September 28, 2023
Commentary

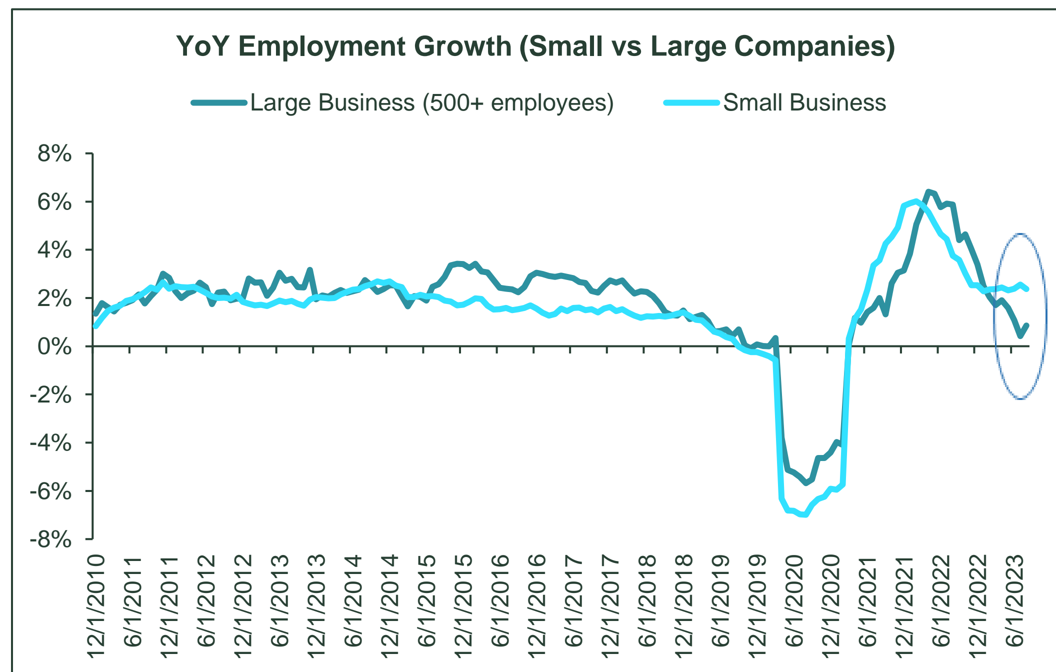
Weekly Market Update

Insight of the Week

Small Businesses Deserve Extra Attentions

When forming an investment opinion, macroeconomic dynamics are usually a critical input. Frequently, a direct link is made between the prospect of the economy and the future of equity markets. While this is a logical link, it's also worth remembering that not all types of equities have the same macro sensitivities. One of these perspectives is large vs small companies.

In the US, 99.9% of companies are small businesses with less than 500 employees and represent 43.5% of the US Gross Domestic Product. In comparison when looking at the Russell 3000, a proxy of the broad US equity market, small businesses only represent less than 4% of the total market capitalization of the index. Broadly, this means that in aggregate, smaller companies influence the macroeconomic story more than their representation within many market cap weighted indices.



Source: SSGA, ADP Research Institute as of 08/2023.

Taking a closer look at the recent employment data, small business employment has remained stable and is above 10+ year historical averages. Large companies however have recently seen softening employment growth. We believe that in order to achieve an economic soft-landing, it's important that small businesses have less inflation concerns and an easier time hiring. With large companies announcing

layoffs, impacted workers could potentially add supply to the small business workforce, easing some of their inflation concerns.

Sources U.S. Bureau of Labor Statistics, Bloomberg, U.S. Small Business Administration, FTSE Russell.

Equities

How Has Real Estate Fared?

Although interest rates have undoubtably influenced residential home owners, with mortgage rates reaching highs not seen since the 2000s, rates are also impacting commercial real estate. The real estate sector of the S&P 500 contains 8 industries, the majority of which are varieties of Real Estate Investment Trusts, which are companies that own, operate, or invest in income generating property.

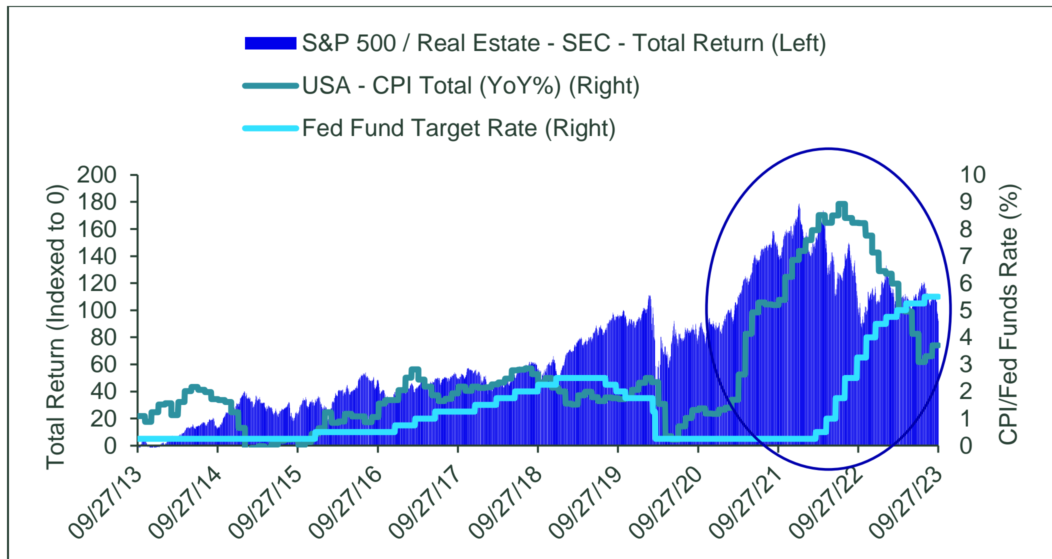
Real Estate
Health Care REITs
Hotel & Resort REITs
Industrial REITs
Office REITs
Real Estate Management & Development
Residential REITs
Retail REITs
Specialized REITs

Source: GICS, FactSet.

The performance of the S&P 500 Real Estate sector has been poor since the Fed began rate hikes in early 2022. From 12/31/2021 to 9/27/2023 the sector has returned -31%, the worst performing sector over the time period, underperforming the S&P 500 by 25%.

There are many forces at play impacting the CRE (commercial real estate) market and ultimately REITs. Real estate is sensitive to economic growth, inflation, and interest rates. Additionally the cultural shift of WFH (work from home) and online retail has introduced another aspect to the mix for both office and retail occupancy. Typically real estate performs well in a high growth and high inflation environment. When there is a healthy level of growth in the economy demand for real estate strengthens, and with flexible rental prices, property owners can adjust rents as needed when inflation is on the rise. For this reason, real estate is commonly viewed as an inflation hedge. On the other hand, a more restrictive macro environment with higher interest rates could introduce trouble by lowering property valuations and making new projects more costly. Not to mention higher fixed income yields that accompany a higher federal funds rate compete with and make dividends from REITS less attractive.

Below is a snapshot of the S&P 500 Real Estate sector performance alongside YoY CPI and the Fed Funds rate.



Source: FactSet. Data from 9/27/2013 to 9/27/2023.

When interest rates were on the rise through 2015-2019 the Real Estate sector actually performed quite well. From 12/31/15 to 7/31/19 the sector returned 37%. However, the federal funds rate was not nearly as restrictive as it is today.

In the circled area of the chart you can see as inflation was rising rapidly, the sector was performing quite well. However when the Fed introduced rate hikes and inflation came down, performance dropped off. This illustrates how the Real Estate market benefitted from rising inflation but faltered under tighter economic conditions with very restrictive rates.

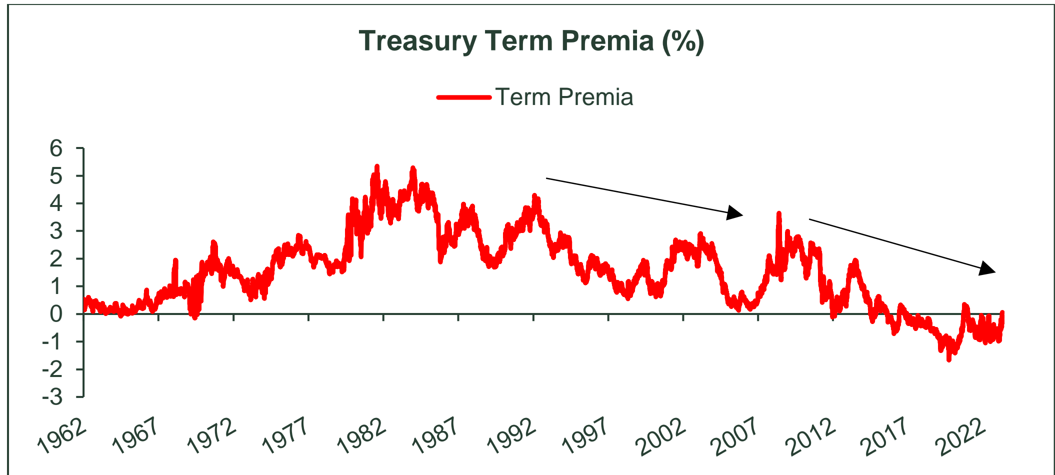
As the inflation story plays out the Fed will be very focused on data, however SSGA Economics believes it is possible the Fed will introduce multiple rate cuts in 2024. On the back of lower rates next year, real estate may be supported and will hopefully recover from the value destruction we've seen since 2022. However, with residual impacts from the pandemic effecting the various subsets of REITs there may continue to be headwinds for the sector.

Sources: FactSet. Data as of 9/27/2023 unless otherwise stated.

Fixed Income

Higher Deficit, Rising Term Premium

Term premium is defined as the excess yield investors require for taking on additional duration or principal risk associated with holding long-term bonds. Put simply, it's a representation of investors' demand for higher returns on long-term debt. Term premium as measured by the Federal Reserve began increasing in the 1960s, peaked in the late 70s and early 80s, and has since been declining. Accommodative monetary policy (QE and lower Fed policy rates) used to stimulate economic growth is the key contributor to declining term premium. In stable economic conditions, term premium should be positive, displayed by an upward sloping yield curve, but for the past several years term premium has been in negative territory.



Source: Federal Reserve Bank of New York: Federal Reserve Board, as of September 27,2023.

Are we at an inflection point? Has the secular bond rally ended and will term premia rise?

Term premia are expected to rise in the near future due to persistent US deficit spending. The United States has run a deficit for the last 50 years, averaging -3.2% per year. Over that time, the federal government has only run a surplus 5 times. To pay for this deficit, the federal government borrows money by selling debt (i.e., T-bills, bonds, notes). This massive deficit can be attributed to increases in spending for many government programs such as Social Security, health care, and interest on federal debt which has outpaced the growth of federal revenue, making it almost impossible to not run a deficit.

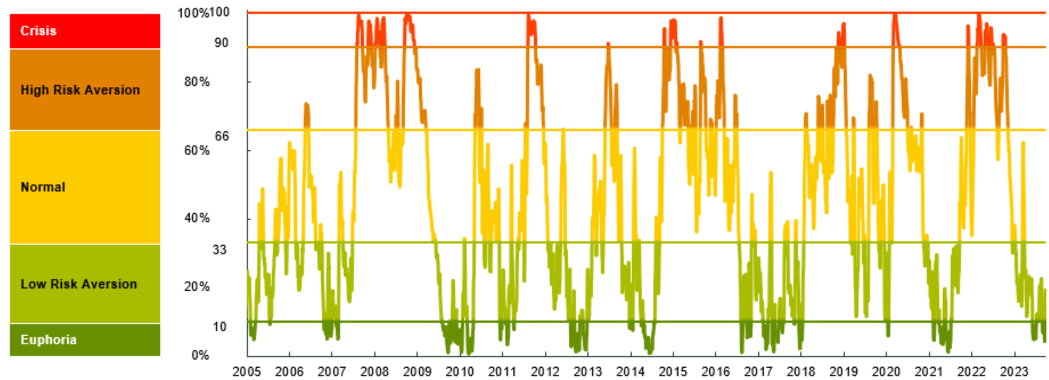
In May, the Congressional Budget office released projections of $1.5 trillion (5.6% of GDP as of Q2) for the 2023 federal budget deficit. As of August, the current numbers show we have already exceeded this projection by $30 billion and are on pace to do more. This will likely cause the need for additional borrowing from the US Treasury and should increase the term premium. We've already seen the effects of this increased borrowing – despite lingering near zero or below for the past 24 months, term premium has turned positive for the first time since 2021. This could be an indication of the yield curve reverting back to an upward sloping curve – higher rates for long-term debt.

Source: Federal Reserve Bank of New York: Federal Reserve Board, SSGA.

Market Regime Indicator

The Market Regime Indicator (MRI) represents a proprietary multi-asset class model designed to characterize risk appetites within the capital markets.

Days in the Low Risk Regime (since September 26): 2 days



As of September 27, 2023. The data displayed is not indicative of the past or future performance of any SSGA product. The portion of results through March 31, 2011 represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis. A slight calculation change was made as of June 28, 2019.

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*Pensions & Investments Research Center, as of 12/31/22.
†This figure is presented as of June 30, 2023 and includes approximately $63 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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