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Oxford Harriman Market Commentary

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After declining for the third consecutive month in October, stocks rallied sharply last week as economic data, Fed commentary, and a reduction in Treasury note issuance led to a decline in interest rates. In fact, the S&P 500 and Nasdaq 100 each had their best weekly gains (up more than 5% and 6%, respectively) since the week of 11/11/22.

The S&P 500 gained more than 20% through the end of July but then experienced a decline of 8.3% over the three months leading up to November. The main driver of this equity market sell-off has been the sharp rise in interest rates, with the 10-year U.S. Treasury yield climbing 1.25% from mid-July through mid-October and rising above 5% for the first time since 2007. The continued increase in Treasury yields weighed on both stocks and bonds as valuations adjusted to a world of higher interest rates. Small-cap stocks underperformed large-cap stocks by over 4.5% in October, and defensive sectors outperformed cyclical sectors. In the credit market, bonds posted another month of negative returns.

Why Rising Interest Rates Cause Bonds & Stocks to Trade Lower

Consider two bonds: Bond A was issued one year ago and pays a fixed 2% interest rate, and Bond B was issued one month ago and pays a fixed 2.5% interest rate. On an annual basis, Bond A yields $2 per $100 of principal, while Bond B yields $2.50 per $100 of principal. Assuming all else is equal, a rational investor would choose Bond B because of its higher yield. To attract investors to buy Bond A and align its yield with Bond B's 2.5% yield, the market will adjust the price of Bond A lower. In this example, the price of Bond A will decline so that its fixed $2 interest payment corresponds to a 2.5% yield. At this adjusted price, investors would earn a 2.5% yield with Bond A, making them indifferent to choosing between Bond A and Bond B.

As mentioned above, rising rates have also caused equity prices to trade lower. As interest rates increase, bonds offer a higher expected return, which makes bonds more competitive with stocks. The higher expected return on bonds may cause investors to sell stocks and buy bonds. Additionally, higher interest rates increase borrowing costs, which can slow economic growth, reduce corporate profits and, as a result, impact hiring and expansion plans. Since households make up 70% of U.S. economic activity, the fear is this will crowd out consumers' ability to keep spending. Higher rates on consumer credit, mortgages, and auto loans, as well as the start of student loan repayments, are beginning to have an impact on the strength of the economy. We continue to monitor consumer delinquencies to gauge the status of U.S. households. If investors expect slower earnings growth, stock prices may decline as investors seek lower valuations to offset the heightened earnings risk.

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In the United States, the manufacturing sector has started to show signs of weakness, and this is also the case in other economies across the globe. Financial conditions have further dampened economic activity, and the full impact of the tightening measures in the U.S. may not be fully realized. Despite some easing of monetary policies worldwide, this has been accompanied by sluggish economic growth due to persistently high policy rates in many parts of the global economy. The recent decline in interest rates may signal a bottoming in these negative trends.

Last week hiring in the United States slowed to 150,000 new jobs in October and the unemployment rate jumped to 3.9%. The share of the population aged 15-64 with jobs surpassed their pre-pandemic peak in August. Also, economic output made up all the ground lost during the pandemic and is now above where it would be if the pandemic never occurred according to what the Congressional Budget Office projected in early 2020. On a relative basis, economic activity remains impressive, defying the expectations of a more severe slowdown.

With the Fed seemingly signaling that it is on hold for now, we are beginning to become hopeful that rates have peaked and will continue to plateau. History tells us that growth companies and small caps do best in the early stages of this environment. While October was a difficult month for these sectors, their performance at the beginning of November reinforces this view. We will continue to consider the full effects of the Fed's moves and the impact they have on the economy.

Enjoy the rest of your week,

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Sources:

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