressive balanced portfolios with higher allocations to stocks.

At a time when most investors hate bonds, their positive view of stocks is elevated. The next chart shows the historical average allocation to stocks by investors going back to 1951 and how that played out in future stock returns. Today, the average allocation to equities (blue line) is near the high end of history. The yellow line in the chart shows how equities performed in the subsequent 10-year period. For example, at the peak of the tech bubble of 1999/2000, when investors had the highest allocation to stocks, the 10-year forward annualized return from stocks was negative low single digits (right hand scale, inverted), which coincides with the stock market return between 2000-2009.



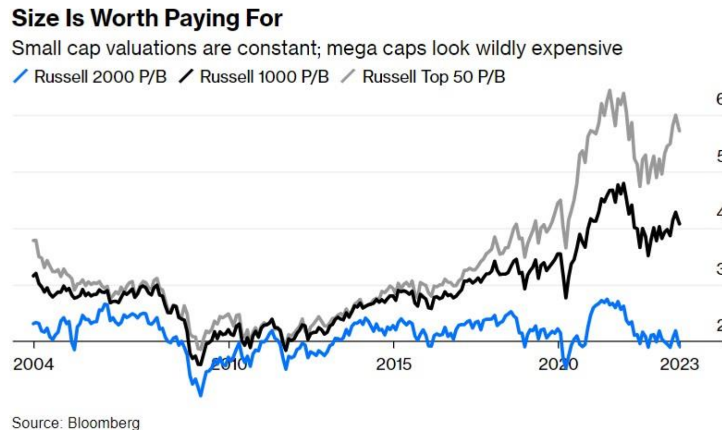
Source: Federal Reserve Bank of St. Louis as of 09/08/23.

Given the tight correlation of this relationship over time (blue and yellow lines similar) and given the fact that investor allocations to equities today are once again at the high end of history, there is a strong possibility over the next decade that investors will earn a low annualized return from investing in a broad market benchmark like the S&P 500 Index. Note that before C-19 hit in early 2020, stock returns as of 12/31/19 were 11% annualized on a trailing 10-year basis. However, there is a strong possibility that starting in 2020, the 10-year annualized return from stocks through the end of 2029 could be minimal. Over time, the risk/reward setup for bonds should become increasingly apparent to more investors.

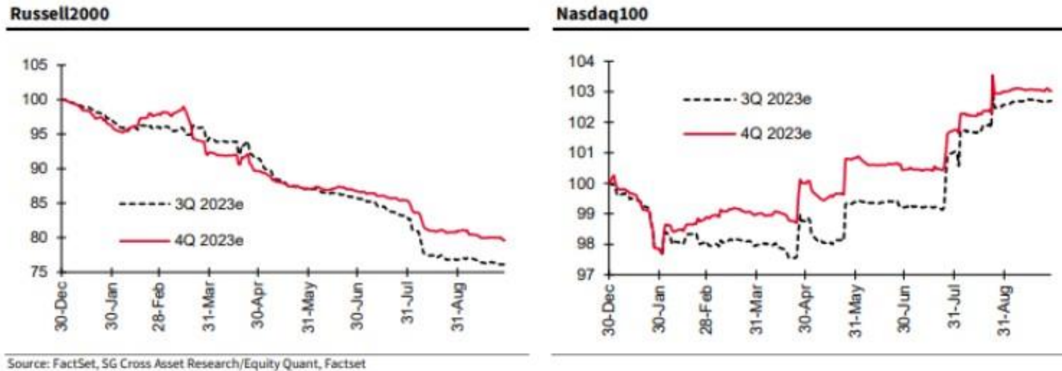
However, just as in bonds, where not everything is always equal, the same is true for stocks as well. Currently, the U.S. stock market is suffering from being a very concentrated market, where a few mega cap stocks are having a disproportionate level of impact on the broad U.S. stock market return. The next chart shows that the cumulative weight of the Top 10 stocks in the S&P 500 Index has soared to 31.7%, a level comparable to the Nifty 50 stock market of the early 1970s. During the tech bubble of 1999/2000, the

largest Top 10 stocks also had a big run higher and the market also became top heavy but it was not as extreme of a setup as exists today.

Today, the biggest market cap stocks are the most richly valued while the rest of the U.S. stock market trades at reasonable valuations. As shown in the next chart, valuation spreads within the U.S. stock market are now at the most extreme levels of the past 20 years. Many investors are enthralled with and crowded into the Top 50 stocks, which includes the Magnificent 7 mega cap tech stocks, while shunning the rest of the market. As shown in the blue line below, the smallest 2000 stocks as measured by the Russell 2000 Index now trade at a very wide valuation discount to the Top 50.



It should be noted that rising interest rates have a bigger negative impact on smaller companies due to their greater financing needs relative to larger, more established companies. Rising interest rates creates a higher cost of capital and that can create greater negative earnings impacts on smaller companies. We can see this in the next chart, where the earnings of the Russell 2000 Index of small cap stocks have been cut and are declining this year. In contrast, the Nasdaq 100 Index, which is dominated by the Magnificent 7 mega cap tech stocks, has seen rising earnings expectations since April.



That being said, stocks outside of the Top 10 have already priced in a great deal of higher interest rate risk and earnings risk. In addition, small cap stocks trade at the lowest PE level of the past 30 years with the Russell 2000 Index trading at 12.5X forward PE compared to 18.2X for the S&P 500 Index. At the same time, mega cap techs stocks have benefited from investor euphoria over artificial intelligence and the belief that these companies are immune to a global economic slowdown and applying a premium valuation for both attributes. However, at today's elevated valuation levels, the forward return prospects for the Magnificent 7 are unlikely to be as great as investors currently believe whereas the return opportunities in mid and small cap stocks are unlikely to be as poor as investors currently expect.

Summary

The past decade has been a lost cause for bond investors with negative returns after inflation is taken into consideration. However, the rapid increase in interest rates by the Fed since March 2022 and the ensuing surge higher in bond yields during 2023 have created a dramatically improved risk/reward setup for bonds. With a key segment of the U.S. stock market trading at rich valuations and investor allocations to stocks near record highs, the forward return prospects for the S&P 500 Index may not be a robust as investors currently expect. For balanced portfolios, bonds not only offer a potential source of competitive returns but also a lower risk profile than stocks. The diversification benefits of bonds in a multi-asset class portfolio have been restored and being underweight bonds is no longer a no-brainer investment decision with a large potential pay-off.

Mark J. Majka, CFA
Chief Investment Officer

October 17, 2023

IMPORTANT DISCLAIMER:

This report and all content on mjminvtadvisors.com is presented for educational and/or entertainment purposes only. Under no circumstances should it be mistaken for professional investment advice, nor is it intended to be taken as such. The commentary and other contents simply reflect the opinion of the author alone on the current and future status of the markets and various economies. It is subject to error and change without notice. The presence of a link to a website does not indicate approval or endorsement of that web site or any services, products, or opinions that may be offered by them. Neither the information nor any opinion expressed constitutes a solicitation to buy or sell any securities or investments. Do NOT ever purchase any security or investment without doing your own sufficient research. None of the parties adding to or affecting the content of mjminvtadvisors.com in any way shall have any liability for any loss sustained by anyone who has relied on the information contained herein. Neither mjminvtadvisors.com nor any of its principals or contributors are under any obligation to update or keep current the information contained herein. The principals and related parties of mjminvtadvisors.com may at times have positions in the securities or investments referred to and may make purchases or sales of these securities and investments. The analysis contained is based on both technical and fundamental research. Although the information contained is derived from sources that are believed to be reliable, it cannot be guaranteed.

FAIR USE NOTICE: mjminvtadvisors.com and reports downloaded from the site contain copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available in our efforts to advance understanding of issues of economic and social significance. We believe this constitutes a 'fair use' of any such copyrighted material as provided for in section 107 of the U.S. Copyright Law. In accordance with Title 17 U.S.C. Section 107, the material on the site and in reports downloaded from the site is distributed without profit. If you wish to use copyrighted material from this site for purposes of your own that go beyond 'fair use', you must obtain permission from the copyright owner.