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THE INVESTOR INSIGHT

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INSIDE:
Q3 Commentary
Too High, Too Fast, Too Long

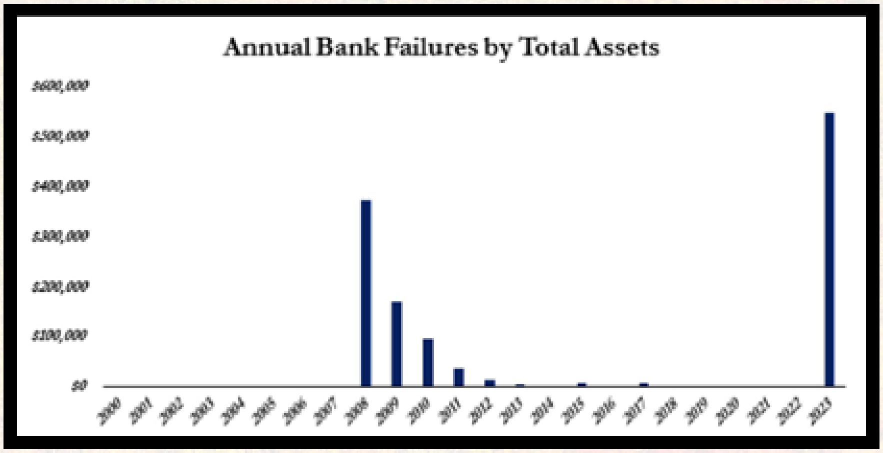
BACK COVER:
Navigating the High-Interest Rate Environment: Impacts and Strategies

Q3 Commentary

Too High, Too Fast, Too Long

When everyone seems to expect a soft economic landing after the unprecedented rate hike cycle in which the Fed has engaged for the past 14 months, brace for impact. That is the lesson of recent economic history, and it's an uncomfortable one for the U.S. right now. There are a multitude of reasons to think that the unwinding of 14 years of easy money—with the Fed pegging rates at zero and four episodes of quantitative easing, the last one right when COVID hit—would not be an easy process. And it is proving to be just that, an extremely difficult undertaking with no historical precedent. The Fed itself admitted such at its last meeting. The reasons are many and varied: the cessation of COVID-era stimulus payments to consumers, the reinstatement this month of student loan payments, government shutdown worries, war, supply chain disruptions, higher oil prices, tighter credit standards from stressed banks, the highest consumer debt on record, and mortgage rates approaching 8% (from 3% early last year). The list seems to keep growing. The bottom line: history and data suggest the consensus has gotten a little too complacent, just as it did before every U.S. downturn of the past four decades. Let's also not forget what happened back in March—several bank failures, whose total assets exceeded those of 2008, as seen in the chart below. Could this be an inflection point, where the Fed finally forces something to break, its hard line on rates leading to more bank failures?

Listening to recent speeches by several Fed governors, the Fed seems likely to embark on more rate hikes and plans to "keep rates higher for longer." That may be the outlook for now, but in my opinion, mounting evidence of a pending economic slowdown will start to change the Fed's tune as we enter Q1'24. One could even argue that the U.S. economy already has seen rolling recessions in several sectors over the past year. As lending standards have tightened considerably, sectors that depend on refinancing debt on a regular basis have found it difficult to do so. For example, we note the significant average downside in sectors over the past year: Utilities, down 31% (and locally, Dominion Energy [D-NYSE] down 56%); Real Estate Investment Trusts, down 32%; and Consumer Staples, down 21%. Some of the most conservative sectors have seen the biggest drawdowns during this period, making a challenging market even more difficult to navigate.


Annual Bank Failures by Total Assets

–continued inside–

September lived up to its reputation as historically the worst month of the year and, as of the writing of this commentary, October has followed, unfortunately. With several ongoing strikes, a continued hawkish Fed, resumption of student loan payments, and mortgage rates at a 16-year high, the markets have a lot on their plate currently. And the impacts of the historic rate hikes are starting to be felt in corporate board rooms. Duke University's Fuqua School of Business found in its Q3'23 The CFO Survey that current interest rates have caused more than 40% of CFOs to curtail spending on capital and non-capital projects. Other factors behind CFO decisions to curtail spending include economic uncertainty (52.2%), weaker demand (41.4%), and hiring difficulties (33.0%). The Conference Board's Leading Economic Index continued to show weakness, declining for the 14th straight month, something we have mentioned several times over the past year in our commentaries and our podcast. And in August, the ratio of Leading to Coincident Indicators hit a ten-year low for the third month in a row. According to the Conference Board, since 1960, the ratio has hit a ten-year low for at least three straight months in seven separate periods, all seven of which were during recessions.

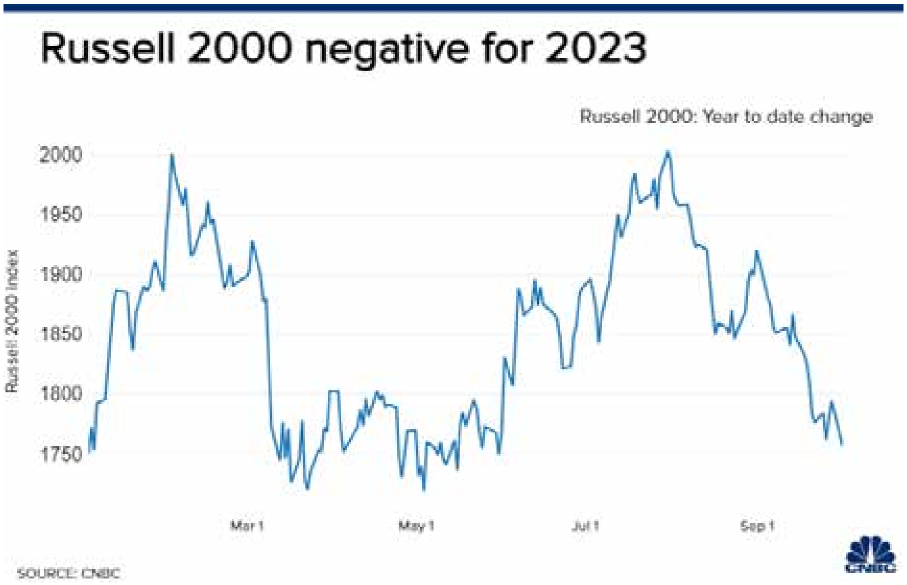
So, are we already in a recession? Although it is difficult to know until after the fact, the weight of the evidence indicates a weakening economy facing the risks already mentioned. But investors should remember to be open to the potential opportunities created by these periods, given that much of what has been discussed could already be priced into some sectors. Remember, markets tend to look forward six to nine months, pricing in the recovery. A good example of this is micro- to mid-cap indexes, which are down for the year and down significantly from their 52-week highs. As seen in the chart below, small-cap companies have trailed large-cap companies by the widest margin in history, and for the longest period in history. Valuations are compelling in the market cap index that has the best long-term record. The current bear market we are in is one that has been in existence for many years, when viewing the indexes from top to bottom. For example, small caps are currently where they were more than five years ago, mid-caps are where they were almost three years ago, the NASDAQ (even with the "magnificent seven") is where it was three years ago, and the S&P 500 is where it was more than two and a half years ago. Those are long periods of no returns, but those periods can potentially create significant opportunity.

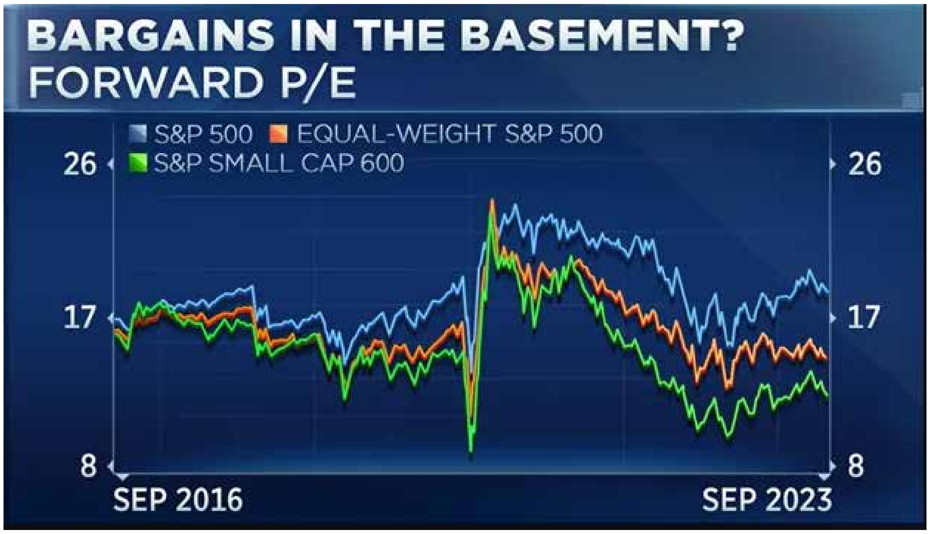
While we are likely at or near the end of the unprecedented rate hike cycle, the Fed's hawkish tone and potentially additional rate hikes could create additional volatility going forward. We do believe that, given the weight of the evidence, a pivot by the Fed is likely in the first quarter or first half of 2024, creating what we believe could be excellent opportunities in areas where capital investment tailwinds flow (and likely will continue to flow). We remain reluctant to be too exposed to the stretched consumer, but there are other areas that continue to see capital investment that is likely to continue for many years to come. We believe that focusing on these areas, specifically stock selectivity, can lead to some exceptional opportunities for investors who keep their heads during these volatile times, and we look forward to vetting these opportunities as they present themselves going forward.

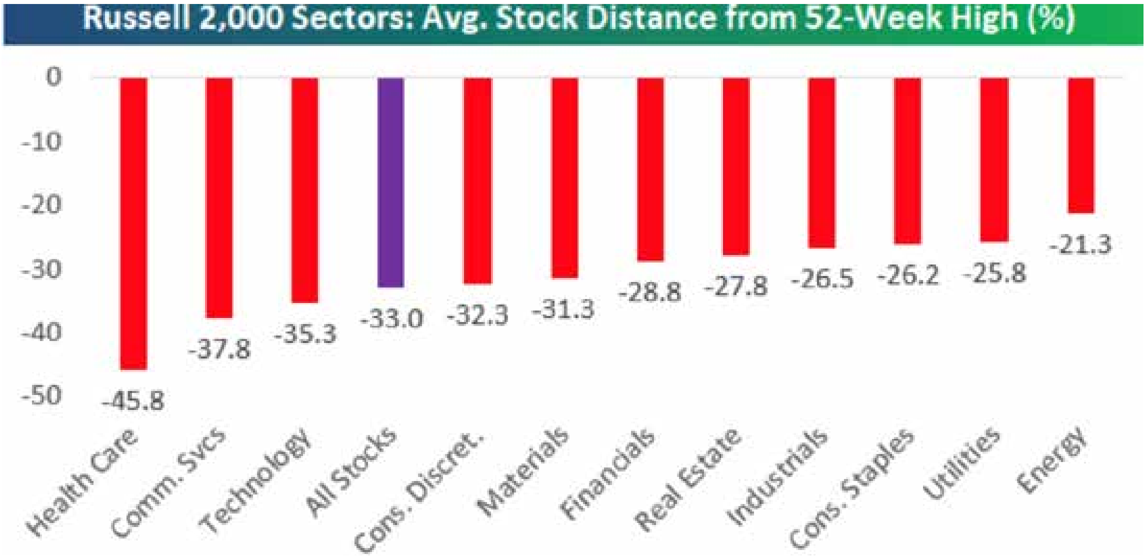
Kind regards,

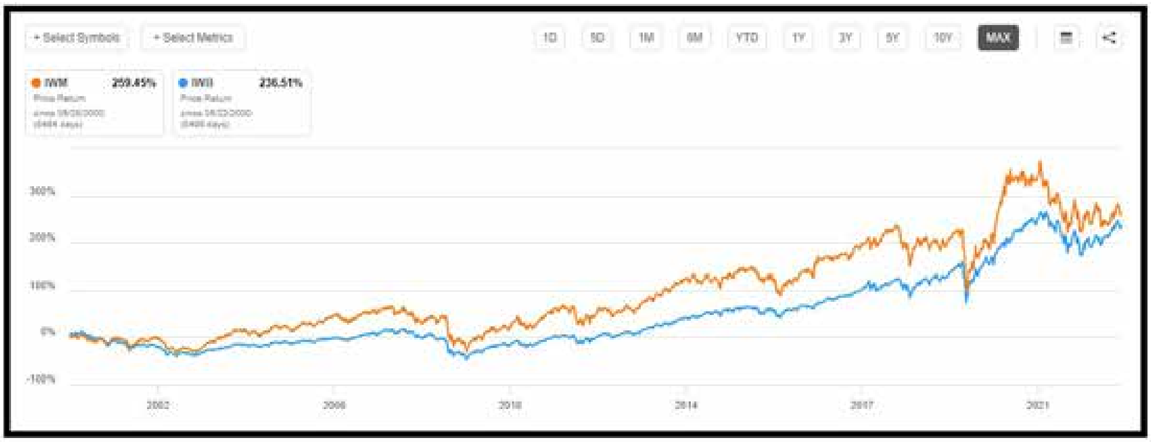
Bill Davis

William D. Davis Jr.
CEO and Portfolio Manager





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1D
5D
1M
6M
YTD
1Y
3Y
5Y
10Y
MAX
● IWM 259.45%
Price Return
since 05/26/2000
(8484 days)
● IWB 236.51%
Price Return
since 05/22/2000
(8488 days)
300%
200%
100%
0%
-100%
2002
2006
2010
2014
2017
2021

Small Caps (IWM) have historically outperformed Large Caps (IWB) (SA Premium)

Navigating the High-Interest Rate Environment: Impacts and Strategies

Recently, the global financial landscape has been marked by a notable shift towards a high-interest rate environment. Central banks around the world have implemented policies to combat rising inflation and stimulate economic growth, resulting in increased interest rates. While this move may be necessary to maintain economic stability, it has far-reaching impacts on individuals, businesses, and the overall financial ecosystem. Below, we explore the significant impacts of the high-interest rate environment and discuss strategies for navigating these challenging times.

Impact on Borrowers

One of the most immediate and noticeable impacts of high-interest rates is felt by borrowers. Be they individuals seeking mortgages, businesses looking for loans to expand operations, or governments financing public projects, higher interest rates mean increased borrowing costs. This can lead to:

- Reduced consumer spending—as the cost of borrowing rises, individuals may cut back on discretionary spending, impacting retail and service industries.
- Limited business expansion—higher interest rates can deter businesses from investing in growth opportunities, potentially slowing economic growth.
- Government budget constraints—governments may find it more expensive to service their existing debt, potentially diverting funds from essential public services.

Impact on Savers

On the flip side, savers and investors can benefit from a high-interest rate environment in several ways:

- Increased savings income—savers can earn more interest on their savings accounts, certificates of deposit (CDs), and other fixed-income investments.
- Attractive investment options—high interest rates can make bonds and other fixed-income securities more appealing to investors seeking stable returns.
- Diversification opportunities—some investors may shift from riskier assets to fixed-income securities to take advantage of higher yields.

Impact on Stock Market

The stock market is highly sensitive to changes in interest rates:

- Equity market volatility—higher interest rates can lead to increased market volatility as investors reevaluate the risk-return trade-off between stocks and bonds.
- Sector-specific effects—different sectors of the economy may respond differently to interest rate changes, with interest rate–sensitive industries such as real estate and utilities often experiencing more significant impacts.

Impact on Housing Market

The real estate market is particularly influenced by interest rates:

- Reduced affordability—rising mortgage rates can make homeownership less affordable, potentially cooling the housing market.
- Housing price adjustments—high interest rates may lead to adjustments in housing prices as demand decreases, impacting homeowners and real estate investors alike.

Strategies for Navigating the High-Interest Rate Environment

- Diversification—including a mix of assets such as stocks, bonds, and alternative investments in your portfolios can potentially help to mitigate risk.
- Savings and Debt Management—review your financial strategy, increase savings, and manage debt wisely to minimize the impact of higher interest rates.
- Consider Fixed-Income Investments—explore fixed-income investments such as bonds, T-bills, and CDs for stable returns in a high-interest rate environment.
- Monitor the Market—stay informed about economic indicators and central bank policies to anticipate potential changes in interest rates.

In conclusion, the high-interest rate environment we are currently experiencing has significant impacts on various aspects of the economy. Borrowers face increased costs, while savers may benefit from higher returns on investments. The stock and housing markets are also influenced, adding to the complexity of financial decision-making. By adopting prudent strategies and staying informed, individuals, businesses, and investors can navigate these challenging times and make informed financial choices to help secure their financial futures.

— Brant Jones, CFP®

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