Cetera® Investment Management

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Commentary

The Temperamental Era Hits Stocks, Too

- Global bond yields have pushed to their highest levels since the mid-2000s this week, and stock prices have started to fall as a result.
- We view the stock pullback as a valuation reset driven by higher discount rates, not a break in the fundamentals.
- Volatility is a reason to lean into quality and income, not to run for the exits.

We wrote last month that bonds were the ones having the tantrum in this Temperamental Era, our term for a market that trades on headlines, not trends. Recently, stocks joined in.

Global yields have been climbing. Last week, the 10-year Treasury yield pushed above 5.2%, its highest level since 2007, and the 30-year Treasury yield rose above 5.5%, a level last seen in 2004. It isn't just a Washington story either. German, French, and Japanese long bonds are all sitting at multi-decade highs of their own.

A cluster of factors is driving the move higher, and they're pulling in the same direction:

- **Geopolitics**. Renewed friction in the Middle East resurfaced this weekend after the White House rejected a Tehran proposal to reopen the Strait of Hormuz, and Brent crude traded well above $100 a barrel. Energy shocks feed directly into inflation expectations, and inflation expectations feed straight into long-end yields.
- **Lack of Forward Guidance from the Fed**. In the past, the Fed would signal its next move ahead of time and markets would calm down and wait. Under new Chair Kevin Warsh, that road map is gone, so every data point and every headline forces the market to guess on its own, and each guess shows up as a bigger swing in yields.
- **Weak Demand at the Auction Window.** Last week's five-year Treasury auction priced at its highest yield since 2006 with soft participation, and the seven-year auction that followed was lackluster as well. Investors are telling Washington that higher yields are needed to clear the growing pile of new supply.
- **Data Still Running Hot.** Last week's S&P PMI readings and other data show the economy still has fuel in the tank, giving the Fed less cover to ease.

For weeks, equities mostly shrugged off the bond market's turbulence. Cyclicals, financials, and small caps lagged, but the S&P 500 held near record highs as mega-cap growth and semiconductor names carried the index, a sign the market was reading the yield move as a growth story rather than an inflation scare. That decoupling has recently broken down. As the 10-year Treasury yield pushed through the roughly 5.25% level that would be considered the real pain point for stocks, the selloff broadened. The Dow, S&P 500, and Nasdaq all fell today, and software and semiconductor stocks, among the most richly valued corners of the market, were hit especially hard. Think of it this way: if you were shopping for a car and the sticker price just dropped 15%, you wouldn't call that bad news. Instead, you would call it an opportunity to buy. Bond prices and yields move inversely, so a rising yield is, in essence, a discount. For investors who hold to maturity, that higher yield is locked in regardless of near-term price swings.

The mechanics are the same ones we've been highlighting in bonds. Stock prices reflect the present value of future cash flows, and discounting those cash flows at a higher rate mechanically produces a lower number today. That math is least forgiving for long-duration growth stocks, since more of their value sits far out in the future, which is also why software, semiconductors, and other high multiple corners of the market have led this recent leg of the selloff.

With that said, it's not all bad news:

- **Income Is Back.** For income-focused investors, retirees, and anyone living off portfolio yield, current levels are genuinely attractive, something we haven't been able to say for most of the past decade.
- **The Fed Gets Help**. Higher borrowing costs slow growth on their own, which can take some of the inflation-fighting burden off the Fed.
- **Valuations Get a Reset.** A pullback in the market's most expensive corners gives us a chance to rebalance into quality names at better prices, rather than chasing a narrow group of leaders.

A few catalysts could take the pressure off both bonds and stocks:

- **Clarity on Iran.** A durable deal to reopen the Strait of Hormuz would remove a real risk premium currently baked into oil prices, and by extension, into inflation expectations.
- **Fiscal Restraint.** History offers a tailwind here. Post-midterm years, especially with a likely split government based on current prediction markets, tend to bring less deficit spending simply because political gridlock makes big new spending harder to pass.
- **Fed Credibility.** If the Fed reinforces its inflation-fighting credibility, through words or action, that could anchor expectations and pull long-end yields lower, as well as relieve the pressure on stocks. In fact, if the Fed proves to raise rates less than the markets currently expect over the next year, yields could retreat.

Rising yields and falling stock prices feel uncomfortable in the moment, and nobody enjoys watching both sides of a portfolio wobble at once. But discomfort and opportunity often look identical in real time. We're using this stretch to add income at yields we haven't seen in years and to rebalance into quality equities at more reasonable prices, not to run from either market. Stay diversified, stay disciplined, and remember in the Temperamental Era, the best returns usually go to those who buy the mood swing, not the ones who react to it. Please contact your Cetera

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