

State of the Markets

From the desk of Darrell L. Cronk



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Bonds, breadth, and business cycles

“None of us wanted to be the bass player. In our minds, he was the ... guy who always played at the back.”

— Sir Paul McCartney

If an investment portfolio were a rock band and equities were the lead singer, bonds would be the bass guitar.

Bass players can fade into the background, the quiet ones in the raging cacophony of sights and sounds, but they provide a critical function. They can be the steadying force for a band. Bass players help set the foundational rhythm for a piece, and they provide a bridge between lead guitar and percussion, signaling a pickup or slowdown in tempo.

Bonds, too, are foundational for a portfolio. In simpler times, they have provided a steady, rhythmic stream of income that can buffer the volatility of equity markets. During bull markets, they can fade into the background.

It's rare that the bass player steps to the front of the stage, but that is exactly what U.S. Treasury securities have done over recent months. Rising interest rates have pushed bonds to the front of the stage, creating a volatile autumn for equity markets and a set of choices for investors unlike any they've had to consider in the past 15 years.

To make sense of it all, I'd suggest that investors consider the three Bs — bonds, breadth, and business cycles.

Bonds

Since the beginning of June, the nominal 10-year U.S. Treasury yield has climbed by 100 to 120 basis points (100 basis points = 1%) to the highest level since 2007. Real yields (nominal yields minus inflation) also surged, increasing 80 to 100 basis points, to a level last reached in 2008 — that's important because, historically, rising real yields have been one of the most important indicators for tightening financial conditions.

The recent bond selloff has been driven by a few fundamental factors, including stronger-than-expected economic data, a daunting supply-demand imbalance within the U.S. Treasury markets, and the widespread belief that the Federal Reserve (Fed) may still have more hikes to implement.

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- U.S. economic data has printed stronger than expected for most of 2023, pushing most of us in the forecasting business to revise growth expectations higher. We'll see the first estimates of third-quarter gross domestic product (GDP) growth later this month, and we would not be surprised to see growth between 3% and 4%, a level of late-cycle strength historically consistent with the late stages of prior business cycles. Resilient growth, along with stronger-than-expected labor, inflation, and retail sales prints, have put upward pressure on the long end of the yield curve.
- U.S. deficits have also been larger than expected. Rising deficits must be financed by new and increasing U.S. Treasury issuance. Through September, U.S. Treasury issuance for 2023 was \$1.6 trillion and on a projected run rate to rise to slightly above \$2 trillion for calendar year 2023. This compares to the full calendar year 2022 issuance of \$1.4 trillion. This increasing supply of Treasury securities — against a backdrop of shrinking demand from large historical buyers like banks, overseas investors, and institutional buyers bruised by recent losses within their fixed-income portfolios — has investors concerned about supply-demand imbalances within the all-important U.S. Treasury market. That, too, puts upward pressure on interest rates.
- Comments by Fed speakers suggest that the recent rise in interest rates may have already done some of the Fed's work for it, and therefore, it may hold off on another interest rate hike in November. We still believe the Fed has one more interest rate hike left — at either its November or December meeting. But clearly markets have begun to turn their focus from how many more hikes are left to how many interest rate cuts may happen next year.

At the beginning of this hiking cycle, the number of Fed interest rate hikes was largely based upon inflation data, but going forward, we believe the number of interest rate cuts will be based upon how the real economy performs. The crucial point, in our view, is that the music of Fed interest rate hikes this cycle is about to stop. The next order of business is to watch the bass player — the bond market (and particularly long-term yields) — to understand when the tempo of growth will slow as tightening monetary policy reverberates through the economy.

Breadth

While bond yields have been the story in fixed income markets, the breadth of market participation has been the big topic in equity markets. Investors may find it hard to believe that the average stock in the S&P 500 Index is down close to 20% from its rolling 12-month high — even as the broad index has posted double-digit gains year to date (through October 16, 2023). Simply put, the top 10 market-cap-weighted names within the index have accounted for more than 95% of year-to-date gains. If you have not owned these names, most of which are large technology companies, there is a good chance your portfolio performance has struggled in 2023.

Lesser known is the strong aggregate performance — in both price performance and earnings growth — of large companies over smaller companies. The S&P 500 (U.S. large cap stocks) has outperformed the Russell 2000 (U.S. small caps) by almost 15% this year. We have continued to favor U.S. Large Caps over U.S. Small Caps all year in portfolios as higher interest rates disproportionately hurt small-cap business models. Smaller companies tend to hold a higher percentage of debt on their balance sheets than larger companies, which means the cost of capital for growth increases to dangerous levels as rates increase. True to other business-cycle wind downs throughout history, over 40% of Russell 2000 companies have failed to turn a profit in the past year.

One of the important questions we ask as equity markets seek to find a durable bottom is this: Have the right sectors and industry groups displayed signs of early-cycle recoveries?

The S&P 500 Index made its low for this cycle, so far, just over a year ago, in October 2022. If this price point marked the beginning of a new sustainable bull market, we should see leadership coming from areas like small caps, banks, and real estate investment trusts (REITS). Even with better-than-expected trends in 2023, small caps (as measured by the Russell 2000 Index) are flat from last October lows, which would mark one of their worst performances coming off a durable bottom in history. Bank stocks are down more than 15% since the October lows of last year, and REITs are struggling to muster any positive returns. Both are taking their cues from higher bond yields, and neither reflects historical early-cycle dynamics.

Add to that the humanitarian tragedy of war in the Middle East and Eastern Europe, with the looming geopolitical uncertainty of broader escalation, and we would advise investors to hold off before buying into the notion that today's moody equity markets are ready to change their tune from the blues to rock and roll.

Business cycle

Much ink has been spilled over the past year and a half attempting to predict both a recession and the timing of one. Predicting a contraction in economic growth has always proven elusive, even for the wisest in our business. But attempting to predict a slowdown and then put precision on its timing? That's a fool's errand, a nearly impossible feat given lags in monetary policy and contradictions in real-time data.

Whether or exactly when U.S. GDP growth may drop below 0%, marking a recession, is not the right question to ask, in our opinion. The right question within a business cycle has always been whether growth is slowing and deteriorating, or accelerating and strengthening, from today's level. Economic growth is not linear, but we **can** piece together patterns in the data to understand direction and trajectory. We **can** gauge where we are at any given time within a business cycle. And, despite more resilient growth and a more prolonged drum roll than most expected in 2023, what we see today when we look at the indicators is a clear picture of late-cycle dynamics.

During the past 12 recessions since World War II, both nominal and real GDP growth remained strongly positive in the months leading up to a recession. In two of the most recent three recessions, real GDP growth fluttered between 2% and 3%, household employment was either at or close to setting cycle highs, and the equity market exhibited robust performance leading into these slowdowns. It is important to note that over the past 50 years, each time the Fed raised the federal funds rate by 300 basis points or more, regardless of the starting point, we experienced a sharp downturn in the economy. This cycle, we have seen the Fed raise rates by 525 basis points since March 2022, a pace of tightening we haven't witnessed since the early 1980s. We've only seen the beginning, in our view, of the toll this tightening is likely to take on consumers and business.

Business cycles are just that. They are cycles that, like empires and dynasties, rise and fall, and the next one can't begin until the last one ends. We've all been waiting for this maddeningly sluggish cycle to end, but that has not happened yet. Let's remember, even in the throes of our desire to be done with this cycle once and for all, that the absence of a recession does not automatically mean the presence of a recovery.

While easy to overlook amid the gyrations of day-to-day market movements and economic prognostications, the three Bs play a critical, but often underappreciated, role in how to position assets in a portfolio in the waning stages of a business cycle. Like a bass player, bonds, breadth, and the business cycle stand at the back of the stage, offering clues to where the music goes next.

Investors would be wise to listen to the rhythm and tempo of the data, and right now, the data are telling us to respect the lag of tightening monetary policy, the weakening of financial and credit conditions, and the guideposts of leading indicators. The green and red lights may flash, and the wailing lead singers on your television screen may try to convince you that this time will be different, but from the back of the stage, the quiet bass guitarist provides the rhythmic repetition that grounds the music in fundamentals tested through time.

When it comes to long-term investment planning, we'll hearken the words of Sir Paul McCartney: "Whisper words of wisdom/Let it be."

Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions. Other risks associated with investing in listed **REITs** include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

Definitions

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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