OBSERVATIONS: *Equities weak, 10-Year Treasury yield tests 5%, spending surprises.*

- Markets were generally weaker last week, the S&P 500 fell -2.4%, while the Russell 2000 (small cap index) declined -2.3%. The tech heavy Nasdaq lost -3.2% on the week and the 10-year Treasury yield reached 5.00% for the first time since 2007.[1]
- Consumer spending surprised to the upside in September. US retail sales (ex-auto and -gas) jumped +0.6% month-over-month (MoM), far better than expectations of a +0.1% increase. The control group, which excludes certain categories of spending and feeds directly into GDP was also up +0.6%.[1]
- Industrial production (IP) came in slightly ahead of expectations at +0.3% MoM, but August was revised down to 0.0% MoM. Overall, IP is up +0.1% year-over-year (YoY), though lost in these short-term comparisons is the fact the level of industrial production sits at the highest level since early 2019.[1]
- Home builder confidence declined in September to their lowest point since January-2023 as mortgage rates over 8.0% have weighed on foot traffic for new home showings and priced new buyers out of the market.[1]
- New housing starts rebounded slightly in September; new housing starts were 1.358 million (annualized rate), which was +7% MoM from August, but through the first nine months of the year new housings starts are running -12.1% below the first nine months of 2022. Building permits declined -4.4% MoM in September with both new starts and permits particularly weak for multi-family units.[1]
- Initial unemployment claims fell to 198,000 last week—weekly initial claims below 200,000 have only occurred on 10 previous occasions since 1970 and this is consistent with a very strong labor market.[1]

EXPECTATIONS: *House remains in disarray, Fed Chair Powell – nothing new, Q3 earnings season ramps up.*

- The US House of Representatives failed to elect a new speaker last week and with no clear path to elect a speaker soon, the specter of a government shutdown looms with funding set to expire on 11/17. The House will hold a candidate forum early this week for a slate of nine new candidates—it is still unclear if any candidate can get the support needed to get the 217 votes required to fill the void. [1]
- Fed Chair Powell's speech at the Economics Club of New York seemed to back the increasing market narrative that the continued rise in long-term bond yields is doing some of the Fed's job. For our part, future rate hikes are likely to remain a function of the Fed's data dependency and the focus should be on higher for longer rather than whether the Fed will hike one or two more times.[1]
- Earnings season is underway, 17% of the S&P 500 has reported earnings with 73% beating earnings estimates. While early, the 73% beat rate is pacing just below the 1-Yr, 5-Yr, and 10-Yr average beat rates. This week will see 160 companies report results.[2]

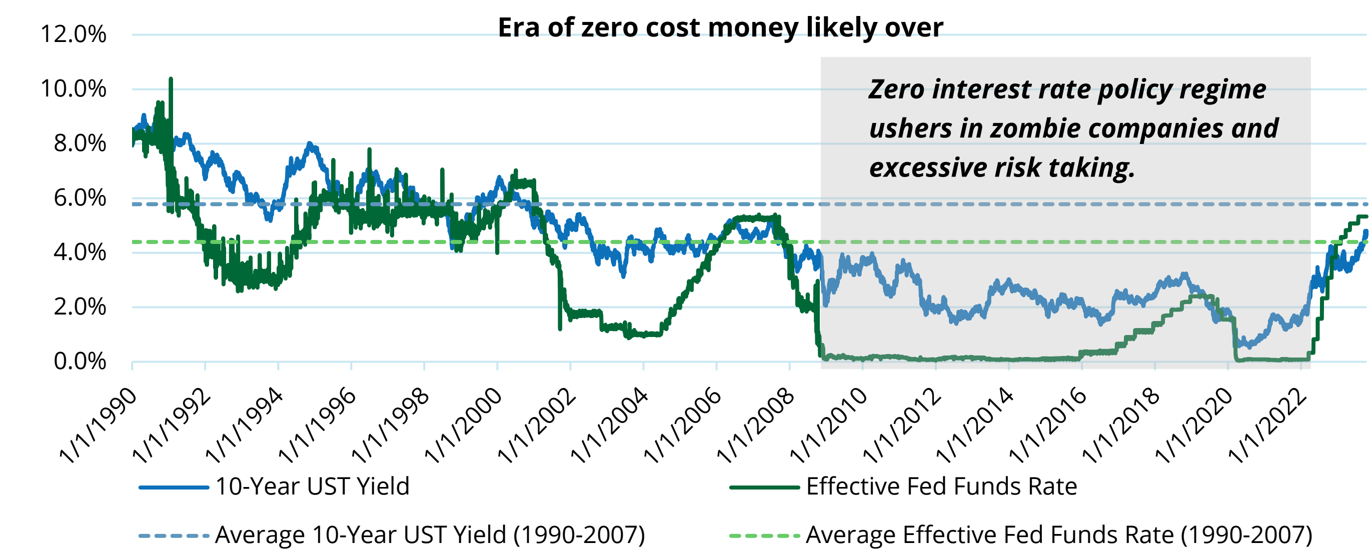
ONE MORE THOUGHT: '*Higher for longer' beginning to take a toll on leveraged corporates.*[3]

Some prognosticators are looking for rising rates to lead to a systemic event or shock for the economy and markets. Our base case, as of today, is that 'higher for longer' is more likely to take its toll as part of a traditional cyclical process and has begun showing itself as stress in the most leveraged and low-quality cohorts of US households and corporations. The Fed's zero-interest rate policy of the last decade-plus created a legion of 'zombie' companies whose existence and fate were predicated on ultra-cheap financing in public and, increasingly, private markets at low base rates and historically low credit spreads. Higher for longer means that pressure is likely to mount for those companies that relied on a zero-interest rate policy regime to effectively fund their businesses—many of which are

[1] *Bloomberg LP*
[2] *Factset Earnings Insight, as of 10/20/2023*
[3] *Bloomberg LP, Carlyle, S&P Global Market Intelligence, OrbiMed Advisors LLC.*

likely to go away. To be clear, higher for longer doesn't necessarily mean extraordinarily high, but perhaps emblematic of the 1990-2007 period pre-Great Financial Crisis (GFC) when the benchmark 10-Year US Treasury yield averaged over 5.5% and the Fed Funds rate averaged nearly 4.5% during those years (Chart of the Week). Recent data suggests that the interest burden from rising rates is taking a toll on lower quality borrowers. Over 35% of companies now have negative free cash flow and US corporate bankruptcies are creeping higher, both of which are pacing at 2010 levels. Meanwhile, delinquencies are beginning to rise for some consumer segments in credit cards and auto loans. Importantly, at the household level, the aggregate share of household debt that is sensitive to higher interest rates is just 11.0% today (the effective mortgage rate on outstanding mortgages system-wide is around 3.6%). To put into perspective, in the GFC era, that share of household debt that was sensitive to interest rates was 25.0%. All of this is to say that higher for longer is just another way of saying 'back to normal', begging the question: what is normal? One way to answer that is by first acknowledging that the period post-GFC to post-COVID was clearly abnormal and the period from 1990-2007 may be a better starting point for answering that question. While pressure is building for those financially stretched corridors of the economy, employment remains strong, and the economy continues to chug along. That said, we are attuned to the fact that higher for longer will continue to make its way into the economy in coming months and quarters.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, daily data as of 10/17/2023, Past performance is not an indicator of future results.

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