MarketView

Third Quarter 2023

Higher Rates and their effect on the economy

Surging interest rates are intensifying the challenges for the U.S. economy and threatening to derail the Federal Reserve's drive to tame inflation without causing a deep recession.

Since mid-summer, the yield on the 10-year Treasury note, a benchmark for many loans, has steadily climbed, causing a rise in other borrowing costs. The costs of mortgages, auto loans and credit card debt have all risen in response. The collective impact of higher rates across the economy is increasing the cost of the government's own finances, as well.

The yield on the 10-year Treasury recently touched a 16-year high of 4.8%, up from 3.3% in April. The average 30-year fixed rate mortgage hit 7.3%, the highest rate in 23 years, according to mortgage buyer Freddie Mac.

Rising rates have been a result of a continued strong economy and persistent inflation, albeit at lower levels than last year. Furthermore, the economy is coming off a robust summer, fueled by strong consumer spending on travel, concert tours and recently, the clothing sector as consumers address their post pandemic wardrobe. The economy is estimated to have grown at an annual rate of 3.5% in the July-September quarter, according to economists at Goldman Sachs. Job growth has been strong as well. On Friday, the government provided a snapshot of how employers are factoring the turmoil into their hiring plans when it issued the September jobs report. While economists forecast a solid 162,000 jobs created last month, the actual number came in much stronger at 336,000.

Yet growth will likely slow to a meager 0.7% annual rate in the final three months of the year, Goldman estimates. In addition to higher rates, student loans are expected to take a noticeable bite out of the economy. Roughly 43 million people will resume paying several hundred dollars a month to the government, which Goldman predicts could cut one-half of a percentage point from annual growth in the October-December quarter. More expensive gas could shave an additional 0.3 percentage point from growth in both the fourth quarter and the first three months of next year.

In addition, the strike by the United Auto Workers, now in its fourth week with no resolution in sight, could reduce vehicle sales in coming months. Finally, the threat of a government shutdown, narrowly averted on October 1st, looms large again, especially

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given the chaos over the leadership of the House of Representatives.

A shutdown, should it occur next month, would lop another 0.2 percentage point off growth for each week it endures, according to calculations by Nancy Vanden Houten, an economist at Oxford Economics.

"We think the narrative is going to shift quite materially before the end of the year," said David Page, head of macro research at AXA IM, a London-based investment manager, who expects the economy to actually shrink in the fourth quarter. Rather than optimism for a "soft landing," in which inflation is curbed without causing a recession, there will be renewed fears of a downturn, he said.

On Tuesday, Loretta Mester, president of the Federal Reserve Bank of Cleveland, said she and other Fed policymakers will have to consider the rise in long-term rates in deciding whether to raise their key rate once more before year's end. Although her remarks suggested that the higher borrowing costs might lead the Fed to forgo another hike, but the recent strength in jobs may prompt her to reconsider. The Fed has repeatedly underscored that it intends to keep its key short term rate elevated for much longer than financial markets had expected earlier this year. However, it may be the market that controls this narrative rather than the Fed over the longer-term.

This coming year, the Treasury Department is auctioning off more debt to cover the government's swelling budget deficit. Excluding the funky accounting of the on again, off again Student Loan Forgiveness program, the federal deficit is projected to double from nearly $1 trillion in 2022 to $2 trillion in 2023. This is also double the 2019 pre-pandemic deficit level and is the largest peacetime increase since 1950 outside of the fiscal crisis and the pandemic emergency spending. Higher Social Security and Medicare are part of the increase as well as a 34% increase in the cost of servicing the ballooning debt. However, the biggest driver is the much lower than anticipated tax receipts due mainly to the collapse in capital gains taxes, which we anticipated and wrote about in our April Newsletter. With both stock and bond markets down in 2022, there were few gains to tax.

This huge increase in supply of Treasurys is growing while the Fed is reducing its holding own holdings of bonds. Overseas buyers

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have reduced their purchases as well, thereby forcing rates higher to attract buyers. “All of that is driving these fears of higher rates, and no one knows when it’s going to stop,” said Gennadiy Goldberg, head of US rates strategy at TD Securities.

Benson Durham, a former Fed economist who is head of global policy at Piper Sandler, suggested that long-term rates are rising because investors consider it riskier to hold government debt for the long run when the economy appears particularly volatile and uncertain, as it does now. All that said, a pronounced slowdown in the economy could lead to a quick adjustment in rates to much lower levels.

Fed officials, Durham noted, have shifted from well-telegraphed rate hikes to a hazier stance. Chairman Jerome Powell has repeatedly stressed that the central bank is “data dependent,” meaning it will raise rates again only if the latest economic data supports doing so — or forgo a rate hike if inflation falls steadily. “What they’re really telling us is, ‘We’re all over it like a cheap suit, but we’re not sure what exactly we’re going to do,” Durham said.

What does this mean for our clients?

We too are unsure as to whether it will be a soft or hard landing or if rates will go higher or lower. What we do know is that for the first time in over 15 years, bonds offer a much more competitive rate of return. For the last several years, bonds provided liquidity and stability from the gyrations in the stock market, but very little in the way of income. Now, with some treasury and corporate rates over 5% and tax free municipals offering 3-4% or more, investors are making a return on the fixed income portion of their portfolio for the first time in quite awhile.

Therefore, we have been and are continuing to tighten up our historically high allocations from equities back to bonds and are gradually extending the duration of our bond portfolios from very short-term paper to longer term bonds. This will continue through the 4th quarter of this year and into the early 2024 and as bonds mature over time.

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Notable Quotes

"The time to repair the roof is when the sun is shining.
John F. Kennedy

"In regards to the price of commodities, the rise of wages operates as simple interest does, the rise of profit operates like compound interest.
Adam Smith

"Rather than justice for all, we are evolving into a system of justice for those who can afford it. We have banks that are not only too big to fail, but too big to be held accountable."
Joseph E. Stiglitz

"It is hard to imagine a more stupid or more dangerous way of making decisions than by putting those decisions in the hands of people who pay no price for being wrong."
Thomas Sowell

"Socialism is an alternative to capitalism as potassium cyanide is an alternative to water."
Ludwig von Mises

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GSI Tenets

GS Investments

GS Investments, Inc. is an investment management company specializing in individual and institutional asset management. Privately owned and operated, GS Investments, Inc. is run by its owners, Glenn H. Steinke, C.F.A., John G. Steinke, M.B.A. and Greg Cunningham.

Glenn Steinke, CFA brings over 50 years of investment management experience to the business. Previous capacities include Vice President and Senior Investment Officer with a major pension fund ($1.8 billion under management) and Senior Vice President with a major Minneapolis-based financial institution ($3 billion under management). Glenn is a graduate of the University of Minnesota.

John Steinke MBA offers a broad financial services background with 29 years of portfolio management experience and 7 years of banking experience including capacities as a Vice President of a $50 million bank and as a private banking office for a large, Minneapolis-based financial institution. John received his BA from Concordia College (Moorhead) and his MBA from the University of Minnesota.

Greg Cunningham Prior to joining GS Investments, Greg spent 18 years at Minneapolis-based Ameriprise Financial, a national leader in financial planning with over 2 million retail clients and $300 billion in assets. Here he worked with the Chief Investment Officer in support of the international and domestic hedge funds and with the President and General Manager of RiverSource mutual funds. Greg is a graduate of Gustavus Adolphus College in St. Peter, MN.

Sheri Ritchie brings over 30 years of financial services experience to the business. Previous capacities include client service and support positions with Dean Witter and Kemper brokerage firms and a Minneapolis-based investment management firm. Sheri is a graduate of the University of St. Thomas.

GSI Investment Philosophy

GS Investments, Inc. utilizes a balanced approach for the majority of its accounts although each account is tailored to the individual needs of each client. Taxable or tax-exempt bonds are used along with a common stock component. The division between bonds and stocks is determined by the personal objectives of each client. A need for income and a willingness to assume risk are also determinants of an account's bond/stock mix.

GS Investments, Inc. emphasizes the purchase of quality securities and employs a long-term investment style, as market timing, frequent shifts in asset allocation and interest rate forecasting are not consistent with the firm's philosophy. In-depth market analysis and many years of experience support this approach.

GSI Fixed Income Strategy

GS Investments, Inc. emphasizes a staggered maturity approach when purchasing bonds. Individual security investment grades and call protection are considered when making these investments. Quality grades of "A" or higher are favored with tax-exempt issues. Government bonds are dominant among taxable securities.

GSI Equity Strategy

GS Investments, Inc. favors stocks emphasizing quality and growth. Appropriate cyclical growth stocks and small capitalization growth stocks are used periodically as well. Additionally, GS Investments, Inc. believes that a growth oriented philosophy tends to result in less frequent trading and lower tax payments (for taxable accounts) on realized capital gains. This provides a lower cost approach for the client.

GSI Client Communication

GS Investments, Inc. emphasizes client communication. Written investment objectives as well as periodic oral and written reports are used to heighten the understanding between the client and investment manager. In addition, easy to read, detailed reporting is provided by state-of-the-art investment software in order to inform the client of portfolio progress.