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Ellumination Newsletter

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What about stock and bond prices through the end of the year?

October 17, 2023

The consensus forecast was that stock prices would drop in 2023. The major U.S. indexes defied that forecast and rose significantly from January through July. Since then, the S&P 500, Dow Jones Industrial Average, Nasdaq 100, and Russell 2000 have all been chopping downward.

Long term bond prices (10-30 years) chopped up and down within a relatively tight range from January through July. Then prices fell apart as interest rates accelerated upward.

We are all left wondering what will happen to financial asset prices through the end of this year. Are we in for a Santa Claus rally in stock prices? Should we worry about a hard-landing and recession in 2024? Will interest rates stay higher for longer? These are the key questions on everyone's minds.

I can tell you that there is no consensus on any of these questions. Even if there were, it would be difficult to trust; particularly given how far off consensus forecasts were for 2023. But there are factors that are providing clues about how markets are behaving.

The Fed is no longer the "buyer of last resort" for Treasury Bonds

From the financial crisis of 2008-2009 through early 2022, our Federal Reserve Bank was the biggest buyer of long-term Treasuries and mortgaged backed securities. We've seen data that indicates they purchased as much as 80% of the bonds issued at some auctions. Today they are out of the market. They have been reducing their balance sheet for over a year. They are raising rates and leaving it to others to buy bonds.

CNBC.com reported last week that the percentage of bonds purchased by foreign buyers has also been declining in recent auctions. Remaining buyers have not been able to absorb all of the current supply. Buyers were lacking during the September auction of 10-year Treasuries. Primary dealers had to buy almost 19% of the bonds offered. Last Thursday we saw a repeat of this process as primary dealers had to buy 18% of the 30-year Treasuries that were offered.

(Source:CNBC.com). Primary dealers are firms that buy government securities directly from the government, **with the intention of reselling them to others**, thus acting as a market maker for government securities. The operative concept is that they intend to sell them, not get stuck with them!

The supply of government bonds is expected to keep growing because of higher budget deficits. Morningstar.com reports that "a year ago, the median estimate of the federal budget deficit was $1.02 trillion in 2023 and $1.275 trillion in 2025. It's now projected by the Congressional Budget Office to be $1.4 trillion this year, $1.75 trillion in 2025, and nearly $2 trillion in 2028."

Not only does the government need to raise more money, but the Treasury is also shifting the kinds of debt it has been selling. "Blake Gwinn, head of U.S. rates strategy at RBC Capital Markets, notes that until recent months, the Treasury had been handling its greater borrowing needs through the sale of T-bills. However, it's now shifted those stepped-up debt sales to Treasury notes. We're moving into unforeseen places in terms of the amounts of longer-term debt." (Source: Morningstar.com, October 13, 2023)

Note: *(T-Bills have maturities of four weeks to one year. Treasury Notes have maturities from 2 two years to ten years.)*

Finally, there is less and less confidence that the government can ever turn around their appetite for more and more debt. Appetite for fiscal restraint seems to have disappeared. At Fidelity, fixed-income portfolio managers Jeff Moore and Michael Plage point to how concerns about the deficits affect the yield curve. "Questions will inevitably include if and how they will be reduced and be financed. In our view, continued very large fiscal deficits could fuel some uncertainty and lead to even more yield curve steepening". (Source: Morningstar.com, October 13, 2023)

We are now hearing that "the market may be doing the Fed's job" and that seems to be the case. Long term rates are still trending up, simply because of lack of demand at current yield levels. Buyers seem to want higher rates to take the risk of deploying capital into longer term notes and bonds. While opinions about direction of long-term rates remains conflicted, it's getting easier to see how the 10- and 30-year Treasury yields could push over 5% before satisfying the market. These yields finished last week at 4.617% and 4.757% respectively.

Rising rates would continue to pressure stock prices

Lately the movement of stock prices has been totally correlated to the movement of long-term interest rates. Rates move up, stocks move down. Rates move down, stocks move up. This is not likely to end unless companies prove that they are increasing their earnings, despite higher rates. We are about to enter the heart of earnings reporting season for Q3 2023 results. During earnings reporting season, we also hear future guidance from most companies. This will be critical in determining whether or not stock prices can rally into the end of the year. Overwhelming positive guidance could extend the bull market. Neutral or negative guidance could easily end it, for now. It's quite possible that the same narrow group of tech/AI companies that led the rally between January and July could reemerge as market leaders. That could be enough to rally the S&P 500 and the Nasdaq 100 into the end of 2023. After that the outlook appears murkier.

Finding the ceiling for long-term rates will also help. The Fed may be done raising short term rates, but the market has to finish raising long term rates before equity investors can be confident about stock prices moving up in 2024.

In the meantime, long term bonds are now providing a real yield, after inflation

The annual U.S. inflation rate is currently reported to be 3.7%. The 10-year Treasury yield is currently 4.61%. Inflation seems to be coming down, albeit grudgingly. Jim Reid, a research strategist for Deutsche Bank, reports that the average yield on the 10-year Treasury has been 4.5% dating back over two hundred years. He also notes that inflation (measured in 10-year rolling periods) has stayed below 4.5% 86% of the time. Until recently it was above the 4.5% average only during periods of world wars and the global energy shock of the 1970's. The fact that inflation was running higher than 9% per annum earlier this year indicates how unusual current circumstances are. (Source: Deutsche Bank research report, September 23, 2023)

The Fed is targeting 2% annual inflation. Frankly, we don't see any way for that to happen unless the economy sinks into recession. The average annual inflation rate in the U.S. has been 3.22% from January 1929 through February 2023. (Source: Investopedia). Is it possible that the Fed helps guide inflation back to 3% and 'calls it a day'? There are many that think that is highly likely.

Final thoughts (for today) on stocks and bonds

Long term treasury notes and bonds, mortgage back securities and high-quality corporate bonds are finally offering a real yield. It seems to us that they have real a place in portfolios at this time. For investors seeking more certainty and more safety, maybe they should be a larger allocation than any time in the past 15 years.

The stock market has proven very resilient this year in the face of rising rates. The S&P 500, Dow Jones Industrial Average, and Nasdaq 100 are all still up on the year. Interest rates have risen a lot, and quickly. It shouldn't be a surprise to anyone that the stock market is taking a breather after its surprising rise in the first half of 2023. It's important for equity investors to remember that both short term and long-term interest rates have returned to more normal levels. The zero-interest rate environment from 2009 through 2022 was the exception, not the norm.

Even so, we need to see rates level off to have confidence that the stock market can continue to rally. If long term rates keep rising, and move over 5%, it should not surprise anyone to see stock prices continue trending downward. Depending how much and how fast rates rise we could see the S&P 500 fall back into the 3800-4100 range. Ironically this is the range in which many originally forecast it to end 2023. That would be disappointing, but not a disaster. Stock prices are adjusting to the new interest rate regime. Once that adjustment is complete the stage will be set for further longer term advances.

All the best,

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All return calculations for the S&P 500 were done using https://dqydj.com/sp-500-return-calculator/unless otherwise noted.

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