STRATOS
INVESTMENT MANAGEMENT

IT'S ALL ABOUT DA RATES... 'BOUT DA RATES...





Figure 1 - Source: FactSet

The Fed increased the Fed Funds rate by 0.25% during the quarter and the yield curve moved sharply higher on fiscal concerns. Equity markets, which had rebounded sharply in late July/early August, gave back some of the gains as the quarter moved towards its end yet significant divergence between the headline index and the equal weight version told a far different story. The markets weren't showing their strength. Rather, higher rates and the threat of them climbing still higher suddenly brought about questions regarding asset values. If rates are headed higher, shouldn't asset values (including equities) head lower? A very good question indeed.

In the following paragraphs we will look at what has happened during the third quarter and propose some potential outcomes if interest rates continue their march upward.

COMMENTARY

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Stratos Investment Management
3750 Park East Drive
Beachwood, Ohio 44122

Why do rates matter?

How does one value any asset? Conceptually, it is quite simple. One values any asset by calculating the present value of all future cash flows. Therefore, interest rates matter because that is what investors and the market use to value future cash flows.

Concerns have risen about asset prices (and to a certain extent interest rates) because we have spent much of this century at interest rates that had been at historically low levels. People came to believe that zero or near zero interest rates were normal, when they were not. Figure 2 below helps put this into perspective.

While current rates are certainly higher than they have been in some time, they really aren't out of the ordinary. In fact, a very good case can be made that the rate experience from the Great Recession forward has been the unusual period.

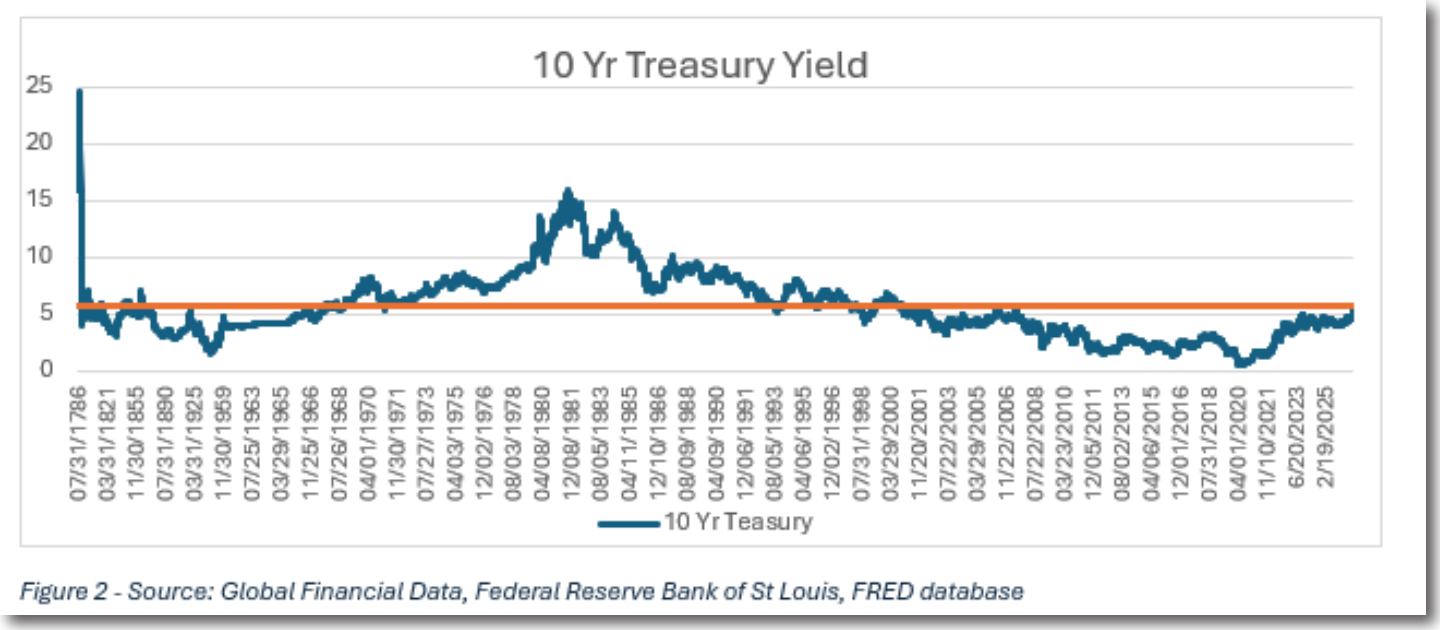


Figure 2 - Source: Global Financial Data, Federal Reserve Bank of St Louis, FRED database

Going back to the question that began this section, why does it matter? The Fed changes interest rates. The market changes interest rates. As long as things are going well, shouldn't market prices hold up? Not necessarily – and here is where an example might help.

The basic idea behind discounted present value (valuing future cash flows as of today), is that a dollar received tomorrow is worth less than dollar received today. This is because inflation erodes the value of that future dollar. As a result, to determine if a stream of cash flows is worth as much as a lump sum of cash, one doesn't simply add up the stream and compare it to the lump sum. You need to discount the value of the future cash received to determine what its value is today. What rate do you use? That is where the real fun begins.

An appropriate discount rate should take into consideration the risk you are taking when investing in an asset that provides future cash flows as well as the time period over which the investment is to be made and your need for liquidity (the ability to turn the investment

into cash should you need immediate access to your invested dollars). For example, you would not value a 10-Year Treasury Bond using the rate for a 6-month Treasury Bill, and you would not value a bond rated AA the same as a bond rated CCC[2].

But why does it matter? How does the level of interest rates impact the value of an asset? In general, interest rates and asset values move in opposite directions. Take, for example, a one-year bond that currently pays 4% interest at maturity[1]. If an investor purchases the bond (purchased at a discount, maturing at $1000), they will pay $961.54 for the right to receive $1000 in one year. If, after purchasing the bond, interest rates rise by 1%, the value of the bond will drop from $961.54 to $952.38. Conversely, if interest rates were to drop by 1%, the value of that bond would rise to $970.87.

While not all assets make consistent interest payments or have consistent cash flows (i.e., precious metals, some stocks, etc.), the general principle stays the same. As interest rates change, the value of the asset could move in the opposite direction of interest rates. Which gets us back to Figure 1 and what happened during the third quarter. While interest rates increased somewhat modestly at the short end of the yield curve (from Fed Funds to 6-months, rates increased by 22-35 basis points), they increased substantially more at the longer end of the curve. (Rates from 1 year to 30 years rose between 57 and 89 basis points.)

The larger increase in longer-term interest rates should, in theory, have a larger impact on longer-dated assets like stocks. This is because their longer duration[3] should cause values to fall more. (Longer duration assets are more sensitive to changes in interest rates than shorter duration assets.) While some equities certainly had difficulties during the quarter (i.e., small cap stocks), the S&P 500 did ok. What gives? In a word, earnings.

Market Returns and the Economy

The S&P 500 performance continues to be dominated by the largest names in the index as the largest ten companies by market capitalization represent nearly 41% of the total index, and half of those companies are in the information technology sector (which itself represents nearly 39% of the index). The index saw 53% earnings growth for the second quarter and is expected to see earnings growth of nearly 30% for the third quarter. Assuming earnings growth continues to come through, the impact of higher rates on equity values could be overcome.

That said, all company earnings are not created equal. The inflationary impact of high energy prices is negatively impacting certain businesses and have been responsible for spikes in the Price Index components of both the ISM Manufacturing and Services PMI reports. Both expanded at an accelerating rate during September, scaring markets that were already concerned about acceleration in the inflation rate.

Continued higher than target inflation data continues to rear its head across nearly all data points. Whether it is higher than desired GDP Chain Price data (final estimate for Q2 of 4% year-over-year), core and headline PCE (3% and 3.4% year-over-year respectively), CPI (3.4% year-over-year) or producer prices (up 5.4% year-over-year) inflation doesn't seem to be falling to acceptable levels.

Given that Fed Chair Warsh stated in his Jackson Hole speech on August 28 that, "… there should be no misunderstanding: The Fed's price-stability objective of 2 percent, as measured by the personal consumption expenditures (PCE) price index, is a firm, fixed target," it shouldn't be too surprising that market expectations for rates would trend higher if price data indicated that inflation didn't appear to be slowing.

Throw in economic growth numbers that ended up higher than expected (the final estimate for Q2 GDP was reported at 2.2% versus 2.1% in its last estimate) and stubbornly high energy prices and there doesn't seem to be much good news from an interest rate perspective.

As indicated earlier in this note, other than the S&P 500, domestic equities had a difficult time in the third quarter. While smaller cap stocks, as described by the Russell 2000 and S&P MidCap 400 indices led the domestic equity performance derby in the second quarter (emerging markets actually led Q2 performance), they were the worst performing equities in the third quarter. The small-cap Russell 2000 lost 7.23%, while the S&P MidCap 400 gave back 6.36%. Developed global (MSCI World High Dividend Yield and the MSCI ACWI) and broad-based domestic equity indices (Russell 3000 and S&P 500) were the leaders, showing modest single digit returns.

Rising interest rates put pressure on all but the shortest of the fixed income benchmarks with the ICE US Treasury 7-10 Year Bond moving down by more than 4.5%. The Bloomberg US Aggregate Bond Index was off 3.51% and the shorter-term benchmarks all (except the 1-Yr Treasury Note) declined less than 1%. (Bloomberg US 1-5 YR -0.91%; FTE World Gov't Bond Index hedged -0.55%; ICE Bank of America 1-3 Yr US Treasury -0.13%).

Jobs, however, seem to be a bright spot (depending on who you talk to). Anecdotally, as we speak with employers, we continue to get the same answers we have been getting for some time. Employers are simply not able to find qualified people to fill the positions available. Job openings, which have fallen from approximately 7.6 million in April to under 7.1 million in August, remain larger than the number of unemployed people. In our view, this speaks about the inability of employers to find any candidates, let alone qualified candidates, and is confirmed by JOLTS[4] data.

Figure 3, next page, shows the growth rate of what we call the "working age" population or those people ages 16-65. We choose that range because age 16 is when a person enters the non-institutional population from which the labor force is derived, and age 65 is the presumed retirement age. We can see from the chart below that the growth rate in the working age population has been declining steadily since the early 2000's and has been negative since approximately 2018. (The blip upwards in the growth rate is, in our view, a statistical anomaly caused by a drop in the 65+ population beginning in January 2022. This is because the 65+ population was disproportionally impacted by the COVID-19 pandemic[5].) This should mean that the number of job openings is less indicative of the health of the US job market and is more reflective of the demographic situation. In plain English: There are fewer people available to fill existing job openings.

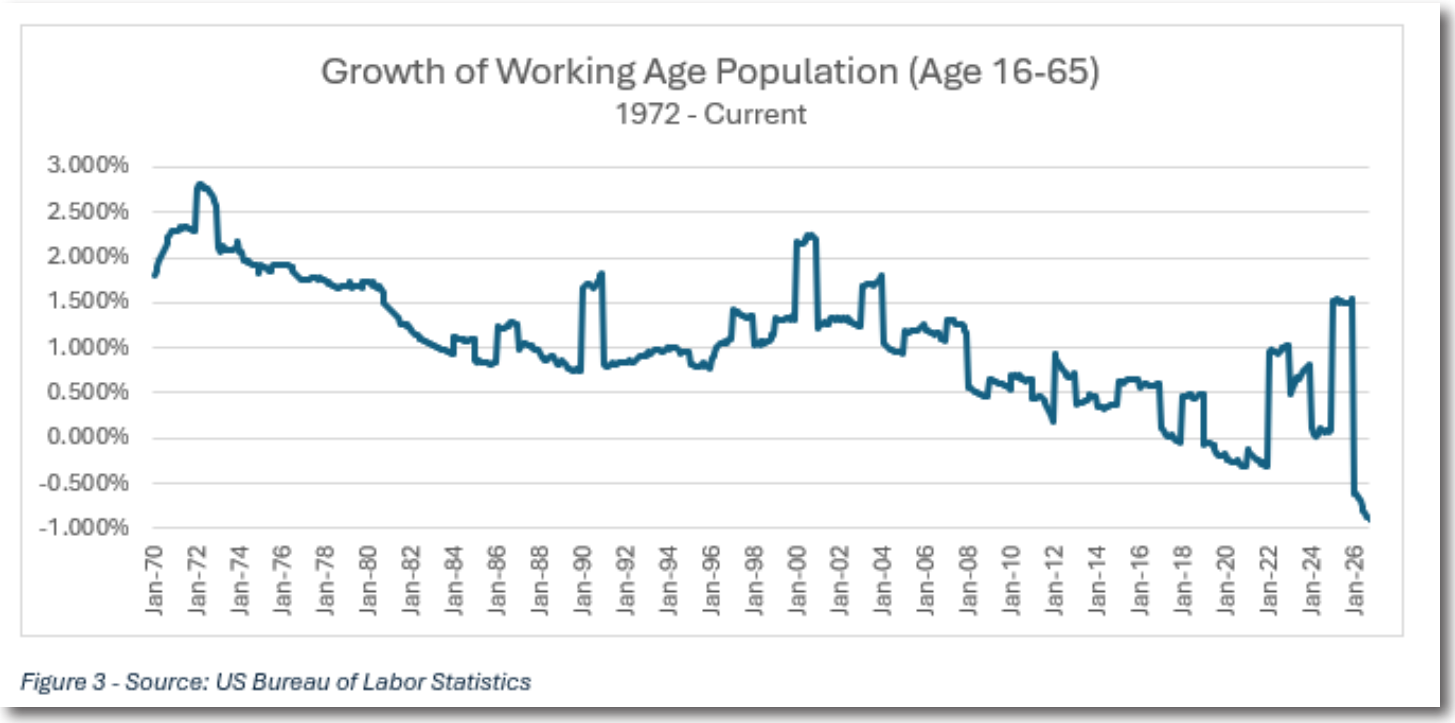


Figure 3 - Source: US Bureau of Labor Statistics

Our Outlook

The fourth quarter could be a very interesting time indeed. With mid-term elections less than a month away (as of this writing) and a soon-to-be lame duck Congress, it could either be a scramble to get legislation passed and signed or it could devolve into a blame-game, finger pointing exercise. In either case, SIM believes that there could likely be a scapegoat made of someone in the administration because President Trump's wants (lower interest rates, better fiscal situation and an improving trade balance) didn't happen.

Who could that be? Though interest rates have not been going the direction President Trump would like, it doesn't seem likely that he would move to replace Fed Chair Warsh. It seems more likely to us that Treasury Secretary Bessent may catch the blame for the country's fiscal situation.

While the administration may be in a bit of flux through year-end and could be even more of a lame-duck than is typically the case in the second half of its second term, SIM believes these factors may not be enough to keep equity markets from ending the year with double digit returns. Assuming that happens, this would mark the fourth straight year of double-digit returns for stocks, as described by the S&P 500. This has only happened four other times since 1926: 1942-1945, 1949-1952, 1995-1998 and 1996-1999. In only one of those instances was the fifth year returns greater than zero (1995-1998), and the average return for year 5 across all of the instances was just under 1%. If you take out 1999 (which was the only positive year five return at 21.04%), the average return for year five drops to -6.05%. Put another way, while we are constructive about the balance of this year, next year could be a different story.

What about "da rates"? This is where (at least to us) things get interesting. As you can see from Figure 2 above, long-term interest rates have generally gone down since the early 1980's. This long-term downward or "secular" move in interest rates, we believe, ended in the early part of this decade. What this means for investors is this: investors should pay attention to both the long-term secular and short-term cyclical cycles. This could allow them to consider cyclical changes in rates and periods of higher rates when evaluating locking in higher yields on their bond holdings. It would also allow them to consider whether to use unrealized losses in existing bond holdings to generate tax losses that could either be used to offset gains or current income (to the extent they are allowed) or to be "banked" for use in future years.

As far as our outlook on rates is concerned, we believe that because inflation has not been cowed, that short rates (i.e., Fed Funds) are likely to work their way higher. Whether the next hike takes place before or after the mid-term elections, in our view, makes little difference. We believe that it is highly likely that the Fed may hike rates at least once more this year and at least one additional time in 2027. Will we get more than one increase in 2027? That depends on whether inflation continues to be stronger than desired and whether or not the economy continues to roll along with better than 2% growth.

If interest rates do work higher, then higher interest rates may be likely to negatively influence smaller cap stocks since smaller cap stocks tend to finance themselves via banks (through floating interest rates) rather than more permanent public markets (at fixed rates). This is why smaller-cap stocks underperformed during the big upward move in rates during the third quarter.

We put a wrap on this quarter's commentary with something we have said a number of times. It is important that investors stay vigilant. Understand the risks that exist and weigh it against potential returns. Rebalance as appropriate. Reallocate from those investments that might have increased in value to reduce the risks to which you are exposed. Remember, in an environment where the long-term trend in rates may be higher, paying attention to where we are in the interest rate cycle (both cyclical and secular) can go a long way towards helping you balance risk and return. Remember, it's all about da rates...

Definitions and End Notes

1. This example is for illustrative purposes only and is not meant to represent any actual bond currently traded in the market.
2. AA and CCC are just two of numerous credit ratings from Standard and Poor's (S&P). Ratings range from AAA (highest investment grade) to D (default). Bonds rated above BBB are viewed as "Investment Grade" bonds and bonds rated BB and below are viewed as "Speculative Grade" (i.e., High Yield) bonds.
3. Duration: A measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. (Source: "Duration Definition and Its Use in Fixed Income Investing", by Adam Hayes, Investopedia.com). Duration can also be applied to equities as found in "Implied Equity Duration: A New Measure of Equity Risk" by Patricia M Dechow, Richard G Sloan and Mark T Soliman, University of Michigan Business School; May 2002.
4. JOLTS: Job Openings and Labor Turnover Survey – US Department of Labor Statistics
5. Disparities in Excess Mortality Associated with COVID-19 – United States, 2020

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