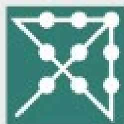
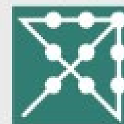
 Yardeni Research 

MORNING BRIEFING
October 11, 2023

Bonds & Stocks

Check out the accompanying chart collection.

Executive Summary: Fitch's downgrade of US debt on August 1 was triggering for both the bond and stock markets. Bond yields since have soared, while S&P 500 companies' collective valuation has staggered. Today, we examine the underlying issues that have kept yields elevated and the question of whether they've now risen high enough to attract sufficient demand to clear supply. … And: Joe shares stats on the MegaCap-8's valuation declines since the end of July. Notwithstanding their valuation hits, these eight stocks now represent a slightly bigger slice of the S&P 500's market cap, at a record-high 27.4%, than they did in July.

Bonds: Explanations for the Recent Rout. Why did the 10-year Treasury bond yield soar from 3.97% on July 31 to 4.81% on October 3 (*Fig. 1*)? There are several explanations, and the answer is probably "all of the below." Consider the following:

(1) *Too much supply of Treasuries.* We've been arguing that the deluge of Treasury supply has been the main driver of this rout in the bond market. The rapidly widening federal deficit forced the Treasury to announce during the summer a significant increase in the securities that would have to be sold over the rest of the year. During August and September, the amount of US Treasury debt held by the public rose $335 billion and $286 billion, respectively (*Fig. 2*). The bond yield rose quickly to a level that should stimulate enough demand to clear the increased supply of Treasuries over the rest of this year through next year.

(2) *Higher for longer short-term interest rates.* Another thesis that also makes sense is that the rout was exacerbated by Fed Chair Jerome Powell when he reiterated at his September 20 *press conference* that the FOMC intended to remain restrictive through next year by maintaining the federal funds rate higher for longer. Specifically, he said: "We're prepared to raise rates further if appropriate, and we intend to hold policy at a restrictive level until we're confident that inflation is moving down sustainably toward our objective. In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

The big shock that same day was the release of the FOMC's latest quarterly *Summary of Economic Projections* (SEP). Instead of four rate cuts totaling 100bps next year (as was projected in June's SEP), the latest SEP showed two cuts totaling 50bps.

(3) *Stronger-than-expected economic growth.* Meanwhile, the yield-curve spread between the 10-year and 2-year Treasury notes has narrowed significantly from a recent low of -108bps to -30bps on Friday (*Fig. 3*). The disinverting yield curve might suggest that a recession is less likely now. After all, Q3's economic indicators have been mostly stronger than expected, as evidenced by the Citigroup Economic Surprise Index (CESI) (*Fig. 4*). Since the summer, it has been hovering around 60.0, which is a relatively high reading. The 13-week change in the bond yield tends to track the CESI closely (*Fig. 5*).

In the past, inverted yield curves disinverted during recessions when the Fed cut interest rates to revive economic growth. Short-term rates fell faster than long-term rates. This time, the 10-year Treasury bond yield is rising faster than the 2-year yield. If that continues, the chances of something breaking in the credit markets will increase. If something breaks, it could precipitate a credit crunch and a recession after all!

(4) *Demand for Treasuries has decreased.* Exacerbating the bond rout has been the weakening demand for Treasuries. The Fed started its quantitative tightening (QT) program on June 1, 2022. Since then, through the October 4 week, the Fed's holdings of Treasuries has declined by $841 billion (*Fig. 6*). In effect, QT has widened the consolidated federal deficit of "T-Fed" by that amount over that period. The Fed is on pace to continue to reduce its holdings of Treasuries by $60 billion per month.

The Fed's QT program has put downward pressure on the demand deposits of the commercial banking system. So the banks stopped increasing their holdings of US Treasury and agency securities when QT started. Instead, they've been letting them mature and using the funds to offset the weakness in their deposits (*Fig. 7* and *Fig. 8*). The banks' holdings of Treasuries and agencies is down $554 billion from the week of June 1, 2022 through the September 27 week. (There's no data for just Treasuries held by the banks.)

While the Fed and the banks have been letting their Treasury and agency securities mature without rolling the proceeds into more securities, foreign private investors added $755 billion to their portfolios of US Treasuries over the 12 months through July (*Fig. 9*). That's the latest available data from the US Treasury International Capital System (TICS). There's no evidence in the TICS that foreign central banks and other official institutions have been

major sellers of US Treasuries, on balance, as widely feared. From 2015 to 2020, they were mostly selling, but they haven't done much buying or selling since then.

(5) *Why are foreign bond yields also soaring?* By the way, the supply-demand imbalance theory has been disputed by economists who observe that yields have also soared overseas, where fiscal profligacy isn't as much of a concern as in the United States (*Fig. 10* and *Fig. 11*). That's true, but the bond market is a global one, and yields overseas tend to follow the path of comparable US yields.

(6) *The bottom line.* The question is whether the backup in the bond yield is enough to attract enough demand from domestic and foreign individual and institutional investors to boost demand for the increased supply of demand. We think so. So we expect that the bond yield can stabilize between 4.50% and 5.00% through the end of this year into next year.

That's mostly because we expect that inflation will continue to moderate. We also think that the Fed is done raising the federal funds rate (FFR), especially after two Fed officials acknowledged on Monday that the recent surge in the bond yield might have mitigated the need for any additional FFR hikes given that the bond market has done all the heavy lifting in the fixed-income market recently.

(7) *Stress tests ahead.* The next auctions of the 10-year and 30-year Treasury bonds will be on Wednesday and Thursday. September's PPI and CPI will be released on Wednesday and Thursday. We will be looking at the bid-cover and foreign participation stats for both auctions for indications that yields are high enough to stabilize the bond market.

Stocks: MegaCap-8 a Bigger Share of the S&P 500 Despite Valuation Decline. The MegaCap-8 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) currently accounts for a record-high 27.4% of the S&P 500's capitalization and has led the index higher in a big way so far in 2023 (*Fig. 12*). The stocks' performances this year in part reflect much improved revenues and earnings growth prospects for most of the eight companies.

However, the MegaCap-8's valuation has pulled back since July amid stock investors' angst over the bond market after Fitch Ratings downgraded US federal debt on August 1. The eight stocks' collective market cap has shrunk accordingly. However, their share of the composite index's market cap has increased, as they weren't the only stocks to take valuation hits after Fitch's downgrade (*Fig. 13*).

Currently, the group's collective valuation is higher than when the year began, but it is substantially lower than it was during 2020-21, when the MegaCap-8's forward P/E flirted with 39 (*Fig. 14*). We don't expect a return to those heady valuations anytime soon. However, the Mega-Cap-8's valuation has held up slightly better than the collective valuation of the S&P 500 companies in recent months. Supporting the MegaCap-8's valuation have been earnings—mostly strong Q2 results and even stronger y/y growth results expected for Q3.

I asked Joe to update us on the MegaCap-8. Here's his report:

(1) *Market capitalization.* The combined market cap for the MegaCap-8 stocks tumbled 41.5% in 2022 before rebounding 66.8% ytd to an 18-month high of $11.8 trillion through July 18. Since then, it fell 9.1% in a near-correction to $10.7 trillion on September 26 before rising 4.9% through Friday's close. That leaves the group up 58.9% ytd compared to a 12.2% gain for the S&P 500 (*Fig. 15*).

Following their deep bear market decline of 45.0% through January 5, the MegaCap-8 stocks have now improved to 9.0% below their peak back on December 27, 2021. If their collective earnings expectations continue to improve faster than the rest of the market's, as we expect, the group's combined market cap may be on the road to new highs despite lower valuations.

(2) *Market-capitalization share at a record high, again.* As a percentage of the S&P 500's market cap, the group was at new record-high of 27.4% during the October 6 week. Its market-cap share had soared from 19.4% at the start of the year to a then-record-high 27.3% during the July 14 week, before dropping to a low of 26.0% during the August 18 week.

(3) *Valuations slipping amid higher rates.* The MegaCap-8's forward P/E rose above 30.0 in mid-June for the first time in 15 months but has since dropped below that mark, as investor activity has not maintained the group's valuation despite strong Q2 earnings and upwardly revised forecasts for the future. After the forward P/E bottomed at 21.1 during the January 6 week, it soared 46% to its 2023 high of 31.2 as of the July 14 week. The forward P/E is now down 13% since then to 27.0 as of the October 6 week, which remains below the record high of 38.5 during the August 28, 2020 week.

Looking at the individual MegaCap-8 stocks, forward P/Es rose for all of them from January 6 through mid-July, before correcting along with the rest of the S&P 500's collective

valuation amid bond market's turmoil. Illogically though, the growthier MegaCap-8 has dropped just 3.3% since the market's July 31 high, less than the 5.5% decline for the S&P 500 through Monday's close. While five of the MegaCap-8 stocks now—as of Friday's close—are valued above their January 6 bottoms, all have declined since the end of July, as Joe shows below.

Here's how much valuation has changed for each of the MegaCap-8 stocks since the S&P 500's July 31 high through Friday's close: Nvidia (down 38% to 29.8 from 48.4), Amazon (down 30% to 42.8 from 60.9), Netflix (down 16% to 25.8 from 30.6), Apple (down 11% to 26.7 from 30.2), Meta (down 11% to 19.5 from 21.9), Microsoft (down 6% to 28.4 from 30.3), Tesla (down 3% to 61.5 from 63.7), and Alphabet (down 2% to 21.1 from 21.6) (*Fig. 16*).

The sharp valuation declines for Nvidia and Amazon come despite sharply increased forward revenues and earnings guidance relative to their MegaCap-8 cohorts, but that likely reflects investors taking some of their ytd gains off the table. Nvidia's stock had tumbled 16.9% through September 21 from its August 31 record high, but has since risen 10.4% through Monday's close to a ytd gain of 209.8%. (FYI: Forward revenues and earnings are the time-weighted averages of industry analysts' estimates for the current year and following one.)

While Nvidia's forward earnings are at a record high now, Amazon's remains challenged. Its forward EPS, though up 82% ytd, remains 9% below its record high in July 2021, and Amazon's stock price reflects that. It tumbled 55.7% from its November 18, 2021 record high to its bottom on December 28, 2022, and remains in a deep 30.6% bear market through Monday's close.

(4) *Reviewing the MegaCap-8's y/y forward revenues and earnings performance.* Seven of the MegaCap-8 companies have enjoyed both rising forward revenues and rising forward earnings so far in 2023 (*Fig. 17* and *Fig. 18*).The only laggards are Apple's forward revenues and Tesla's forward earnings. As a group, the MegaCap-8's forward revenues has jumped 7.3% y/y, and its forward earnings has soared 17.2%—trouncing the S&P 500's forward revenues rise of 4.3% ytd and forward earnings gain of only 4.7% ytd.

Here's how each of the MegaCap-8 companies' forward revenues and earnings forecasts has performed y/y: Alphabet (forward revenues up 5.1%, forward earnings up 12.7%), Amazon (6.6, 55.1), Apple (-1.3, 2.2), Meta (14.8, 51.3), Microsoft (6.6, 7.7), Netflix (11.1, 38.5), Nvidia (150.4, 263.5), and Tesla (2.6, -24.5). Nvidia's surge in such a short period on

expectations for AI chip sales is stunning, and certainly ranks among the all-time top performers (i.e., since consensus forecasts were first calculated over 40 years ago).

(5) *Forward profit margins improving broadly.* The S&P 500's forward profit margin—which we calculate from forward earnings and revenues—dropped when this year began, from 12.6% at the beginning of January to 12.3% during the March 30 week, but since has recovered all of that decline, clocking in at 12.6% during the September 28 week. The MegaCap-8's collective margin has surged from 18.0% at the year's start to 20.8% at September's end, with 1.5ppts of that gain coming since the Q2 earnings season started. Among the MegaCap-8s, all but Tesla have seen their forward profit margins rise ytd: Alphabet (up from 23.0% to 25.8%), Amazon (3.0 to 4.9), Apple (25.2 to 26.6), Meta (21.1 to 29.8), Microsoft (34.6 to 35.0), Netflix (14.1 to 17.8), Nvidia (36.7 to 51.3), and Tesla (15.9 to 12.4) (*Fig. 19*).

It can be disconcerting for investors when valuations disconnect sharply from a company's earnings prospects. But opportunistic entry points are available for investors who take their cues from the profit margins implied by analysts' revenue and earnings expectations, considered in the context of past levels.

Finally, we would add that, while higher bond yields tend to weigh on the valuations of Growth stocks more than on those of Value stocks, investors may be buying the MegaCap-8 because their exposure to rising bond yields tends to be less than that of many companies, having relatively less debt exposure.

Calendars

US: Wed: Headline & Core PPI 0.3%m/m/1.6%y/y & 0.2%m/m/2.3%y/y; MBA Mortgage Applications; FOMC Meeting Minutes; EIA Short-Term Energy Outlook; IMF Meetings; Bowman; Waller; Bostic. **Thurs:** Headline & Core CPI 0.3%m/m/3.6%y/y & 0.3%m/m/4.1%y/y; Initial Unemployment Claims 210k; Natural Gas Storage; Crude Oil Inventories & Gasoline Production; Federal Budget Balance; IEA Monthly Report; OPEC Monthly Report; IMF Meeting. (FXStreet estimates)

Global: Wed: Germany CPI 0.2%m/m/4.3%y/y; Italy Industrial Production; Japan PPI 0.1%m/23%y/y; Japan Core Machinery Orders 0.4%m/m/-7.3%yy; China New Loans & Total Social Financing ¥2.5t & ¥3.8t; Mauderer; Noguchi. **Thurs:** UK GDP 0.2%m/m/0,5%y/y; UK Headline & Manufacturing Industrial Production -0.2%m/m/1.7%y/y

& -0.4%m/m/3.4%y/y; UK Trade Balance –£15.2b; UK BoE Credit Conditions; China CPI 0.3%m/m/0.2%y/y; China PPI -24%y/y; China Trade Balance ¥510b; ECB Publishes Account of Monetary Policy Meeting; Woods; Pill; Elderson; Panetta. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Owners remain pessimistic about future business conditions, which has contributed to the low optimism they have regarding the economy," said NFIB Chief Economist Bill Dunkelberg. "Sales growth among small businesses have slowed and the bottom line is being squeezed, leaving owners few options beyond raising selling prices for financial relief." September's *Small Business Optimism Index* (SBOI) fell for the second month, dipping 1.1 points during the two months through September to 90.8; that's after climbing the prior three months by 2.9 points to an eight-month high of 91.9. That marks the 21st consecutive month that the index was below its 49-year average of 98.0, not having exceeded the average since December 2021. In September, five of the 10 components increased, four decreased, while capital outlay plans was unchanged at 24%. Current job openings (+3ppts to 43%) recorded the biggest positive contribution, while the remaining four positive contributors all rose by just 1.0 percentage point: plans to increase employment (to 18%), sales expectations (-13), current inventory (-4), and earnings trends (-24). The biggest drag on September's SBOI once again was expect the economy to improve (-6ppts to -43%), followed by expected credit conditions (-4 to -10), now is a good time to expand (-1.0 to 5), and plans to increase inventories (-1 to -1). Quality of labor (24%) and inflation (24) tied for first place as small business owners' *single biggest business problem*, with taxes (13), cost of labor (9), and government requirements (7) rounding out the top five. The net percentage of owners *raising selling prices* climbed for the second month to 29% in October after sinking to a 29-month low of 25% in July; it was at a near-record-high 66% last March. The net percentage of owners *planning to increase selling prices* was unchanged at 30% in September, after slipping from 31% in June to 27% in July—though above its recent low of 21% in April. It was at a record high of 54% during November 2021. A net 36% of owners reported *raising compensation* last month, the same as during August and down from 38% in July—returning to June's 25-month low; it was at 46% the first two months of this year and at a record-high 50% at the start of 2022. A net 23% of owners *plan to increase compensation* in the next three months, down from 26% in August, which was the highest this year. The percentage is 9ppts below October 2022's 32%, which matched the record high posted the final two months of 2021.

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