FS INVESTMENTS®

Episode 72

Q4 Research roundup: Can the growth continue?

Our experts dive into the latest in commercial real estate, corporate credit and macroeconomic trends.

Lara Rhame (00:05):

Welcome back to Fireside, a podcast from FS Investments. My name is Lara Rhame, and it's time for another of our favorite episodes, the quarterly research roundup. Thanks, Rob. Welcome. Today I'm joined by the experts, Rob Hoffman, who you just heard, is our Head of Credit Wealth Solutions and our thought leader on all things credit. And Andrew Korz is the Director on the research team who informs our commercial real estate views and analysis. So welcome.

Rob Hoffman (00:37):

Happy to be here.

Lara Rhame (00:38):

First, I want to acknowledge that we're recording on October 11th, 2023, and it's important to acknowledge the terrible events that occurred just several days ago in Israel and are ongoing. Our thoughts and prayers go out to the Israeli people and we hope that if you have family or friends in Israel, they are safe and in good health. And I also acknowledge this because markets are moving fast and so many of the market and economic themes we discuss in our outlooks and today on this podcast are longer term, but of course many of them have been impacted by these recent attacks. So with that in mind, the structure that we often do to kick this off is taking a quick look back at the third quarter, and I'll fall on the sword first. And I'm the only one that has to fall on the sword in this room because you guys are looking great. When we read back on your third quarter outlook...

Rob Hoffman (01:34):

What's harder being a chief economist or a weatherman?

Lara Rhame (01:39):

Yeah, I feel like I'd rather read a teleprompter and point to a green screen some days. So the Q3 outlook, I called it "Sailing into a slowdown", and that was wrong in the third quarter. In fact, still early days, but Q3 real GDP growth looks like it may be north of 4%. And the Atlanta Fed now cast has 4.9% as its GDP now indicator. And I think what we have continued to see is an economy that is truly firing on all cylinders. Strong household consumption, strong investment spending, government spending. I think hiring is so important. We added 800,000 jobs in the third quarter, and the average, the unemployment rate average 3.7%. So I think the tailwinds of excess savings, the foundation of a strong labor market, all of those things combined with the fiscal stimulus in the form of infrastructure spending had just all really continued to carry us through really, really robust growth. And I will now set the stage and connect that to financial markets so that to give you to the platform to look back as well. But I think this is one of the most misunderstood paradoxes that occurs oftentimes when the economy is performing well, financial markets do not. So, the S&P 500 was up 7% in Q1, up 8.3% in Q2, third quarter down 3.7%.

Lara Rhame (03:16):

Traditional fixed income, Bloomberg Agg up 3% in Q1, rocky second quarter down 0.8%, third quarter down 3% with the surge in long run interest rates. So, I think with that backdrop in mind, let's go around the horn. Andrew, we'll start with you with CRE because this move in interest rates is kept right on going. What impact did that have in the last quarter?

Andrew Korz (03:43):

Yeah, sure. So, I think on the surface Q3 and as we talk about CRE is it's a slow-moving beast. There's not always a ton new, at least new trends to point out for a given quarter. But on the surface it was really, I would say more of the same, at least from an activity standpoint. Deal volumes have been pretty much flat for three straight quarters. That's really been the story of the year. You have investors that have the ability to wait, are waiting, and ditto for sellers who have the opportunity to wait. So the deals that are happening are either motivated sellers that are sitting on stronger assets or opportunistic buyers who see more rent growth in a property than maybe the current holder has. So I do think it's important we take a step back from that and consider that more of the same is actually sort of a positive thing, right? We're about 16 months into this correction and the left tail outcomes that I think so many people have been talking about for the majority of those 16 months have really not come to fruition.

Lara Rhame (04:40):

Yeah, I think that's one of the punchlines that you have always said. That this correction is going to be totally different from the 2007, 2009 environment. It's not going to be a repeat. And I think happily that's turned out we're not done with a correction, but it has been totally different.

Andrew Korz (04:58):

No, I mean you talk about the two big risks are either financial fragilities or economic fragilities, right? And I think we dealt with the financial fragilities following the GFC with lower leverage levels, a much more robust lending market and just better sort of documentation and loans. And that's really shown, right?

Lara Rhame (05:14):

Yeah.

Andrew Korz (05:14):

Delinquency rates are rising in office, but everywhere else look pretty good. And then in terms of economic fragility as you just laid out, we're certainly not seeing that that's flowing straight through to fundamentals. So I think those things combined, I think Q3 was a continuation of what we've seen in a lot of ways, but I think for most people I think that's just fine considering what some of the expectations were.

Lara Rhame (05:34):

Sure. And Rob, let's talk about credit because stocks and bonds both down over 3% in the third quarter. What was up? High yield 0.5%. Take us through how last quarter was in the credit market as vis-a-vis your outlook, which I think also was correct, unlike mine.

Rob Hoffman (05:53):

Yeah, no, well look, certainly we perfect on the year, and I think you go back to one of the things that there were maybe two things in particular to highlight that we called for the year. One of which was credit to outperform equities and the other was for BBs to outperform lower quality CCCs. Now through much of this year, obviously equities have done really, really well and I think that's a proxy for a kind of risk on trade across markets. And when you look into markets like high yield or loans, you've seen CCCs have vastly outperformed BBs. But when you look at the third quarter, something started to change and as you noted, equities were down in the mid threes, high quality bonds, the Agg into the mid threes. It's only the fourth time in the past 30 years or something where both stocks and bonds have been downed by more than 3%.

(06:48):

And I think you started to see this microcosm where now the higher yields available in credit markets actually led to outperformance against equities. And as equities bumped up against 20 times PE ratios, the littlest bit of bad news created a lot more downside in equities, while you have really nice income and some duration protection as you get into markets like high yield and loans that protected those markets against the type of moves that really impacted equities. And so as you noted, the high yield was up a half a percent. The loan market by the way was up almost three point a half percent in the third quarter. So you really started to see some of these attributes for credit to shine through, especially when you think about the nature of what caused the market to sell off and the bear steepening the rising in long-term interest rates. But what caused that, it's been fundamentally positive and even above expectation macroeconomic news. And so as I think back to what drives long-term returns for credit markets, yes they become impacted by the swayze and sentiment and what's going on in equities, but if fundamentally the economy's growing at four plus percent, that means the underlying quality of companies and credit markets is really good. And I think you've started to see some of that shine through, especially because yields are so high in what that offers for credit.

Lara Rhame (08:19):

And I wonder, we've talked so much about the just very different industry and sector composition in the high yield market or in credit markets overall compared to equities. And that was obviously a headwind in the first half when equities just rode tech stocks higher. I think in Q three you started to see that become more of a tailwind for credit markets because they didn't have that sort of tech sensitivity to higher interest rates.

Rob Hoffman (08:40):

Yeah, absolutely.

Lara Rhame (08:42):

Well, let's talk about equities quickly too, just to round out the look back because was it just what happened with equities down 3%? Was it just higher interest rates or yeah, it was a tough quarter especially. I mean July was actually pretty strong. I mean we were starting from a really high valuation.

Andrew Korz (08:57):

Yeah, we got to just short of 20 times forward at point, I remember I

Lara Rhame (09:01):

Wanted to put in a graph of forward PE and you were like, no, no, wait until it hits 20 and it never did.

Andrew Korz (09:06):

Well, 20 is a very important psychological,

Lara Rhame (09:10):

It got close enough.

Andrew Korz (09:12):

I think me saying to wait for that was probably the same thought the markets were saying of, hold on, we can't get to 20 times fee. But no, it was a challenge, especially the past, the last two months of the quarter down more than 6% over August and September. And I think a lot of it was the move in rates as Rob just mentioned, the 10 year was up almost a hundred basis points. Most of that was over the last two months, and most of that was a move in real rates. So I think, and if you look under the hood a little bit, the rate sensitive sectors, tech, which is sensitive from a valuation standpoint, utilities in real estate, which are yield centric, got hit pretty hard, financials outperformed, there's still obviously a lot of issues in banks, but the steepening of the yield curve really kind of helped smooth out the financial sector there. And cyclicals were sort of in the middle. On one hand, they react positively to the good economic news. On the other hand, I think there's this recognition that real rates went up a lot very quickly and

Lara Rhame (10:03):

15 year highs and

Andrew Korz (10:04):

Nobody really knows yet. So far the economy has been resilient to higher rates. Absolutely, we're going to grow 4% g D P in Q three, but I think there's this recognition that at some point that's going to flow through to the economy. And I think for cyclicals, you're seeing this hesitancy to really accept the current economic news because real rates have gone up so much. So I think Q three was really about this market recognition that you can't have your cake and eat it too. The resilient economy sort of comes with a price, and that price is this bear steepening that we're seeing right

Lara Rhame (10:32):

Now. And I think this is a good place to look now to the fourth quarter and what we're expecting because, am I going to double down on sailing into a slowdown question?

Andrew Korz (10:45):

Eventually you'll be

Lara Rhame (10:46):

Right. Yeah, maybe. Listen, we can't grow. The reality is that the

Andrew Korz (10:53):

Potential

Lara Rhame (10:53):

Growth rate of the US economy is still one in three quarters, 2% is a high estimate. Sustained growth at 4% is just not realistic. So I feel like odds are in my favor that we're going to slow down to at least 2%. Let's go

Andrew Korz (11:11):

Back to the 1960s, come on

Lara Rhame (11:13):

Or the late 1990s. I think the slowdown is something that a lot of the headwinds I highlighted are still there when you look at both Q four and a little bit ahead into next year. The idea is, and I think this is reflected in a lot of corporate filings, a lot of earnings discussions,

(11:40):

We can't sustain the growth that we have today. Is a slowdown totally dodged or is it delayed? And that was my title. And I think more importantly, just this idea that the growth is not sustainable at these current levels. So very quickly, my three things that I'm looking at in the fourth quarter continue to be household spending. That is solid. We have a solid foundation from the strong labor market. But I'm going to add in the fact that consumer confidence, and this is a small vulnerability, consumer confidence today remains surprisingly anemic relative to where it was before the pandemic. And when you look at the two drivers of the main indicators that we look at, one of them is inflation, and I'm going to get to that in the next breath. But the other one is the labor market. The conference board's measure of consumer confidence is highly tied to the labor market, which is by all measures strong and still consumer confidence is below where it was before the pandemic.

(12:49):

So to me, that really says that there is a part of the household psyche that is still nervous, and at the end of the day, that is what really controls those spending decisions. So inflation I think is going to be a really key piece of this. And while the fed can declare progress on inflation, they cannot declare victory. We have seen some of the small factors that are starting to come back in higher energy prices, higher food prices, goods, prices have stopped falling. We're going to see those, I think continue to make it hard to fit inflation back in that 2% basket. Today, inflation's still 4%. And this is something that I really highlight in the quarterly outlook. The sticker shock is still very much with us. I don't care how good any statistician feels about the fact that used car prices are flat year over year. They're 30% higher than they were two and a half years ago.

Andrew Korz (13:52):

That

Lara Rhame (13:52):

Is so painful for household budgets, housing affordability has gotten crushed still. And these are the factors that I think to me really make the household a little more cautious and going forward I think is going to continue to, and

Andrew Korz (14:07):

You're just starting to see real wage gains. If you draw a trend line from

Lara Rhame (14:12):

Before

Andrew Korz (14:13):

Covid, real incomes have not recovered, but consumption has. So I think households are feeling that discrepancy, they're spending more and they're making less than they would have on the pre covid trend.

Lara Rhame (14:24):

That's such an important point, Andrew. I think exactly to that point. There's this huge discussion. I'm not going to get into it about excess savings.

(14:32):

How much is there really who's going to be spending it? I think all that I'll say is that it's not a bottomless well, and I think that as consumers over time, and this varies across income cohort, but that tailwind will fade at some point, but clearly timing that has just proven extraordinarily difficult. And the last thing, I'll just cap my piece with the Fed, and I think this can lead directly to Rob's views on credit in the coming quarter, but I think the Fed is clearly winding down its rate hike cycle. I'm going to go out on a limb and say, I think they're going to raise again in the fourth quarter. Markets do not agree, but I still think that's a more likely than not scenario they've penciled into the do plot, but this move in long-term rates, that's shadow tightening, stronger dollar, higher oil prices, high real yields, all of that is also I think going to continue to be a headwind. So Rob, I'll kick it to you because that was enough about macro.

Rob Hoffman (15:29):

No, I mean I think credit in Q four look underpinning my expectation for continued positive returns, high yields now yielding in excess of 1.6% per quarter. The loan markets almost at two point a half percent per quarter. That's a significant amount of carry of income that those markets generate. That provides a very strong base for return. At the same time, you also have still some decent upside from a price perspective. So the average price in the high yield market is just under 90.

Lara Rhame (16:03):

That's

Rob Hoffman (16:03):

Very different than if you were to just take spreads of 400 or 4 25 where they are right now and look back in previous environments of spreads at this level, your average price could have been par and the amount of bonds trading above their call prices much higher than now.

Lara Rhame (16:19):

We're almost none on, this is something we've always talked about that from a relative value standpoint, there's more opportunity in credit than there is and especially the deeper spectrum of credit than there is in the equity market in public markets. I

Rob Hoffman (16:32):

Mean, not only do you have high income, but you still have the strong ability to generate price appreciation if the economy continues to grow at trend or double trend,

Lara Rhame (16:43):

Right. But say that it returns to trend. I mean I think that's the question. Is this still a sector that's going to remain resilient in that scenario? I

Rob Hoffman (16:51):

Mean, I think that companies have been so conservative and we've seen this impact the market in a couple of different ways. It has beneficial for investors, one of which is that there has been very little new debt issuance by companies both in terms of bonds and loans. Part of that is because m and a transactions, acquisitions, transaction volume is way down because nobody wants to buy anything right now. Bid ask spreads are too high, the cost of financing is too high. But what it's caused companies to do is just focus on refinancings, which doesn't create net new debt in the market. And as a result, companies, and we saw a pickup in this in Q three, it's been pretty slow this year, but the supply demand dynamics of the market has been exceptionally favorable. Both bonds and loans are set to contract for a second year in a row, and again for a second year, you have demand, whether that's coming from new dollars coming into the market or reinvestment of cash flows and coupon and other things, demand outstrips new supply.

Lara Rhame (17:52):

Do you think those supply dynamics are going to continue in the fourth quarter?

Rob Hoffman (17:56):

I think that one of the things we talked about in our Q three outlook was the possibility of this maturity wall that isn't so much an issue in 2024, but I hear

Lara Rhame (18:06):

A lot about that, but

Rob Hoffman (18:07):

Starts to become an issue in 2025 and certainly 26 and 27 in credit markets. Historically, credit's done a pretty good job of addressing maturity wall issues. We had the same thing in the financial crisis and everybody started looking to 20 12, 20 13, 20 14. It's like this is going to be a huge issue for markets. But then things eventually got strong in 10 and 11 and companies were able to refi. I think we saw a little bit of that start to happen in the third quarter, especially in the month of September where markets had been strong enough, the refi window had started to open up, companies started to do more refinancing issuance to try to dial back this 2025 maturity wall. So I think companies will continue to look to address

Lara Rhame (18:49):

That. Yeah, they're smart enough to be opportunistic about it, right? Yeah.

Rob Hoffman (18:52):

All you need is a one or two month window where the market opens. Everybody will rush. They'll start to bring a bunch of refinancing. They're not bringing a lot of net new deals, but they're going to refinance a lot of those short-term maturities. I think the market will continue to do that and should be able to do it successfully. The other thing that is incredibly important is just credit fundamentals continue to be really strong. Now look, this is backward looking data. The most recent data we have is Q two, but Q three G D P growth is going to be four plus percent. And so you're not going to see a deterioration in credit fundamentals when G D P is growing that strongly. And look, in the high yield market, the amount of cashflow coverage that companies have relative to interest expense is running above five times for seven consecutive quarters. It's never been that high in the entire history of the data before covid. So corporate fundamentals are good, income is really strong. I think it still creates a pretty good environment to take the risk that credit offers to generate the potential for really good returns.

Lara Rhame (19:55):

Yeah,

Andrew Korz (19:56):

It's so interesting. Just going back to your point about the refinancing, it's sort of that narrative in commercial real estate as well. And it's almost like as I hear you talking about it, it's like this is why the Fed is so dead set on keeping rates where they are or maybe raising one more time. If rates were to go down from here meaningfully the ground swell of refinancing and of activity that would all of a sudden pick right back up in the housing market and commercial real estate and credit, all of these markets would just flood back in. And it's almost like that's one of the primary reasons that the Fed is so staunch in there in their keeping rates where they are.

Lara Rhame (20:34):

I think that is the hammer and the dance. They're keeping an eye on financial conditions because I think their sort of deal is, their bargain is listen, we'll stop raising rates if the higher long-term rates, and if long-term rates were to go back down to three and a half, I bet that they would just be continuing to raise rates. So Andrew, for commercial real estate, I know that you've been optimistic about multifamily, you've really highlighted strength in the industrial sector. Has anything changed? Are you looking more, is it your discussion more about capital markets? What are the key highlights that you want people to take away from the fourth quarter outlook?

Andrew Korz (21:15):

No, so I think the first thing is just very tactically, I think Q four is generally the most active quarter. Again, we've had deal-making for three straight quarters, basically. It'll be very interesting to see if we do get a bit of dam breakage here and deals start to get done.

Lara Rhame (21:31):

Yeah, people get itchy. They want to make a move.

Andrew Korz (21:34):

Look at a circling a building for

Lara Rhame (21:35):

Three quarters.

Andrew Korz (21:36):

You want to pull the trigger. There's psychological, you want to get deals done before year end. It'll be interesting. And I'm not saying there's going to be this giant uptick in deals we saw in

Lara Rhame (21:44):

21 or something like that,

Andrew Korz (21:45):

But it will be interesting to see do we get more price discovery in Q four than we have during the first three quarters of this year? I do think the office sector is very interesting. I think we're, is

Speaker 4 (21:53):

There something going on there? I'm not sure.

Andrew Korz (21:56):

Although we are in the office right now. So

Lara Rhame (21:58):

Absolutely

Andrew Korz (21:59):

We are starting to see some trends develop, I think in the positive and the negative. On one hand, I think delinquency rates, if you look at certain banks, a lot of these big commercial banks post their delinquency rates by sector. Most sectors are very strong. Still office is not. We're seeing delinquency rates rise across banks in C M B Ss. On the other hand, there are some promising sort of forward-looking metrics, whether it's public transit utilization, whether it's there's these unique ways to track cell phone data in certain cities. There is still a gradual but continuous uptick in whether it's like the New York subway, right? Yeah.

Lara Rhame (22:36):

I think we were waiting for a new normal to

Andrew Korz (22:39):

Emerge

Lara Rhame (22:40):

Emerge for work from home, and it still hasn't yet. It's

Andrew Korz (22:43):

Interesting. I think to your point, I think people sort of expected this hybrid Tuesday to Thursday type of world to emerge, and we have kind of seen that. But again, utilization rates of public transit continue to go up. I think we are slowly but surely seeing some downtowns improve from where they were.

Lara Rhame (23:02):

But I know there's a big mismatch in office, but a lot of these, especially the big offices, are like 20 year leases. And the headlines, especially in central business district, remain challenged.

Andrew Korz (23:12):

Absolutely. And what you're seeing, this is a chart we have in our Outlook deals are disproportionately being done for newer, well leased

(23:22):

Strong tenant type of buildings. So in Manhattan, for example, that only represents 10 to 15% of the stock of buildings, but it represents something like 30 to 40% of the total deals done in Manhattan. And that's part of the reason why you've seen in the data prices maybe haven't fallen as much as some people expect. So as we get more of these deals coming to market, on one hand it's going to be painful from a value perspective. I think for a lot of these office buildings. On the other hand, investors more than anything want certainty if not certainty, something close to it. So when we can put a value and say, in this city, this type of building fetches me $200 a square foot, $180 square foot, whatever it is, that level setting is positive for the market overall. And I think we're starting to see that as folks get more comfortable with what the future is going to look like.

Lara Rhame (24:12):

Okay. All right. Good. So green shoots emerging.

Andrew Korz (24:15):

Yes. I

Lara Rhame (24:15):

Think something that we talked about,

Andrew Korz (24:17):

Pick greens. I would say

Lara Rhame (24:18):

Yeah, we like to, I think pick one overarching theme that we expect to impact things in the coming quarter. And this, I do feel like we hit the nail on the head last quarter, which was, we called it two-way risk in interest rates. And I still am really comfortable with that language, even though over the third quarter it really only went one way, which was higher in the third quarter. The fed raised rates once one quarter, 25 basis point rate hike, but the 10 year yield went from

Andrew Korz (24:53):

3 83

Lara Rhame (24:54):

To four 80, a hundred basis point increase. And just to remind every listener, when we talk about the yield curve, which technically because it was so inverted, we call that steepening in this case really flatter, but steepening. And when that happens, because yields are rising,

Andrew Korz (25:16):

It

Lara Rhame (25:16):

Means it's happening because prices are falling, they're just falling a lot more in the long-term part of the yield curve than in the short-term part of the yield curve. And the language that we say for that is bear steepening. So if you've heard that expression out there and you are trying to catch up on what it is, that's what it is. It's when yields are going up across the time spectrum, but they're going up a lot faster in the long-term than in the short-term end. So this bear steepening is something that is rare in the later part of a fed rate hike cycle, and it is very painful for markets across the board. And I think again, it's been a geopolitical catalyst that has caused long-term interest rates to go from four 80 back to 4 55, which is today when we're recording this. But to me, this two-way risk is still really powerful. And not to repeat the order again, but Rob, I want to talk about that with you because I think to me, one of the most important features of investing is this idea that people say, why would I do anything other than buy a two year treasury at 5%? That's a great deal. And of course, I think we all recognize that there are cohorts and times that is an obvious choice for at least part of your portfolio, but recognize that

(26:34):

The price swings have been vicious and you're losing a lot of money in the month to month statement that you're getting with that investment. And hey, with inflation at 4%, 5% nominal yield may not be as great as you think that it was. I mean, to me, you need to be looking for more income to offset those price swings. And I think in terms of overarching theme of investing in general, to me that's a really important one that we are still only retraining around.

Rob Hoffman (27:07):

Yeah, I mean, look, I've been on the road a lot with advisors

Lara Rhame (27:11):

Over

Rob Hoffman (27:11):

The course.

Lara Rhame (27:12):

I wanted to get your thoughts from the road because you've been in such high demand

Rob Hoffman (27:15):

And it's been very interesting. I will say in many, many meetings, you start a conversation with an advisor and you're talking about markets, and one of the things that's come back overwhelmingly is just we're starting to look at fixed income again for the first time in decades,

Lara Rhame (27:30):

I've

Rob Hoffman (27:30):

Never really had fixed income allocations. I wasn't really interested in fixed income funds or strategies. Now all of a sudden I'm starting to come back to that as something just given what's gone on with rates and where the market is. And I think that takes different forms. It can be more duration sensitive because they think rates are going to fall, but they acknowledge that yields are high. Now it can be more credit focused because the return prospect may be strong. We see a lot of interest in private credit strategies to try to get even higher income without maybe some of the day-to-day volatility. I do think there is a lot of interest that has come back towards fixed income as a function of this, but I think you're right in that we do have to acknowledge that over the past 18 months you've had this very big difference in outcomes between equities markets and fixed income markets.

(28:18):

And you do have two-way risk, especially as you get to more duration sensitive parts of fixed income rates, go back to four and a half to five again where they were, and suddenly the ag is going to be down a bunch. And I do think that that's an interesting dynamic, but absolutely high yields have created people looking towards fixed income. Look, there is a lot of uncertainty out there in markets. I think those types of broad attitudes about where our equity is going to go, where's the macro environment going? You can tell just from our discussion here, it's very similar talking with advisors and as they talk with their clients, there is not one strong consistent view about where things are going. And then lastly, I would say that the other hottest topic that comes up in almost every meeting is office and real estate. And just wonder what,

Lara Rhame (29:09):

It's still only

Rob Hoffman (29:10):

A small

Lara Rhame (29:10):

Slice

Rob Hoffman (29:11):

Of

Lara Rhame (29:11):

Cre, but it's

Rob Hoffman (29:13):

A hot topic. It's the main headline. And so there is this propensity to associate everything commercial real estate with the health of the office market. But as we've talked about before, that's not necessarily the right way to look at it, but it's

Lara Rhame (29:25):

Why you need to read Andrew's CRE quarterly. But

Rob Hoffman (29:27):

It's such a hot topic,

Andrew Korz (29:28):

And I would argue it's almost the opposite of that because to the extent that we go back to some pre covid new normal in office, I mean people are working from home less and people maybe put marginally less value on their apartment. So I think multifamily has actually been sort of a beneficiary of some of the work from home stuff. So I think there is sort of this inherent diversification in commercial real estate right now that some people aren't really acknowledging.

Lara Rhame (29:53):

I want to take us quickly back to the yield discussion because

Andrew Korz (29:56):

Andrew,

Lara Rhame (29:57):

A chart that you made that it's in our mixed market signals playbook. It was a chart of the week shows

Andrew Korz (30:04):

The

Lara Rhame (30:04):

Risk-free, so the 10 year treasury yield that bellwether that we all know and love at the same rate as free cashflow yield for the SS and P 500.

Andrew Korz (30:14):

Yep.

Lara Rhame (30:15):

Why do we care? What is the connection between equities and yields and why does it matter?

Andrew Korz (30:20):

Sure. So and that's the first time I think in 15 years, 17 years that that's been the

Lara Rhame (30:26):

Case That keeps coming up 15 years I think. Yeah, something

Andrew Korz (30:29):

About the last 15

Lara Rhame (30:30):

Years or so. Yeah, something about

Andrew Korz (30:30):

It. So here's what I would say. There is no law that says that equities have to yield more than treasuries because they're riskier. That's not an inherent sort of law that needs to be true. However, it does really raise the bar for earnings growth and for economic growth in the coming years because if you think about it, you're buying a 10 year treasury, you're getting the same income for the next 10 years. If you're buying equities, they grow earnings over time. But there's also the risk that earnings fall because you have a recession or

Lara Rhame (31:05):

Something like that. I mean, equities are an inherently riskier investment than a 10 year treasury. There,

Andrew Korz (31:10):

I would say two justifications for high equity multiples. One is what we saw during the 20, during mostly the late part of the 2010s, which was incredibly low interest rates which drive up the value of future cash flows. The second would be a belief that earnings growth is going to be durably stronger in the medium to long-term future. I think that is what's driving the current sort of dynamic, which you mentioned, which is that the 10 year treasury and the s and p 500 are yielding almost the exact same. So I think this belief that earnings are going to grow 12% in 2024 earnings are going to grow 12% again in 2025, is what's driving this current valuation regime. And I think for me, the risks are skewed to the downside there personally

Lara Rhame (31:56):

Because

Andrew Korz (31:57):

That implies really strong real G D P growth over the next two years.

Lara Rhame (32:02):

I mean, I've phrased it differently. Are equity markets appropriately compensating you for the risk? And I think that's the question.

Andrew Korz (32:10):

No, and

Lara Rhame (32:11):

I think

Andrew Korz (32:11):

The higher rates have even raised that bar for earnings growth even higher because now you've got higher real rates than you've had in again, 15, 16 years.

Lara Rhame (32:20):

So

Andrew Korz (32:21):

I think given the risk that we have not dodged but merely delayed an economic slow down or recession, the market is just not pricing that in right now at 18 times earnings. It's just not.

Lara Rhame (32:32):

Yeah. I think one final

Andrew Korz (32:36):

Point

Lara Rhame (32:36):

To make on this interest rate piece is the fact that when there's a threshold moment when long-term interest rates are above four point a half percent, the diversification between stocks and bonds changes, it flips and the correlation flips. And we've seen the 52 week correlation between these two asset classes turn positive. And that to me is something that, again, we have this idea that stocks and bonds offset each other, diversify each other, and that that's also somehow some natural law of gravity. And it's not. It's something that happens when interest rates are very, very low, but when interest rates are high, when inflation's high, that no longer holds. And so it's something we've observed and again, something that I think I'm hoping

Andrew Korz (33:22):

To

Lara Rhame (33:22):

Break that mantra, it doesn't hold an all in all backdrops, and this is a backdrop in particular way, I don't think it's going to hold over the next year.

Rob Hoffman (33:31):

It certainly poses a lot of challenges for typical 60 40 portfolio construction. It gets even harder when that 60% in equities is concentrated heavily in the top seven tech stocks that also historically have traded with higher correlation to fixed income markets. So you're sort

Lara Rhame (33:48):

Of

Rob Hoffman (33:49):

Doubly adding it on and you get results like Q three when both markets were down more than 3%, and that's the only other times that had really happened was Q one, Q two, and Q three of 2022.

Lara Rhame (34:00):

All four of those quarters have been in the last two years. So it's really extraordinary. Andrew, impact of

Andrew Korz (34:07):

Higher

Lara Rhame (34:07):

Interest rates on CREs got to be pretty direct.

Andrew Korz (34:10):

I've sort of an interesting way of thinking about this. So from the mid 1940s through 2010, the 10 year treasury yield averaged around 40 basis points below what the trailing one year,

Lara Rhame (34:21):

It's the 70 year spectrum.

Andrew Korz (34:23):

So on average, roughly half the time the 10 year was below the nominal G D P growth rate. Half the time it was above during the 2010s, the average 10 year yield was 230 basis points below the growth rate of nominal G D P.

Lara Rhame (34:38):

I never thought about it that

Andrew Korz (34:39):

Far, remarkably different environment and consider that nominal G D P has grown around 4% over the past year through six 30 after Q three numbers, it'll be higher, it'll be closer to 5% and consider the fed's recent projections, which show 1.5% real growth next year and 2.5% inflation for a four to 4.2% nominal G D P growth rate. If we think about that in a pre 2010 context rates, long-term rates of 4.5 to five are not that crazy, right?

(35:08):

If nominal GDPs grow in 45%, this is about where you'd expect to be. So now think about that from sort of a real estate perspective. Rent growth generally is going to track real economic growth plus inflation, right? Real estate's generally sort of an inflation hedge. Rents are broadly on an aggregate standpoint going to grow with nominal G D P and when you have rates and thus financing costs that are way below that growth rate of rents. You have this sort of Goldilocks environment for commercial real estate. And if we are now in an environment, I think in which long rates roughly average the growth rate of nominal G D P, at times when the fed's trying to tighten, it's going to be above. When they're trying to loosen, it's going to be below. I think that's going to be a much different environment. We've sort of talked about this a lot over the past few quarters, but I think it's just going to introduce this very different environment for real estate investing.

Lara Rhame (36:04):

Yeah, absolutely. Alright, speed round. To wrap us up for what we're thinking in terms of 2024, I know we're going to have our 10 for 20 fours coming out and our outlooks for January. Tell me what sneak peak right now, what are you thinking, Andrew?

Andrew Korz (36:25):

For C R e I will give you one number and that's 8.5%. That is the average annual unlevered return on real estate equity since 1980. That feels like a ceiling for 2024, but let's just say it's a base case. Let's, let's put on our rose colored glasses and say 8.5% in this case for real estate equity returns. You can basically get that in real estate debt right now in terms of yield. So I think we're going to continue to see this shift in terms of the relative attractiveness of equity versus debt. I don't think that changes in 2024

Lara Rhame (36:56):

And prices, the corrections probably going to this broader price correction is probably

Andrew Korz (37:01):

Going to continue to be, that's best case scenario.

Lara Rhame (37:02):

Yeah,

Andrew Korz (37:03):

I think next year you still continue to see pressure on prices. On

Lara Rhame (37:05):

Prices and upward

Andrew Korz (37:06):

Pressure on cap rates, but I think even if you do have this sort of rose colored outlook on things, the relative value is just, it's so much different than it was.

Lara Rhame (37:14):

Alright, so I broke my rule for the speed round Rob.

Rob Hoffman (37:18):

I thought it was no numbers, so I was going to go with a single two letter word, which was up. I think that when you look at, it's a great

Andrew Korz (37:25):

Movie,

Lara Rhame (37:26):

He wins for brevity.

Rob Hoffman (37:28):

Yeah. I think that when you look at current yields in credit markets, you could have 200 basis points or more of spread widening and credit markets could still generate positive returns next year. And if you get that type of sell off, I think credit versus equity is going to look very attractive. But yeah, I mean I think that the bar is very high, or I guess maybe the bar is low when you think about the income and the ability for credit markets to generate positive returns when you're starting income level is so high. I think it gives a strong propensity for the markets to be up as it relates to credit next year.

Lara Rhame (38:08):

Alright. For me next year, I think everybody's asking this question, recession no recession. To me the real focus is going to be inflation. And I continue with my biggest call in 2024, which is that inflation is not going to fit neatly back in the 2% bottle, the genie's out and it's going to float up around three to 4% next year, causing a lot of challenges for policymakers. All right. So for equities, want to end us there, Andrew?

Andrew Korz (38:36):

I mean, I think a lot sort of depends on this AI narrative and whether this is a pause in that narrative or not, but I think we've almost gone backwards from a late cycle environment to more of a mid-cycle environment right now where I think markets favoring quality, they're favoring value, again, over growth a little bit and in a mid-cycle environment, this is a dangerous call, but I think instead of the macro which is dominated for so long, I do think fundamentals and earnings reports start to come back to the forefront. Dangerous. That is dangerous. Love it.

Lara Rhame (39:05):

Alright,

Andrew Korz (39:06):

Macro controls all.

Lara Rhame (39:09):

Thank you so much.

Lara Rhame (39:10):

Really appreciate it and look forward to seeing how the next quarter evolves. We'll keep everyone posted. All right, take care. Thank you. This episode is recorded at the F SS Investments headquarters in Philadelphia's historic Navy art. It was produced by the investment research team. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.