SK Market Insights

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Paradigm Shift

▼ Summary

- **The US Federal Reserve is committed to achieving its target inflation rate of 2% through additional rate hikes**
- **The recent rally in growth stocks did little to assure the Fed that their rate hikes are cooling the economy; the market expects an additional 75 bps of rate hikes by September 2023**
- **US 10yr Treasury yields are unlikely to see any further weakness for now and could test the October 2022 high of 4.33%**
- **With commodities on the verge of a secular bull market, inflation could be here to stay**
- **We are likely moving to a period of single-digit US equity market returns for a while with bonds offering shelter and attractive returns**

▼ The US economy remains resilient with further rate hikes expected

The US Federal Reserve is on a mission to tame inflation in the US economy and is committed to doing what it takes to achieve its target rate of 2%. Last year, **the Fed embarked on what has been the fastest rate hike in recent history**, bringing the current Fed Funds rate in the range of 4.5 – 4.75%. While preliminary results from the CPI data for November and December 2022 showed promise, **the economy continues to show resilience, for now**. Retail spending is at a record and unemployment remains firmly around 3.4% despite news of layoffs at various businesses. These **figures do not give the Fed any reason to slow down rate hikes** in the foreseeable feature. Further rate hikes are anticipated with the market expecting an additional 75 basis points by September 2023. The most recent rally in growth stocks in January /

February 2023 did very little to assure the Fed that their rate hikes were helping cool the economy.

▼ Global liquidity, investor optimism and hopes of a Fed pivot are holding up the market

So **what is holding up this market**? There are **a number of factors**, most notably **global liquidity**, despite the US Fed reducing its balance sheet. Another is the **optimism of investors**, given the strength of the economy and the jobs market. However, this is exactly the reason why the Fed is unlikely to either pause or pivot soon. Under the hood, data may offer some relief such as the rise in credit card delinquencies and a wall of corporate debt, borrowed previously at much lower interest rates, falling due in 2024/25. It is the **fervent hope of the market that the Fed will pause or even pivot** before this debt comes up for renewal at much higher rates, thereby avoiding highly leveraged companies from bankruptcy. Absence of a pause or pivot could be a trigger for a recession.

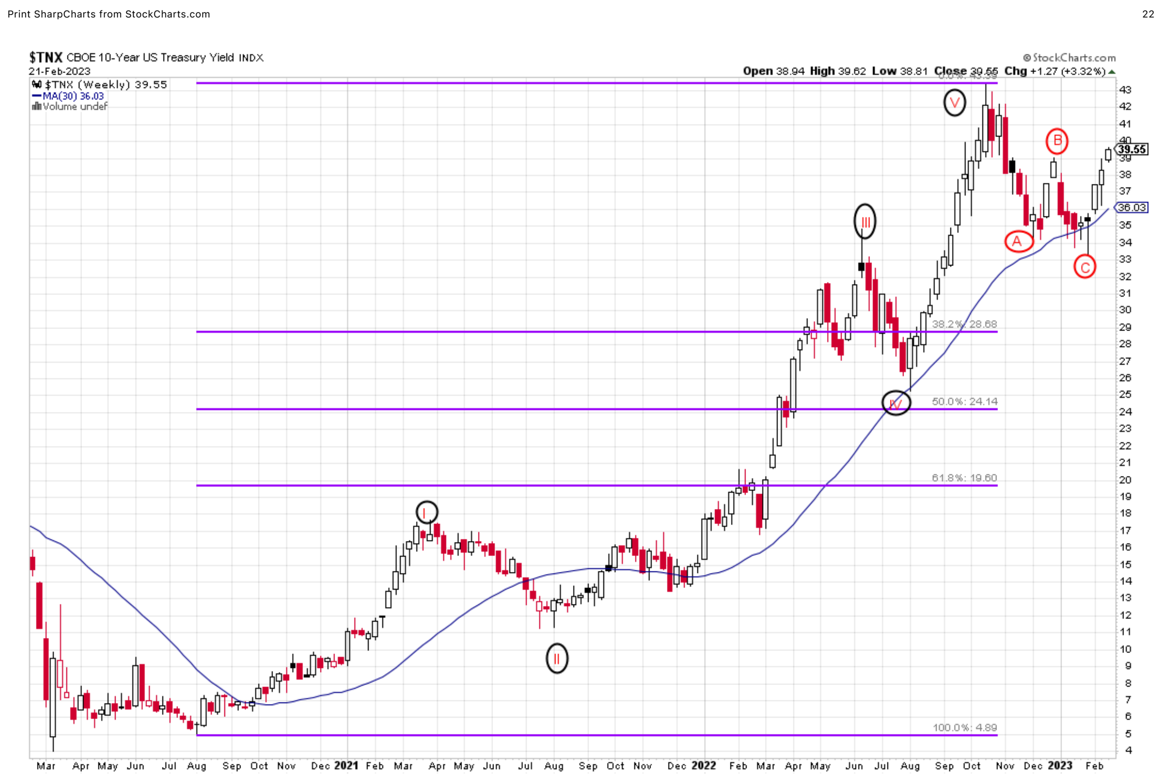
▼ US Treasury yields unlikely to see any further weakness for now

Now let us see what the charts have to say. Starting with the US 10 yr. Treasury yield chart below (Figure 1), my earlier forecast last month was for yields to correct to a level of between 2.9-3% as shown by the labels A-B-C. However, the "C" leg did not quite make it to this target. Instead, an intra-week low occurred at 3.3% while yields held the 30-week moving average. This was also earlier support in Aug 2022. The underlying message from this movement is that **rates are firmly supported for now and unlikely to see any further weakness.** This is confirmed by the economic data so far.

Following a test of the 30-week moving average, yields have moved higher, surpassing its prior high at "C". This implies that **the bond market expects the Fed to further increase rates** which in turn will, in all likelihood, lead the 10 yr. yield to test the October 2022 high of 4.33%. Up until now, the Fed funds rate was moving higher on its own while the Treasuries were not quick to follow. Now, **the bond market has literally "thrown in the towel" and joined the Fed funds rate on its move**

higher. It remains for the stock market to fall in line with the bond market and the Fed.

Figure 1: The US 10-year treasury yield has corrected but is unlikely to correct any further for now



Source: SK Market Insights, StockCharts.com

▼ With Commodities on the verge of a secular bull market, Inflation will likely remain high in the next decade

It ought to be clear to the readers by now that **inflation is here to stay.** The Fed funds rate is now expected to move higher in the range of 5.25-5.5% by September, assuming three 25 basis points hike between now and September 2023. This **may cool the economy somewhat**, however, events in the commodity markets may make this victory pyrrhic.

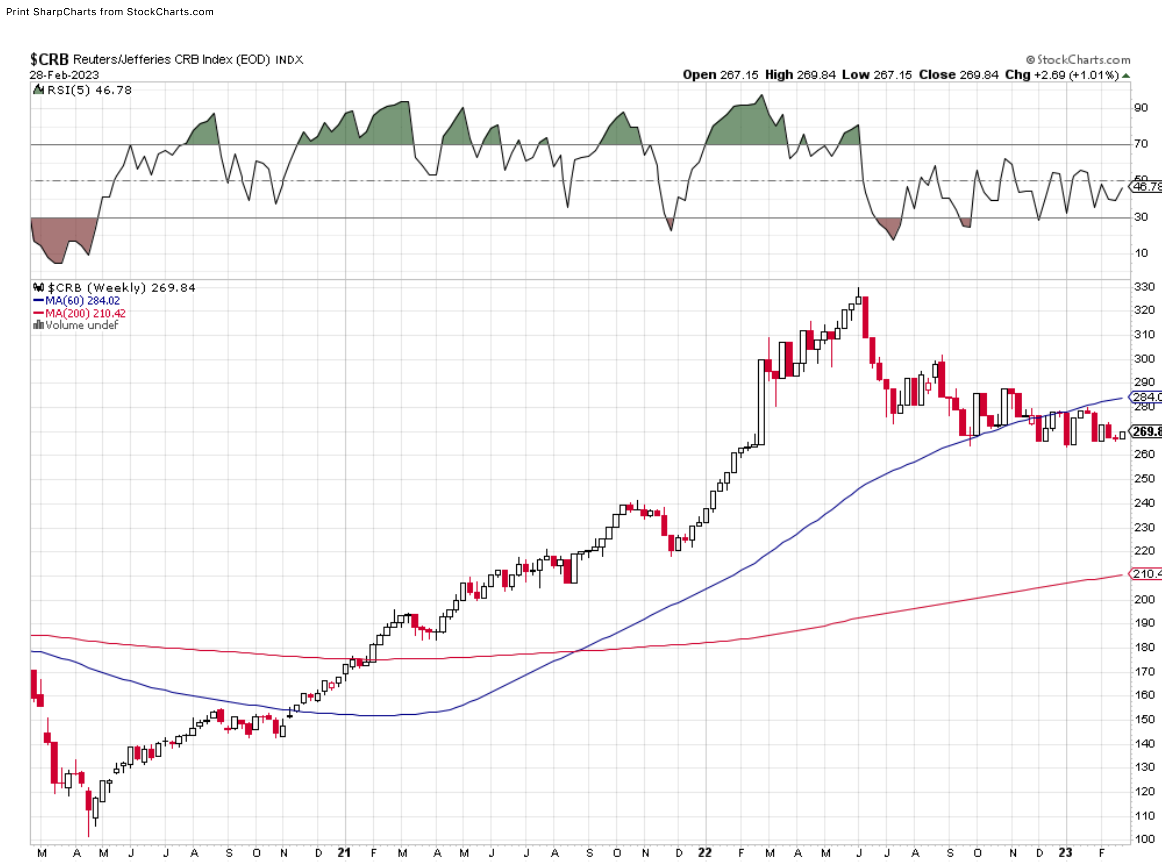
To understand this better requires a look at a weekly chart of the Commodity Index shown further below.

The **chart below represents a basket of commodities** from agriculture to energy, base metals and precious metals. Readers will be aware that energy was the outstanding performer in the S&P500, in both 2021 and 2022, and remains well supported. Other commodities have flat lined in the meantime. Hence a chart of commodities is essentially a proxy for energy. With that view, an examination of the weekly chart below reveals that **this index is firmly supported between $260-270 since September** of 2022 (Figure 2). Even more interesting is the relative strength chart above it, showing that each successive attempt to push this index lower has been weaker, meaning higher lows of the RSI.

With the index well supported here **it may be just a matter of time before it moves higher** based on global energy supply/demand fundamentals. Oil producing companies in the U.S. have now discontinued prospecting for new sources of oil and instead are focusing on returning cash to shareholders in the form of higher dividends and share buybacks. Further, even if the Ukraine war were to end it would take a long time before sanctions are lifted on Russian supplies. Finally, the U.S. will at some point have to refill depleted reserves in the Strategic Petroleum Reserve which has experienced considerable drawdown in the past year. This sets itself up for a "perfect storm" as western economies attempt to increase reliance on renewables. **We may well be in a secular bull market for commodities** as global demand for energy increases, an observation shared by others on Wall Street.

So what does this all mean for investors? Inflation will likely remain high in the next decade. The U.S. Fed may well have to revise their target rate upwards to 3% from the current 2%. There will of course be ups and downs, as in any market, and **readers may well benefit from the higher returns offered by a range of bonds** starting with US Treasuries.

Figure 2: The Commodities index is will supported between $260-270 and it may be just a matter of time before it moves higher



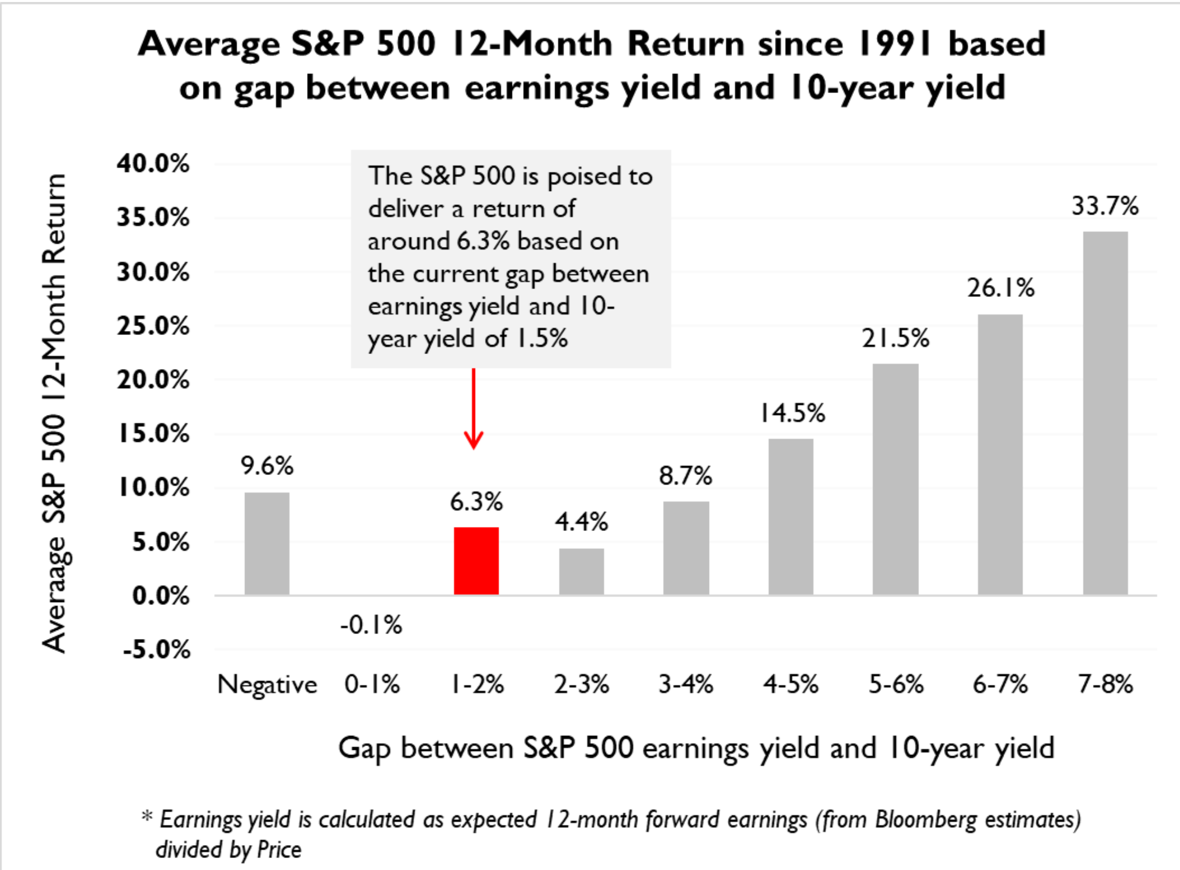
Source: SK Market Insights, StockCharts.com

▼ A paradigm shift for the US Equity market: equity returns will remain in single digits

This is a paradigm shift from the last decade. **Equity returns in such an environment will remain in single digits** as shown by the chart below (Figure 3). The x-axis here is the gap between the S&P500 earnings yield less the yield on 10 yr. U.S. Treasuries and the y-axis represents the corresponding S&P500 returns. As an example, the most recent consensus estimate of 2023 S&P500 earnings is around $222. With the SPX close on Friday March 2nd of 4045, this results in an earnings yield of 5.49%. Comparing this with the 10 yr. U.S. Treasury yield of 3.96% as at last Friday's close, we arrive at a difference of 1.53%. This then corresponds with a gap of between 1-2% on the x-axis and the associated return on the S&P500 is estimated to be around 6.3%.

As this differential decreases, so does the return on the S&P500. It stands to reason that **during periods of high inflation investors seek the safety of risk-free bonds.** In contrast, prior periods of negative to zero interest rates in the Western world enabled double digit returns on equity as there was no alternative (TINA). This is shown by the grey bars moving towards the right of the chart along the x-axis. If this trend continues, **we may well be moving to a period of single digit equity returns for a while with bonds offering shelter and attractive returns.**

Figure 3: Why growth vs. Yield Matters or why US Equities are poised to deliver low single-digit returns for a while



Source: SK Market Insights, eToro, Bloomberg

Please feel free to contact me for any further questions or clarification.

With Compliments,

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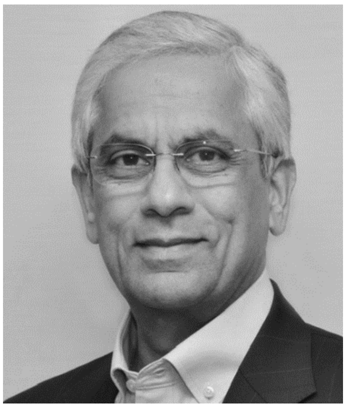
Sowmi is a Chartered Market Technician (CMT)and a member of the CMT Association, N.Y., U.S.A.; as well as an Associate Member of the Society for Technical Analysts, U.K. After completing a 35 year career with Mobil/ExxonMobil in a variety of roles in the across U. S. A., Asia Pacific and Europe, including an 8 year stint in a number of oil trading roles for Mobil in Asia Pacific, he has decided to embark on a new career in technical analysis, leveraging on his prior experience. In addition to his CMT, Sowmi has a Ph. D in Chemical Engineering and an M. B. A. in Finance. He is an avid sports enthusiast and has a keen interest in golf.



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