

The October Outlook

Market Stance

MACRO ENVIRONMENT

The macro backdrop remains driven by growth and policy expectations, not a fiscal crisis

Commentary

- Yields have risen as central banks pivot from cuts to tightening, amid higher energy prices and firm, if unspectacular, global growth
- Hyperscaler capital spending has added to borrowing needs and pushed yields higher.
- Equity markets have absorbed this without breaking, as strong profit growth has offset the move in yields

Upshot

- Growth, not fiscal stress, remains the dominant driver, keeping the macro backdrop broadly constructive

GOLD

Gold has delivered negative, volatile returns this year, detached from its usual fundamental drivers

Commentary

- Returns are negative year to date, with higher volatility than normal
- The metal looks detached from its usual fundamental relationships
- This largely reflects an unwind of positioning after the Q1 price surge, rather than a loss of fundamentals

Upshot

- We expect fundamentals to reassert themselves as the positioning effect fades

FIXED INCOME

We remain sceptical that deteriorating fiscal positions are the main driver of higher yields

Commentary

- Yield rises have been similar across the US, UK and Germany; a fiscal-driven sell-off would show more divergence
- Long-term inflation expectations have stayed stable and short rates have risen more than long rates, both pointing away from fiscal causes
- France is the exception: fiscal and political risk has hit French and wider euro markets, though a full euro crisis looks unlikely given the ECB backstop

Upshot

- We hold no long-dated bonds or French government debt, and maintain relatively short duration across fixed income

SARANAC POSITIONING

Staying selective as yields rise

Commentary

- Equity exposure remains modest but has been increased through the year, with limited exposure to the most richly valued segments
- Fixed income exposure is lower than a year ago and tilted toward high quality, short duration credit
- We continue to hold above-average allocations to hedge funds, commodities and structured products for diversification

Upshot

- Higher yields are improving fixed income's relative appeal, and we favour a diversified, duration-light stance over the most richly valued parts of the market

The Long Read

Will higher bond yields unsettle equity markets?

SNAPSHOT

Global bond yields have continued to rise, with the US ten-year yield now above 5%, yet equity indices remain close to record highs. Last month we argued that the rise in yields has been primarily cyclical; this month we consider what that implies for equities.

Higher yields reach equities through several channels - the cost of corporate debt, consumer spending, valuation and the macroeconomic effect of tighter financial conditions

Rising yields driven by growth or inflation have historically coincided with compressed equity risk premia. The equity market has already absorbed part of this year's move in bond yields through a lower earnings multiple, masked by exceptionally strong earnings growth.

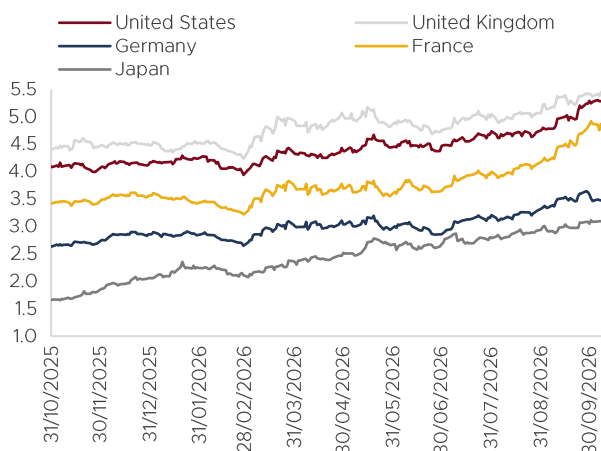
The principal risk is a rise in yields driven by the term premium (the additional yield investors demand for holding a long-term bond instead of investing in a series of short-term bonds) rather than growth, which lowers activity without lifting earnings. Smaller companies, private credit and highly indebted borrowers are most exposed.

Why the source of higher yields matters for equities

Last month we argued that the rise in global bond yields since the spring has been primarily cyclical: markets have moved from expecting modest rate cuts to expecting modest rate rises, and the increase in US yields has come almost entirely from higher real interest rates, with inflation expectations stable. Since then yields have risen further. The US ten-year yield is now around 5.3%, a level not seen since 2002, whilst the two-year yield sits well above the current policy rate, implying that the market expects further increases. Meanwhile UK thirty-year gilt yields have touched 6%.

CHART 1

10 Year Bond Yields



¹Source: Saranac / Bloomberg

Equity markets have, so far, taken this in their stride. The S&P 500 is within a whisker of its recent record high, and the Nasdaq 100 has set a new one. This has revived a well-trodden debate: at what point do higher bond yields become a headwind for equities? The question is often posed as if there were a single threshold. It is more helpful to recognise that higher yields affect equities through a number of distinct

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channels, each with its own transmission speed and its own winners and losers, and that the answer depends largely on the question we addressed last month - why yields have risen. A rise driven by stronger growth, one driven by higher inflation expectations and one driven by a higher term premium (the additional return investors demand for holding long-term bonds) have quite different implications. These explanations are not mutually exclusive, but their relative weight matters a great deal.

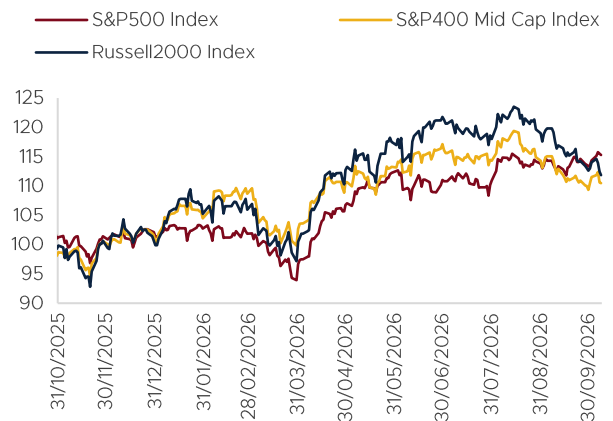
The cost of debt

The most direct channel runs through corporate balance sheets. A company that borrowed at 2% in 2021 and must refinance at 6% sees its interest bill on that debt triple; unless profits have grown in proportion, less remains for shareholders. The impact of this, however, depends on who borrowed, for how long and at what rate, and here the current cycle is unusual. Many large companies refinanced their debt at fixed rates during the period of near-zero interest rates. Similarly, many of the largest US technology companies hold more cash than debt, and higher rates increase their interest income. For this group, which dominates the main indices, higher yields have been a modest benefit rather than a headwind.

The picture lower down the capitalisation spectrum is quite different. Smaller companies rely more heavily on bank loans and floating-rate debt, which reprice quickly, and a substantial share of smaller US listed companies are unprofitable. It is therefore unsurprising that the Russell 2000 index is down nearly 10% from its August high, and the equal-weighted S&P 500 nearly 6%, whilst the capitalisation-weighted index remains close to its peak. Smaller companies are the most interest-rate sensitive part of the equity market and have historically been the first to react when higher yields begin to affect the real economy.

CHART 2

US Equity Index Performance



²Source: Saranac / Bloomberg

Meanwhile credit default swap spreads have widened in recent weeks. Private credit in particular is showing renewed signs of distress: listed vehicles have fallen sharply and a number of non-traded funds face redemption requests in excess of their quarterly withdrawal limits. To date this stress has remained within private credit. And while wider credit spreads led equities lower in 2007; they have also, on other occasions, widened and recovered without wider consequence.

The consumer

Corporate earnings largely depend on consumer spending, and higher rates reach households through several routes. Mortgages are the most obvious, and here the structure of the market determines the speed of transmission. In the UK, most borrowers hold fixed rates of two to five years, so a sizeable cohort moves to higher payments each year and the full effect takes several years to pass through. In the US, most mortgages are fixed for thirty years, meaning existing borrowers are largely insulated, unless they decide to relocate, and the

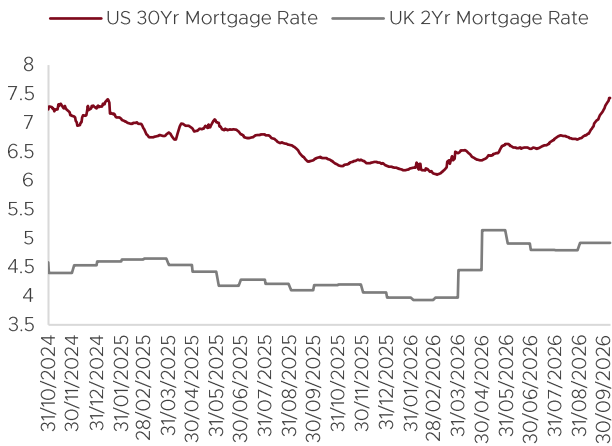


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burden falls on new buyers. This partly explains why US consumption has proved more resilient than many expected, and why the US housing market is, in effect, frozen.

CHART 3

US & UK Mortgage Rates



³Source: Saranac / Bloomberg

However unsecured borrowing, car finance and credit cards reprice far faster and weigh most heavily on lower-income households. Savers, by contrast, benefit: households holding cash and bonds now earn a meaningful income for the first time in fifteen years, and these households tend to be older and wealthier. The aggregate effect is a redistribution from borrowers to savers which may leave total spending little changed whilst shifting its composition.

This wealth effect deserves particular attention in the current cycle. Equities have risen to a record 34% of US household net worth and 46% of household financial assets. Individual investors tell surveys that they are bearish, yet hold most of their portfolios in shares with only small allocations to cash. The strength of the equity market is therefore itself supporting consumption; with household exposure at these levels, the effect would be correspondingly powerful in reverse.

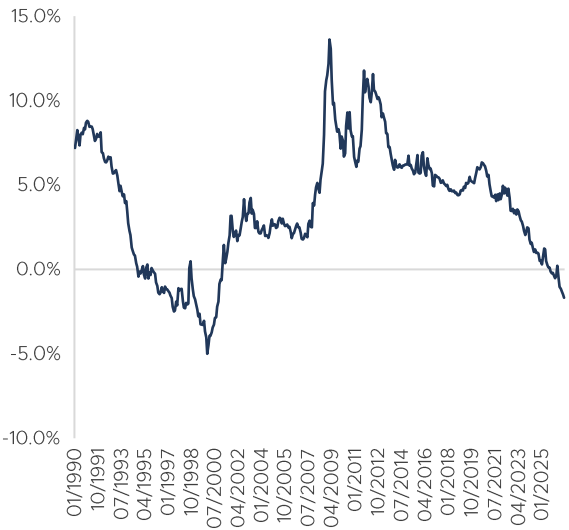
Of course governments are borrowers too. In both the UK and the US, interest on public debt now exceeds spending on defence. As we noted last month, the arithmetic is unforgiving, and further increases in base rates will in turn feed back into the yields that started the chain.

Valuation: what the equity risk premium does, and does not, tell us

The third channel is valuation. A share is a claim on future profits, and those profits are worth less today when the rate at which they are discounted is higher. The equity risk premium illustrates this dynamic well: the gap between the earnings yield on equities and the yield on government bonds, representing the compensation investors receive for bearing equity risk. In the US this premium currently sits near the lowest level in over twenty-five years, and it briefly turned negative earlier this year.

CHART 4

Global Equity Risk Premium



⁴Source: Saranac / Bloomberg

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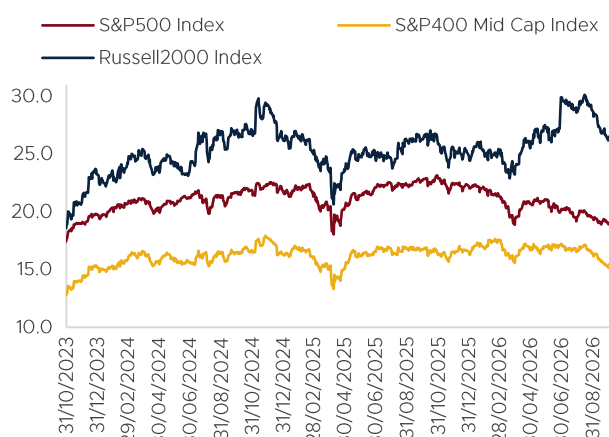
This may sound alarming, yet the implications are more nuanced. Over the past quarter-century, nominal bond yields at or above today's levels have not generally resulted in equity bear markets. Indeed, in the limited number of periods when the US ten-year yield has exceeded 5% and the equity risk premium has been negative, this has not always led to sudden market downturns. If real yields are high because growth is strong, higher earnings expectations lift equity market multiples. On the other hand if inflation expectations are high, multiples tend to hold whilst the premium narrows, which is intuitive: equities offer better protection against inflation than nominal bonds, and investors should rationally accept less compensation for holding them.

There is, moreover, evidence that the equity market has not been ignoring bonds at all. Forward earnings for the S&P 500 have risen by close to 30% this year whilst the index has risen by about 13%; the forward price-earnings multiple has therefore fallen to around 19x forward earnings. The seven largest US companies trade at around 23x forward earnings; small and mid-sized companies have de-rated even more meaningfully. The adjustment to higher yields is already under way, but it has been masked by exceptionally strong earnings growth. A thin equity risk premium thus does not in itself force a correction. What it does is remove the margin for error should earnings disappoint.

The exception to this relatively benign history is a rise in yields driven neither by growth nor by inflation but by the term premium. In this case the usual logic - that higher yields coincide with higher earnings - breaks down, and there is no reason the equity risk premium should remain compressed. This is the channel through which higher yields damage the economy, and hence earnings, without any offsetting support.

CHART 5

US Forward Earnings Multiples



⁵Source: Saranac / Bloomberg

The distinguishing feature of a term premium shock is that the economy pays the cost of higher long-term rates without receiving the income that usually accompanies them. When bond yields rise because growth expectations have improved, the higher cost of capital is matched by higher expected cash flows: firms invest because the returns justify it, and households borrow because their incomes are rising. When the term premium rises, long-term rates increase because investors have become less willing to hold longer-term bonds yet nothing on the other side of the ledger improves.

The transmission runs through just about everything priced off the long end of the yield curve: US mortgages, corporate bonds, project finance and, not least, the long-dated issuance now funding AI capital expenditure. Investments with a long payback period are the most sensitive, which is why business capital spending tends to bear a disproportionate share of the adjustment, followed by housing and, with a lag, employment.

Two things make this more dangerous than a conventional tightening. First, the central bank is less able to offset it. A rise in term premium driven by

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doubts about inflation or fiscal sustainability cannot be countered by cutting policy rates without risking a further loss of confidence. Second, the fiscal arithmetic is self-reinforcing. Higher long-term yields raise debt servicing costs, widen deficits and increase future issuance, which is itself a source of term premium. Where this loop takes hold, the currency usually weakens as well, adding imported inflation to the mix.

For equities this means the discount rate rises with no offsetting improvement in earnings expectations, so valuations must adjust, and the companies with the longest-dated cash flows - the growth stocks that have led this cycle - are the most exposed. The correlation between bond and equity returns turns positive, as it did in 2022, removing the diversification on which multi-asset portfolios rely and prompting investors who target a given level of portfolio risk to reduce exposure to both.

The key question, therefore, is what has been the driving force behind this Summer's rise in yields? The increase in real yields, relatively stable inflation breakevens, and the continued strength in demand for credit, point towards growth, rather than inflation expectations or fiscal concerns, to be the most plausible explanation.

As a result higher yields have not broken the equity market. The large companies that dominate equity indices are partly insulated from the cost of debt, the consumer channel is working slowly and is offset by interest income and record household wealth, and the valuation adjustment has been offset by growth in earnings. Of course that is not to say that the rise in yields had no impact on other parts of the economy. Smaller and more indebted companies, private credit, lower-income consumers and government balance sheets are all feeling the brunt of higher financing costs - and each becomes more exposed the longer yields remain elevated.

Saranac positioning

Within Saranac multi asset portfolios, equity exposure remains modest but has been increased throughout the course of this year. We continue to have relatively minor exposure to the more richly valued parts of the global equity market, where valuations offer little or no safety margin should earnings disappoint against a backdrop of rising bond yields. Fixed income exposure today is lower than what it was a year ago, and within the asset class we favour high quality, short duration credit where current yields can offset some further increases in yields. Importantly, we feel a more diversified asset allocation has merits and thus continue to have above average allocations in hedge funds, commodities and structured products.

SARANAC

PARTNERS

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Saranac Partners Limited

+44 (0)20 7509 5700

16 St James's Street London SW1A 1ER

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