CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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Good Labor Report Propels Bond Yields to 16-Year High

- Stock markets are reacting to rising bond yields.
- Relationships between stocks, bonds, oil, and gold change and rules of thumb don't always hold true.
- As volatility picks up, diversification is even more important.

The S&P 500 is trading about 8% lower since August 1 as the 10-year Treasury yield went from around 4% to over 4.80% in roughly two months. The 10-year Treasury yield is considered as a benchmark for consumer loans such as mortgages and business loans. While the interest rate on these loans will not match the 10-year Treasury yield, these loans tend to be correlated, meaning when Treasury yields rises so do interest rates on these loans. For instance, the national average for a 30-year fixed mortgage has recently climbed above 7%, reaching the highest level in decades.

The rise in bond yields has sent both bond prices and equity prices falling. Additionally, oil prices are rising, and gold prices are falling. This has many investors scratching their heads. Shouldn't bonds go up when stocks fall? Shouldn't oil prices be falling if a possible recession is coming? And finally, while inflation is moderating it is still relatively high, shouldn't gold do better? While it may seem like we are living in an upside-down world, these relationships change over time, and these general rules do not always apply. Let us break it down.

First, bond yields move inversely to bond prices. So, when bond yields rise, bond prices fall. This isn't a general rule, though. This will always be the case. If yields rise, bond prices must be adjusted lower to compensate would-be bond investors for the new prevailing market yield. During times of stock market stress, investors typically flock to bonds for safety and thus bid up bond prices and drive down bond yields. However, now we are seeing equity investors react to rising bond yields. Higher yields equate to higher borrowing costs for corporations meaning lower future earnings. You could argue that stock and bond investors alike have been fighting the Fed, and they are starting to take the Fed's word when they say they will keep short-term interest rates higher-for-longer. Confirming the Fed's narrative, job openings surprised to the upside and the labor market remains resilient. And while core inflation is still moderating, headline inflation, which includes food and energy prices, is re-accelerating. Though core inflation doesn't include these volatile categories, if oil prices remain at these levels, it will start to impact other areas of the economy as most goods are shipped by either land, air, or sea.

So, why are oil prices rising if some economic metrics are raising red flags about a potential recession? During a recession, oil prices fall because demand falls. Less people will drive to work, buy goods and services, and go on vacation. All this requires less oil. While these are all good points, this is only one side of the equation. Demand will fall in a recession. The supply side of the equation is driving oil prices higher. Most recently Saudi Arabia and Russia decided to cut production. Additionally, while the risk of recession is elevated it is less elevated than before as economic data has been stronger than expected recently and job data continues to remain strong.

Finally, while gold can hedge against inflation, the correlation isn't one- for- one. Gold is not always a good hedge against inflation. Currently, the fall in gold prices has more to do with the strength of the U.S. dollar than inflation. Stronger than expected economic data combined with higher-for-longer interest rates has the U.S. dollar appreciating versus other world currencies. Gold is generally dollar denominated, so a strong dollar can push down global gold prices.

Market volatility has been relatively low in 2023 until recently, and we have been expecting more. With the recent rise in bond yields, we have finally seen volatility pick up. All the scenarios we discussed can change quickly, making diversification crucial. Equity investors could flock to bonds for safety and the relatively high yields, which would pressure bond yields lower. Oil- producing countries could increase supply and recession fears could impact demand eventually. Finally, it isn't wise to fight the Fed, but the Fed is data- dependent, so if inflation and economic data weaken, it will likely reverse course. Your financial professional can help you stay focused on your personal financial goals. As always, please contact your financial professional with any questions on tailoring the appropriate portfolio to your personal situation.

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