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Can Bonds Still Do Their Job?

LIZ ANN SONDER: I'm Liz Ann Sonders.

COLLIN MARTIN: And I'm Collin Martin.

LIZ ANN SONDER: 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.

Well, hi, Collin. No doubt the next few weeks will be filled with political headlines and news. We are not, blissfully, an election show, but you can check out our colleague Mike Townsend's podcast called *WashingtonWise* to hear all about the midterm election and everything politics. Our focus here on our pod is on the markets, and we have seen some fairly wild swings in the 10-year Treasury yield last week. So what's been driving that? How much of it is inflation? Could it be AI-related expectations for Fed policy? What do you think the drivers are?

COLLIN MARTIN: Yeah, I think it's all the above. And last week was ... it was an interesting one. So not to get too deep into the weeds, but we saw the 10-year Treasury yield really bounce around. And if we look specifically, the movement started last Wednesday following the Consumer Price Index report that came in a little bit hot. We saw the 10-year Treasury yield jump sharply following that release, jumped about 14 or 15 basis points in a matter of minutes. It got as high as 5.32%.

So it took the elevator up, and then as the course of the day went on, it kind of took the escalator down, actually ended lower to start the day. And I think that's where your AI point kind of works its way in here. Because the initial idea with CPI, if it's hot, maybe the Fed needs to hike more aggressively or sooner. But then there started to be some concerns about AI-related investments. We actually saw the stock market sell off a little bit on Wednesday and then again on Friday. And we saw the 10-year Treasury yield end at its lowest level in a few weeks, kind of in the 5.07% area or so.

And I think that was a good thing because, Liz Ann, the momentum for Treasury yields had just been up. They'd just been rising very sharply. And I think that scares a lot of investors because it pulls the value of bonds lower, but it also, if you're seeing yields rise, it kind of wants ... it may make you want to sit on the sidelines a little bit and wait. Say, "Well, let me ... I'll wait for yields to keep moving up." It finally stopped to a degree, and we saw 10-year Treasury yields come down a little bit, mainly on growth concerns. There's a few things we could point to, but I think the general idea is if there's concerns about just the pace of all this AI expansion, build-out, stuff like that maybe that could impact growth down the road.

So I think that was the key driver there. But I think it was a good thing because I think the 10-year Treasury yield, and Treasury yields in general, kind of needed to take a little bit of a breather rather than just continuing to rise up, which can have negative effects on businesses, individuals, the government, and I think it kind of spooks investors. But you know, most importantly, I think this can calm investors because last week, arguably, bonds did exactly what they're supposed to do, in that yields fell, their values rose because bond prices and yields move in opposite directions, as the stock market declined a little bit.

And that's one of the key benefits we talk about with bonds, whether it's price stability, capital preservation, or diversification benefits. Now, it wasn't a big drop in stocks. They're still, you know, pretty close to their all-time highs, but they dropped a little bit, and bonds did well. Think that's good news. Because I think there's still a lot of concern from investors. I don't know about you, but I keep hearing the whole 60/40 debate kind of getting raised. And I scratch my head at that a little bit, because if I just look year-to-date at returns, the S&P 500® is up this year. Bonds are actually down this year on a total-return basis, which is kind of what the 60/40 suggests. You might have a good year with one, maybe a bad year with the other. And I wonder are investors worried about just the idea of what a rate-hike cycle might mean? Because last time the Fed hiked, that's when we saw the concerns about the 60/40. But is that something you've been hearing about lately? Is it a question you've been getting?

LIZ ANN SONNERS: Yeah, a little bit more, and it may be because the correlation. I look at rolling one-month, rolling three-month, rolling one-year, you name it, correlation between the 10-year yield and the S&P 500, and that is still in negative territory, which means at least on a rolling one-month basis it is in negative territory, which means that bond prices and stock prices are moving in the same direction.

So when you have that correlation, I think it naturally brings up that question. But as you certainly know even better than I do, even if we're in an environment where

bond prices may be under pressure, that doesn't mean you're in a losing game, given the income you're generating in the portfolio and if, you know, assuming it's a security that is held to maturity, you do get the principal back. So I think there's often a misunderstanding of how bonds work within a portfolio. In addition, there's, you know, there's so many other asset classes that individual investors, even smaller individual investors, have access to. You know, there's been so much democratization of investing that there are other areas to look for non-correlated assets aside from just a very simple, you know, 60/40 or 60/30-type portfolio.

And I think that's another reason why I get the questions a lot, is just increasing interest in whether it's, you know, commodities or real estate investments or the private markets, just investors opening their eyes to a broader swath of opportunities in terms of diversifying their portfolios.

COLLIN MARTIN: I like what you said there. I was actually just having a conversation with one of our colleagues this morning about this, about the power of income. Because let's say that yields, bond yields, whether it's Treasuries or the average yield of the U.S. aggregate index, let's say it bounces around in a somewhat tight range, but for a prolonged period of time just kind of holds in that range. If you look at that in a vacuum, you might think, you know, "It's directionless. What am I getting here?" Well, you're getting the income.

And if you invest in a, you know, an index or a strategy that can offer you a 5% yield and then, you know, the values hold steady for a while, again, not that we're saying that will happen because there can be fluctuations here and there, but that's the value of bond investments, the income they provide. So even if we're kind of directionless or holding in a steady state, we're at a level right now where yields we think are very attractive and focus on those income payments.

But Liz Ann, let's talk a little bit about equities. I don't want to hog all the time on the bond market. And although ...

LIZ ANN SONNERS: Sure you do.

COLLIN MARTIN: I mean, I do. You're right. Let's be let's be honest here. But there's two of us here. And even though bonds, bonds are hot these days, obviously we know a lot of our listeners love hearing about the stock market. So, you know, one thing obviously that's going on right now is earnings season. So can you kind of touch on that, how it's shaping up and what you're looking for?

LIZ ANN SONNERS: So we're still very early in earnings season. So the percentages in terms of beat rate, which is a little bit above average, and the percent by which

companies beat, that is literally ever changing with every new report that comes in. So far not bad, but there are elevated concerns that have crept in for obvious reasons. The latest, I guess, poster children for concerns in the AI space would be the neocloud companies with CoreWeave being paramount among them. And for those not familiar, the neocloud companies are specialist cloud companies. They basically rent out GPU computing power from the likes of Nvidias and they rent them out mainly to AI developers who need it to train and run models. And CoreWeave is one of the largest of the publicly traded ones. And they differ from hyperscalers because they have a narrower focus, whereas, you know, Amazon Web Services or Google Cloud sell hundreds of services, storage, databases, software, et cetera, where neoclouds mostly sell one thing, which is access to large clusters of mostly Nvidia GPUs.

And I always want to caveat any comments that I make that bring in individual names with I'm not an analyst. I don't cover the tech sector. I don't cover any of the stocks as an analyst. So it's just sort of a proxy for what's going on. And we've had these roving concerns about the AI spend, capital investment outlooks.

But maybe most importantly, and this is where it does tie back into your world, Collin, is the leverage and the debt financing that increasingly is needed to fund the build-out. And if you know, if we think about it, leverage is really just ... you're financing the timeline, the timeline meaning from when the investment is made to when it bears fruit. And one of the problems in the world of AI is that a lot of these investments have a relatively long duration associated with them, yet news flow and narratives are changing in rapid-fire fashion in this space. So I think that's another reason why there's increased focus on the debt side of things.

And the neoclouds are arguably the most rate-sensitive corner of AI because they are long-duration growth companies, but they're funded with sort of short-fuse debt. And there's just heightened sensitivity in a rising-rate environment. The other place it's showing up is at the factor level in terms of what's working and what's not working. On a day-to-day basis, it's common to look at "OK, what sectors were in the lead, what sectors lagged," but I think a slightly more granular approach is a little bit more of a tell in terms of how the economic inflation monetary policy backdrop is influencing the market. I think you've got to look a little under the surface of both the indexes and the monoliths of sectors.

And you see you know, factors like high interest coverage, low volatility, stability and profit margin doing well. If you go down the cap spectrum and you go into the Russell 2000, the profitable Russell 2000 stocks are outperforming the non-profitable Russell 2000 stocks by 18 percentage points. Last year was the opposite. The non-profitable stocks had twice the performance of the profitable stocks. But

now there is just this sort of hunt for quality in an environment where there's increase in concerns about earnings estimates, profit margin stability, the capex spend, how that capex is being financed, what's the difference between the cost of capital and the return on invested capital. And so it's a trickier earnings season because there is this heightened concern around everything AI. And I think you really don't quite pick that up if you only are looking at the cap-weighted indexes and their performance at that high-level index level.

COLLIN MARTIN: We're seeing the same thing in the bond market. There can be winners and there can be losers. There can be haves and have nots. And you mentioned leverage before. You know, that's basically a measure of debt relative to earnings. It doesn't need to be just a business term. It can be for individuals, and there can be good leverage and bad leverage. But when you buy a house, usually that's leverage. You know, you're putting a down payment, borrowing the rest. And I'm not going to say it's always the best idea, but for a lot of people, it is a good idea. You know, you buy a house by putting a small amount down, you pay for it over time, and you have that house.

In the bond market, there can be good and bad leverage. And I like how you framed it out with when we look at the AI build-out, I think so many of these companies, they see where the opportunity is here and what the growth potential is. So they're borrowing now to finance that. And for, you know, hopefully for a lot of companies it will work out, but it might not work out for everybody. And like you said, I think it's important to discuss what the risk factors are. You mentioned CoreWeave, just like Liz Ann, I, you know, I'm not a bond analyst at an issuer name, and I don't cover CoreWeave or anything like that, but just objectively it was a junk-rated issuer. So when you think about concerns with a sub-investment-grade issuer, that happens when you have those junk ratings. You know, a junk-rated issuer sets ratings BB or below, usually they already have high leverage. They might have volatile cash flows. There can be a number of reasons why they have those low ratings. And with low ratings come usually more volatility. They might be more sensitive to rising interest rates, which is the environment we're seeing right now.

So you can't necessarily paint the picture with it with a broad brush because not everyone is the same, you know. For a lot of the so-called hyperscalers, those are investment-grade issuers that have diversified business lines, and their debt relative to their earnings, you know, aren't really at concerning levels, even though they've issued so much. So it's important to understand each bond, each issuer, and what those risks are. And like anything, you know, there's no free lunch. And if you see a high yield offered, usually there's some risks there. And that's why we talk about the investment-grade corporate bond market, the high-yield bond market. Doesn't

mean one is good or bad, but that's why those they have their credit ratings, which are an indication of risk, and why you earn, you know, higher yields by some magnitude over the perceived safety of Treasuries, given those mixtures of risks.

So Liz Ann, let's look ahead to next week as we always do. So what is top of mind for you and what should our listeners be paying attention to?

LIZ ANN SONNERS: Well, I won't steal your thunder. We know we have a Federal Open Market Committee meeting, FOMC meeting, so I'll let you weigh in on what you think's going to happen there. And tied to that we also get, although after the meeting, I think, the Personal Consumption Expenditures price index, which is the Fed's preferred measure of inflation. So interesting timing there.

We also get a whole bunch of regional Fed surveys. We get durable goods. We get some more home price or housing data, I should say. It's not been great lately. we get home prices next week and also home sales. So given the move up in mortgage rates, that is something to keep an eye on. We get consumer confidence and some trade figures. And we also get personal income and spending. And then I think it's toward the end of the week we get the first look at third quarter GDP, gross domestic product.

So talk FOMC, Collin.

COLLIN MARTIN: Well, first I'm glad you mentioned the housing data. I think that's important. We've seen this big jump in mortgage rates. So mortgage rates had already kind of been elevated relative to the past, you know, call 15 years. They picked up a little bit recently, then they kind of turbocharged even higher. So it'll be really interesting to see how that's flowing through to the more and more housing data we get.

But as you said, yeah, we have the Federal Open Market Committee meeting next week. We don't expect any change to policy. So we expect the Fed to hold the rate in the 3.75% to 4% area right now. Importantly we will not get updated economic projections or a dot plot. That's something that we get at every other meeting. We got it in September. We won't get it next week. So we won't have too many specific things to point to in terms of expectations or about where various Fed officials see the path of policy going forward.

What we'll be focusing on, I think, first is whether or not the decision is unanimous. I'm not sure if it will be because we know there's a few hawkish committee members, some voters, hawkish meaning they are worried about inflation and might feel the need to act. So I think we could have a dissent or two in favor of a

hike, knowing that, you know, they hiked last month, and if you look at the inflation data, it really hasn't cooled. You know, so I, you know, it's aside from kind of the idea that they want to take a patient approach and see how the outlook evolves, the outlook hasn't improved. So there might be an official or two who actually dissents.

And then of course we'll be paying attention to how Fed chair Kevin Warsh describes the economic outlook, if at all. I think, you know, we're starting to hear more from him, you know, we got that at his Jackson Hole speech. So maybe we'll hear a little bit more about how he's viewing the economy. I don't expect any forward guidance, of course. I don't think he'll tell us what he plans on doing down the road, but I'm hoping for something in terms of you know, has inflation improved or held steady or is he more concerned now than he was? Those are the sort of things we'll be looking for.

You know, building on what you mentioned, the Personal Consumption Expenditures, the PCE report, comes out the next day. That's going to be really important. It's all about inflation right now, and that should be the key driver of Fed policy going down the road. So we're going to be looking at the core monthly readings. Expectations right now are for core PCE to rise by 0.3% month-over-month. That'll be a little bit too hot, I think, for officials. And then of course the diffusion index. This is something that Kevin Warsh is paying attention. It's not just the one number we see. He wants to take a look under the surface about the share of subcomponents rising at a 3% annualized rate. So we're going to, you know, hopefully we'll get some improvement there. But if, you know, if we start to see upside surprises, or we see that breadth kind of stay where it is and not really improve, you know, the likelihood of more rate hikes should be high. So even though we expect a pause next week, we do expect a hike by year end in December and then another one sometime in early 2027.

You touched on all the other main releases. I think GDP will be interesting. You know, the advanced release for the third quarter, there's always a lot of revision, so it's ... I don't read too much into it, but I'll be paying most attention to the consumption numbers, if consumers are still consuming. And then, you know, non-residential investment to see how businesses are spending.

LIZ ANN SONNERS: And you know, I'm glad you mentioned that. Non-residential fixed investment is the line item in GDP that is business capital spending. What I'll also be watching is the import-export relationship, because a lot of what is being purchased for the build-out in AI are imports. That does not accrue to the benefit of GDP because it's a net-exports reading. So it's interesting that we've had these booming capex numbers, but a little bit of an offset that has come from that import-export trade relationship.

COLLIN MARTIN: That's it for this week, Liz Ann. For our listeners, thank you all for listening. As always, we really appreciate it. You can always keep up with us in real time on social media. As Liz Ann just mentioned, there's a lot of funky things that go on with these releases. So GDP, for example, we'll try to post some updates there. I'm @CollinMartinCS on X and LinkedIn. That's Collin with two Ls, and the CS is for Charles Schwab.

LIZ ANN SONDEERS: And I'm @LizAnnSonders on X and LinkedIn. Here's my usual PSA. Make sure you are following the real me and not an AI bot of me. And you can find all of our written reports, including lots of visuals always, charts, graphs, tables, you name it. And they can be found at schwab.com/learn.

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