Market Brief Recap: Fed Jitters, Bond Upside & the High-Yield ETF Trap

The latest Market Brief Podcast from HCM Wealth Advisors and CPAs features Senior Investment Strategist Doug Johnson, CFA, and Investment Strategist Dan Rinck, APMA. The discussion focuses on the strength of the stock market, potential sources of volatility heading into the fall, the changing risk-reward profile of bonds, and the growing popularity of high-income ETFs.

A Strong Market Facing More Cross-Currents

The S&P 500 recently reached all-time highs, with virtually every sector participating in the year's rally. While that broad participation is encouraging, Johnson believes investors should prepare for a potentially more volatile period ahead.

One of the strongest aspects of the current market is corporate earnings. Recent earnings growth approached 50%, although that figure was influenced by gains associated with major IPO-related transactions. Even after removing those unusual effects, underlying earnings growth remained around 23% to 24%—an unusually strong level for a market that is already well into a long bull market. Historically, growth rates of this magnitude are more common when the economy is emerging from a recession or earnings trough.

Artificial intelligence and the significant spending associated with AI are contributing to earnings growth, but the strength isn't limited to technology. Johnson and Rinck point to broad earnings growth across multiple areas of the market, suggesting that the fundamental backdrop remains relatively strong.

The market has also experienced significant leadership rotation. Different sectors and investment styles have taken turns leading over the past six months. Value has substantially outperformed growth on a year-to-date basis, although that gap has narrowed over shorter periods. The broader lesson, according to Johnson, is that diversification has been beneficial this year.

The Federal Reserve Remains a Major Source of Uncertainty

The Federal Reserve is one of the biggest potential catalysts for market volatility. Following the Jackson Hole meeting, Fed commentary reinforced concerns about inflation. The transcript describes the Fed as generally leaning hawkish, with uncertainty centered on whether policymakers might raise rates or leave them unchanged. At the time of the discussion, the market was assigning roughly a 50-50 probability to those possibilities.

Johnson and Rinck question whether higher interest rates would actually solve the current inflation problem. Much of the recent inflation pressure has been attributed to elevated energy prices stemming from the ongoing Iran conflict. They argue that monetary policy cannot directly resolve a supply shock such as an energy disruption. Raising rates could instead reduce economic demand while doing little to address the underlying source of higher energy prices.

The Treasury is also attempting to influence longer-term interest rates by purchasing longer-term Treasury bonds. While this initially pushed long-term yields lower, the effect appeared limited as yields subsequently moved higher again. If rates continue to rise, the higher cost of capital could eventually place additional pressure on stocks, particularly areas of the market that depend heavily on borrowing to fund growth.

Bonds Are Becoming More Attractive

Despite concerns about rising rates, HCM sees an increasingly attractive opportunity in bonds. As yields have risen, the potential reward from owning longer-duration bonds has improved relative to the potential downside.

Johnson illustrates this with a 10-year Treasury example. At a yield around 4.75%, an investor would earn approximately that amount if rates remained unchanged. If rates rose another percentage point, the resulting loss over a 12-month period could be roughly 2.5%. But if rates instead declined by one percentage point, the potential 12-month return could be approximately 12.5%. The difference demonstrates the increasingly asymmetric risk-reward profile of bonds.

This doesn't mean HCM expects rates to fall immediately. Rather, the firm believes today's higher yields provide a better entry point than investors have seen in recent years. HCM has consequently begun making modest tactical shifts from shorter-duration bonds toward somewhat longer maturities. Corporate bonds offering yields around 5% can also provide attractive income even if interest rates remain relatively stable.

Seasonality and Midterm Elections Could Add Volatility

The fall could bring additional uncertainty. Historically, the period from roughly late August through October can be challenging for equities, particularly during midterm election years. While seasonality isn't a guarantee, the speakers point out that investor expectations themselves can influence behavior. If enough investors expect volatility, their actions can contribute to the volatility they anticipate.

The midterm elections could also lead investors to reposition portfolios based on expectations about government spending, taxes, deficits and individual sectors. The speakers don't expect election-related volatility to fundamentally derail the strong earnings environment, but they do anticipate increased market "chop" as investors adjust to changing political expectations.

Given the numerous competing forces—including tariffs, the Iran conflict, AI investment, Fed policy and elections—HCM's approach is not to predict exactly what will happen. Instead, the firm intends to react to changing conditions. For now, the strategy is to stay the course while monitoring developments closely.

The High-Income ETF Trend

The second major topic is the growing popularity of high-income ETFs. The discussion was prompted in part by Goldman Sachs' acquisition of NEOS, an ETF provider known for products designed to generate unusually high distributions. Some of these funds advertise distributions in the 10%, 12% or even 15% range—far above traditional income investments.

The key question is how these funds generate such high distributions. Many use covered-call and other options strategies. For example, an ETF may own a basket of stocks similar to the S&P 500 and sell call options against those holdings. The premiums generated by selling the options become additional income for investors.

The trade-off is important: investors are effectively selling away some of their upside potential. If a stock rises substantially above the option's strike price, the fund generally won't participate fully in that gain. Covered-call strategies can therefore make sense for investors prioritizing current income over long-term capital appreciation, but they can lag significantly during strong bull markets.

High Distribution Doesn't Mean High Return

Perhaps the biggest warning from the discussion is that investors shouldn't confuse a fund's **distribution rate** with its **total return**.

Some high-income ETFs also use return of capital as part of their distributions. Although return of capital isn't immediately taxable in a taxable account, it reduces an investor's cost basis. Over time, that can create a larger taxable gain when the investment is eventually sold.

The speakers highlight extreme examples of leveraged and options-based products where very high advertised distributions have been accompanied by substantial losses. One example discussed had a distribution around 24% before suffering a catastrophic decline during the COVID crisis. Another Bitcoin-related high-income ETF had a distribution around 33%, yet its total return was negative and its NAV had fallen substantially.

The takeaway isn't that all high-income ETFs are bad. More conservative covered-call ETFs can have a legitimate role for investors who specifically need current cash flow and are willing to sacrifice some capital appreciation. However, HCM believes these strategies should generally represent only a small portion of a portfolio, particularly for investors with longer time horizons.

Bottom Line

The central message of the podcast is one of **cautious optimism**. Corporate earnings remain unusually strong, market participation has been broad, and diversification has worked well. At the same time, investors face several potential sources of volatility, including Fed policy, elevated energy prices, rising bond yields, midterm elections and seasonal market patterns.

HCM sees an increasingly attractive risk-reward opportunity in bonds as yields have risen, while remaining cautious about chasing extremely high distribution rates from complex income ETFs. The firm's broader philosophy is to avoid trying to predict every market move and instead respond thoughtfully to changing conditions.

For investors, the overarching lesson is simple: **look beyond the headline yield, understand where the return is coming from, and make sure the strategy fits the portfolio's long-term objectives.**