September 2023

MONTHLY MARKET INSIGHTS

Key takeaways:

- Long-term yields are at decade highs and a further backup in rates will, in our view, likely bring selling pressure for equities.
- Soft landing appears to be the consensus among market participants.
- Technology, retail, and bank stocks will provide clues on where the market goes next.

Equities experienced selling pressure in August as the S&P 500 and NASDAQ suffered their first monthly declines since February. The pullback in the S&P 500 reached -5% on August 18, as traders booked profits in big tech, and investors became concerned with current valuation levels due to rising bond yields. However, US equities found their footing in the last week of the month after Fed Chair Powell delivered a benign speech at the Jackson Hole Economic Symposium. Overall, Powell outlined a balanced outlook for inflation and the economy, but he added that the Fed is in a "position to proceed carefully as we assess the incoming data and the evolving outlook and risks."[1] Investors took that remark as proof that the Fed's rate-hiking campaign has essentially ended.

A few days later, on August 29, the bulls were rewarded with more good news. The Job Openings and Labor Turnover Survey ("JOLTS") showed a significant drop in job openings. While still well above pre-pandemic levels, the survey is now at levels dating back to early 2021 and supports the view that the labor market is cooling. According to the Fed and most investors, a softer labor market is a prerequisite for achieving the Fed's 2% inflation target. Not surprisingly, equity investors celebrated the JOLTS release with one of the best rallies of the year. By month end, the S&P 500 and NASDAQ had recouped much of their earlier losses to end the month with modest declines of -1.8% and -2.2%, respectively. Of concern, the more diversified, small-cap Russell 2000 index had a sharper decline of –5.2%, which is emblematic of this year's narrow breadth of equity returns.[2]

The soft JOLTS report also helped trigger a sharp rally in the bond markets to end the month, providing some yield relief for equities. However, one of the most significant developments in August was the steady march higher in longer-term yields despite encouraging disinflation trends. The US 30-year yield reached a high of 4.48% (highest level since 2001), and the 10-year yield reached a high of 4.37% (highest since 2007) driven by stronger-than-expected economic data and increased scrutiny on government deficit and issuance following the Fitch downgrade.[3] Though yields finished the month well off their highs, the trend suggests that longer-term yields are biased upward in the near term. Higher yields pose a new threat to equities as valuation multiples have expanded this year due to S&P earnings declines. With the S&P 500 already trading at a premium multiple, a further backup in rates will likely ensue in more equity selling pressure.

We believe that strong economic data over the last few months has made a soft landing the consensus view among investors. The odds of a recession are clearly lower, which has been good for equities, but it has also helped drive yields higher, posing a new threat to equities. Based on the market reaction to the soft JOLTS report, we seem to have reached a point where market participants welcome softer economic data. This is a double-edged sword, because if we start to see a string of weak economic data reports, it will not be long before the consensus

1. "Speech by Chair Powell on the Economic Outlook." Board of Governors of the Federal Reserve System, 25 Aug. 2023, www.federalreserve.gov/newsevents/speech/powell20230825a.htm.
2. Bloomberg.
3. Id.

shifts from soft landing to recession. For now, we believe the market will trade range-bound until we get more clarity on the path forward for yields and the economy.

Key areas to watch going forward are the performance of technology, retail, and bank stocks. The major catalyst for June and July's big equity rally was Nvidia's shockingly good earnings report in late May. The company's second-quarter revenue guidance was over 50% above analyst consensus, and management attributed the outperformance to investments in artificial intelligence ("AI"). Nvidia's report and commentary sparked a sharp rally across the technology sector, and other perceived AI beneficiaries, which carried the S&P 500 to new year-to-date highs forcing hedge funds and other professional investors to cover short positions. While NVDA delivered another stellar quarterly report in August, investors responded to the report by broadly selling tech stocks. Importantly, this earnings season has made clear that very few companies are seeing the same immediate uplift from AI as NVDA. If anything, most companies will experience increased costs before seeing any revenue or productivity benefit.

While consumer spending has been a bright spot for the economy, some red flags are starting to bubble to the surface. During this earnings season, several large retailers warned about troubling trends in credit delinquencies and shrink, which is industry jargon for theft. With outstanding credit card balances hitting new highs and the savings rate well below pre-pandemic levels, consumer excess savings appear to be running low. Another concern is that the student loan payment moratorium has ended, which is estimated to add an additional monthly expense of $383 to borrowers.[4] Thus far, most of the trouble has been isolated to the low-end consumer. Still, we will watch retailers closely to see if consumer spending and credit becomes a broader problem for the economy and markets.

Finally, the lingering effects of March's regional bank crisis pose a continued risk. Banks are still paying up for deposits, and lending standards have tightened considerably. A reduction in credit usually constrains growth over the intermediate term. While bank stocks are well off of their March lows, they remain down sharply for the year, and their underperformance suggests that the crisis may not be over yet.

With equities trading at an elevated valuation and consensus now calling for a soft landing, we believe the balance of risks skews to the downside for equities, and that the Fed's aggressive rate-hiking campaign over the last twelve months will eventually induce a recession. During this period of elevated uncertainty, we continue to focus on diversification and capital preservation, and we believe that credit markets offer more favorable risk/reward than equities at current valuations.

4. Clifton, Daniel. Policy Outlook: Three Student Loan Catalysts Ready To Hit & Loom Large Over US Consumers, Strategas, June 2023.

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