STOCK MARKET IMPLICATIONS OF BONDS' MARGIN CALL

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The bond market has had a rough two years.

The Bloomberg U.S. Aggregate Bond index started slipping, albeit gently, in August 2020. Last year the grind continued, with the index declining by a not frightful but annoying 1.7%.

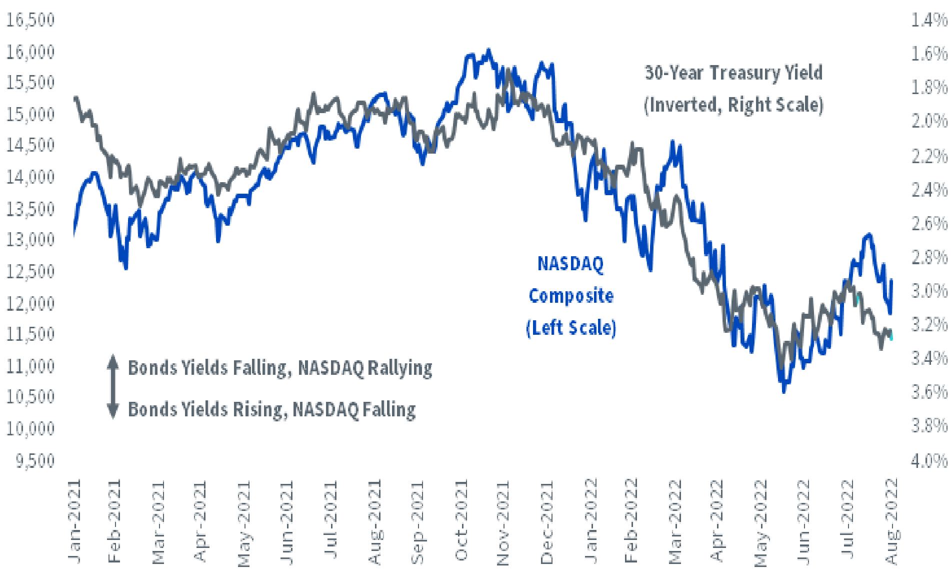
Then came 2022.

With the index down by more than 10% this year, bond investors are bracing for a portent that has been rare, at least for as long as I've been in this business: three quarters in a row of red ink in the fixed income page of the brokerage statement. It may or may not come to pass—bonds were down 0.06% in July and August, so a little rally in bonds in September would end the streak.

Nevertheless, 2022 has been weird. In "normal" times, bonds would be expected to thrive in a weakening economy. But this year, that old truism has been thrown out the window.

The NASDAQ is taking its cue from the long bond yield. It's down 23%, and the S&P 500 Growth index is tracking it with a 21% loss. This puts the relative haven status of the S&P 500 Value Index, which is down "only" 7%, into perspective.

Figure 1: The NASDAQ Is Tied to Bond Yields



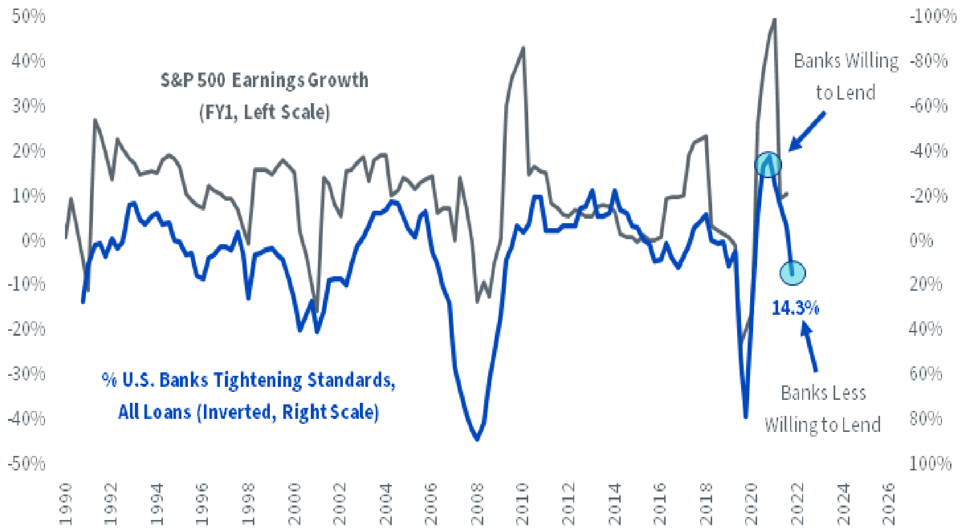
Source: Refinitiv, as of 8/30/22. Past performance is no guarantee of future results. An investor cannot invest directly in the Index. 30-Year Treasury Yield: A U.S. Treasury debt obligation that has a maturity of 30 years.

Stock market earnings look suspect. I think that is a problem for the very high beta stocks that tend to populate growth baskets.

Consider this. The New York Fed's Q3 Senior Loan Officer Survey found that a net 14% of U.S. banks are tightening their lending standards. In figure 2, we can see three episodes over the last quarter-century in which that metric has deteriorated from net easing to a net tightening of this severity. Those episodes were in 2000, 2007 and 2020—all good times to make a prediction that earnings would decline.

Granted, I don't know if making a comparison to the global financial crisis is warranted at this stage of the game, so take this with a grain of salt. Nevertheless, a scenario that sees S&P 500 earnings growth declining in 2023 is plausible, reasonable and possible.

Figure 2: Tightening of Bank Lending Standards Bodes Ill for S&P 500 Profits



Sources: Refinitiv, New York Fed, as of Q3/2022, with I/B/E/S earnings data as of Q2/2022. Past performance is no guarantee of future results. An investor cannot invest directly in the Index.

Should that come to pass, we would have a situation where the entire yield curve may be following the Fed higher on rates, while at the same time, equity investors are finding little solace in earnings reports.

We don't know if current relationships will hold, but it seems to me that if the bond market wants to sell off and S&P earnings want to lay an egg, then growth stocks are a problem child in 2023.

In other words, growth stocks are now the anti-diversification, pro-concentration asset class. As the bond market receives its proverbial margin call, there may come that time that every investor dreads: scanning the holdings list for something to sell.

If it's the Bloomberg Aggregate that gives investors headaches in the coming months and years, it might just be the NASDAQ-style holdings that meet the sell button. If the bond market's action continues to punish growth stocks, our dividend strategies may represent something of a shelter.

Unless otherwise stated, data is as of 8/30/22.

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DEFINITIONS

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Bond : A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

Nasdaq 100 Index : Includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies, including investment companies.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Stock : A stock (also known as equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."

Senior Loan Officer Opinion Survey on Bank Lending Practices (SOSLP) : A quarterly survey of up to 80 large domestic banks and 24 branches of international banks. Conducted by the Federal Reserve Board, the survey is completed in time to be discussed at Federal Open Market Committee (FOMC) meetings. 1

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

Bloomberg Aggregate Bond Index : The Bloomberg Aggregate Bond Index or "the Agg" is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.