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THE CURRENT RATE CYCLE

Market Review **JANUARY 2023**

> **"Short-term rates exceeding long-term rates is a somewhat rare occurrence and may signal that the economy has become overheated in the short run."**

The "term premium" in savings has gone missing from certain investments as interest rates have risen. Traditionally, this term premium represents additional compensation to investors for investing in longer-term investments, such as bonds. Currently, there is less incentive to save money in long-term investments and greater yield in short-term ones. Short-term rates exceeding long-term rates is certainly not a normal occurrence, but it can happen. It is often part of a cycle that may signal that the economy has become overheated in the short run.

The most recent historical example of a cycle like this is in the events leading up to the 1980s. However, this experience isn't quite the same because the United States isn't directly involved in many wars, which was the case in that time. The US economy ended up with inflation because too much money started circulating without enough productive resources available to absorb the surplus. The good news is that this feels like an engineered problem and, in theory, it should be reversible given enough time. The problem is that people worldwide feel the effects when the Federal Reserve turns the dial too hot and too cold. And, certain groups of people feel these impacts disproportionately more than others, especially in developing (emerging market) regions.

Interest rate policy designed to push short-term rates up above long-term rates (which is known as an "inverted yield curve") generally does not occur by accident. The Federal Reserve is obviously a significant contributor, but so are regular investors who cannot afford to lose purchasing power on new money that enters the market. Moreover, since the current expectation is for high inflation today and lower inflation later, investors won't require as high of a premium to store money away in longer-term investments. Therefore, as the disinflationary process continues, short-term interest rates should start to move lower and, one day, short-term rates should end up below the long-term rates again.

As for now, higher short-term rates serve two critical purposes to remove inflation from the economy. First, the high short-term rates make it more costly for banks to use overnight reserves. The overall impact is a slowdown in bank lending, which can then hit spending. Second, high short-term rates present a significant opportunity cost for people with money to spend rather than save, especially when the general belief is that high inflation rates won't last. In the meantime, as long as investors sense less uncertainty regarding future price increases, they can save income and earn a decent return instead of spending that money. So, within reason, higher short-term rates can have a particularly adverse effect on economic spending. Therefore, individual choices that find savings more attractive when short-term rates are high may partially explain why inverted yield curves tend to pre-date recessions.

Another explanation for the lost term premium is that the economic risk of loss is currently higher now in the short-term relative to the long run. As a result, short-term expected returns need to be higher to incentivize risk-taking. Therefore, the downward nature of the yield terms wouldn't just exist in bonds but in other assets that have a long time-horizon, such as stocks. The stock market's volatility index is a great place to observe a negative term premium in stock returns. The volatility index reports high standard deviations currently, but seems to indicate that risk is likely to decay as time passes. Consequentially, expected stock returns may appear better today as a tradeoff for accepting more risk in the short-term relative to the long-term. This is one of the major reasons why stock markets tend to generate strong returns in short time periods following bear market periods.

Much of the current concern regarding savings, lending, income, and spending is focused on the short-term, and not as worrisome further out in time. Again, these developments are often found during periods of economic slowdowns. Over time, we expect many of today's economic experiences and challenges to smooth out, which should restore the term premium. As a reminder, investment markets are traditionally viewed as a leading economic indicator, which means investment returns often foreshadow what is to come in the economy. Although 2022 resulted in a challenging investment environment, it has indicated some level of economic slowdown. This also often results in investments beginning to generate stronger returns during periods of economic slowdowns, as they forecast better economic periods ahead.

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Asset Categories	US STOCKS	FOREIGN STOCKS	US BONDS	FOREIGN BONDS	HARD ASSETS	HYBRIDS
Monthly	-5.31%	-1.68%	-0.49%	0.81%	-3.36%	-2.17%
Year to Date	-15.74%	-19.03%	-9.60%	-14.17%	-10.79%	-16.16%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING DECEMBER 31, 2022.

US STOCKS

US Stocks lost more ground in December, despite the Santa Claus rally of the last few days in the month. Large-, mid-, and small-cap losses were similar and generated a -5.31% average loss in December. Year-to-date losses among the group were closely aligned, too. However, mid-caps outperformed in 2022 with losses of -14.01%, but better than the average annual loss of -15.74% from all three category averages combined.

FOREIGN STOCKS

Foreign Stocks rolled returns back in December similar to the domestic markets. However, the monthly loss wasn't as sharp relative to US stocks. In December, the average loss in the foreign categories was only -1.68%. That brought the year-to-date average back down to finish 2022 with a -19.03% loss. Year-to-date losses from developed market stocks mirrored US stock losses; it was the emerging markets and small caps that lost most value for the year.

US BONDS

US Bonds experienced only modest losses in December. This category average finished last month with an average loss of -0.49%. However, bank loans provided investors with a slight gain in December. Overall, virtually all bond categories declined in 2022. Bonds suffered from inflation and the sudden rise in interest rates, and those bonds with the longest maturities were generally hurt the most.

FOREIGN BONDS

Foreign Bonds generated some modest gains in December. Overall, the category's average monthly return was 0.81%. Emerging market bonds have started to see some life again as they've experienced gains in two consecutive months. Yet, emerging market bonds lost -14.50% in 2022, while the global bond category average declined -13.84% over the same time period.

HARD ASSETS

Hard Assets performed poorly in December, resulting in an average monthly loss of -3.36% for the category. Energy and real estate were among the hardest hit areas—both experienced losses exceeding -5% for the month. Hard assets provided some diversification with a -10.79% year-to-date loss. Energy was essentially the only hard asset sector that generated a gain in 2022, while the other hard asset categories suffered losses that were in the double digits.

HYBRIDS

Hybrid Assets fell another -2.17%, on average, in December. The category was weighed down by more underperformance from convertible debt. Convertible bonds generated -17.50% in investor losses in 2022. Year-to-date performance in preferred stocks succumbed to a -14.82% loss. Overall, the category's performance fell by -16.16% as the average year-to-date return.

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