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Yields fall, stocks rally: Breaking down this week's market moves

Weekly - Regional View US

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The magnitude and velocity of the rise in Treasury yields has been a key market driver since the summer, as the 10-year yield briefly surpassed 5% in mid-October; this coincided with the S&P 500 briefly entering correction territory last week. This week, however, markets have seen some relief. Ten-year US yields have now fallen about 50 basis points from their high point, and equity markets have rallied sharply. So what has contributed to this recent reversal? We would point to a few important factors:

Markets seem more confident that the Fed's hiking cycle is over

The policy decision from this week's FOMC meeting was hardly a surprise: The federal funds rate was left unchanged at 5.25–5.5%, in line with market expectations. However, the positive market reaction was largely in response to specific nuances within the verbal and written messaging.

The Federal Reserve underlined that financial conditions have tightened, referring to the sharp increase in long-end rates that has taken shape since the summer. Chair Jerome Powell was also clear that the FOMC is asking itself on an ongoing basis whether the tightening implemented so far is enough, and for how long the restrictive monetary stance should be in place.

Still, the Fed is not ready to close the door completely on further tightening and wants market participants to know it's in wait-and-see mode—an understandable stance given the current uncertainty. And we recognize there's still more than enough data coming to influence decisions before year-end, with one more nonfarm payroll print and two CPI inflation prints ahead of the December FOMC meeting.

However, for now, the market has basically priced out the probability of a December rate increase. And accounting for recent developments, it is our view that the hiking cycle is likely over.

Latest data show the economy is slowing in a healthy way

After the Fed meeting, all eyes turned to this week's jobs report for confirmation that the economy is slowing in a healthy way. Gladly, it delivered just what investors were looking for. The economy added 150,000 jobs, below expectations of 180,000, along with downward revisions to the

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August and September data. Moreover, the unemployment rate rose slightly to 3.9% in October, from 3.8% in the preceding month.

This supports our view that growth will slow over the coming quarters and that we are heading toward a soft landing. Private consumption growth should start to face more headwinds, given factors like the resumption of student loan payments and the overall burden of higher rates, which has weighed on affordability for items like houses and cars. At the same time, the still-strong balance sheet of consumers, along with a resilient labor market, should underpin domestic demand and allow the US economy to dodge a meaningful recession, in our view.

Technical factors eased at the margin, but may continue to loom

As expected, growth and Fed policy expectations have been the main drivers of the move in yields since the summer. However, there have been more than enough tail events that have contributed to rate volatility. Just in the past few months, we've endured concerns around Treasury supply, a potential government shutdown, geopolitical events, energy prices whipsawing, and shifting policy from the Bank of Japan (BoJ). As of now, the market seems to have largely processed these events; it is easier to rally when uncertainty clears up a bit.

And notably, while the BoJ took one step closer to "normal" policy this week, the market perceived this as a financial stability and market functioning measure rather than a large step toward tightening monetary policy.

Accounting for technicals, we also highlight that the Treasury refunding announcement came in below median market expectations, with most of the downside surprise in supply taking place in the long end of the curve; 10-year US Treasury yields dropped about 15bps as soon as the information hit the screens.

It is important to highlight, though, that the fourth quarter historically brings illiquidity in the Treasury market, which could lead to yield spikes before year-end. This is a near-term risk from a mark-to-market perspective, which should be accounted for by investors.

How to position

Putting this all together, we continue to believe yields will trend lower over the coming quarters. In our view, the 10-year is likely to reach 4.25% by year-end and head toward 3.5% by the end of 2024.

Looking at the yield curve, the market seems to price the Fed neutral rate at some level between 4% and 5%. We don't think this is a sustainable long-term level, however, as it would likely come at the cost of some financial instability. In our opinion, a more reasonable US neutral rate is somewhere around 3.5%.

This implies that when the market finally processes that the Fed's hiking cycle is over, the belly of the curve and long-end rates will have significant room to rally. As such, from a total return standpoint, we think there are several interesting opportunities in the fixed income space.

First, we think it's a great time to lock in yields, especially in areas like Treasury Inflation Protected Securities and investment crade (IG) corporate bonds. Within IG specifically, we believe the 1–3-year range can provide low-volatility income, while longer-duration securities in the 7–10-year space should perform well from a total return standpoint given our view that nominal yields will be lower in 2024. We are more cautious about going too far in the long end given its greater sensitivity to technical factors like supply and liquidity.

We also see opportunities within municipal bonds, especially for taxable investors, where yields on high-quality munis now sit at the highest levels seen in over a decade. Tax-equivalent yields in AA munis can be close to 10% for investors in some of the highest tax states.

Finally, we note that while equities recovered some ground recently, the risk-reward has improved relative to the summer. Granted, the market has remained quite sensitive to any negative earnings news. However, we believe that the earnings recession is over and that the reacceleration in profits remains on track.

This supportive earnings picture should provide upside heading into next year; our 2024 year-end S&P target stands at 4,700. In an environment of slower growth, we believe that high-quality companies with stable balance sheets and strong and sustainable profit margins should be best positioned to generate earnings.

Appendix

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