ROBERTSON STEPHENS®

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Macro Data, Interest Rate Volatility and Stock Market Reactions Around the World

Equities and Discount Rates

Last week, equity markets saw a strong rally, marking the S&P 500 Index's best weekly return since June 2023. A decrease in longer-term interest rates over much of the week provided support for growth stocks by reducing the implied discount on long-duration future earnings. Smaller-cap stocks outperformed large-cap stocks in this "risk on" regime, narrowing in part the significant year-to-date gap with large-caps.

However, August brought the Index's first monthly loss since February, indicating a mixed performance. The market rally declined towards the end of last week as bond yields climbed, partly due to a strong manufacturing report offsetting optimism generated by jobs data. The jobs report depicted a labor market in a controlled slowdown phase. Given the interest rate implications, we believe the week appeared to be one in which bad news for the economy was considered good news for stock prices. On Tuesday, the S&P 500 Index recorded its best one-day gain since June, following news that job openings unexpectedly fell by 338,000 in July and hit their lowest level since March 2001. Job quits, considered by some to be a more reliable indicator of the strength of the labor market, also fell considerably.

Bond Prices and yields move in opposite directions

In sum, investors believe this moderation in labor dynamics allows the Federal Reserve room to consider pausing rate increases this month while keeping future options open. In the bond market, auctions of Two- and Five-Year Treasury notes recorded the highest yields since before the 2008 Financial Crisis, reflecting a broader bond market selloff ahead of another potential Fed rate increase. While short-term Treasury yields decreased considerably over the week, the yield on the benchmark 10-year U.S. Treasury note increased on Friday morning, leaving it modestly lower for the week.

Europe

The pan-European STOXX Europe 600 Index ended 1.49% higher on expectations that interest rates would soon peak and that a recession, while possible, would likely prove to be shallow and short-lived. Stocks also appeared to receive a lift from China's efforts to bolster its economy. Major stock indexes in France, Germany, Italy, and the U.K. also advanced.

European government bond yields edged lower as core inflation data and comments from policymakers suggested that the European Central Bank (ECB) could be nearing the end of its monetary policy tightening cycle. The yields on 10-year government bonds issued by France and Germany ticked lower.

Japan

Japan's stock markets gained over the week, with the Nikkei 225 Index rising 3.4% and the broader TOPIX Index up 3.7%. Some weaker-than-forecast U.S. economic data releases boosted expectations that the U.S. Federal Reserve was getting closer to halting its interest rate hiking cycle, supporting sentiment. Investors also welcomed China's latest measures to boost its markets and economy.

What We Are Watching

With the S&P 500 now up year-to-date ~19%, and non-U.S. equities up ~9%, any diversification from equities this year has been a portfolio drag. On a rolling 90-day basis, the correlation between stocks and bonds (S&P 500 and the U.S. Aggregate Bond Index) has gone from as high as +0.53 (positive correlation) in November of 2022 to as low as -0.38 (negative correlation) in July of 2023 (both the high and low of the last ten years) and now sits at +0.12. When Treasury yields rise (prices fall), that is helping support the U.S. dollar. Conversely, when Treasury yields fall (prices rise) that is causing the U.S. dollar to see selling pressure.

We believe high quality fixed income and the U.S. dollar in time will be risk-off beneficiaries and both have struggled this year in a more risk-on environment.

Equity markets seem to stabilize when yields stop heading higher. This investor pattern seems to support the view that the main near-term threat to "risk on" markets is the potential for bond yields to rise further (due to sticky inflation), rather than a pivot into a recession. In a recession, investors typically expect the Fed to cut rates (price up / yield down) to stimulate activity.

In a resilient economy, with higher oil prices (Brent crude rose to $90.04 a barrel, closing above the $90 mark for the first time since November 2022) and a stable housing market, inflation is more likely to be sticky above the Fed target of 2%, and the "Fed Put" (cutting rates) seems less likely. Therefore, a risk is higher bond yields (lower prices) and lower P/E ratios (due to higher discount rates).

Portfolio Considerations

Data continues to point to a resilient U.S. economy. While we believe that there is a heightened level of risk to an economic slowdown, the strength of the labor market in the U.S. remains a core pillar, albeit a lagging indicator. As a result, we remain intentionally focused on high-quality fixed income that is below benchmark duration and modestly diversify our equity allocations to include high-quality equities with a history of growing dividends.