Farro Capital

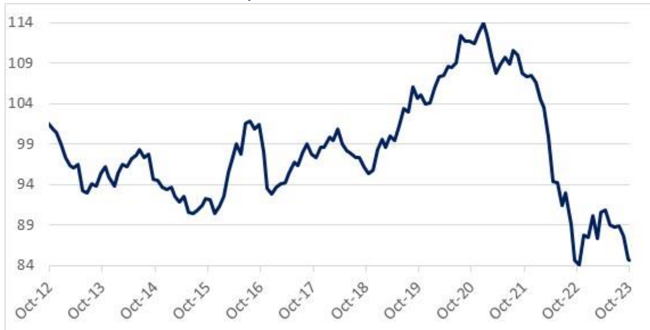
Market Insights

20th October 2023

"Bonds promoted as offering risk-free returns are priced to deliver return-free risk" — Shelby Cullom Davis

The above quote serves as a stark reminder of the long-held belief that the bond market knows better. Warren Buffett, the Oracle of Omaha, echoed a similar sentiment in his 2012 letter about the prospects of so-called risk-free bonds. Lo and behold, how risk-free return has delivered return-free risk for investors (Chart 1).

Chart 1: Total return of $100 Investment in Govt bonds.



Source: Citi G7 Bonds Index

Fast forward to 2023, despite an environment laden with restrictive monetary policies and recessionary fears, it isn't just these low-risk bonds that again have disappointed. Low-risk large cap stocks – defensive – have struggled too versus their high-risk counterparts – cyclicals. However, amid this risk appetite, high-risk small & mid cap stocks have severely underperformed even as risky high yield bonds, including the floating rate leveraged loans, have posted stellar performance (Table 1).

Table 1: Cross-Asset Behavior.

	Financial Assets	YTD 2023	Since Oct 2022
Fixed Income	7-10yr UST	-3.33%	-2.5%
	US Leveraged Loans	9.3%	12.7%
	US CCC rated Bonds	7.7%	9.6%
	US High Yield Bonds	3.3%	7.8%
	EU High Yield Bonds	5.3%	10.8%
Equities	Global Defensives	-5.6%	5.9%
	Global Cyclicals	5.9%	20.9%
	Magnificent 7s	84.4%	61.4%
	US Mid-Small Cap	-2.2%	3.9%

Source: S&P, Russell, iBoxx, CS, BBG. Global defensives (equally wght Staples, Utilities & Healthcare). Global Cyclicals (equally wghtd Financials, Industrials, Energy & Materials. Magnificent 7 (equally wght Aapl, Msft, Amzn, Goog, Meta, Nvidia, Tsla).

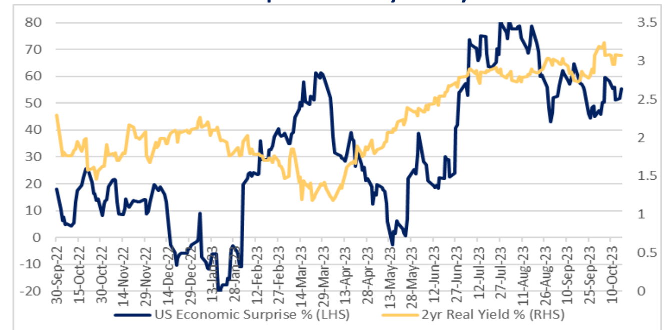
So, why are markets delivering such unique cross-asset currents: compressing risk premiums against the backdrop of the fastest (coordinated) tightening cycle since 1980 under the trustees of global reserve currency? Are risk-free assets now attractive?

In our latest market insights, we try to eke out the possible macro drivers of these somewhat unprecedented market dynamics and share possible path forward for stocks and bonds.

The elusive r* versus the obvious value-transfer.

The prevailing discourse in markets centers around r*- short-term rate that is neither restrictive nor stimulative - and the resilience of US economy despite high interest rates (Chart 2). However, r* is elusive and depends on steady state. Instead, what's more obvious have been economic value-transfers, an unprecedented phenomenon that has played on the economy due to persistent fiscal easing and delayed monetary tightening.

Chart 2: US economic surprises and 2yr real yield.



Source: BBG, Citi US Economic surprise index

1.Value transfer from govt. to private sector: fiscal payments to households and incentives to businesses, mirror image being the rise in govt. deficit and debt.

2.Value transfer from financial to private sector: private sector refinancing at low fixed rates, mirror image being huge unrealized loss in banks' excess capital.

Table 2: The great value-transfer.

(US$ trillion)	2019	2023	Gain/(Loss)
US Household Net Worth	110.0	146.0	36.0
US Government Net Worth	(15.5)	(22.4)	(6.9)
US Fin. Sector Net Worth	2.1	0.8	(1.4)

Source: FRED. US Fin. sector net worth (Commercial banks & Federal reserve capital less unrealized HTM losses).

By moving the burden of monetary tightening to the relatively less rate sensitive govt. balance sheet & financial sector's excess capital, these transfers may have buffered household spending & corporate margins (Chart 3 & 4).

Chart 3: Households financial obligation-to-disposable Income.

Source: FRED, BEA.

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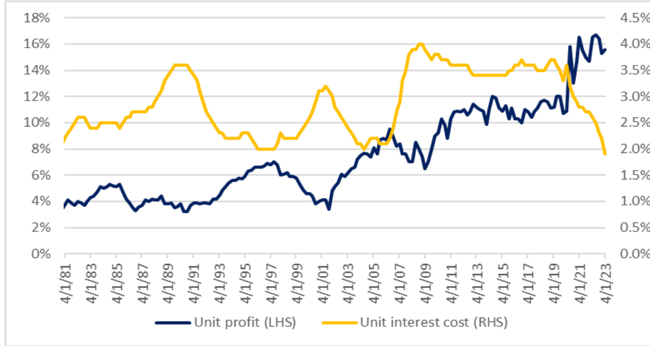
Chart 4: Non-financials corporates unit profit and unit cost.

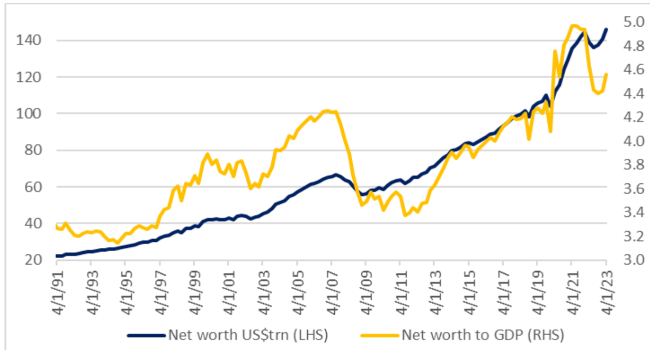


Source: FRED, BEA

Furthermore, value transfers are not necessarily a zero-sum game.

In fact, amidst these transfers, the rise in US household net worth - the most comprehensive measure of private wealth that includes excess savings, home equity, stock market etc. - has more than offset the decline in US govt. and financial sector net worth. This may be having a classic “wealth effect” on the economy i.e., high net worth, high spending, and low savings-rate.

Chart 5: Household Net Worth as of 2Q23.



Source: FRED

Nevertheless, despite a roaring economy and dollar, the actual systematic cost of these value transfers on the economy and private wealth is not yet clear.

That said, our assessment is that either it’s some secular shift or it’s this cause-effect (circular loop) of value transfers in the US economy that is behind current market dynamics. Only time will tell which one.

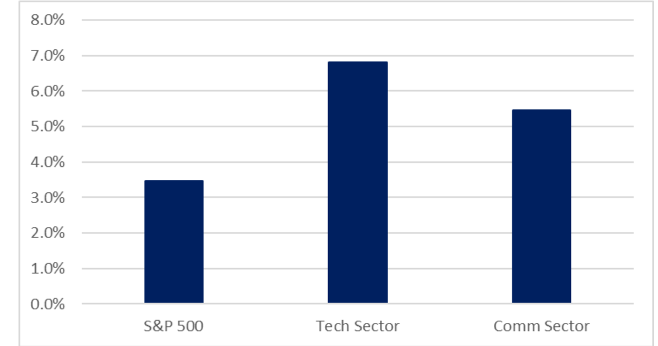
The risk-on boom versus the risk-free bust.

In August, we communicated to our readers that equity market was pricing in goldilocks scenario of “no-landing plus soft landing” and that volatility was the cheapest asset class.

While markets have sold off on surging bond yields, price action in equities, especially S&P 500, suggests that that risk-on pricing has not yet fully reversed. Why it seems so?

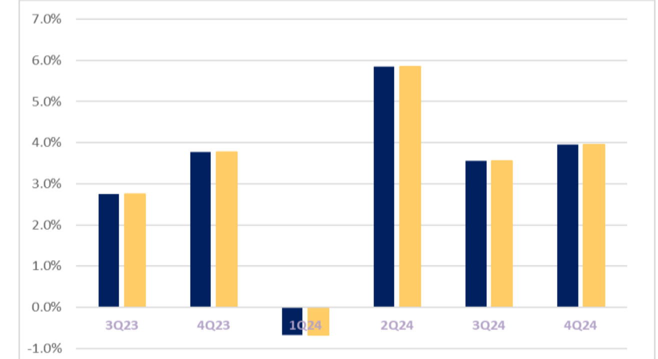
- First, EPS revisions and growth: since August, analysts have revised up S&P 500 EPS (blended 12 month forward) led by Tech and comm sectors (Chart 6). For 2H23, analysts expect sequential growth whereas for 2024 EPS growth of 12% driven by margin improvement (Chart 7).

Chart 6: EPS Revisions since Aug 2023.



Source: BEst

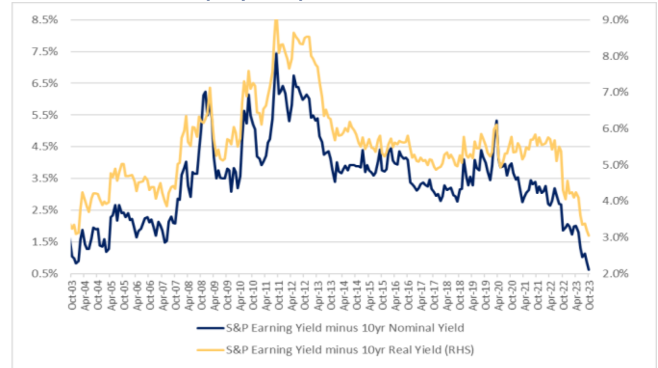
Chart 7: Quarterly EPS growth (yellow QoQ, blue YoY).



Source: Factset

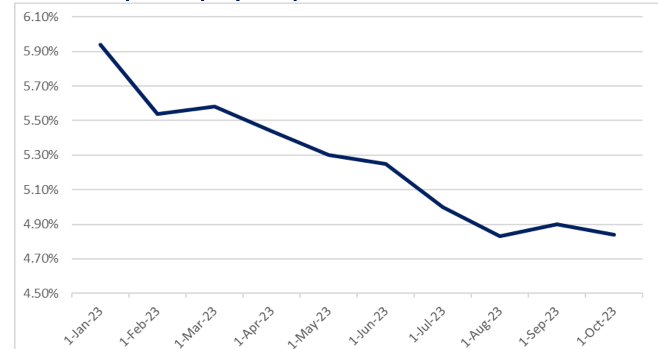
- Second, the equity risk premium: relative risk measures such as earning yield minus nominal bond yield, & earning yield minus real bond yield, have compressed further (Chart 8) whereas implied equity risk premium (which includes EPS growth) remains under 5% (Chart 9).

Chart 8: Relative equity risk premium.



Source: BBG

Chart 9: Implied equity risk premium.



Source: Damodaran

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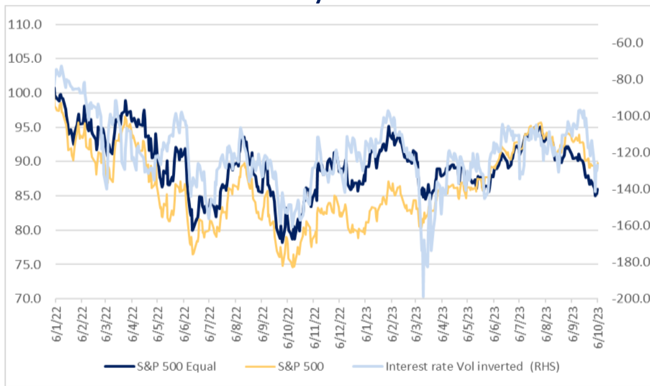
That said, our assessment is that the recent sell-off in equities is driven by a rise in interest rate volatility, and not due to a change in the fundamental outlook.

Chart 10: Interest rate volatility and S&P 500.



Source: S&P, Move Index

However, as we have been suggesting, the bar for risk-on boom to continue without setbacks remains high unless productivity cycle kicks-in like it did in the mid-1990s and actual earnings beat estimates. Big-tech to the rescue?

This brings us to the recent bust in US treasuries – the bedrock of the global financial system. If we were to sum it up with an analogy: what GFC was for risk-assets, this GTC (great treasury crises) has been for risk-free asset (Table 3):

Table 3: GFC vs GTC.

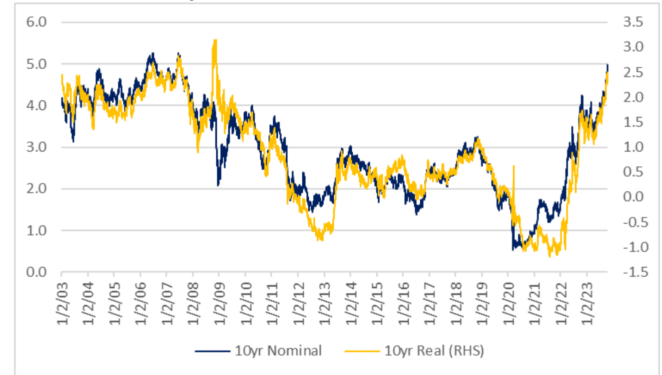
	Peak-to-Trough
S&P 500	-57%
Long Term Treasury	-44%

Source: BBG

- GFC was driven by excess leverage of the private sector whereas GTC has been driven by excess leverage of the government sector.
- Post GFC, the risk premium of risk assets increased while that (term premium) of risk-free assets decreased.
- Post GTC, risk premium (term premium) of risk-free assets has increased whereas that of risk-assets has decreased.

Or could it just be that the surge in yields has been exacerbated by the value-transfer we highlighted above?

Chart 12: Treasury Yield %.

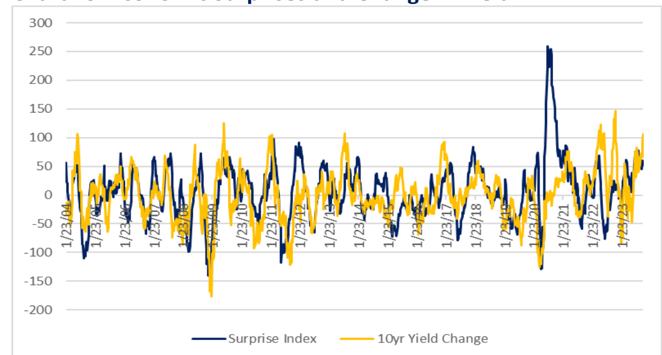


Source: FRED

Nobody has a crystal ball.

Increase in treasury supply, decrease in foreign demand, QT, could all be valid reasons too for this drastic surge in yields. However, our assessment is that risk-reward of treasuries is now looking attractive: they now offer 5% nominal and 2.5% real return (Chart 12: last seen before the GFC) and likely a lot more should US economic surprises reverse (Chart 13).

Chart 13: Economic Surprises and Change in Yield.



Source: Citi, FRED. 10-year yield 13-week change basis point.

If you have made it to the end, we appreciate your patience. Lastly, we will quickly summarize the fate of mid-small cap stocks with the same theme of value transfer: investors maybe expecting that in a high-for-longer interest rate environment, mid-small cap companies are more likely to service their debt obligation than make dividend distributions.

For further details on our active fund management capabilities and strategies, you can reach out to us at IR@farrocapital.com

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