CHANGES IN ATTITUDES

Jimmy Buffett sadly passed away over Labor Day weekend, coinciding with the unofficial end of summer, leaving behind a legacy as a troubadour and an empire of tropical escapism. Although Warren Buffett referred to him as "Cousin Jimmy", there was no relation despite the same last name. The lives of both men are a paradox as their laid-back persona and seemingly relaxed approach to their crafts are what made them billionaires. Beloved by their fans, Jimmy toured frequently, and Parrot Heads followed, while Warren welcomed more than 30,000 fans to Berkshire Hathaway's 2023 annual meeting. Released in 1977, *Changes in Latitudes, Changes in Attitudes* was Jimmy's breakthrough album. It was the catalyst for his "Margaritaville" brand, consisting of restaurants, resorts, booze, and merchandise, while Warren's Berkshire Hathway empire is a culmination of investment success across insurance, energy, manufacturing, retail, and railroads. With quotes like, "It's only when the tide goes out that you learn who has been swimming naked", and "It takes no more time to see the good side of life than it takes to see the bad", both men are revered for their quotable wisdom, and you may not be sure of who said what.

The U.S. economy has been sailing through choppy waters, stirred up by inflation and tighter monetary policy, and has been faced with several challenges recently. As stated by Federal Reserve Chair Powell at the Fed's last meeting, "It's the strike, it's government shutdown, resumption of student loan payments, higher long-term rates, oil price shock…there's so much uncertainty around these things."

- The UAW strike is against all three Detroit automakers, with the union seeking 40% pay increases and re-establishment of other benefits, to close the wage gap between executives and average workers. The industry is still building back inventory of new cars and replacement parts from pandemic shortages and is navigating the costly transition to electrical vehicle production. Factory disruptions, inventory issues, and EV initiatives are all driving prices higher for consumers.

- A government shutdown was recently averted yet resulted in the removal of House Speaker Kevin McCarthy and a six-week deal of short-term funding to keep the government open. Regardless of one's politics, this continued dysfunction has been noted as an "erosion of governance"[i] from a government that must be a reassuring presence to the financial markets and global economy.

- The student loan moratorium, which began in March 2020, is ending in October and may divert up to $100 billion in U.S. spending over the next year. The actual impact remains to be seen; however, retailers are wary as pandemic excess savings are nearly depleted and credit card delinquencies are climbing. Conversely, employment data remains strong with a 3.8% unemployment rate, higher labor force participation, and easing wage growth that now outpaces inflation.

- Oil prices rose through the third quarter as demand remained high and Saudia Arabia and Russia, the world's two largest exporters of crude, announced a decrease in output until year-end. Prices may move lower if demand is curbed by high importing countries, like China, due to economic weakness or by tapping reserves. Notably, the Strategic Petroleum Reserve of the U.S. is at its lowest level since 1983, as the Biden administration released reserves in 2022[ii].

The changes in attitudes of investors to the financial markets have been driven by the crosscurrents of these economic challenges and surge in higher long-term interest rates. The 10-year and 30-year treasuries ended September at 4.59% and 4.73%, moving higher by 50 bps and 53 bps, respectively, during the month. This sent a ripple effect through markets as this is the highest level for the 10-year yield since 2007. The rise in bond yields in 2022 was driven by expectations of higher rates from central banks, while the possible cause in 2023 is less clear. A likely cause is a higher term premium. This is the greater yield investors demand for longer-dated assets and will be higher if projected levels of inflation are elevated. The Fed is no longer actively buying government bonds due to quantitative tightening, and lower demand pushes those yields higher. Additionally, a brewing cold war between the U.S. and China, Russia's war in Ukraine, and more recently, the horrible Hamas attack on Israel, suggest peak globalization for the world economy may be behind us. Aging demographics, geopolitical turmoil, and higher energy and natural resource costs tend to keep inflation levels elevated, thus pushing yields higher. Lastly, the Trump and Biden administrations have disregarded the growing U.S. deficit, contributing to the country's perceived fiscal deterioration, which also drives yields higher. Foreign governments, U.S. banks, large funds, and other significant investors in U.S. treasuries may now require higher yields to compensate for risks during the holding period, which was not the case during extended periods of low inflation levels and accommodative monetary policy.

There are likely structural changes in attitude for investors in how they approach capital allocation, albeit, depending on one's portfolio objectives. The correlation between stocks and bonds was positive in periods of above-average inflation (mid 1960's to the late 1990's) and was negative in periods of below-average inflation (early 2000's to 2021). The return to a positive correlation was shown by the negative returns in both asset classes in 2022 and in the third quarter of 2023[iii]. Despite pricing pressure on bonds, this has provided investors with higher yield opportunities in the short-term, such as treasury bills, CD's, and money market funds, and now the long-term, to lock in higher yields in investment-grade bonds, for example. Bonds still provide a portfolio ballast as a protection of principal, redeeming at par when held to maturity, but now provide a competitive income alternative to equities. Investor changes in attitudes towards stocks may not be as evident, given the 11.7% YTD return for the S&P 500 through the third quarter. The S&P 500 Equal Weighted Index returned just 0.3% YTD, however, resulting in the widest differential between the two indices since 1998. Although higher interest rates tend to contract valuation multiples, their greater impact this year has been on dividend paying stocks, as higher yielding bonds offer an attractive alternative. According to FactSet, there are fewer than 30 S&P 500 stocks with a dividend yield above the six-month treasury bill yield of ~5.5%, and the ~3.0% difference between the S&P 500 dividend yield and the 10-year treasury yield is the greatest since 2007. It's the changes in attitudes towards bonds that will likely drive a greater allocation to them, while changes in attitudes towards dividend stocks likely present an investment opportunity. The caveat of a bond's predictable interest income is that it does not grow over time and bond yields must be considered after the impact of expected inflation. Stocks have historically provided an inflation hedge and companies can increase dividend payments over time, dependent on management ability to run a profitable company with excess free cash flow. Regarding management, Warren gave Jimmy advice while he was growing the "Margaritaville" empire: "Management in place", he said. "Find a good business that makes sense, and make sure there are good people running it."[iv]

[i] Fitch Ratings Inc.
[ii] Federal Reserve Bank of Dallas
[iii] Fidelity Viewpoints
[iv] New York Times