

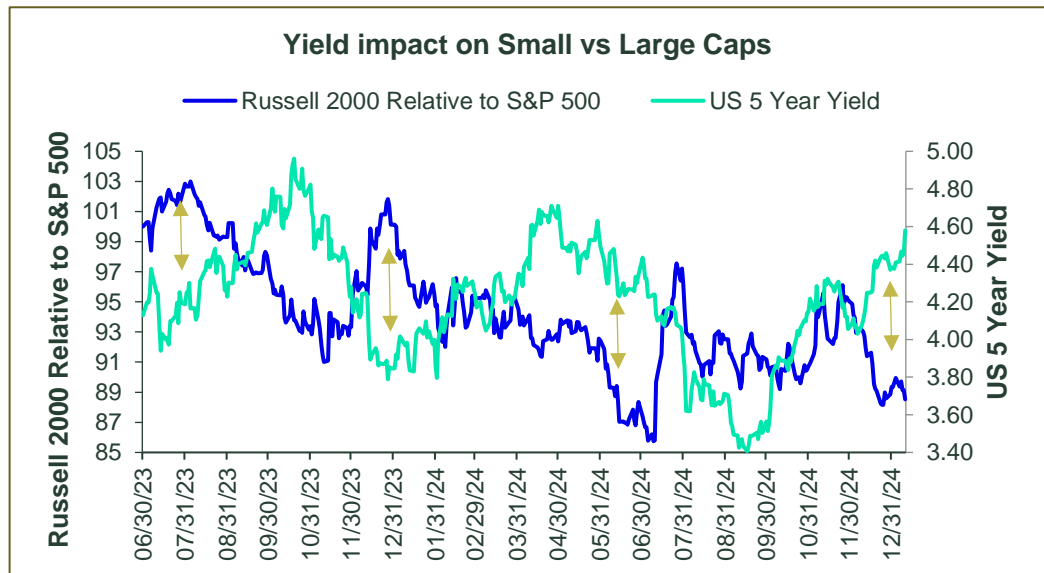
January 16, 2025  
Commentary

## Weekly Market Update

### Insight of the Week

### Small Caps Remain Sensitive to Yields

The chart below illustrates moves of the 5 year yield compared to the relative returns of the Russell 2000 index vs the S&P 500, highlighting the relationship between small vs large cap equities and interest rates. An inverse relationship is evident – small cap stocks tend to underperform as yields rise. A little over a month ago the 5 year yield was around 4% and has since climbed to almost 4.6%. And during this time we’ve seen small caps lag.



Source: Russell, S&P, FactSet. Prices used 6/30/2023 - 1/10/2025.

Higher interest rates mean higher costs to finance operations. This effects small caps more for two reasons. First, since small caps are generally more risky, they already start with a higher cost of debt. Second, small caps are usually unable to refinance and lock in long term debt in the same way as large caps. For instance, some large caps were able to issue 10 year bonds a few years ago when rates were low, locking in this low cost over a long period. Many small caps, however, need to roll their debt over every 3-5 years, meaning they are closer to refinancing at current higher rates, which will directly affect their bottom line.

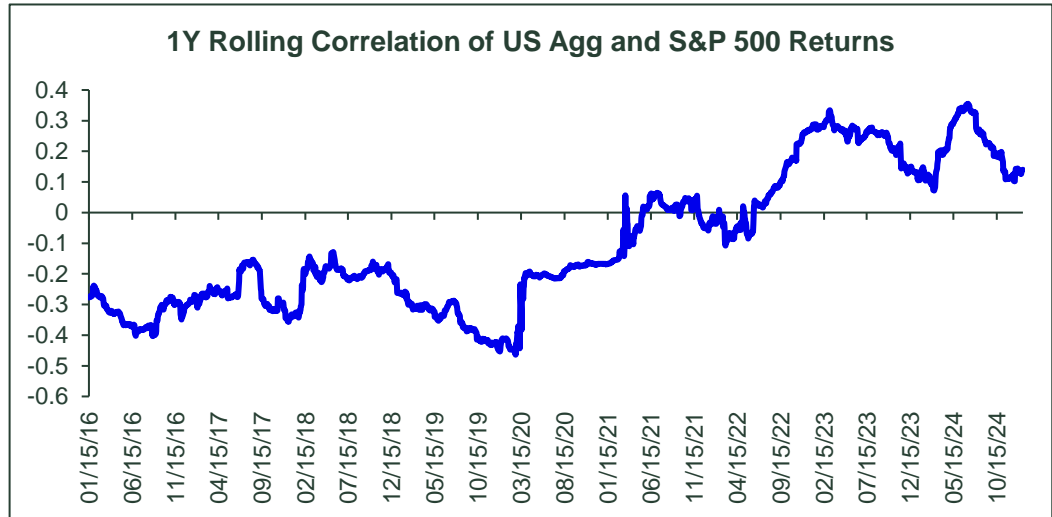
For 2025, while we do have a preference for US large caps, we also expect a rounding out of earnings to other sectors of the market. Should unemployment remain low and economic growth remain healthy, this may allow small caps to perform to higher expectations.

**Equities and Fixed  
Income**

**Asset Allocation Update – Stock Bond Correlation and the 60/40**

One of the most valuable components in constructing a portfolio is the long standing negative relationship between stocks and bonds. We’ve seen this dynamic change entirely over the past five or so years that many once called for the death of the 60/40 portfolio.

We check in on the stock bond correlation below.



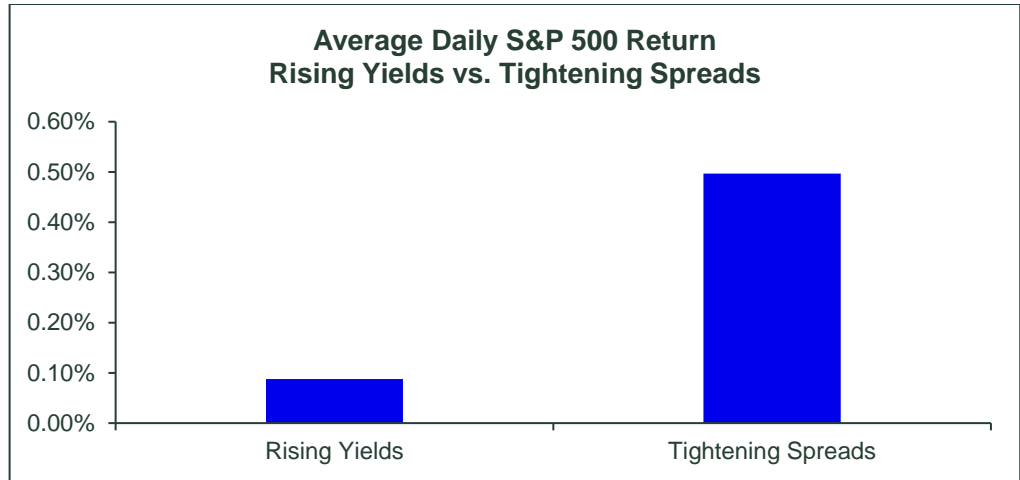
Source: FactSet. Daily data used as of 1/14/2025.

The latest metric measuring daily correlation over the past year shows as 0.14. The chart depicts a trend of normalization, with the data moving in the preferred direction. However, now that the Feds path is less prescriptive, markets have been more reactive to the latest macroeconomic data prints. The “good news is bad news” phenomenon is back.

We saw a glimpse of this with the latest payrolls and CPI print. December consumer price inflation showed slower than expected core inflation at 3.2%, in support of a lower Fed Funds rate. Yields fell and the stock and bond market both reacted positively up 1.83% and 0.04% respectively. Similarly, the stock and bond market reacted in sync with the nonfarm payrolls print on January 10 which showered stronger than expected payroll numbers at 223K. Yields rose on the back of the report, and stock and bond markets had a tough day down 1.54% and 0.59% respectively.

Yields backing up has become synonymous with equity markets taking a hit. However, high yield credit, typically known to be more “equity like” offers more information about equity market performance. Widening spreads, indicative of a higher risk environment, typically go hand in hand with increased equity volatility.

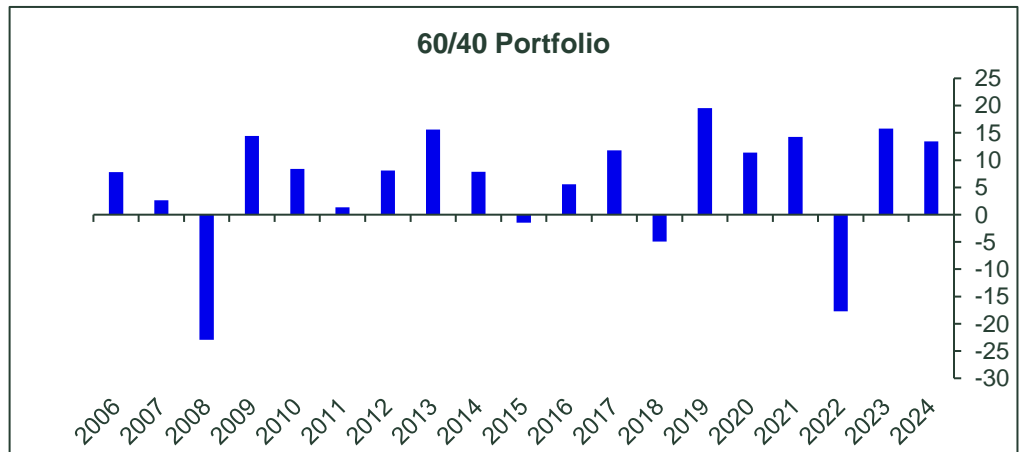
This dynamic is explored in the chart below which shows higher daily average price reaction of the S&P 500 during times of rising yields vs. tightening spreads.



Source: FactSet, S&P, Bloomberg. Average return calculated from 1/14/2020 to 1/14/2025. Changes in yield measured by daily change in 10Y UST. Changes in spread measured by daily change in Bloomberg US Corporate High Yield OAS.

Interestingly, as the market tries to navigate rates, credit spreads remain at a very tight level. Although rates remain elevated, and in our opinion, above neutral, credit markets aren't sweating the backdrop and are hinting towards a stable macro environment. This could mean good news for the equity market, and indeed we favor U.S. equities as the year rolls on.

The snapshot below takes a look at the overall performance of a 60% equity 40% fixed income portfolio. 2024 was another good year for the diversified portfolio with a return of 13.43%.



Source: FactSet. Equity market proxy = S&P 500. Fixed income market proxy = Bloomberg US Aggregate Index. Data as of 12/31/2024.

As we head into the new year, we hope to see rates normalize as the Fed makes their way closer to neutral. Of course, this will likely come with volatility. Keep an eye on credit spreads as a better indicator of equity market performance and the overall health of the economy.

Source: State Street Global Advisors, FactSet, Bloomberg, S&P.

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\*Pensions & Investments Research Center, as of 12/31/23.

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