SK Market Insights

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The near-term outlook for 10 year US Treasuries and its implications for the broader market

▼ Summary

- **The rise in US 10 yr. Treasury yields since August 2020 is about to take a breather** reflecting a pause in inflation expectations in the coming months. A correction in the uptrend for yields is likely to trigger a counter trend rally in the bond market.
- **Lower yields could also have a knock-on effect on the US Dollar** which has remained strong until now. A weaker dollar could trigger a long overdue **relief rally in emerging market equities, US large caps with international earnings exposure and US real estate**. A weaker dollar would **also be a tailwind for commodities as they are priced in dollars.**
- **A relief rally in US equities with demonstrated earnings capability**, low debt/equity ratios, strong cash flow and sound balance sheets **is also likely as we head towards the end of 2022**.
- **Caution is advised on the longer-term outlook beyond three months** due to an increasing likelihood of a US recession. Moderation of inflation may cause the FED to pause rather than to pivot to achieve their unemployment target of 4.4%

▼ Analysis

Central to the current analysis are the actions taken by the Federal Reserve to fight inflation. Results up to date have not been encouraging as inflation in the US continues unabated despite several rate increases. In all likelihood, another rate hike of 75 basis points at their November meet is all but confirmed. The Fed is data driven, however, this data is backward looking. Markets, on the contrary, are forward looking and operate with up to the minute data. The bell weather US 10 yr. Treasury, a consensus

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of market expectations, appears to indicate that the current rally in yields may be coming to an end as the following analysis shows;

The following chart shows the progression of US 10 yr. treasury yields since 2020 as viewed through the lens of a technical analysis method known as Elliot Wave Analysis (R N Elliot, 1938). Elliot viewed price progression in waves that followed a certain Fibonacci sequence, the latter being a commonly used method on Wall Street to measure price retracements. Elliot propounded that uptrends were in a five wave sequences and could be measured using Fibonacci ratios. Applying this theory to the movement of 10 yr. yields in the chart below we find that a five-wave sequence that began in August 2020 with yields at 0.05% has recently been completed in the past week at a peak of 4.33% (Figure 1).

Figure 1: US 10 yr. treasury yields have completed a five-wave sequence that began in August 2020

Source: SK Market Insights, StockCharts.com

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On completion of a five wave sequence prices retreat in a three-wave corrective sequence and this can be expected with yields going forward. Targets for the corrective sequence can be established using Fibonacci retracements again and these are shown as horizontal lines on the chart. The time period for this corrective sequence can be anywhere upto 1/3rd of the time taken for the entire rally from August 2020 to date (27 weeks) and a minimum target of 3% at the 38.2% retracement, is likely.

▼ Near term implication of a pause in rate hikes

A correction in US 10 year yields could cause the FED to pause and would be favorably viewed across most asset classes in the market. Bonds are likely to stage a much-awaited relief rally from a very oversold condition. Lower yields would result in a weaker dollar, particularly as Europe is still on a rate hiking cycle. A weaker dollar would provide much needed tailwind for emerging markets, large cap US equities, particularly those with pricing power, strong cash flow and balance sheets and low debt/equity. Commodities would also benefit from a weaker dollar, particularly, oil, agriculture and to some extent base and precious metals.

From a sector analysis of the US equity markets shown below, defensive sectors will continue to outperform in the current environment. Sectors that have performed well in the past year will continue to outperform going forward due to persistence of momentum. Energy, staples, healthcare and utilities will continue to outperform as the likelihood of a recession increases. These are also sectors that pay a good dividends that investors seek in the current environment.

Energy has been the best performing sector so far with annual return of 77.6% (Figure 2) due to a number of favorable tailwinds. Demand for oil is likely to increase as economies come out COVID lockdowns and regulatory requirements have discouraged oil companies in the US to explore for reserve replacement. They have instead decided to return cash to shareholders. This has played well into the hands of OPEC which will use its newfound leverage to maximize the return on their assets and is likely to result in higher oil prices.

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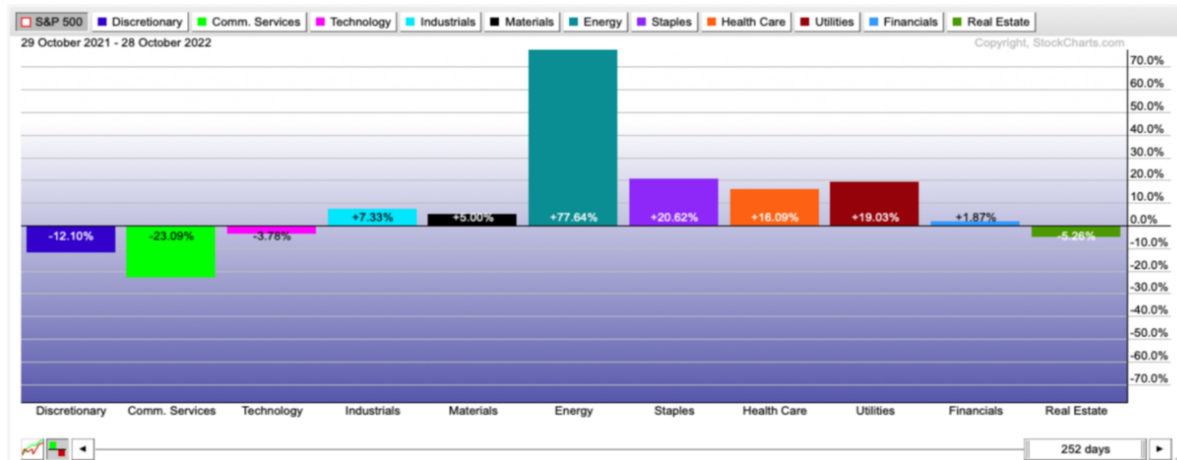
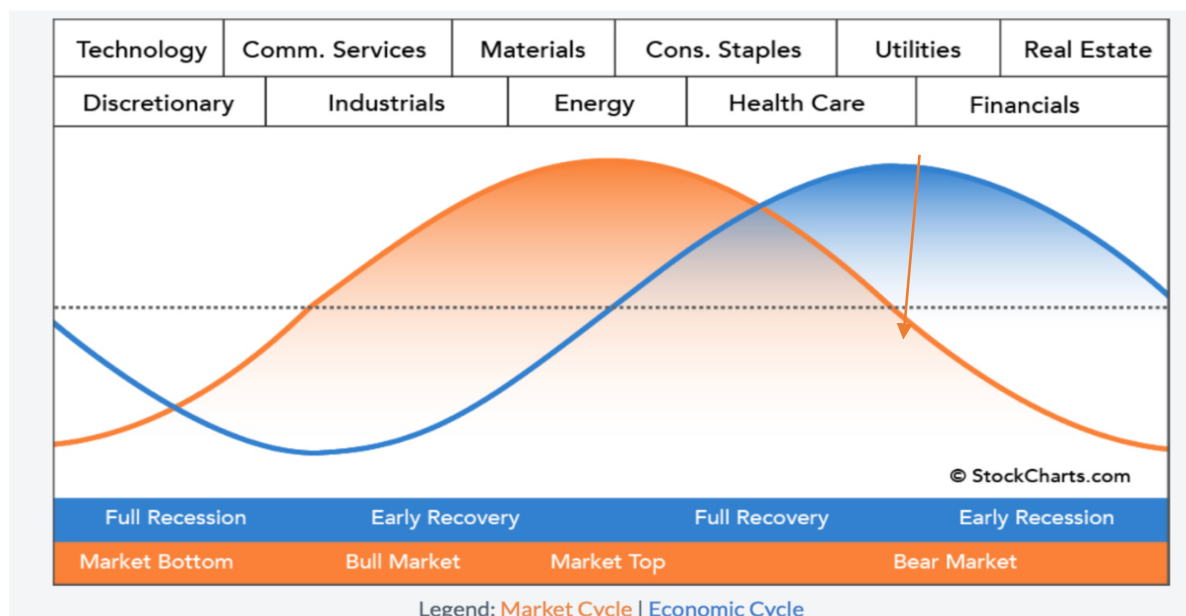
Figure 2: The Energy Sector is the best performing sector this year with annual returns of 77.6%



Source: SK Market Insights, StockCharts.com

▼ Where are we in the economic cycle?

The following chart originally produced by Sam Stovall is useful in identifying where the US is in its economic cycle. Current estimate is shown by the arrow and lines up quite well with the sectors (shown above the arrow) that are currently performing well.



Source: SK Market Insights, Sam Stovall, StockCharts.com

▼ Conclusion

We remain in a bear market for US bonds and equities as prices make lower highs and lower lows. Searching for a bottom could be an exercise in futility as prices adjust to the new reality of higher interest rates. Companies with no demonstrated earnings potential as well as those that miss earnings have been severely punished. In a high interest rate environment what really matters is stable cash flow, dividend potential, pricing resilience and low debt/equity. The two assets that have shown a positive return year to date are the US dollar and energy.

In this environment, market rallies are to be viewed as counter trend until the US Federal Reserve is convinced that it has inflation under control. Further downside in Q1 2023 appears to be the base case as a recession-led earnings compression results in lower prices for equities. Tradeable rallies occur in bear markets to relieve oversold conditions and we could expect one in the near term as we enter a seasonally strong period for equities. This aligns itself with a pause in interest rates as described earlier. Rallies should therefore be viewed as opportunities to liquidate long positions rather than initiate new long positions. Defensive sectors such as staples and healthcare are expected to outperform in such an environment along with energy which is expected to continue as a star performer.

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

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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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