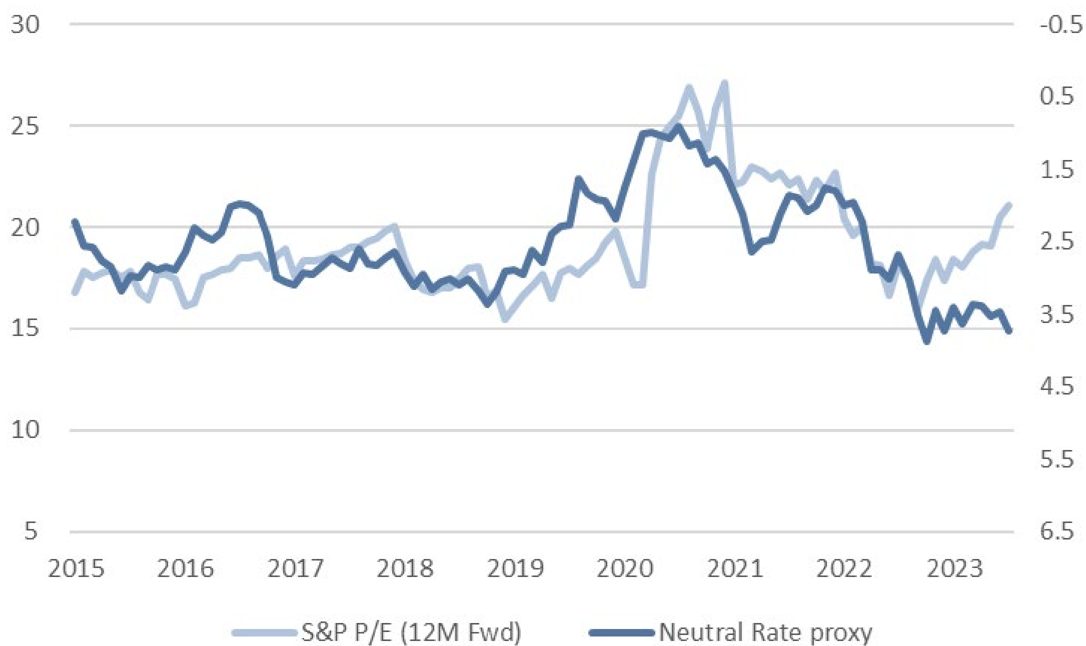
Weekly Commentary

Last week...

- The 10-year Treasury rate continued to hold steady near a 4% yield.
- The Black Knight Home Price Index, a repeat sales price index, hit an all-time high in August. Coupled with mortgage rates above 7%, home affordability is likely at an all-time low.
- The Atlanta Fed GDPNow tracker increased to 4.1% for Q3 2023.
- Year-over-year core CPI declined slightly from 4.8% in June to 4.7% in July.

Higher Rates Are a Risk to the Rally

Fig. 1: US equity valuations are pricing in a soft landing



Source: Bloomberg, Mill Creek.

As we've discussed, the Fed has a few months of breathing room while we wait for incoming economic data to confirm or reject Powell's expectation of a soft landing. Stock and bond markets have embraced this outcome of continued disinflation, steady growth, and central bank rate cuts that start sometime in 2024.

However, expensive segments of the equity market, including US growth equities, are vulnerable if interest rates rise further. US large cap equity valuations have disconnected from rates in 2023 (Fig. 1) and are at the top of the range that could be considered fair value. While we cannot discount a continuation of the euphoria surrounding mega cap tech, the scope for additional rerating higher is limited and a breakout in yields could be a catalyst for giving back some of 2023's gains in that segment of the market.

S&P 500 Earnings Growth Declines for Third Consecutive Quarter

While valuations have disconnected from rates, equity prices have disconnected from earnings growth. As the second quarter earnings season concludes, the market is on pace for a ~5% year-over-year decline in earnings growth, which would also be the third consecutive quarter of negative earnings growth.

However, the market continues to shrug off the current "earnings recession," but as noted above, valuations are elevated. The current price-to-earnings multiple of the S&P 500 exceeds the 5 and 10-year averages. Whether due to higher rates, continued pressure on corporate earnings in the second half of 2023, or some other unforeseen factor, equities—particularly US large cap growth equities—could lose some of this years' gains. As a result, we continue to advocate for a diversified approach across your global equity allocation and would caution against chasing the US market higher at these levels.

This week's contributor: Michael Crook, CAIA and Sam McFall, CFA, CAIA

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