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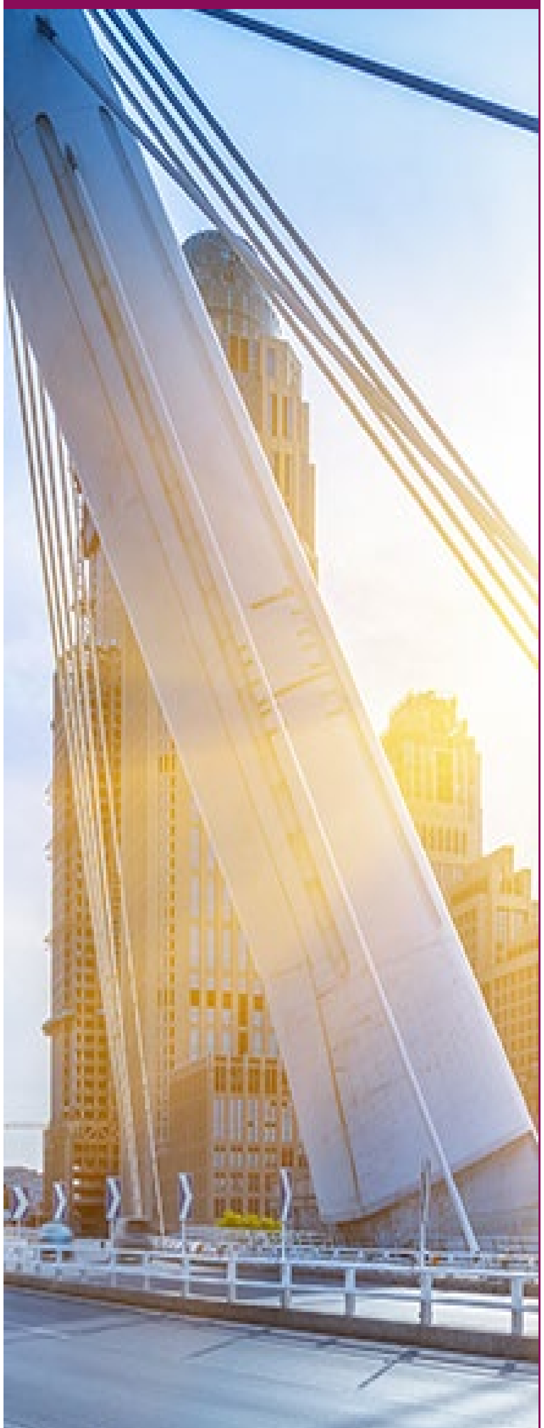
RICHARDSON Wealth

Market Ethos

The latest market insights from Richardson Wealth



Craig Basinger

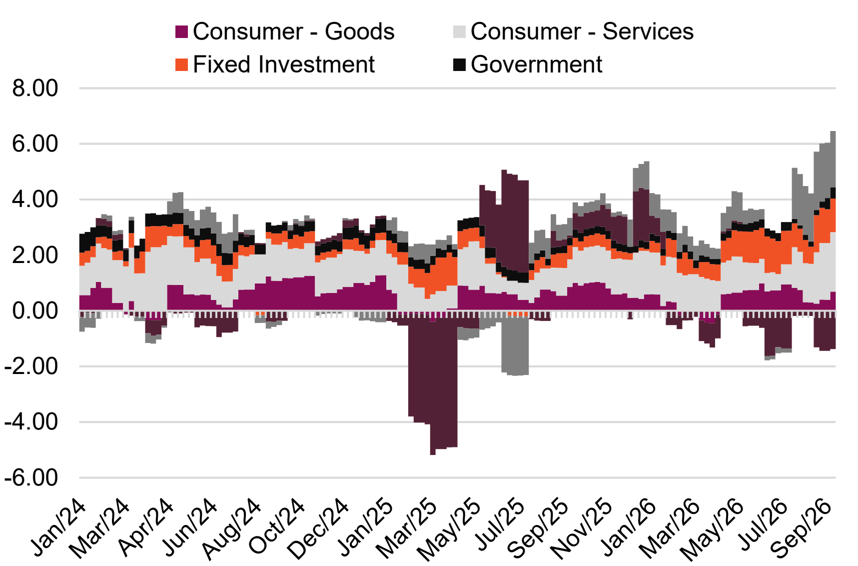
Turning up the heat

Last week we took a break from talking about yields and look what happened: they just kept going higher, with the U.S. 10-year Treasury yield peaking above 5.2%. Up 50 bps in a month and this yield was below 4% as recently as February. One would think a run-up in yields like this would elicit equity market weakness, but not so (or yet) with the S&P 500 sitting near its all-time highs.

If runaway inflation, or soft bond auctions, or central bank faith, or fiscal concerns were the biggest factor in these higher yields, you would likely see equity market weakness. And while these are all likely contributors, this move higher in yields appears largely driven by an economy that is getting hot (aka growing quickly). GDP is the standard measure of economic activity, but the official reporting data suffers from a long delay, being reported about three weeks after the quarter ended. To provide a timelier indication of economic activity, the Atlanta Fed created GDPNow, which updates the data as various pieces are reported throughout the quarter.

GDPNow is flying high and, as you can see in the following charts the big contributors, consumer spending has been moving higher, mainly on services. Fixed investment (orange) is pretty big —that is all nonresidential business investment as residential is a minor negative. Nonresidential is where data centre spend sits. And then there is inventories, which are a positive contribution.

GDPNow - Economy is Hot!!!

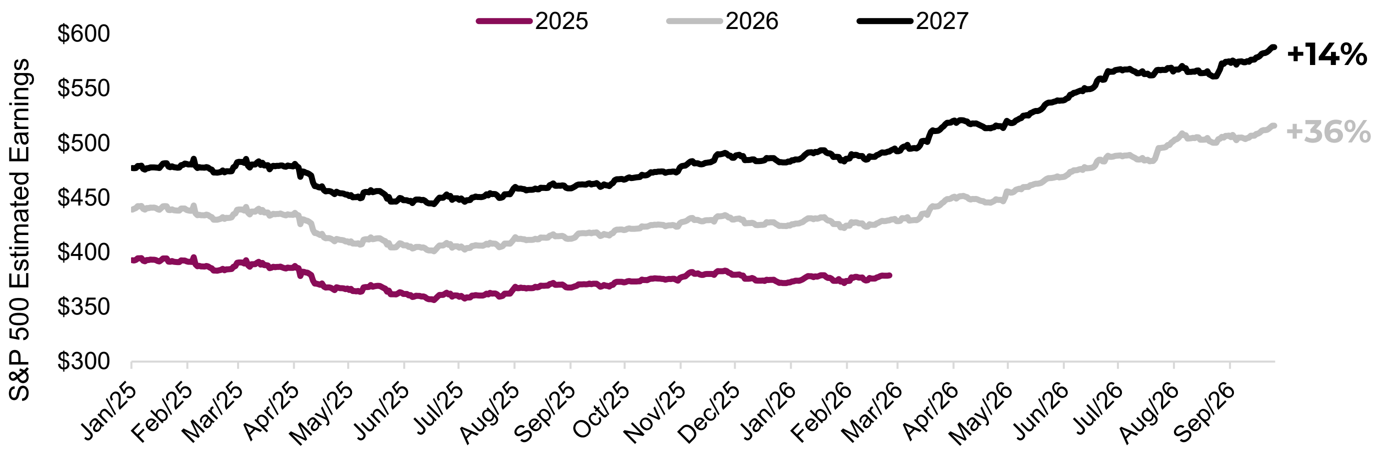


Source: Bloomberg, Purpose Investments, Atlanta Fed

What are inventories in GDP data? GDP (Gross Domestic Product) is a measure of a country's production but many of the input data feeds are based on final sales. So, if a country produces more than it sells, inventories rise and are added to GDP. This can be good news as companies are producing more as they are expecting rising demand. Or it could be bad if inventories are accumulating, as demand is softening and production hasn't adjusted. With strong demand, it is likely the former. Now back to Ethos.

Bond yields higher on strong economic data is not a bad thing. Because that stronger economic activity is certainly helping earnings growth. A big factor in the equity markets' resilience to higher yields, higher oil prices and higher geopolitical uncertainty has been the rising earnings. With two earnings seasons complete and two to go for 2026, earnings look to be rising an astonishing +36%. That kind of earnings growth buys the market a lot of resilience. And with Q3 earnings season starting in a few weeks, likely another good one given steady trends to last quarter.

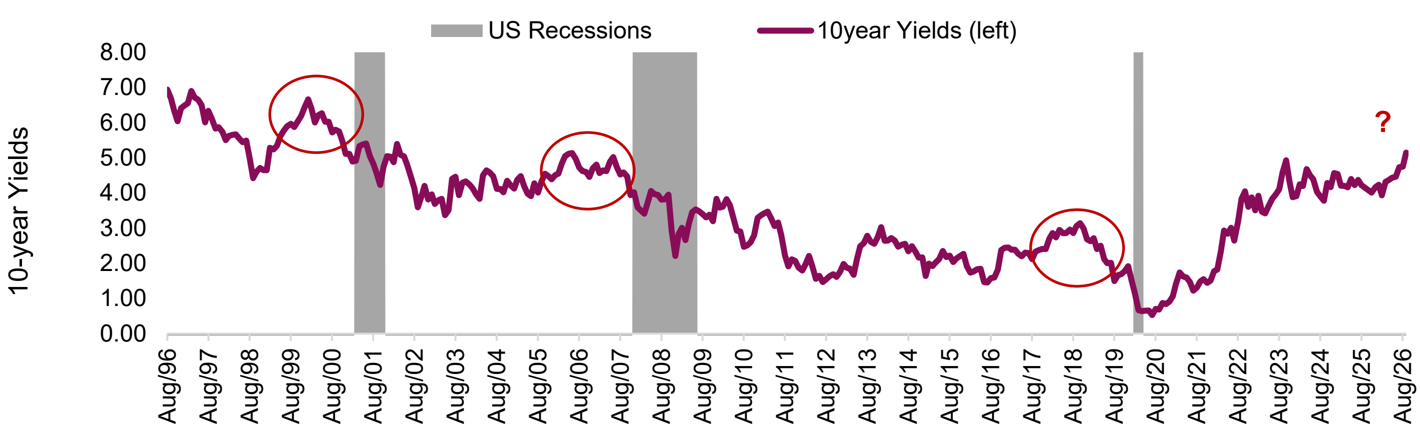
Economy flying, earnings flying



Source: Bloomberg, Purpose Investments

Make no mistake, these higher yields are having an impact. This is roughly where yields topped out in 2007 before the housing deceleration led to the great financial crisis of 2008. Higher yields are having an impact on the more interest-sensitive parts of the economy, namely housing. But since manufacturing and the AI buildout are big drivers of economic activity, this spending is not as interest-rate-sensitive. While not an apples-to-apples comparison, the economy during the dotcom buildout was also not very interest-rate-sensitive and continued, despite much higher yields. Yields are a drag, but the economy continues to prove resilient thanks to its composition.

Economy is yield resilient for now



Source: Bloomberg, Purpose Investments

On the downside, these higher yields have resulted in a rising bond/equity correlation. This has made diversification harder to come by for portfolios with those two core building blocks. And while there is a clear hate-on for bonds these days due to rising yields (lower price), let's not forget the foundation of bond/equity diversification. It goes something like this: when the economy is slowing down, earnings growth falls and optimism around equities falls as recession risk rises. At the same time, yields fall as slowing economy typically results in less inflation pressure, so bond prices move up, providing diversification to the suffering equities. Today is the opposite: economic growth is accelerating, rising inflation expectations and rising earnings growth. This is good for equities and not good for bond prices. Hate them if you want but they are actually doing kind of what they are supposed to.

While bond/equity correlations are elevated, making diversification a bit harder to find, we have some good news. The correlation between individual stocks is historically low, also known as high dispersion. Sometimes the equity market, in this case S&P 500, moves as one. Other times there is a wide dispersion of performance among index members. That is the case today, which does make finding diversification within the index much easier.

We are not naïve and are well aware that if the market goes for a tumble, this internal stock correlation will spike as everything goes down. Nonetheless, there is diversification among equities. The S&P 500 is top-heavy and highly concentrated — it is divergence among those names that is helping lower correlations within the index.

S&P 500 internal stock correlations are very low

Source: Bloomberg, Purpose Investments

Final thoughts

Yields are up and markets don't seem to be bothered, mainly because this yield move is being driven by the good news story of stronger economic growth. This will have its limits of course — if yields go too far the negatives will overwhelm the good news. There is probably a line in the sand for yields, but so far we haven't crossed it. And for the economy, it is getting hot in here.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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