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Market Commentary

Weekly perspective on current market sentiment **April 10, 2024**

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Last week's S&P 500 Index: -1.0%

Yields increase

Key takeaways

- The consensus now expects better economic growth and inflation staying higher for longer.
- Under those conditions, it makes sense that the yield on the 10-year Treasury note has trended higher this year.

The S&P 500 Index has been on quite a run this year, posting a 9% gain, excluding dividends, at the time of this writing. We certainly wouldn't want to annualize those gains as, in our view, much good news has already been priced into stocks. One could argue the market is far too optimistic on where inflation might be going in the near term, the Federal Reserve's (Fed) policy rate decisions, and the yield on the 10-year Treasury note over the coming 6 to 18 months.

Conventional wisdom coming into the year said the Fed was going to cut rates six or seven times as inflation continued to fall. Of course, this same line of thinking called for a slowing economy and maybe even a mild recession at some point. But, in a relatively short period of time, consensus estimates for economic growth (gross domestic product or GDP) have crawled up to 3% in the first quarter of this year and almost as high (2.8%) for the second quarter. The expected rates of growth for the last two quarters of 2024 are lower (1.9% and 1.4%, respectively) but certainly not near recessionary (contractionary) levels. Note that quarterly GDP reports are a measure of quarter-to-quarter annualized real (adjusted for inflation) rates of growth.

With the consensus now expecting better economic growth than initially projected and the prospects of inflation staying a bit higher than the Fed's long-term average 2% target for longer, the yield on the 10-year Treasury note has climbed noticeably in the last few weeks from approximately 4.07% in early March to the current level just under 4.4%. Some market participants are concerned that higher interest rates will curb the enthusiasm for stocks, at least in the near-to-intermediate term. Quickly climbing rates often create headwinds for equities.

For perspective, one can make the argument that if economic growth is expected to be better and inflation is expected to be somewhat higher, then the yield on the 10-year Treasury note should also be higher. Bloomberg data show that the average yield on the 10-year Treasury from 1961 to now is 5.85%. The data also show that average Consumer Price Index (CPI) inflation has been 3.8% over that same time frame. That means an approximate average real rate has been 2.05% (5.85% - 3.8% = 2.05%). Applying that same real rate to today's 3.2% CPI reading, it would make sense if the yield on the 10-year note was well above the current level based on the average long-term relationship of the data.

But where are the economy and inflation headed? Our call is for the 10-year yield to end the year near the current level. If rates jump even modestly higher in the near term, the equity market might get nervous. This potential volatility is an important reason why we remain focused on rebalancing into quality sectors (i.e., stronger balance sheets and revenue prospects). Specifically, we favor U.S. large-cap equities and the Industrials, Materials, Energy, and Health Care sectors.

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