Economy

Market Commentary: October 2023

By **Rob Edel**, Chief Economist
November 16, 2023 | 11 min read

Share article:

Written as of November 14, 2023.

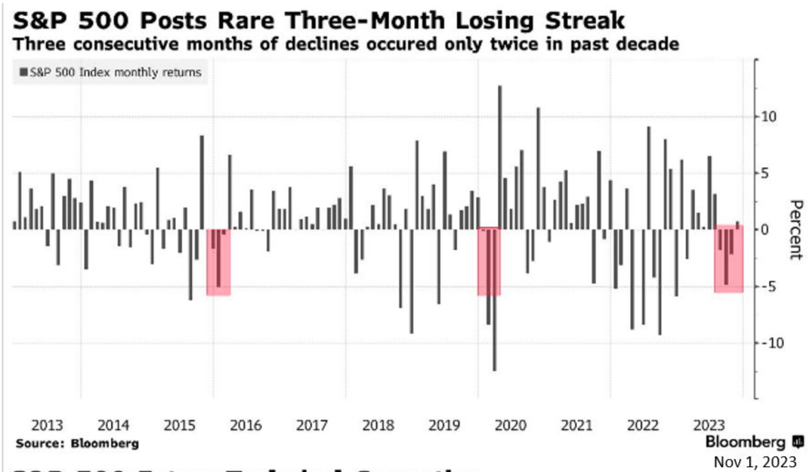
View the Nicola Wealth Investment Returns: October 2023.

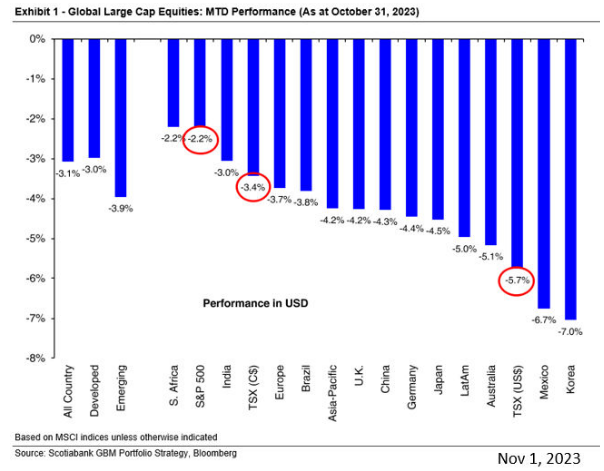
Highlights this Month

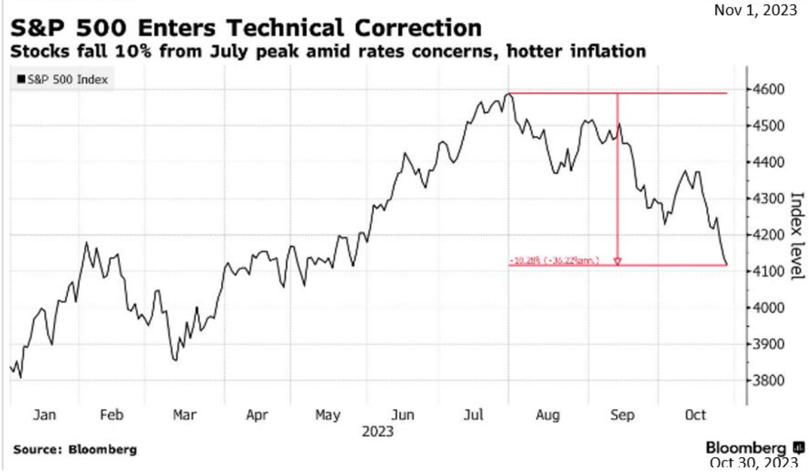
- Impact of higher yields on stocks.
- The strategic positioning of the Magnificent Seven.
- Economic growth and job market challenges.
- Inflation trends and lingering doubts.
- Canadian homeowners face a precarious situation.
- Challenges for homeowners and corporations.

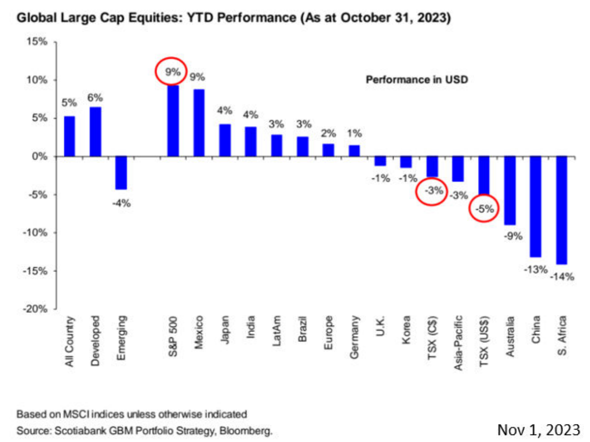
October in Review

In October, for the third consecutive month, markets faced increased pressure, experiencing declines such as the S&P/TSX Composite Index at -3.2% (total return in Canadian dollars), the S&P 500 at -2.1% (total return in U.S. dollars), and the NASDAQ at -2.8% (total return in U.S. dollars). According to Bloomberg, this marks only the third instance in the past decade where the S&P 500 has undergone three consecutive months of declines. The S&P 500 and the NASDAQ also plummeted over 10% from their July highs, entering a technical correction. Although the S&P/TSX Composite Index avoided entering technical correction territory, this was mainly due to Canadian stocks failing to generate a significant rally throughout the year.





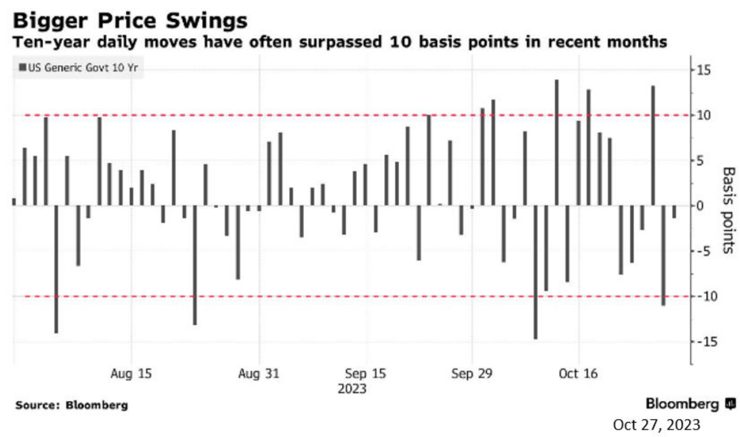


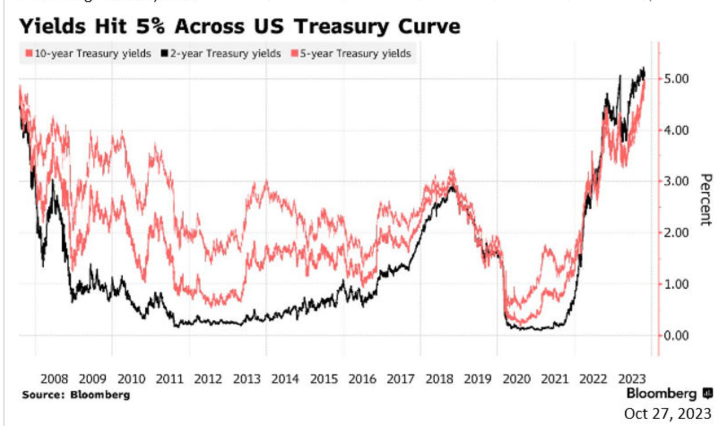


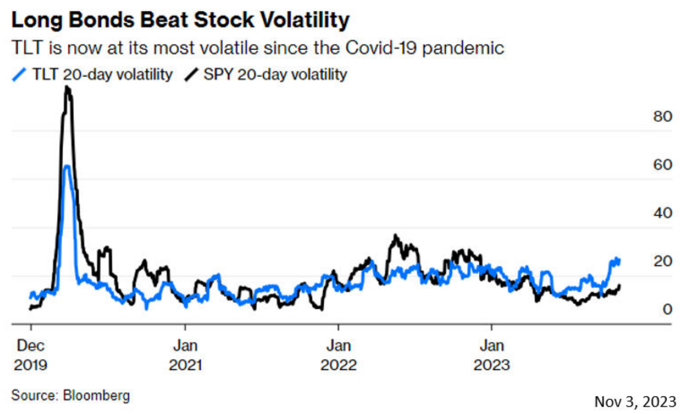
Year to date, the S&P/TSX Composite Index has remained relatively flat, while the S&P 500 is still up by 10.7% and the NASDAQ by +23.6%. Despite recent market downturns, the focus remained on the bond market, which exhibited heightened volatility. Yields converged around the 5% level across most of the yield curve, maintaining elevated bond market volatility. Year to date, the ICE BofA MOVE Index, measuring U.S. Bond option volatility, has doubled the average seen over the past decade. Volatility on the iShares 20+ Year Treasury Bond ETF (TLT) has reached its highest level since COVID-19, surpassing volatility for the S&P 500 ETF Trust (SPY). This departure from the norm raises concerns, as traditionally, bonds are not expected to be more volatile than stocks.

Daily fluctuations in 10-year treasury yields routinely exceeded ten basis points in recent months, causing unease among even the most seasoned investment professionals. Notable figures like JP Morgan's Jamie Dimon and Bridgewater founder Ray Dalio attribute rising yields to U.S. fiscal spending and increasing public debt levels. While Hedge Funder Bill Ackman initially supported this view, global risks and slowing economic growth prompted him to close out his short bond positions (short bonds to profit when yields rise). PIMCO co-founder Bill Gross sought refuge in futures tied to the secured overnight finance rate. All four seem to subscribe to the "higher for longer" narrative adopted by most traders, with Ackman and Gross expressing more immediate concerns about potential risks to the economy.

As rates continue to rise, it is crucial to understand the underlying reasons. In the following sections, we delve into potential explanations and examine the impact higher yields have had on stocks and the implications for future asset returns.





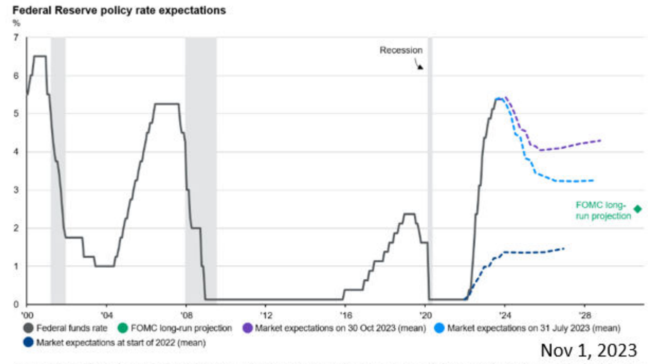


The Fed's influence on rates.

According to David Rosenberg, the correlation between the Fed Funds Rate and 10-year Treasury yields is the dominant factor influencing rates. With short-term rates anticipated to remain high for at least a year, investors seek enticements to commit funds for longer terms. Alpine Macro notes that higher short rates are elevating 1-year yields.

Economist – Nov 5, 2023

Chart 3 - The market is acknowledging a 'higher for longer' rate outlook

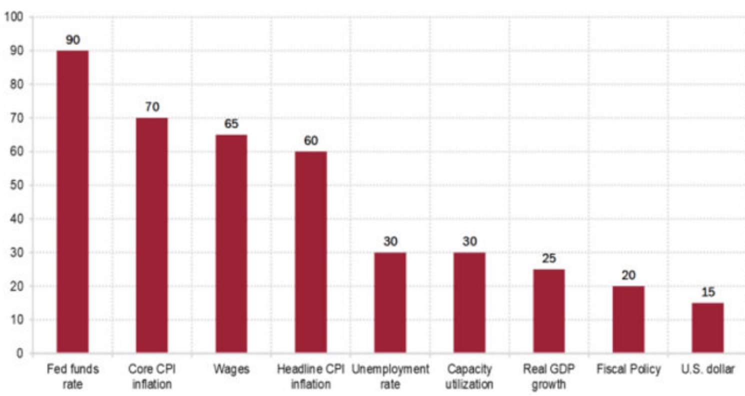


Nov 1, 2023

Source: BLS, Bloomberg, Federal Reserve, J.P. Morgan Asset Management. Market expectations are calculated using OIS forwards. Periods of recession are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results.

CHART 6: Nothing More Important for Bonds Than the Fe

United States: *10-Year Treasury Note Historical Correlations*
(percent)

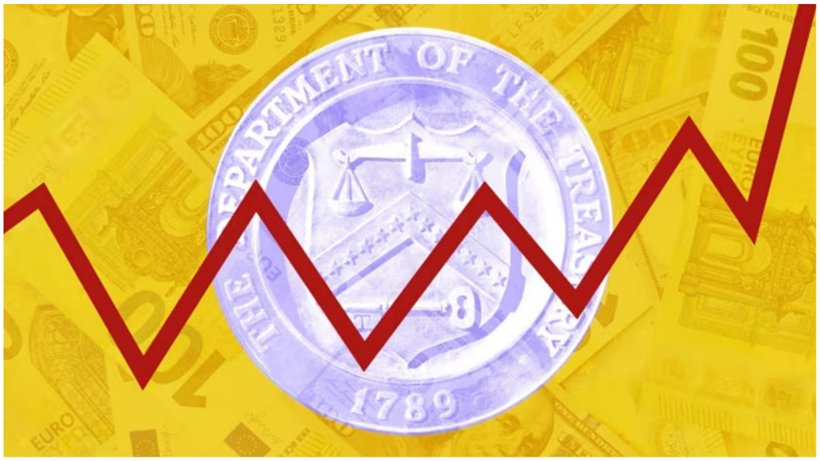


Source: Haver Analytics, Federal Reserve, BLS, BEA, Rosenberg Research Oct 31, 2023

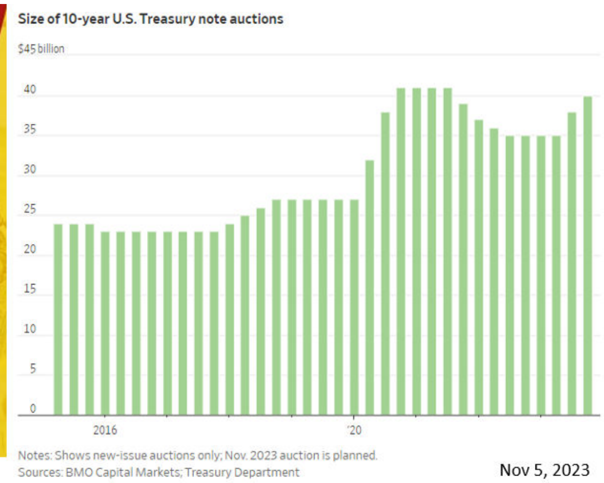
Alpine Macro – Oct 31, 2023

The Treasury’s role in shaping yields.

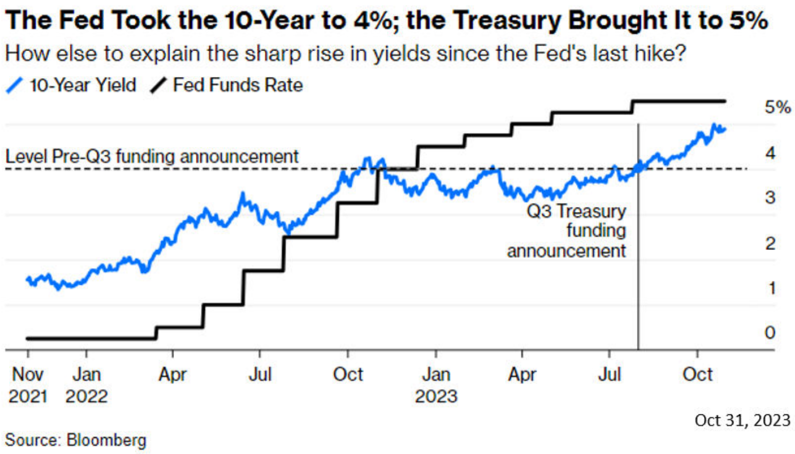
The U.S. Department of the Treasury is pivotal in driving higher yields. Tasked with funding the growing U.S. government deficit, Secretary Janet Yellen must strategically determine the mix of short and long-term issuances. Traditional buyers of U.S. government debt, such as foreign governments and the Federal Reserve, are presently absent or net sellers. Hedge funds, mutual funds, and pension funds being more price-sensitive, have taken their place. The Treasury, aiming for a balanced portfolio, faces the challenge of issuing short-term T-bills yielding over 5.5% and longer-term bonds. Deutsche Bank attributes the surge in 10-year yields from 4% to nearly 5% to the Treasury's guidance on increased 10-year bond issuance.



Financial Times – Oct 6, 2023



Nov 5, 2023



Oct 31, 2023

Shifting Demand for Treasuries

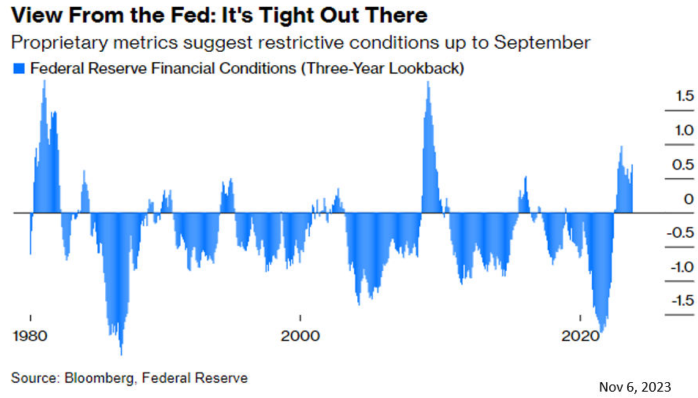
Net purchases of US government bonds are tilting to price-sensitive buyers

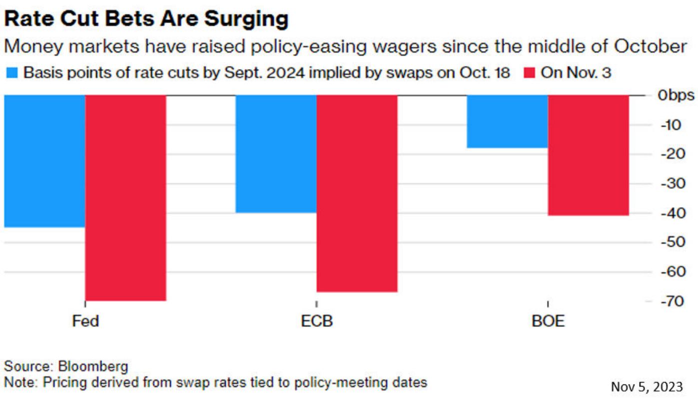
	2022	2023 Estimates
Federal Reserve	$-213B	$-720B
Foreign Investors	376	275
Commercial Banks	-83	-170
Pension Funds/Insurance	-41	150
Broker Dealers	72	0
Mutual Funds	20	275
Money Market Funds	-751	600

Source: JPMorgan

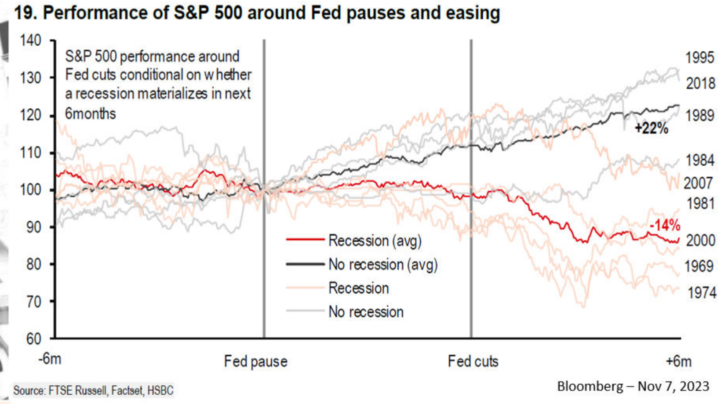
Oct 15, 2023

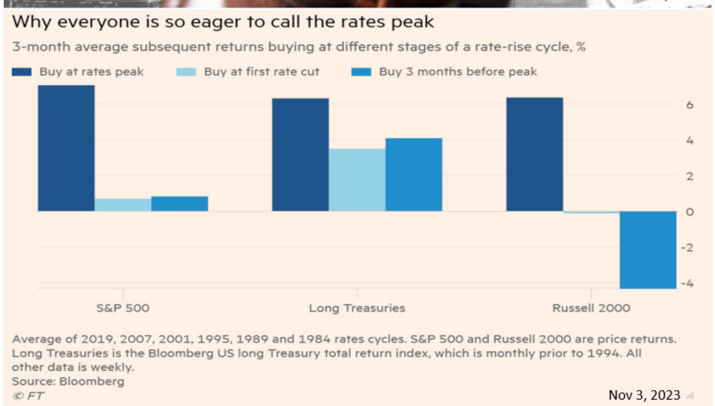
A slight downward revision in the Treasury's refunding plans in early November, coupled with a "dovish" pause by the Fed, contributed to a significant drop in yields. Chairman Powell's indication of a potential halt to rate hikes led to market optimism, with stocks rallying and futures markets pricing in 100 basis points of Fed cuts by the end of next year. However, the interplay between Powell's comments, tightening financial conditions, and market expectations underscores the situation's complexity.

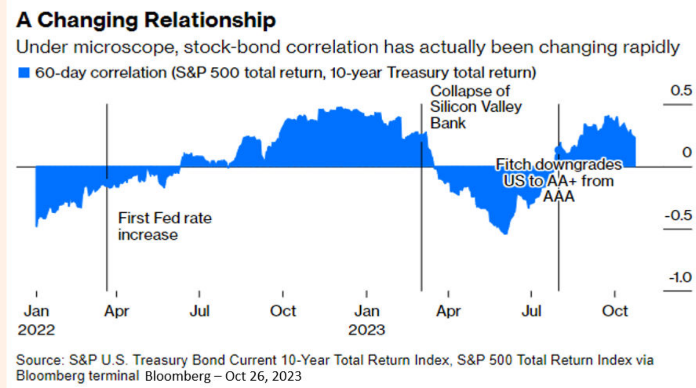




The future trajectory of yields holds significance for both bond and equity markets. The bond market's response to a Fed pause and the overall economic scenario will determine whether the current stock decline is a correction or evolves into a bear market. HSBC emphasizes the economy as a critical factor post a Fed pause, projecting a potential 22% market increase in a soft-landing scenario and a 14% decline in a hard-landing situation. The intricate relationship between stocks and bonds during a soft landing remains uncertain, adding to the market's indecision.

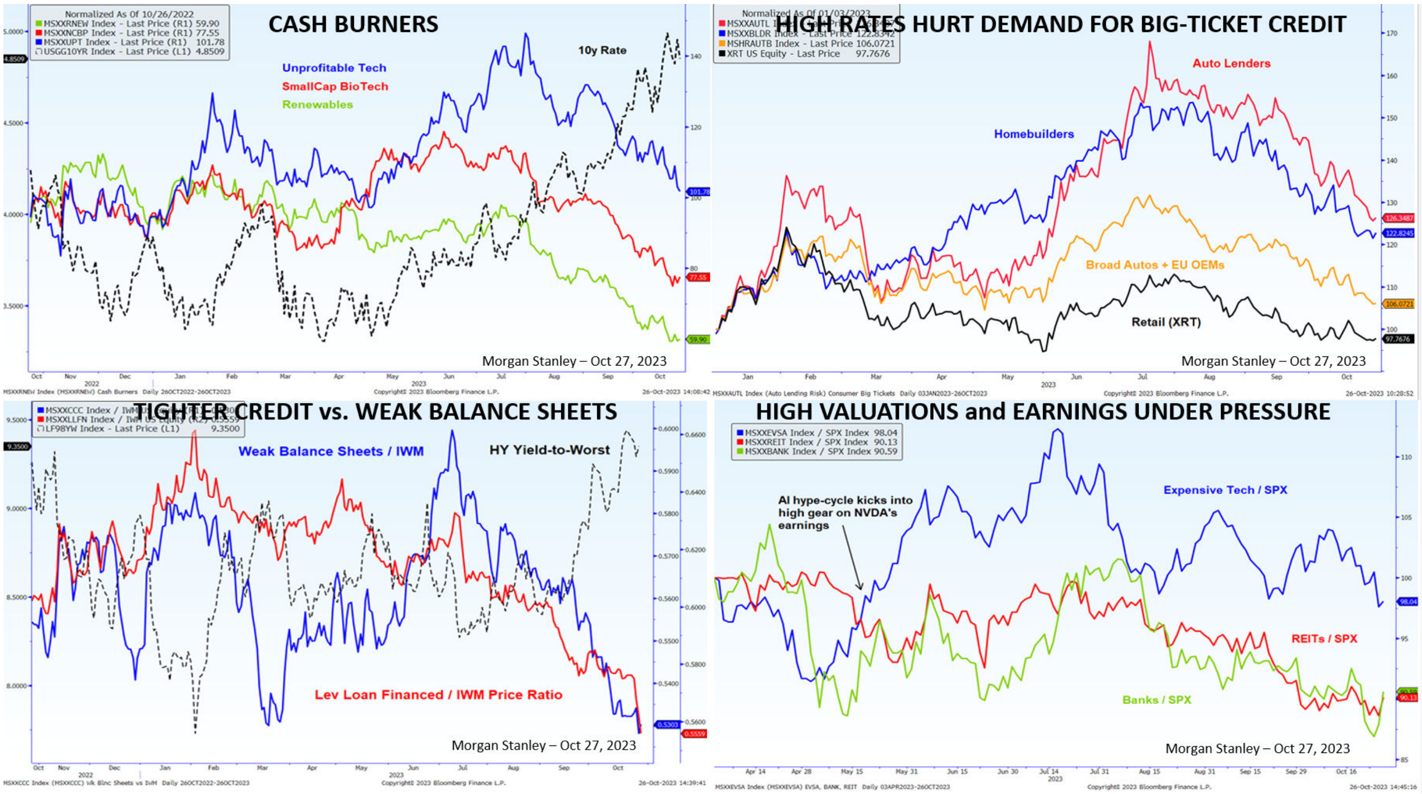






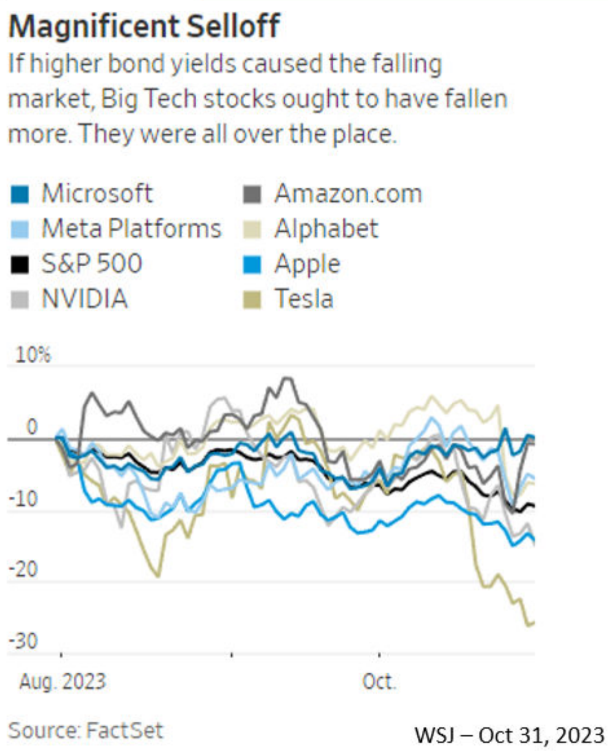
Impact of higher yields on stocks.

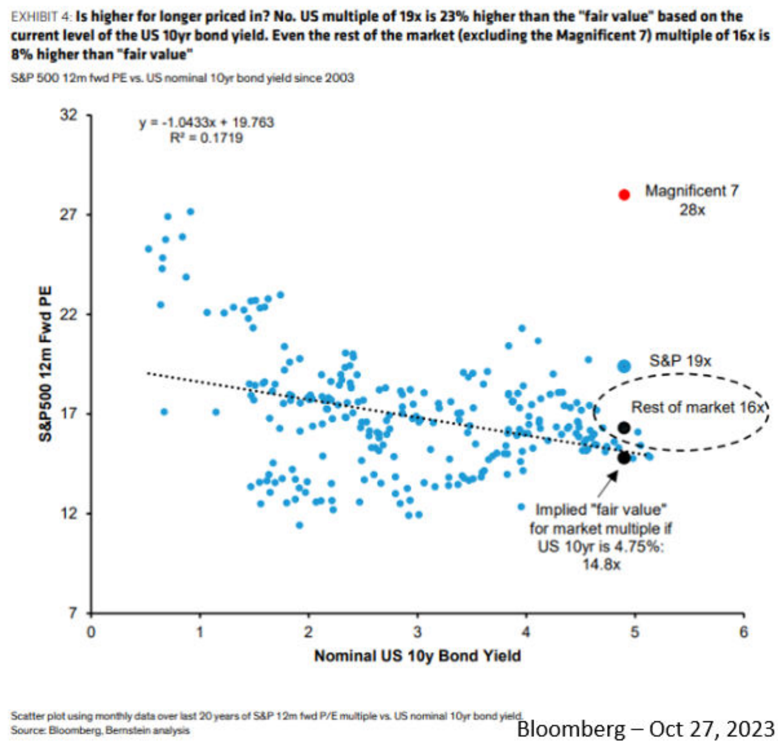
Despite the robust performance of big-cap U.S. equity indices (S&P 500 & NASDAQ), the broader market has faced challenges. Higher yields have inflicted notable damage on stocks, particularly affecting cash-burning companies, those dependent on loans for big-ticket products, businesses with weak balance sheets, and those facing pressure on earnings and high valuations. Last month showcased the adverse effects, highlighting the need for a nuanced understanding of the evolving stock/bond correlations.



Dominance of the "Magnificent Seven".

The "Magnificent Seven" – Apple, Microsoft, Meta, Amazon, Alphabet, Nvidia, and Tesla – wield unparalleled influence in both size and valuation among expensive technology companies. Bernstein's analysis reveals a notable shift, reducing the 12-month forward PE multiple for the S&P 500 from 19X to a more standard 16X when excluding these giants. Surprisingly, despite the general downturn in pricey stocks due to rising bond yields, these behemoths demonstrated resilience. While they experienced declines, the impact was neither uniform nor as significant as observed in the broader market.

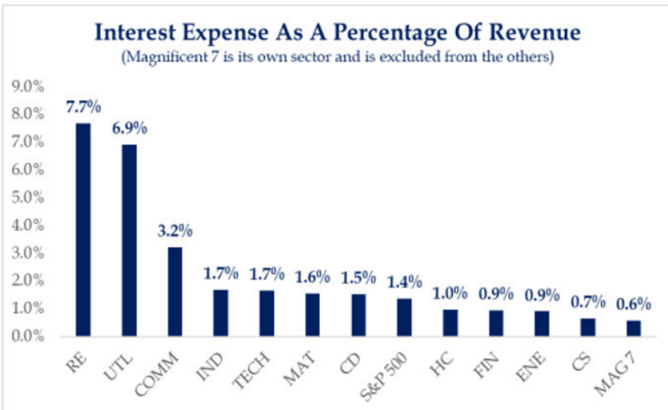




One key factor contributing to their resilience is their superior earnings growth. Rosenberg Research's calculations show that Q3 profits for the Magnificent Seven surged at a remarkable 59% year-over-year pace, in stark contrast to the rest of the S&P 500, which faced a profit decline of 13%. Beyond profitability, these companies boast substantial cash reserves, shielding them from the adverse effects of higher yields and increased interest costs. These tech leaders weathered the storm and benefitted from higher interest income.

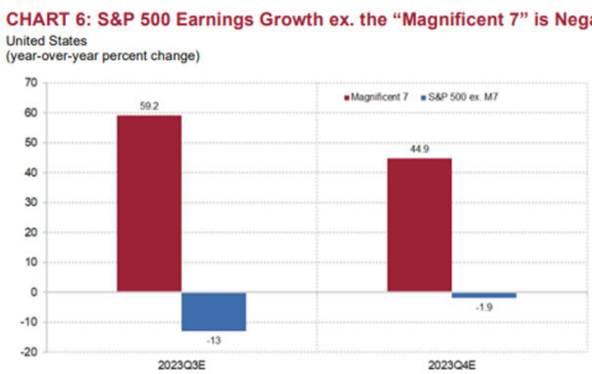
The strategic positioning of the Magnificent Seven.

Strategas strategically grouped the Magnificent Seven as its own sector, revealing their distinct advantage. Comparisons against the S&P 500 and its various sectors demonstrated that the Magnificent Seven had the lowest interest expense as a percentage of revenue, a mere 0.6%. This aligns with the market's preference for low leverage, as highlighted by Strategas' examination of investment styles. Large-cap growth, mainly represented by the Russell 1000, outperformed large-cap value, and an interesting parallel was noted in the underperformance of small-cap growth (Russell 2000) compared to small-cap value. This underperformance is postulated to be linked to the dominance of large-cap growth companies characterized by robust cash flow and substantial reserves, a belief supported by Piper Sandler's chart showcasing the outperformance of small-cap stocks with high interest rate coverage.



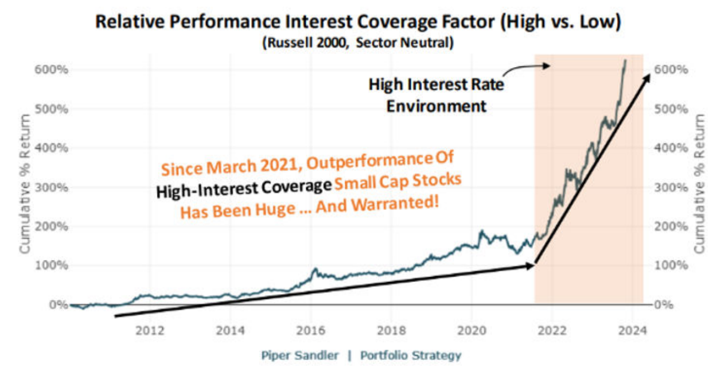
Strategas – Oct 20, 2023

STYLE PERFORMANCE LOOKS DIFFERENT BY CAP-SIZE… WHY?



Source: Bloomberg, Rosenberg Research

Nov 10, 2023

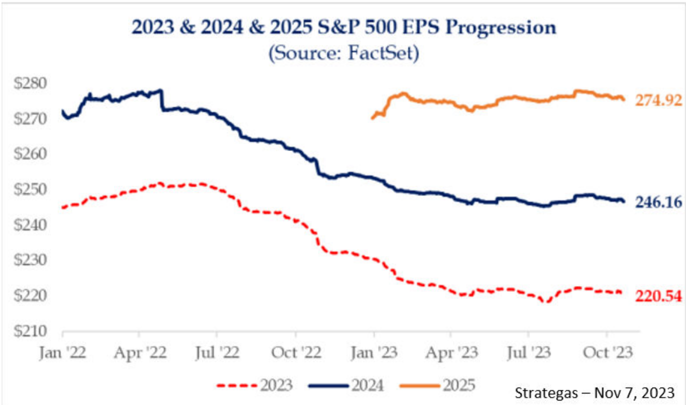


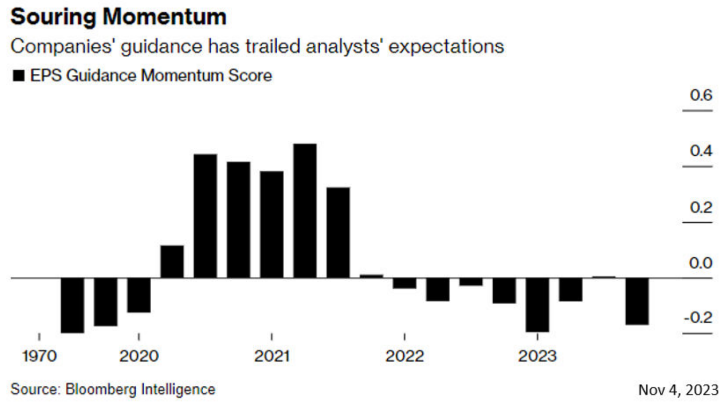
Source: Piper Sandler

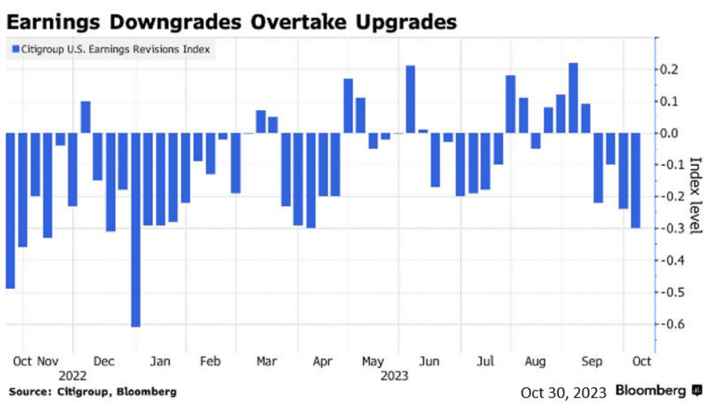
Nov 3, 2023

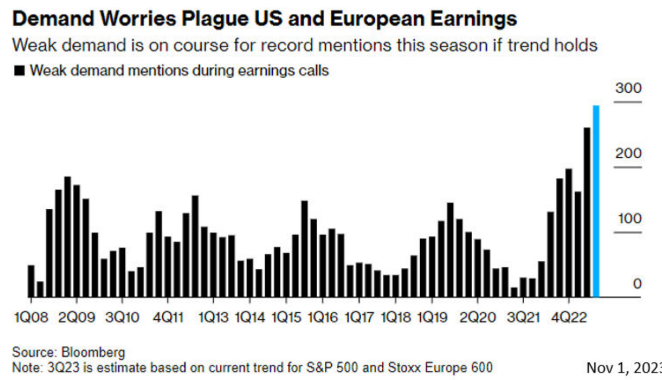
Earnings landscape and emerging cracks.

While overall earnings continue to surpass expectations, signs of emerging challenges are becoming evident. Strategas estimates suggest that 2023 S&P 500 earnings are on track to finish flat for the year, with projections for 2024 and 2025 showing a growth rate of 12%. However, the Citigroup Earnings Revision index's four consecutive weeks of decline signal a shifting landscape, with more companies revising earnings downwards than upwards. Bloomberg reports an increasing number of companies guiding future earnings lower than analyst expectations, expressing concerns over weak demand, reaching record levels in earnings calls. These developments hint at potential headwinds that warrant close monitoring in the evolving market environment.





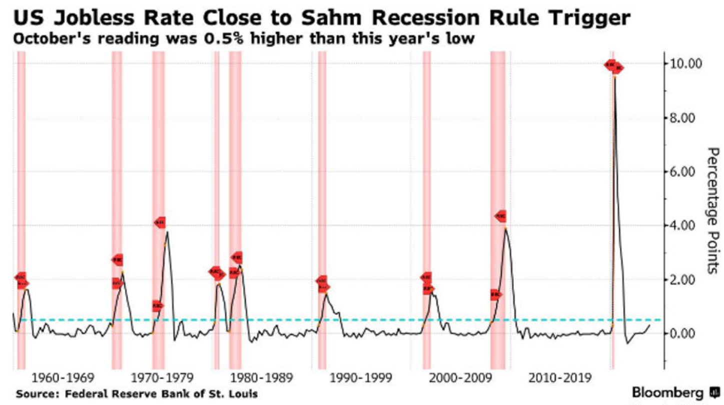




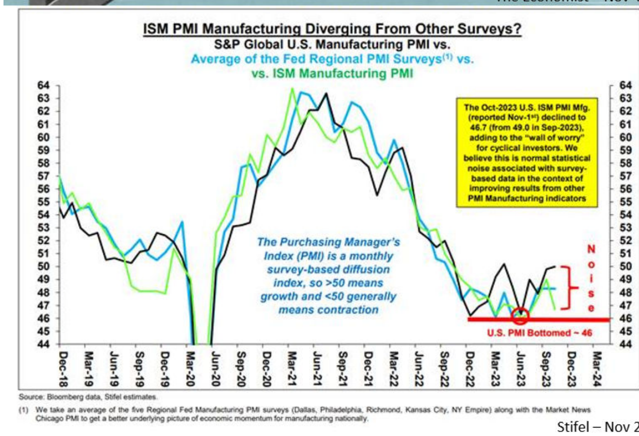
Economic growth and job market challenges.

The pivotal factor influencing future earnings is economic growth, which, despite defying expectations for most of the year, is now revealing signs of strain. October's unemployment rate, rising to 3.9%, represents a 0.5% increase from the yearly low recorded in January. According to Sahm's Rule, a recession is considered underway if the 3-month moving average unemployment rate surpasses the 12-month low. Compounding concerns, Bloomberg highlights that banks are tightening credit standards for small and medium-sized companies to levels reminiscent of past recessions. Additionally, a majority of purchasing manager indices persist in contraction territory.

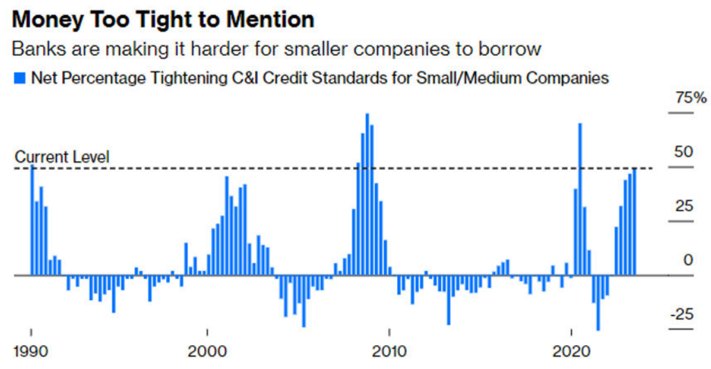
The Economist – Nov 4, 2023



Nov 3, 2023

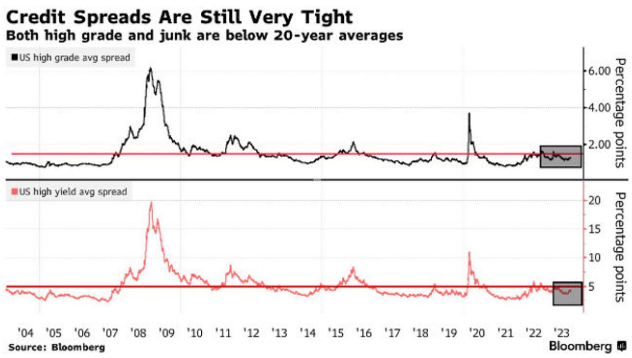


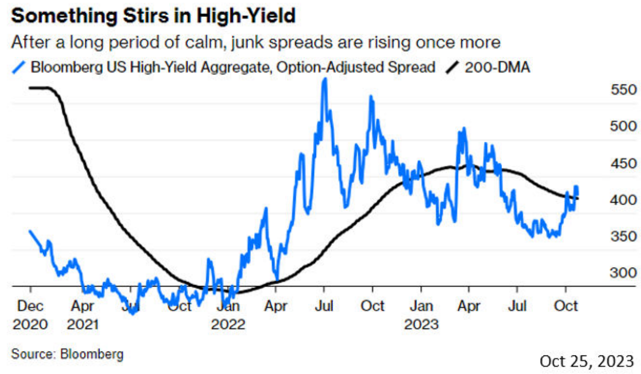
Stifel – Nov 2, 2023



Oct 25, 2023

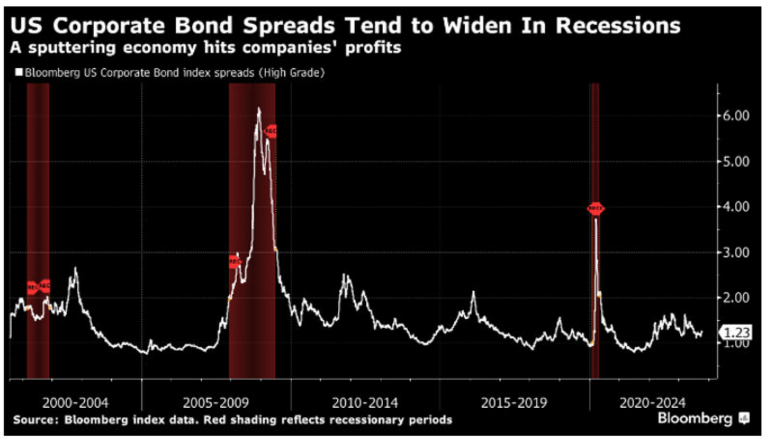
Credit spreads are one of the most effective early indicators for monitoring the economy and corporate health. While credit spreads typically widen in recessions, recent developments indicate some emerging cracks. Although credit spreads for both high-grade and junk credits remain below 20-year averages, they started to show an upward trajectory last month. Of particular concern are smaller companies, as seen in the Russell 2000 index, with more debt maturing over the next several years compared to larger S&P 500 companies, which typically manage their debt in more manageable chunks.

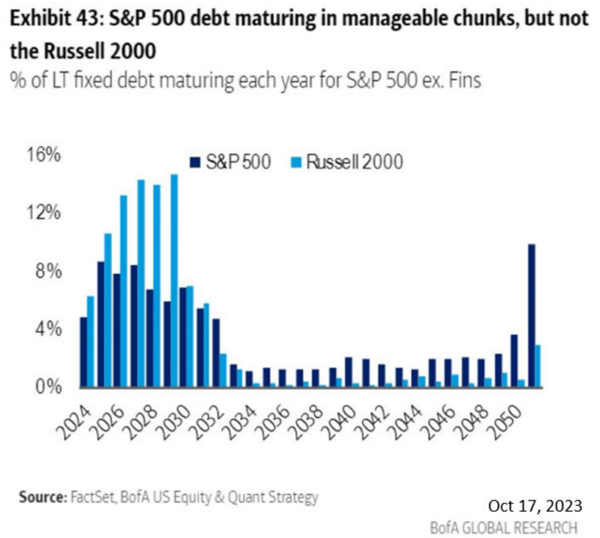




Oct 25, 2023

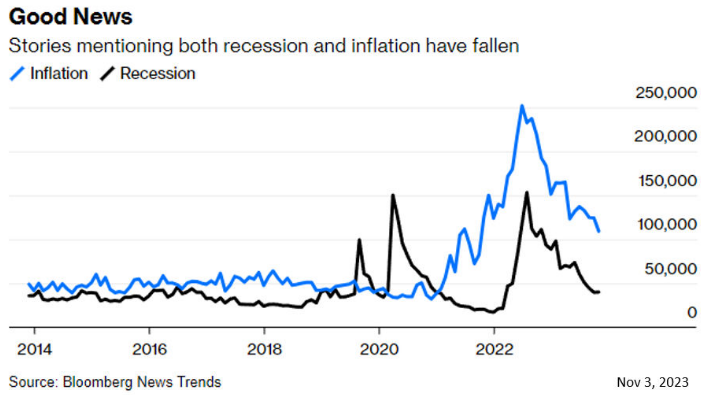
Oct 31, 2023

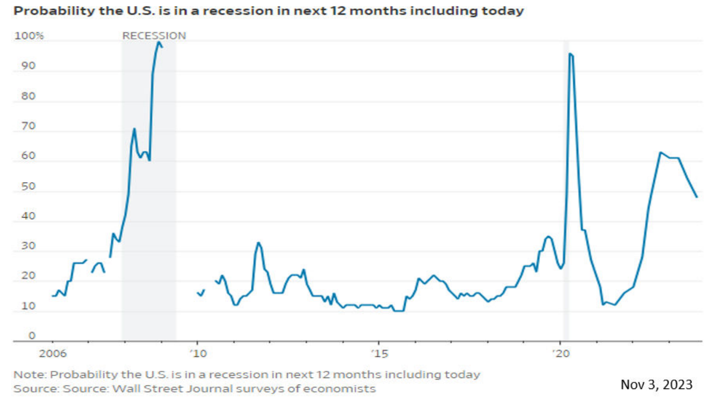


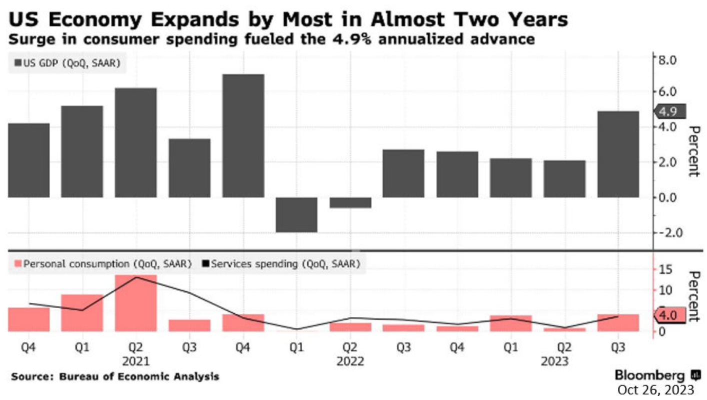


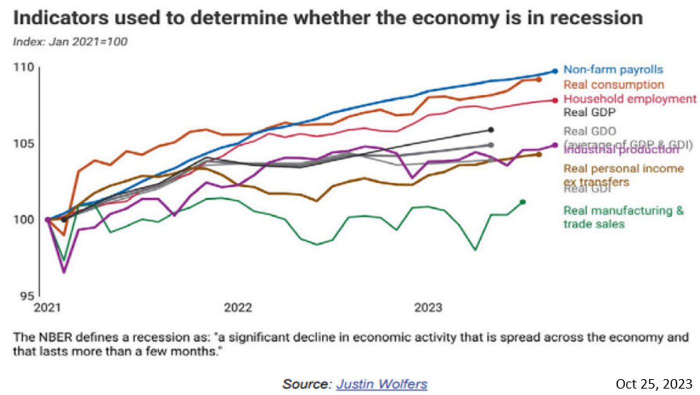
Oct 17, 2023

Despite the emergence of cracks and the potential slow widening of credit spreads, recent news flow has generally been positive. Bloomberg News Trends underscored a decline in stories mentioning both recession and inflation. A survey of economists by the Wall Street Journal in October revealed a decrease in the probability of a recession within the next 12 months to 48%. Furthermore, Q3 US GDP exhibited robust growth at 4.9%, the highest in almost two years. Analyzing factors considered by the National Bureau of Economic Research to determine a recession, the positive trends across these factors make it challenging to predict an imminent economic downturn conclusively.



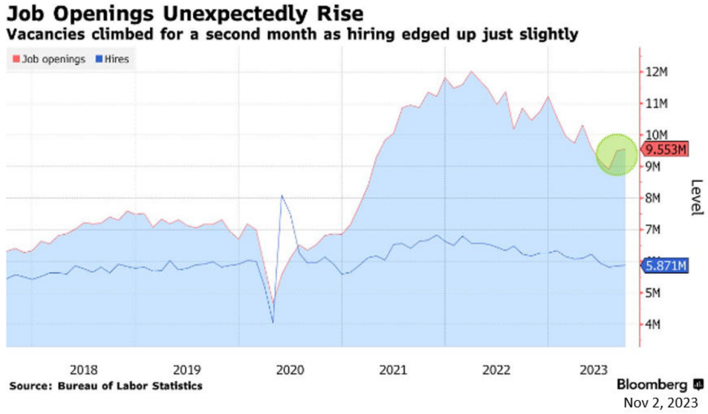


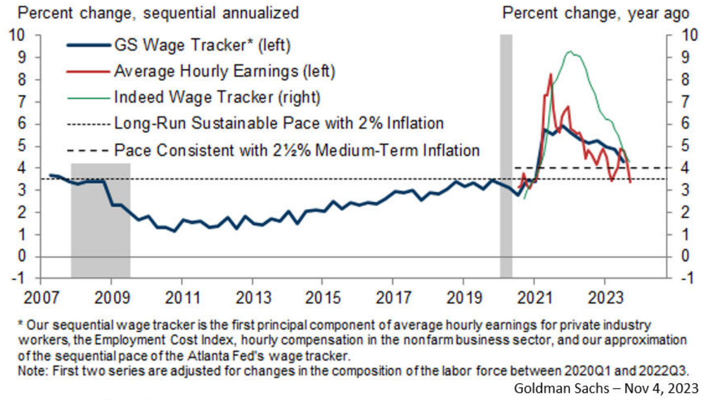


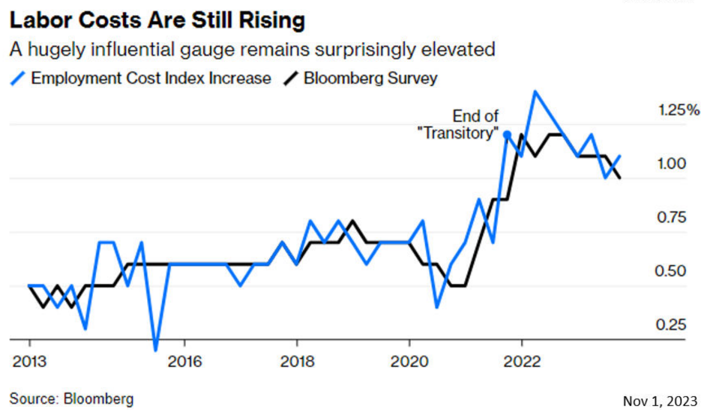


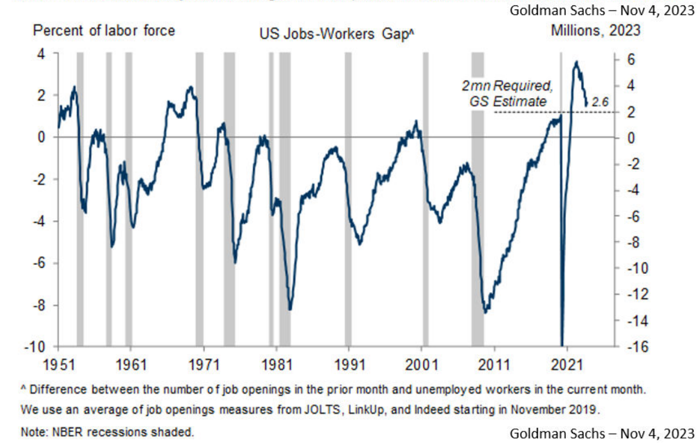
Softening job market and sustainable wage growth.

The key to achieving a soft economic landing hinges on the job market, which, as mentioned earlier, is showing signs of softening, with the unemployment rate rising to 3.9%. Goldman Sachs highlights a substantial reduction in the excess of job openings to workers from a peak of 6 million to around 2.6 million. According to Goldman, a two million-worker gap aligns with sustainable wage growth, estimated to be between 3.5% and 4%. This level is deemed necessary for inflation to fall back within the Federal Reserve's target range of 2-2.5%. With Goldman's base wage tracker currently at an annualized 4.2%, they assert that the Fed has largely completed its job of curbing inflation. However, the employment cost index indicates that wages remain persistently elevated, and job openings unexpectedly increased in September for the second consecutive month. While Goldman sees progress, many strategists contend that the job market remains excessively tight.



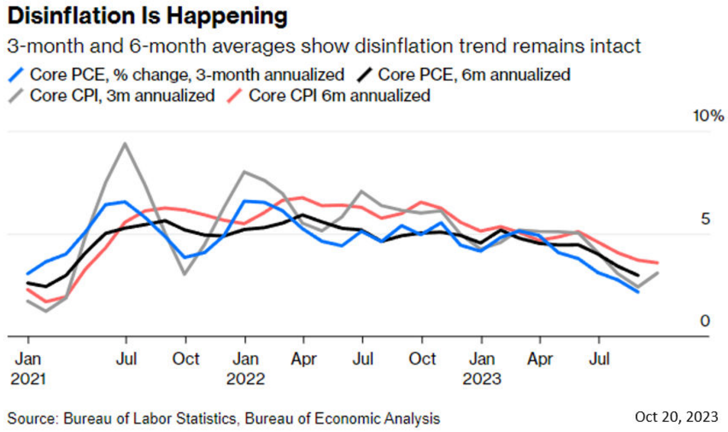


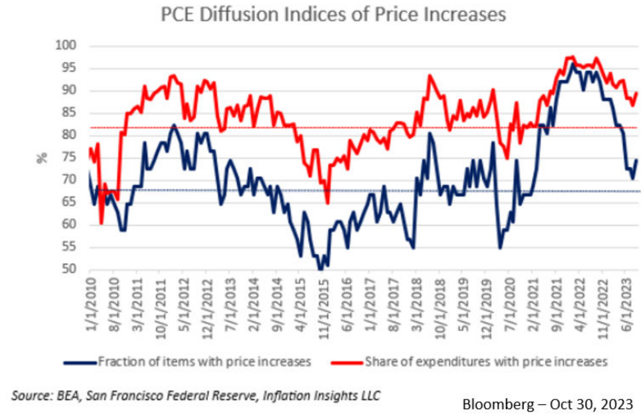


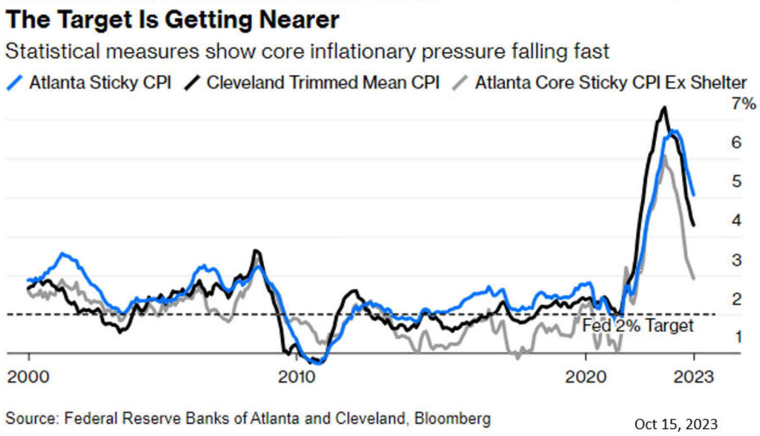


Inflation trends and lingering doubts.

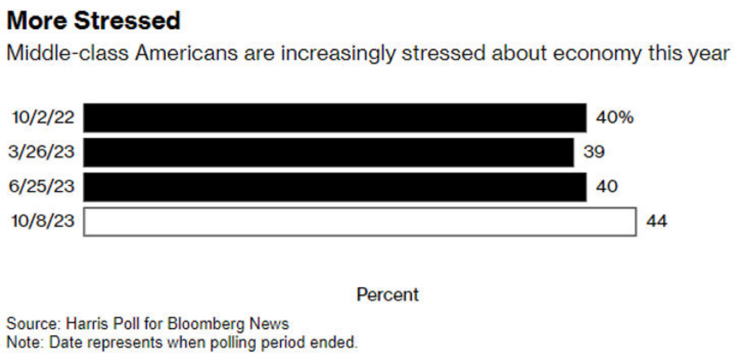
In tandem with the job market, inflation is undergoing a normalization process, yet it is premature for the Fed to declare victory. Despite indicators like the Atlanta Fed's Sticky CPI and the Cleveland Fed's Trimmed Mean showing a continual decline in inflation, longer-term doubts persist, as evidenced by the recent increase in 30-year inflation swap rates. Inflation Insights LLC highlights a nuanced aspect, pointing out that while the percentage of products with significant price increases has decreased, the share of total consumer expenditures on such products has not.



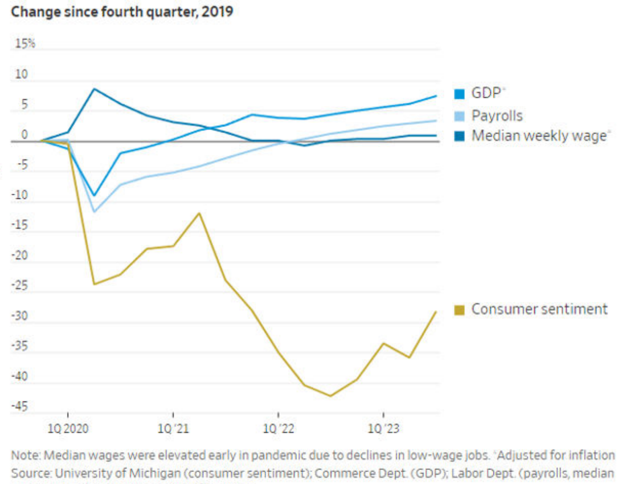




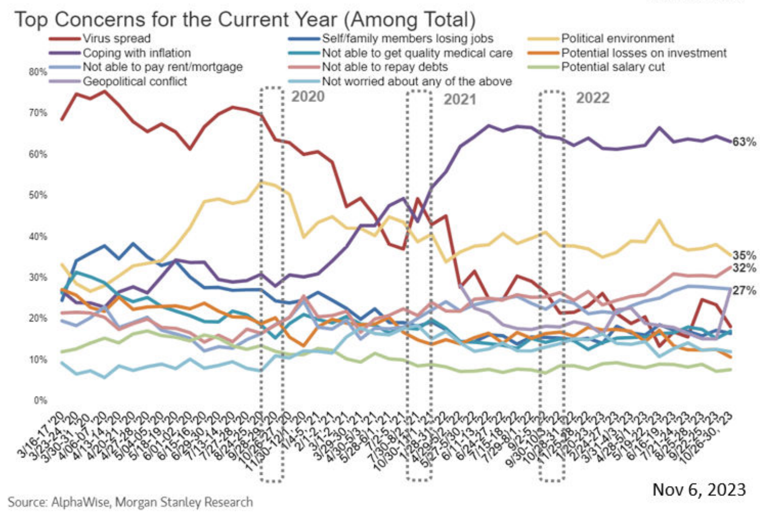
Consumer apprehensions about inflation are clearly reflected in a recent Harris Poll for Bloomberg News, indicating a 44% increase in stress among middle-class Americans regarding the economy. Morgan Stanley's Alpha Pulse underscores inflation as the top concern for nearly 30%. A recent Wall Street Journal article explores the paradox of American pessimism despite robust economic and wage growth and plentiful job opportunities. The divergence between the present situation's consumer confidence index and the expectations consumer confidence index suggests that consumers, influenced by recent experiences with inflation, are less positive about the future. This could be driving a motivation to spend now, fearing further erosion of purchasing power due to inflation. The strength in the economy may be a transitory surge in spending that could prove unsustainable if consumer confidence continues to wane.



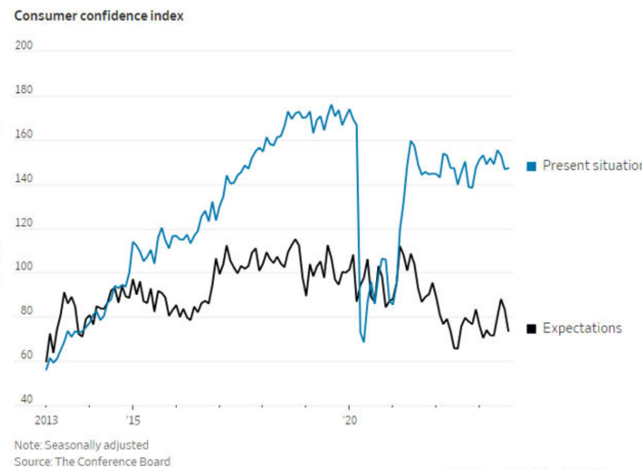
Oct 30, 2023



WSJ – Nov 1, 2023



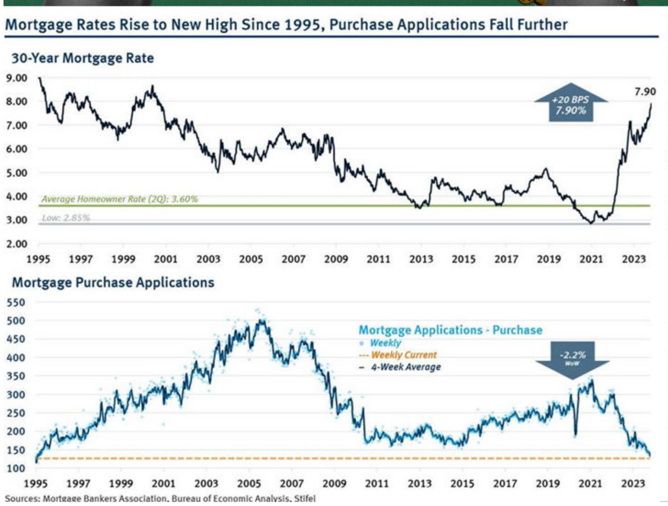
Nov 6, 2023

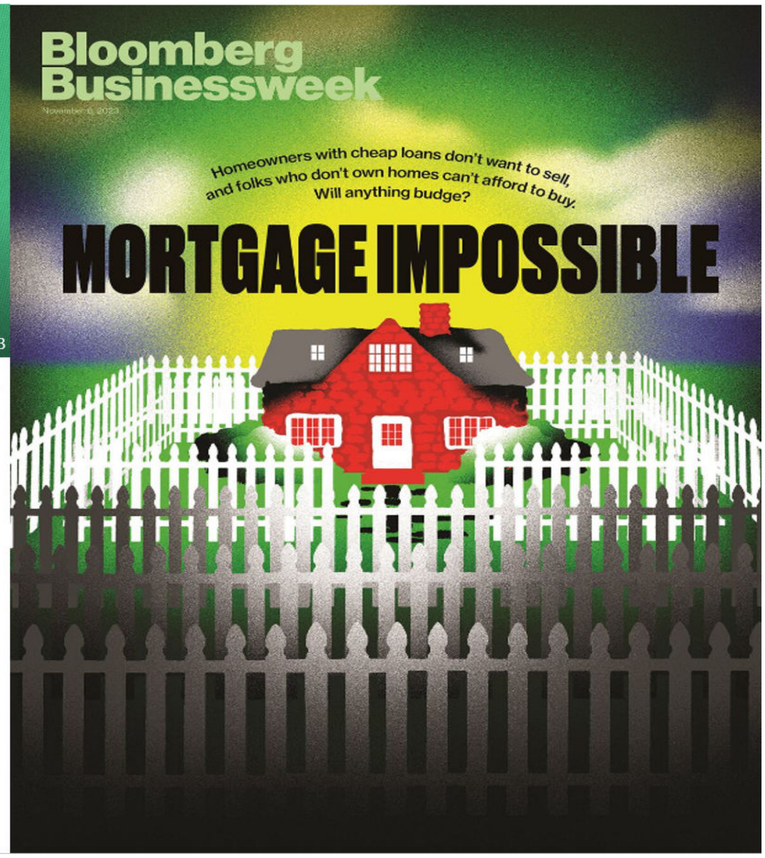


WSJ – Oct 31, 2023

American consumer constraints.

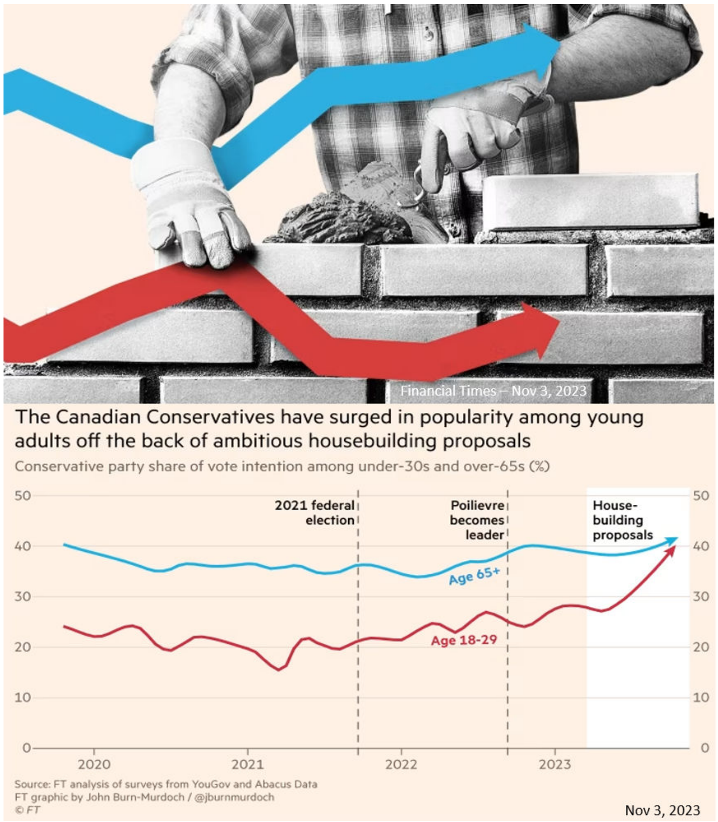
Americans are grappling with a lack of flexibility exacerbated by their financial commitments. The majority insulated themselves from higher interest rates during the pandemic by securing low-rate mortgages and loans. Now, these loans, once advantageous, have transformed into financial constraints, preventing homeowners from selling. The considerable gap between existing mortgage rates and current rates could lead to a substantial reduction in homeowners' mobility over the next decade. With Stifel reporting 30-year mortgage rates nearing 8%, mortgage application rates have understandably plummeted.

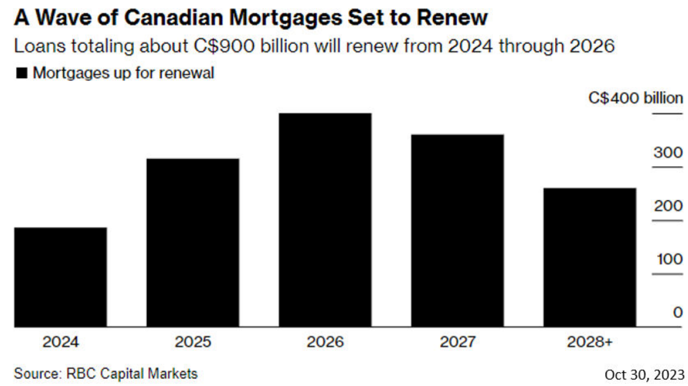


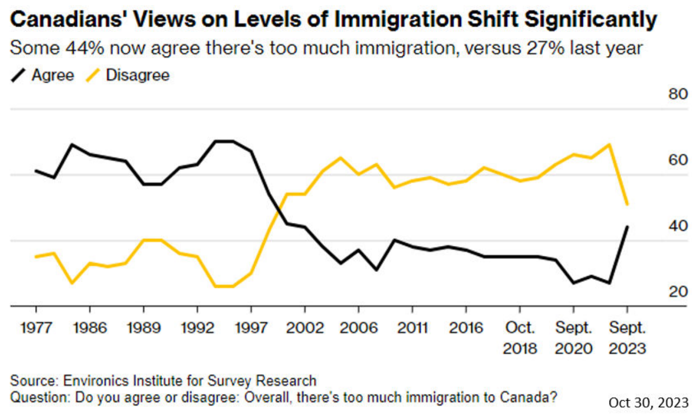


Canadian homeowners face a precarious situation.

The situation is even more precarious for Canadian homeowners. RBC estimates that approximately $900 billion in mortgage debt is set to be renewed over the next three years, potentially resulting in a staggering 60% increase in payments. Those with variable rate mortgages may face even higher payment hikes, reaching an increase of payments of up to 84% by 2026. Housing affordability has become a critical issue in Canadian politics, contributing to the declining popularity of Prime Minister Justin Trudeau and the Liberal Party. This shift in sentiment is also reflected in changing views on immigration, with 44% of Canadians now believing there is too much immigration. Conservative party leader Pierre Poilievre's focus on housing has boosted his popularity, particularly among younger voters.







Challenges for homeowners and corporations.

If interest rates remain at these elevated levels, Canadian homeowners will face significant challenges. While U.S. consumers may be somewhat less sensitive, they too will eventually feel the impact of higher rates if they haven't already. The same holds true for companies, signalling an impending economic slowdown. The timing and extent of this slowdown remain uncertain, and the markets have already priced in some of these concerns. According to Barron's Big Money Investor Poll, respondents are divided on the biggest risks to stocks, with 28% citing a recession, 26% expressing concern about higher rates, and 16% worried about resurgent inflation.

Investors exhibit a split view of the market's trajectory. In Barron's poll, 62% adopt a neutral stance towards U.S. stocks, with 26% adopting a bearish outlook and only 12% expressing bullish sentiment. This equilibrium in investor sentiment prompts consideration of alternative avenues, such as bonds. Strategas highlights a historical trend where stocks gained close to 12% annually during 39 years of falling yields. In contrast, during the 36 years of increasing yields, stock returns averaged around 6%. While bond yields may be embarking on an upward cycle, Barron's and The New York Times recently suggested that now is the time to buy bonds. Despite potential short-term challenges, bonds could prove to be a prudent investment. The longer-term trajectory may be "higher for longer," contingent on the Federal Reserve's actions and economic developments, with concerns lingering about inflation and increased government spending impacting interest rates.