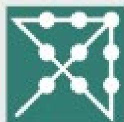
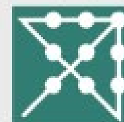
 Yardeni Research 

MORNING BRIEFING
October 3, 2023

The Bond Vigilantes Are On The March

Check out the accompanying chart collection.

Executive Summary: What moves the bond market has changed recently and disconcertingly. The 10-year Treasury bond yield's recent action—and nonreaction to economic news that typically moves it—suggest a shift in bond investors' focus from what monetary policymakers may do to rising alarm about what fiscal policymakers are doing. The worry is that the escalating federal budget deficit will create more supply of bonds than demand can meet, requiring higher yields to clear the market; that worry has been the Bond Vigilantes' entrance cue. Now the Wild Bunch seems to have taken full control of the Treasury market; we're watching to see if the high-yield market is next. We are still counting on moderating inflation to stop the beatings in the bond market.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

The Wild Bunch I: Unrelenting Climb. The latest batch of economic indicators was weaker than expected. On Friday, we learned that real personal consumption expenditures rose just 0.1% during August. The core PCED edged up by only 0.1% during the month. September's Consumer Sentiment Index fell 1.4 points to 68.1. As a result, the Citigroup Economic Surprise Index (CESI) fell to 45.1% from a recent high of 81.9% on July 27 (*Fig. 1*).

The 10-year Treasury bond yield should have declined on the news since its 13-week change tends to track the CESI closely (*Fig. 2*). Instead, the yield has continued to march higher, up to 4.70% on Monday morning. Most of the bond indicators that worked in the past haven't been working for a while. For example, the bond yield was highly correlated with the ratio of the prices of copper to gold from 2005 through 2019 (*Fig. 3*). They've diverged significantly since then, with the ratio currently showing that the bond yield should be closer to 2.00% than to 5.00%.

The same can be said about the usually tight correlation between the bond yield and the M-PMI—i.e., they've decoupled (*Fig. 4*). The bond yield didn't flinch to the downside when September's M-PMI was reported Monday morning showing that the index remained below 50.0 for the eleventh consecutive month. Even the decrease in the M-PMI's prices-paid index from 48.4 in August to 43.8 didn't move the bond yield lower. The index suggests that the CPI goods inflation rate remained moderate last month (*Fig. 5*).

The Wild Bunch II: Disinverting. In the past, inverted yield curves provided strong buy signals for bonds. The 10-year US Treasury yield usually peaked at about the same time as the 2-year Treasury yield rose to match or exceed it (*Fig. 6*). That's because bond investors started to anticipate that further hikes in the federal funds rate by the Fed were increasingly likely to cause a financial crisis, a credit crunch, and a recession. In the past, those expectations typically were met, forcing the Fed to lower interest rates as the economy tanked and inflation plunged.

The federal budget deficit widened during past recessions. But the increased supply of Treasuries was no problem, since private-sector credit demands dropped during those periods. So in the past, the balance between supply and demand in the Treasury market was not a significant issue for bond investors. Instead, they focused mostly on actual and expected inflation and the Fed's actual and expected response to rising, falling, or stable inflation.

The yield curve has been disinverting since the 10- vs 2-year yield spread bottomed around -100bps in June. It was back up to -43bps on Monday. Perversely, now that the Fed seems to be on the verge of terminating its rate hiking, bond investors might have concluded that short-term rates aren't high enough to cause a financial crisis, credit crunch, and a recession. There was a regional banking crisis in March, but the Fed provided a liquidity lending facility that contained the crisis quickly.

While the Fed's restrictive stance of keeping the federal funds rate around the current level for longer might help to bring inflation down, the problem in the Treasury bond market is too much supply because of profligate fiscal policy. The supply problem has been exacerbated by the Fed's quantitative tightening (QT) since last June. The Fed's QT has depressed bank deposits (as have high interest rates on money market securities). So the banks have also stopped buying Treasury and agency securities and haven't replaced their maturing securities. Consider the following:

(1) Since the start of QT in 2022, the Fed's portfolio of Treasuries and agencies is down by $1,015 billion through the September 20 week (*Fig. 7*).

(2) The comparable portfolio held by commercial banks since the start of QT is down $544 billion through the September 20 week.

(3) We've previously observed that since the start of QT in 2022, the Fed's Treasury bond holdings actually has increased, by $75 billion through the September 27 week. The Fed

isn't selling its Treasury bonds, as widely feared (*Fig. 8*).

The Wild Bunch III: High Yields. While the 10-year Treasury bond yield has increased by 81bps since the end of last year from 3.88% to 4.69% on Monday, the yield on US high-yield corporate bonds has been remarkably flat and stable around 9.00% (*Fig. 9*). So the yield spread between the latter and the former has narrowed, suggesting that credit conditions remain relatively easy, at least for high-yield corporates (*Fig. 10*).

While the Wild Bunch—a.k.a. the Bond Vigilantes—has wreaked havoc in the Treasury bond market, they've left the high-yield market alone. Could it be that some of them view the government's securities as riskier than high-yield corporates? The result of their rampage in the Treasury market suggests as much.

Melissa and I are watching for signs that the credit market unrest unleashed by the Bond Vigilantes is spreading to the high-yield market.

The Wild Bunch IV: Uncharted. "We're going to have a debt crisis in this country," Ray Dalio, the founder of hedge fund Bridgewater Associates, warned in an *interview* with CNBC's Sara Eisen that aired last Thursday. The two were speaking at a fireside chat at the Managed Funds Association. "How fast it transpires, I think, is going to be a function of that supply-demand issue, so I'm watching that very closely."

Based on our analysis above, he may be right. The Wild Bunch has caused the Treasury bond market to fully reverse the drop in the 10-year bond's yield from the Great Financial Crisis through the Great Virus Crisis in the past three years (*Fig. 11*).

We aren't ready to join Dalio's camp, yet. We still expect that inflation will continue to moderate, making bonds look even more attractive to investors. We suspect that Fed officials may soon be alarmed by the unyielding climb in yields. If they aren't already, they should be. If a debt crisis becomes more apparent, the Fed probably would suspend its QT program to calm the situation.

Meanwhile, the current message of the Bond Vigilantes to fiscal policymakers in Washington is: "Take meaningful actions to reduce the federal deficit now and in the future or we will push the bond yield up to whatever level it takes to get you to do so!"

Calendars

US: Tues: JOLTS Job Openings 8.830; API Weekly Crude Oil Inventories; Bostic. **Wed:** ADP Employment 160k; Factory Orders 0.3%; ISM NM-PMI 53.6; S&P Global C-PMI & NM-PMI 50.1/50.2; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; OPEC Meeting; Golsbee; Bowman. (FXStreet estimates)

Global: Tues: Lane. **Wed:** Eurozone Retail Sales -0.3%; Eurozone PPI 0.6%m/m/-11.6%y/y; Eurozone, Germany, and France C-PMIs 47.1/46,2/43.5; Eurozone, Germany, and France NM-PMIs 48.4/49.8/43.9; UK C-PMI & NM-PMI 46.8/47.2; Lagarde; DE Guindos; Panetta. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three indexes during the September 29 week in a resumption of their recent gains during four of the five previous weeks. Those gains had been interrupted a week earlier by S&P/Dow Jones Indices' quarterly rebalance along with many index changes. LargeCap's forward earnings returned to a record high after hitting that mark during the September 15 week for the first time in 15 months, dating back to the June 24 week of 2022. MidCap's remains 4.6% below its record high in early June 2022; and SmallCap's improved to 8.6% below its mid-June 2022 record. Through the week ending September 29, LargeCap's forward earnings has risen 6.6% from its 54-week low during the week of February 10; MidCap's is 3.8% above its 55-week low during the week of March 10; and SmallCap's is 5.7% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to 1.5% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -3.9% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -6.9% y/y rate is up from a 32-month low of -12.9% in mid-June and down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since June of last year, but the 2023 estimate for the S&P 500 ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their

forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.3% and 12.1%), MidCap (-12.5, 13.5), and SmallCap (-8.3, 12.4).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady for these three indexes during the September 15 week. LargeCap's forward P/E dropped 0.2pt w/w to a 27-week low of 17.8, and remains below its 18-month high of 19.6 during the July 28 week. It's up 2.7pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was steady w/w at a 19-week low of 13.1, and is down from its 21-week high of 14.4 during the July 28 week. It's now 0.8pt below its recent 10-month high of 14.7 in early February and up 2.0pts from its 30-month low of 11.1 at the end of September 2022, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was also steady w/w, but at a 47-week low of 12.3, which compares to a 21-week high of 14.1 during the July 28 week and is now 1.2pt below its recent 12-month high of 14.3 in early February. It's up 1.7pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's fell to a 23-year low discount of 31%, which compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 120th straight week; the current 6% discount is an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the estimate declines accelerated considerably for the three quarters through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum has turned neutral as analysts' forecasts are unchanged since the beginning of the quarter 13 weeks ago. They're forecasting that the S&P 500's earnings will drop 0.2% y/y in Q3-2023. That's up from a 5.4% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 1.6% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 6.7% y/y in

Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q3-2023 versus their final earnings growth rates for Q2-2023: Communication Services (34.0% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (23.0, 57.0), Utilities (12.4, 0.6), Financials (11.9, 9.3), Industrials (8.6, 15.7), S&P 500 ex-Energy (6.7, 3.6), Information Technology (5.9, 5.0), S&P 500 (1.6, -2.8), Consumer Staples (1.3, 8.5), Real Estate (-7.1, -2.1), Health Care (-9.7, -26.7), Materials (-20.5, -26.4), and Energy (-35.0, -47.5).

US Economic Indicators

Construction Spending (***link***): Construction spending continued to reach new record highs in August, rising every month so far this year, driven by public construction spending and private nonresidential spending, with private residential investment joining the party in recent months. *Total* construction spending climbed 0.5% in August and 7.7% ytd, while private construction investment rose 0.5% and 7.2% over the comparable periods—also to a new record high. *Public* construction spending in August returned to the plus column after falling in July for the first time in 11 months; it rose 0.6% m/m and 14.1% y/y to a new record high in August. Within *private construction*, residential investment rose in August for the fourth month, by a total of 6.7% over the period, breaking out of an 11-month slump. Meanwhile, nonresidential investment climbed for the 14th time in 15 months by 23.5% over the period. Within residential investment, *single-family* construction rebounded 8.6% during the four months through August, after a 12-month plunge of 26.5% to its lowest level since November 2020. *Home improvement* spending has been volatile in recent months, though has picked up 5.5% from its recent bottom in April. Meanwhile, *multi-family* construction remains on a steep uptrend, soaring 24.0% y/y to a new record high!

Global Economic Indicators

Global Manufacturing PMIs (***link***): "Global manufacturing remained in the doldrums at the end of the third quarter, as output, new orders, and employment all contracted," according to the September release. The JP Morgan Global M-PMI edged up for the second month in September, to a four-month high of 49.1, after deteriorating the prior five months, from 49.9

in February to 48.6 in July—holding below the breakeven point of 50.0 for the 13th straight months. According to the report, "All five of the sub-indices comprising headline PMI (output, new orders, employment, stocks of purchases, and suppliers' delivery times) were at levels indicative of a deterioration in overall performance." Output rose in only eight of the 29 nations for which data were available, including China and the US. The Eurozone, Japan, UK, Canada, and Brazil were among the economies seeing production volumes scaled back. Here's how September *M-PMIs ranked by country/region* from highest to lowest: Russia (54.5), Kazakhstan (52.8), Indonesia (52.3), Philippines (50.6), China (50.6), Greece (50.3), Myanmar (50.1), USA (49.8), Mexico (49.8), Vietnam (49.7), Ireland (49.6), Turkey (49.6), WORLD (49.1), Brazil (49.0), Australia (48.7), Japan (48.5), Colombia (47.8), Thailand (47.8), Spain (47.4), Canada (47.5), Malaysia (46.8), Italy (46.8), Taiwan (46.4), UK (44.3), France (44.2), Poland (43.9), Netherlands (43.6), EUROZONE (43.4), Czech Republic (41.7), Austria (39.6), and Germany (39.6).

US Manufacturing PMI (***link***): September's M-PMI took a further step toward recovery, improving for the third month, by 3.0 points to 49.0, after dropping to 46.0 in June—which was the lowest since May 2020. It was below 50.0 for the 11th straight month—the longest string of readings below 50.0 since the Great Financial Crisis (2007-09), though moving upward. Looking at September's report, the production index (52.5 from 50.0) moved further above the break-even point of 50.0, after sinking to a 37-month low of 46.7 in June, while the new orders (49.2 from 46.8) gauge continued its move up and is only fractionally below 50.0. Factories expanded payrolls (51.5 from 48.5) in August after cutting jobs the prior three months. The *supplier deliveries* (46.4 from 48.4) measure moved lower in September after rising from 43.5 in May to 48.6 in August. It is down sharply from May 2021's peak of 78.8. (A reading below 50.0 indicates faster deliveries to factories.) Meanwhile, inventories (45.8 from 44.0) remained below 50.0 for the seventh successive month, as businesses continued to manage inventories carefully. ISM's prices-paid (43.8 from 48.4) measure eased, moving back down toward December's 32-month low of 39.4; it peaked at 92.1 in mid-2021—which was the fastest since the summer of 1979.

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