

October 6, 2023

“Acceptance doesn’t mean resignation: it means understanding that something is what it is and that there’s got to be a way through it.”

-Michael J. Fox

Dear Clients:

In today’s global markets, investors are increasingly recognizing that interest rates are likely to remain higher for a longer period of time. Acceptance seems to have been reached by the end of the third quarter of 2023.

With the realization that the Federal Reserve Bank is not going to soften their position due to strong economic data, multiple markets capitulated during September.

- The S&P 500 Index fell almost 5% during the month, led by many of the “Magnificent Seven” (Nvidia, Apple, Amazon, Google, Microsoft, Tesla, and Meta), which accounted for most of the index’s gains earlier in the year.
- Rising rates took the luster off dividend paying stocks as income could be secured through fixed income investments without the risk of equity volatility.
- Concerns that the “higher for longer” interest rate regime would eventually lead to a recession impacted small-cap stocks (624 stocks in the Russell 2000 are down over 20% in 2023).
- The strength of the U.S. dollar, due to the rise in Treasury yields, drove the MSCI Emerging Markets index down a similar amount to the S&P 500 Index.
- Even bond investors felt pain as interest rates rose and the yield curve steepened.

While September marked the widespread acknowledgement that Jerome Powell was unlikely to deviate from his hawkish stance, many investors have been preparing for this outcome for a while. There is no better indicator of this bearish posture than the fact that the year-to-date performance of the equal-weighted S&P 500 Index is flat. The gains in the traditional S&P 500 Index, and its capitalization-weighted construction, has been driven by a narrow group of large tech companies exposed to generative artificial intelligence. These mega-cap companies comprise almost 30% of the S&P 500 Index, an exceptional level of concentration.

A year and a half ago, in our first quarter letter of 2022, we asked what the future of investing would look like if we returned to a world in which bonds provided positive real (after inflation) yields so investors could seek returns within lower risk asset classes. We concluded that...

Many of the companies in which we invest are likely to be more desirable to a broader set of equity investors in a higher-interest-rate

world. Their *current* cash flow and earnings are more attractive relative to the *future* cash flow and earnings of speculative growth companies. This will also expand our universe of investible opportunities to companies where a more normalized interest rate regime is beneficial to their earnings. The benefits also extend to those of our clients who have a portion of their account in bonds. With higher interest rates, yields should rise and result in greater income. And of course, everyone will likely earn more on any cash that they hold for their monthly cashflows or for unexpected expenses.

Our conclusion hasn't changed. Although the transition to this environment is ongoing and has proven challenging over the last 18 months, we are confident that a more typical interest rate environment will ultimately provide a broader set of investment opportunities.

Not long ago, the acronym TINA was in vogue. TINA stands for "There Is No Alternative" and refers to the fact that large-cap growth equities were the only investible option in a 0% interest rate environment. Unfortunately, pithy shorthand descriptors like this and others – The Nifty 50, FANG, The Magnificent 7 – drive herd mentality and can result in exaggerated market volatility when they fall out of favor. We have seen this over the last few years with SPACs, crypto, and meme stocks.

The realignment of returns across asset classes ultimately allows investors to build portfolios that align with their risk appetite – a blending of stocks and bonds to reduce risk while earning a reasonable return. When interest rates were near zero, fixed income could not deliver the cushion it historically provided during equity market volatility. Some investors sought security in longer maturity bonds. This may have brought some near-term comfort in the form of greater income but exposed those investors to equity-like losses as interest rates rose.

With the era of TINA having passed due to a more normalized interest rate environment, one should follow Michael J. Fox's advice, accept the new reality, and adapt one's strategy to meet new challenges. Whether through our meticulous value-based securities analysis, tailored portfolio construction, or prudent financial planning, we are dedicated to navigating this transition on behalf of you, our valued clients.

As we celebrate our 50<sup>th</sup> anniversary, we remain deeply grateful for the trust and commitment you have placed in us.

Warm regards,

The Partners of CANNELL & CO.