The month of September, traditionally the weakest of the year, was challenging for equities, with the benchmark S&P 500 index falling 4.8%. In fact, 2023 marks the fourth straight year of September losses of at least 3.9%. As we wrote about earlier this year, the extreme dispersion in the equity markets continued in the quarter. As of this writing, the average U.S. stock is now negative for the year, with the broad indices held up almost solely by the mega-cap tech giants such as Apple, Alphabet, and Nvidia.

Despite the recent uptick in equity volatility, the talk of financial markets in the third quarter was the rise in long term interest rates, with the yield on a 30 year U.S. Treasury bond rising from 3.86% to 4.69%, the highest level since 2011. Ever since the Federal Reserve started hiking interest rates in early 2022 to combat high inflation, the financial community has focused primarily on how high they would raise the Federal Funds rate, a short term interest rate controlled directly by the central bank. While Fed actions have a strong influence on long term rates, ultimately long term rates are set by the market. Much of the conventional wisdom since the hiking cycle began was that any rise in long term bond yields would be temporary: the Fed would hike, the economy and inflation would slow dramatically very quickly, and thus long term rates would stay within the relatively low range that they have been in for over a decade. Over the course of much of the last 2 years, this situation played out in markets, with short term rates significantly higher than long term rates, known as “yield curve inversion.” This narrative seems to have changed over the past few months, with the new consensus in financial media of “higher for longer.”

A few drivers have contributed strongly to the rise in long term rates over the past quarter. As previously mentioned, economic growth has remained robust. Long term rates tend to rise when the economy is doing well, and tend to fall when the economy is slowing. However, the recent rise may be better explained through simple supply and demand dynamics. For many years, especially post Great Financial Crisis, there has been a robust demand for long term government bonds. Traditionally, there has been a strong market for these bonds in the form of individuals, insurance companies, pension plans, and other investors. Over the past decade, some more price insensitive buyers became a larger and larger share of the market. Foreign countries such as China bought lots of Treasuries and the Federal Reserve, through its various forms of quantitative easing, bought large portions of the government bond market. These buyers have recently slowed or stopped their purchases altogether. Countries such as China, Russia, and Saudi Arabia have pared back their purchases as geopolitical tensions cool, financial institutions have cut back purchases after bond losses led in part to the regional bank crisis this spring, and the Federal Reserve reversed their policy of quantitative easing ever since inflation started to become a problem. All of these very different financial actors have removed large portions of the demand side of the equation out of the market. On the supply side, large fiscal deficits have led to the need for the U.S. Treasury to issue larger amounts of bonds in recent months. With many buyers out of the market and large issuance being pushed into the market, yields have had to rise to find an equilibrium.

Where does this leave fixed income investors? The answer, as it tends to be in markets, is “it depends.” The benchmark U.S. 10 Year Treasury Bond is on pace for its third straight year of negative total returns, the first such instance in a century should it hold

into year end. The spread between investment grade bond yields and the earnings yield on large cap stocks has swung dramatically as rates have risen, with bonds now more attractive from a relative yield standpoint versus stocks than they have been since the dot com era. Despite this multi-year drawdown and relative valuation advantage, bonds may continue to underperform if the economy stays resilient and the technical factors discussed above continue to stay in play. In high growth and high inflation environments, equities tend to outperform bonds, despite sometimes painful valuation adjustments. Despite these caveats, we do expect to be more active in fixed income markets over the coming months and quarters for client accounts, as we take advantage of these historically attractive yields.

While there is always something to worry about in equity markets, the list at the moment seems higher than normal. High fiscal deficits, rising bond yields, labor unrest, government shutdown, Congressional dysfunction, rising oil prices, trade tensions with China, resumption of student loan payments, bank crisis, and weak office real estate are just a few of the stories catching the markets attention in recent months. However, as we have written about many times over the years, the stock market has a historic tendency to "climb a wall of worry", meaning that when there is a lot of anxiety in the world, markets tend to drift higher. Conversely, the time to worry is when there is nothing but optimism in the air. The wall of worry, plus traditional seasonality and compelling historic analogs, may provide enough ammunition for investors to stay the course. The fourth quarter of the year tends to be historically bullish, and even more so during already strong years. Since 1930, there have been 13 years where the S&P 500 has been up more than 10% through August, and then down in September. The median return for those years over the last 3 months of the year was 7.6%. Also in September, the S&P 500 had lower intra-day lows for 9 consecutive days, a streak only seen 3 times in the past 30 years. In each prior case, the S&P 500 rallied at least 16% over the next 6 months. With the unemployment rate still very low, consumer balance sheets strong, and inflation continuing to gradually fall, there may be enough juice for equities to surprise the bears to close out the year. A pause in the rise in long term bond yields and a strong upcoming third quarter earnings season could be the types of catalysts that the market needs to stem recent weakness.