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What Record Highs Might Be Hiding

LIZ ANN SONDERS: I'm Liz Ann Sonders.

COLLIN MARTIN: And I'm Collin Martin.

LIZ ANN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

COLLIN: Well, hi Liz Ann. We're back again this week. And last week we spoke about the Fed meeting. We kind of did a recap there. And it seems like we're now moving into, you know, an era of a more hawkish Fed, interest rates potentially moving even higher. So, you know, given that, I wanted to check with you to see, you know, if anything's if that changes your outlook. And I ask that specifically because as, you know, I'm the bond guy. And when I look at the S&P 500®, I see it's, you know, very close to its all-time high, which I'm a little bit surprised because usually I think higher rates can have somewhat of a negative impact there. So, you know, what is that telling us right now?

LIZ ANN: So let me answer, Collin, with a little bit more of a long-term perspective and something that we have chatted about on this pod many times in the past. And that's the, for now anyway, the inverse relationship between bond yields and stock prices, in particular the 10-year yield, which is most relevant to the equity market. And to me it further reinforces the end of the Great Moderation era, which was the era from the late '90s up until the inflation spike in 2022. And in that era, bond yields and stock prices most of the time moved in the same direction because bond yields were keying off of what was happening with economic growth, without a lot of inflation concern. Higher yields meant higher stock prices. Well, now we're in this negative correlation territory and I think it has shades of the 30 years that predated the Great Moderation, which I nicknamed "The Temperamental Era." In almost the entirety of that 30-plus-year period of time, bond yields and stock prices moved in the opposite direction, because that was an era where bond yields were keying off of inflation and so higher yields tended to bring stock prices lower and vice versa.

And so I think that's… you know, every day we talk about "What did the bond yield do?," "What did oil prices do?," "What did the market do on a day-to-day basis?" But I think that more secular perspective is an important one. And you know this, and I'll toss it back to you as well. The one thing that gives me some comfort is that first of all, I think the move in the 10 years so far has been fairly orderly and we've actually seen a decline in the term premium. So that reflects, I think, that there isn't yet a major demand for higher yields to take the risk of investing in Treasuries. At the same time, you haven't seen any meaningful deterioration in the economic growth outlook.

So what are your latest thoughts on the term premium? And maybe for the benefit… I actually used that term last night in a client event and somebody said "I don't know what the term premium is." So maybe for our listeners, there might be some out there that we can't assume just automatically know what we're talking about with that.

COLLIN: Yeah, that's a great question. And it's funny if one of our clients doesn't know what it is, that's OK, because a lot of people don't know what it is. Also, it's hypothetical. And this is where things get tricky. So the term premium… it can be considered the premium or the compensation that we as investors earn for holding a long-term bond under the assumption that over the life of that long-term bond, other market interest rates can change.

So it's the compensation that if you invest in, say, a 10-year Treasury note, that over time maybe short-term yields rise and there could have been an opportunity cost there. So it's just meant to compensate for kind of locking your money up for a long period of time. There's a number of term premiums based on maturities. It's not just a 10-year term premium. You can model it out for other parts of the yield curve. And to make it even more confusing, there's a few different models out there.

So these are again, they're models. A lot of them come from the various Federal Reserve banks. And sometimes they can tell different stories. But when we look at the term premium, the one that we look at, the ACM, Adrian, Crump, and Moench, it hasn't really risen too much.

LIZ ANN: That doesn't roll off the tongue, does it?

COLLIN: No, you know, and I wanted to say ACM, that's what everyone calls it, but got to spell it out, of course. So the ACM term premium, like you said, Liz Ann, hasn't moved much. It's up from the lows of a few years ago. But when we look at what's happened, you know, say year-to-date with the 10-year Treasury yield, the move up has not really been driven by that term premium. So that suggests that, you know, fiscal concerns, which are something that sometimes drives the term premium, it suggests that that's really not the key driver. The key driver is really the change in expected short-term interest rates. And I think also just the general rise in global bond yields. Now there's another one out there, or actually there, there's a handful of term premiums. Some actually have risen a little bit.

But what you said I think is really important, Liz Ann, in that it's been, I think, orderly. And even though there's a lot of headlines out there, I think it's really just representative, the move up in in long-term treasure yields is really just representative of the economic environment we're in, where growth is strong, the economy's resilient, and inflation's just a little bit high. You know, let me go back to the equity market real quickly, Liz Ann, because we were talking about this earlier, and yes, stock prices are up, but I don't think that tells the whole story. And I think if we look, you know, kind of dig a little bit deeper, there can be other things going on under the surface. So what can you share there?

LIZ ANN: Yeah, so there's no question that at the index level the market back to near all-time highs is a good thing. But I think you have to peel a layer or two of the onion back to see what's really going on. And I look at every variety of breadth measure, many of which I put on my X feed every single morning for chart nerds that like to look at that stuff and maybe don't have access to something like a Bloomberg terminal or lots of charting-type software. So you can follow me on X and get a lot of that.

But some of the ways that I talk about breadth and write about and chart about are the traditional things like the percentage of an index like the S&P 500 percentage of stocks that are trading above their 50-day moving average or their 200-day moving average. That's a common way to look at breadth. But I also look at some slightly less common breadth measures. And I think these tend to resonate a little bit more with individual investors who maybe don't live, eat, and breathe this stuff every day. And here's some examples. So you've got the S&P 500 near an all-time high, yet only 2% of the index is trading at a 52-week high. Even if you just look at a four-week high, only 8% are trading at a four-week high.

And of all 11 sectors in the S&P 500, only two actually have a reading on percentage of stocks at a 52-week high. The other nine sectors, communication services, consumer discretionary, consumer staples, energy, financials, industrials, materials, real estate, and utilities, have 0% of stocks at 52-week highs. The only two sectors that have a reading on that are healthcare and tech. And in each case, it's still single-digit percent trading at a 52-week high. And this is just one way to highlight just how much churn there is under the surface. Another way I show this notion of churn is to show that the S&P has done very well at the index level this year, didn't even have a correction at the index level. The February-March corrective phase had the S&P only down about 9% from peak-to-trough, but the average member within the S&P 500 has had a drawdown of 25%. So that's bear-market level declines. It's just happened through a process of churn and rotation.

Another way to think about rotation and churn is that there's a record percentage of stocks right now that have a negative beta to the index, which means on a day-to-day basis, they're moving in the complete opposite direction of what the index is doing. And there's a record high percent. So what you have is big tech. And it's not the same big tech, it's not the Magnificent Seven, it's even rotation within big tech, but big tech is where the… not only leadership has been, but the contribution is high because of the big part of that. So when we talk about big tech, it's not just the fact that they're tech stocks are doing well, it's that they're big.

So within the Magnificent Seven, you've got two stocks, Nvidia and Apple, that are ranked in the single digits in terms of contribution to return. They're not the best price performers, but they rank in the top 10 of contribution, and contribution comes as a result of the price performance times the cap size. And the number one contributor, it's actually not part of the Magnificent 7, and it's Micron. So you've got these, even these rotations, but as long as you find leadership in these mega-cap names, these mega-cap tech names, it accrues to the benefit of a cap-weighted index like the S&P 500. But it doesn't tell the full story of whether there's breadth in terms of performance. There's not great breadth in terms of performance. It's still concentrated.

COLLIN: So from an investor standpoint, you know, when I… you know, you mentioned that negative beta, I often think of kind of degrees of positive beta. I often don't think about the negative beta. What does this mean for an active equity, you know, strategy? Is this a good thing? Is this a bad thing? You know, what does that mean and what should investors think about?

LIZ ANN: It's a little less good for active strategies than it was, say, earlier in the year. Another metric that I look at is the percentage of S&P stocks outperforming the index itself over various rolling periods. And over the past month, trailing one month, only about 20% of S&P stocks are outperforming the index itself. That got to as high as close to 70% earlier in the year.

That allowed for one of the better starts of a year from a relative performance standpoint for active managers versus passive managers. But as you see and have seen that breadth deterioration, that does accrue to the disadvantage of active in an aggregate sense. That doesn't mean that there aren't really talented active managers out there or funds doing active strategies. In fact, there's still very healthy growth in active exchange traded funds. So there still is a lot of interest. It ultimately, though, means that it's a less even playing field. It's a little bit less difficult to pick up that alpha with active strategies unless you happen to do a really good job at it.

So I also think that, you know, the shelf life of narratives these days can change pretty quickly and there's so much short-term money in the market that have very short time horizons, including, I don't want to say retail investors, but that retail trading cohort. And then you bring in the cohorts in the institutional sphere that are very high frequency, like the long/short hedge funds and the systematic traders and the commodity trading advisors. And they have time horizons just measured in minutes really, if not even shorter than that. And I think for investors, if anything, we don't try to play that game by dramatically shortening time horizons. If anything, it reinforces longer-term time horizons because over any reasonably long period of time, you do have a connection between fundamentals and prices.

And I would also reinforce being mindful of not letting your portfolio become overly concentrated. That can happen through a cognizant effort to do that, as well as things like rebalancing, which is such a beautiful discipline. So those have been some of the interesting conversations that I have been having with clients, sort of looking under the hood of the equity market and not just leaving it as "Oh, the index that is at an all-time high. That tells the full story."

So we both travel a lot. I'm on the road as we speak. I can see you, you can see me, so you see that I'm in a hotel room. I see you're in your office, or right now you're not traveling, but we do client events all the time and talk to clients. So what lately have been your interesting conversations, with clients or questions that you're getting now more than others?

COLLIN: Yeah, we we've had a bunch, especially following, you know, the kind of the hawkish pivot and then the Fed rate hike last week. And I think the questions kind of tie into the points you were just making about maybe that short-term mindset that investors have. And a lot of the questions I'm getting are kind of binary. You know, "Should I be doing this or that?" And it's good to kind of take a step back. And that's not usually how we consider investing in the bond market. So the two questions kind of focus on short-erm bonds and long-term bonds. The first is "OK, what's next for the Fed because they hiked last week?" And then the idea that if the Fed is going to hike again by some amount, should investors just be sitting in cash and waiting for the Fed to hike? And I think it's important to highlight that even though we expect the Fed to hike, you know, one or two more times in addition to the hike from last week, you know, sitting in cash is a very short-term strategy. When you think about portfolio allocation, there's really three key asset classes: stocks, bonds, and cash. And if what should be bond investments are sitting in cash, then you're just over-allocated to cash, under-allocated to bonds. And we'd highlight that there are a lot of attractive opportunities, or what we think are attractive opportunities in various maturities, short and intermediate term, for example, where you can earn higher yields than what are available, say with Treasury bills or money market funds, and you don't need to wait for the Fed to hike rates and catch up. So I think that's important.

The other question is kind of the other side of the spectrum is "Hey, the 10-year Treasury yield is now near 5%. Should I be going all in long-term bonds right now?" And that's not the answer, either. Just to make it clear, you know, tactically, we prefer short- and intermediate-term maturities. That's maybe somewhere in the two- to five- or six-year range. We think it's a sweet spot where you can earn what's above those short-term rates I mentioned before with Treasury bills or money market funds, but less interest rate risk, meaning the risk that prices fall if yields increase, less interest-rate risk than, say, 10- or 30-year bonds.

I want to highlight that there's a difference between our tactical view there and a strategic view. If you're an investor and you have a long time horizon and 5%, which is what you can get on the 10-year Treasury right now, if that can help you reach your goals, then that's certainly worth consideration and a conversation to have with your financial representative, as long as you understand, you know, the risks involved with that. You know, the longer the maturity, the more sensitive it is to changing interest rates. But if that 5% can help you, then then a portion of your portfolio in slightly longer-term bonds can make sense.

But why we're not more tactically positive is because we just see more upside than downside with that 10-year Treasury yield right now. The, kind of.... the trend is higher right now. Not that we're expecting yields to move significantly higher, but you know, the Fed just hiked rates with a few more expected. Inflation's still sticky. The economy is still pretty resilient. And something that Kevin Warsh said at last week's meeting, he didn't describe the economy as strong. He described it as strengthening.

So that's not something that we'd really want to get ahead of. And then I think most importantly, we look at the relationship between the 10-year Treasury yield and the Fed funds rate. And the 10-year yield tends to peak closer to the final rate hike, not the first rate hike. So we think we have a little bit more time there to kind of see what the outlook looks like. And most importantly, we don't think investors will necessarily miss this opportunity of yields kind of being where they are right now, or the 10-year Treasury yield holding near 5%. We are moving closer to having a more positive view on long-term bonds. There's a few things that we'll be paying attention to. You know, one, if yields continue to move higher, it'll just make the entry point a little bit more attractive. The higher yields go, the more income we earn that can help offset potential price declines. If yields continue moving up, it provides some sort of a cushion.

Another thing that would change our view is if our economic growth outlook deteriorates a little bit, because when growth slows, that usually pulls down long-term yields, but we're not there right now. You know, our house view is that the economy is generally doing OK. So, you know, with all that, it's not an either-or decision. You know, a multitude of maturities can make sense. It doesn't need to be just short-term bonds, just long-term bonds. But our sweet spot from a tactical standpoint is in that short- and intermediate-term region right now, kind of two to five or six years or so.

COLLIN: So Liz Ann, with that, let's look ahead to next week. You know, what matters most for you? What's on your radar and what do you think investors should be watching?

LIZ ANN: Well, I'm guessing what's on my list is similar to what's on your list. It's a big week after not so big a week this week in terms of data that's coming out. The, as it's often described, the all-important employment report, jobs report, which has you know, every variety of nugget in there in terms of, you know, payrolls and the unemployment rate and I say also these days, look at all the details in the jobs report, every aspect of it, average hourly earnings and the labor force participation rate and the differential between the establishment survey, which generates the payrolls number, and the household survey, from which the unemployment rate is calculated. So I think this is a time where you want to look at every release associated with that, not just the headlines.

We also got some home-price data. I think the housing data in the aggregate is relevant again because of the move up in mortgage rates. We get other jobs data, the Job Opening and Labor Turnover Survey or JOLTS. Do keep in mind, especially on a week where we get that and the payroll release, that JOLTS lags pretty much all other job metrics by a full month. So just keep that in mind. We also get the Challenger Layoff announcements, that's key to keep an eye on because that is obviously a leading indicator. And we get PCE, the Personal Consumption Expenditures price index, which is the Fed's preferred measure. That doesn't tend to be a big outlier relative to the consensus expectation, because once you have the Consumer Price Index and the Producer Price Index, any, you know, talented economist can sort of map the components within those two to what the PCE is going to be. So I'm guessing some of those might be on your radar next week, too. Anything else, Collin?

COLLIN: No, you nailed it. I think I'm done for this episode. No, I'll add a little context about what I'll specifically be looking at that could flow into the potential outlook for the Federal Reserve. You mentioned the all-important PCE, Personal Consumption Expenditures. That's very important because that is still the Fed's preferred inflation gauge. Kevin Warsh made that clear. And 2% is still the Fed's target. So we want to look for progress there.

Because as we look ahead, you know, I think what the Fed will be looking at to determine how much additional tightening is necessary, I think are two key things that at least we're paying attention to. The first is breadth. So it's not just the one number we see. "OK, what was the month-over-month change in core PCE, for example, or the year-over-year change?" We're looking at breadth under the surface, because this is something that Kevin Warsh has discussed, where the share of components in the PCE rising at a 3%+ year-over-year rate has been growing. So that might be more important than the actual headline numbers that come out with the release. But we will be looking at specifically the monthly core PCE reading because I've been I've been kind of harping on this for a few months now, but this is a key point that New York Fed president John Williams has highlighted, where he said that in order to be confident that inflation is moving meaningfully towards its 2% goal, he'll want to see core inflation prints at 0.2% or less. So we're going to be looking there to see if it, you know, comes in at what John Williams is looking for. If it comes in a little bit hot, suggests more hiking might be necessary.

And I think on the labor market, you know, we've seen a little bit of strength over the past few months, at least relative to what we saw in the previous few months. If the labor market remains stable, it just takes pressure away from that side of the mandate. And it kind of allows the Fed to focus more on inflation and raise hikes if necessary. You know, if the labor market continues to hold up, if the unemployment rate remains low and inflation's still sticky, I think it gives the Fed confidence that it can continue hiking rates, at least gradually, because they might not see the risk of a severe negative impact to the labor market or the overall economy. So that's kind of how we're viewing those data releases as those come in.

LIZ ANN: Hey, you know, speaking of inflation, Collin, the other data item that we probably all should be paying attention to, if not already, and it's every single day, are diesel prices. Every good in the world gets transported in some form or another, and this is becoming a big hot-button issue. So that that's sort of perpetually on my radar these days, as well.

COLLIN: No, that is a risk. I mean, diesel's very important. It's a big input to our physical economy with trucking, with rail, with agriculture. And, you know, I was looking over the past few days, you know, we've gotten a number of, you know, comments from Fed officials following last week's Fed meeting. And, you know, something that stood out came from Austan Goolsbee of the Chicago Fed. And this is very much in line with something that you and I have been talking about for a few months now, where he warned that, you know, these supply shocks have become more frequent, harder hitting, and longer lasting. And the Fed cannot simply look through persistent inflationary shocks. These have become more of the norm. And historically, the Fed can look through supply shocks, but when they're happening so often and when they're persistent, then that's a risk. And then the Fed, I think that's part of the reason why the Fed has acted and maybe will continue to act.

LIZ ANN: And maybe an example of us being in a more temperamental era, to go back to or the beginning of our conversation.

COLLIN: Yep. Yeah, exactly. Well Liz Ann, I think that's it for this episode. To all of our listeners, you know, thank you for listening. We truly appreciate it. If you don't want to wait a week until the next episode, you can always keep up with us in real time on social media. I'm @CollinMartinCS on both X and LinkedIn. The Collin is with two L's and the CS is for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. Still have a lot of imposters, so please make sure you're following the real me. And you can find all of our written reports, not just mine and Collin's, but all of our colleagues' within the Schwab Center for Financial Research on Schwab.com. There's a "Learn" tab, that's where you find them, and they're always chock full of visuals and graphs and tables and charts. So keep your eye out on those.
I also wanted to put in a plug for another Schwab podcast, which Collin, you were just on, and that is *WashingtonWise*, hosted by our brilliant colleague Mike Townsend. If you just search "WashingtonWise," all one word, give it a listen to hear about all things politics and policy, which is probably on everybody's radar these days.

And if you would like to support our little show here, please consider leaving us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen. And we will be back with a new episode next week.