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COMMENTARY

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Market Volatility Starts to Bubble Up

- U.S. stocks are dropping as bond yields hit three-month highs.
- Market risks continue to grow at a time when stock valuations are elevated.
- Volatility has been low this year, but we expect it to rise.

Stock markets are declining today as bond yields are rising. We saw a similar phenomenon earlier this spring when bond yields rose and technology shares sold off. Then, the 10-year Treasury rose from under 1% to roughly 1.75% by the end of March. The 10-year yield retreated after this and made it down to 1.17% by early August. Currently it is trading around 1.55%. Generally, technology stocks are most impacted by rising bond yields because they tend to have higher stock price valuations that are calculated based on projected future earnings. Higher yields create higher discount rates for valuing those future earnings streams and thus the stocks become theoretically less valuable. Technology stock valuations have been lofty in this low yield environment, hitting levels not seen since the dot-com bubble. The rise in bond yields is happening for a host of reasons. We noted in our recent outlook, "A Watched Pot Never Boils," that bond holders seemed complacent to rising risks in the market. Let's rehash some of these risks.

The Federal Reserve will begin tapering soon, and this will impact the demand for longer maturity bonds, driving up bond yields as bond prices fall. The Fed has been buying bonds to hold down longer maturity yields to spur growth during the pandemic. The low yields helped people refinance mortgages, buy homes and cars and it also helped businesses refinance debt and finance new projects. The Fed feels it is time to stop this program and start reducing these purchases through the process called tapering. They insist tapering is not tightening, but it is tightening in the sense they are removing a form of economic stimulus. The Fed is also expected to start raising short-term rates by the end of next year.

In addition to the Federal Reserve becoming less accommodating, economic growth is slowing from peak growth rates. This is no surprise since the growth was not sustainable and coming off very depressed levels. The concern is that as growth slows, there is some uncertainty at what level economic growth will stabilize. We think it will stabilize above pre-pandemic levels, but there is uncertainty along the way. Growth will not be even around the world either, as Europe catches up and China focuses on longer-term policy agendas, sacrificing short-term growth. China recently made headlines when their largest real estate developer ran into issues trying to pay interest payments on its sizable debt. Questions remain regarding how willing the Chinese government will intervene and help the company. This issue will not be resolved overnight and many worry about the chain reaction this may cause as the developer could miss payments to vendors, suppliers and lenders.

In America, the political divide is on display again as congress feuds about debt limits. President Biden's Treasury Secretary, Janet Yellen, recently warned that if Congress does not raise the debt limit by October 18, the Treasury is likely to exhaust its extraordinary measures. Senate Republicans blocked a bill on Monday that would have funded the government and suspend the U.S. borrowing limit, while disagreement within Democrats lingers. While this feud plays out in the media, we expect market volatility.

With all these risks, U.S. consumers are losing confidence. A report released today shows that consumer confidence dropped a third straight month and suggested concerns around yet another risk, the Delta Variant. The survey noted that its expectations index fell to its lowest level since November.

This year we have seen U.S. stocks rise despite a growing list of concerns. With the S&P 500 trading at valuations not seen since the dot com bubble there hasn't been a 5% pullback in this index since October of 2020. As market risks rise, we continue to anticipate more volatility in the near term. We may see a stock market correction at some point this year, but we still don't expect a big sell-off as we saw in early 2020. Timing the market is not advised as people tend to lose more timing the market than focusing on long term risk and return goals. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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Glossary

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