What if US Treasury Yields Fall? A Contrarian View – Market Commentary

September saw broad declines across global equity markets as yields on US Treasuries climbed again. Apart from driving asset prices lower there were the customary second order effects i.e. in a rising rate environment Value shares would be expected to outperform Growth shares.

Emerging Markets outperformed Developed Markets, though for the year-to-date these are still far behind Developed Markets.

With marginal ZAR appreciation the USD return for the JSE was in line with Emerging Markets. This was due to positive Resources returns while Financials and Industrials were weaker and in line with Developed Markets declines.

In the US the S&P 500 and the Nasdaq were in line, though as mentioned above, on a global basis MSCI Value outperformed MSCI Growth, with both also declining.

These various results are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for September 2023*

	Sep-23	YTD 2023
FTSE/JSE ALSI (ZAR)	-2.5%	2.2%
FTSE/JSE ALSI (USD)	-2.1%	-7.7%
MSCI World	-4.3%	11.1%
MSCI EM	-2.6%	1.8%
MSCI Value	-2.8%	2.0%
MSCI Growth	-5.7%	20.9%
S&P 500	-4.8%	12.7%
Nasdaq 100	-5.0%	35.4%

*Total return indices, Source: Factset

September saw US Treasury Yields rise again, approaching 5% for longer durations. This appeared to be due to a "higher for longer" narrative taking hold. Further, as discussed in our previous month's commentary, Bill Ackman, a well-known US investor had publicly announced his negative views on US Treasuries and associated short positions. Recent developments appear to be proving him right.

We suggest here a possible different scenario. If there is an economic slowdown in the US Treasury yields can be expected to contract rapidly.

How likely is an economic slowdown?

Last month we considered US monetary policy and suggested this to be extremely restrictive due a contraction in money supply and higher short term and long term rates. The real interest rate on US Treasury Inflation-Protected Securities is now 2.24%, a level last seen during the Financial Crisis.

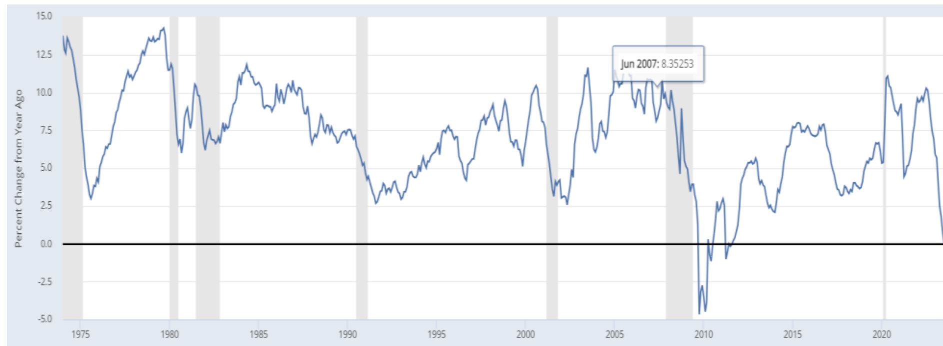
In spite of, it seems, never-ending public debates and crystal ball-gazing of a hard landing, soft landing, no landing, we are seeing increasingly ominous signs.

We discuss here a contraction in bank lending, negative savings and a sharp rise in bankruptcies.

Bank lending

Bank credit extension is a key indicator of economic activity and spending. It is presented in Chart 1 below and has recently contracted.

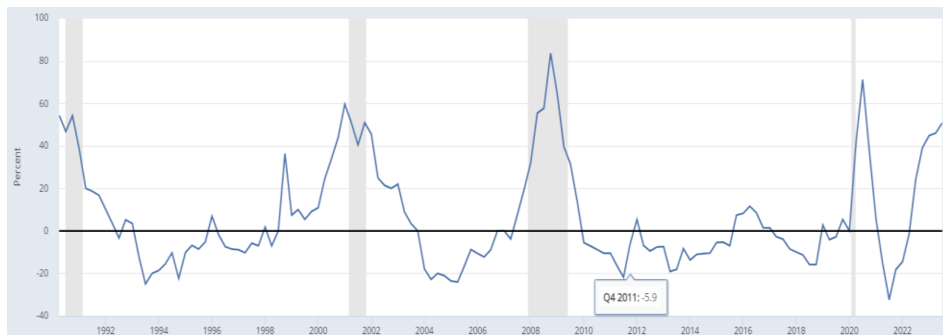
Chart 1. US bank lending % change on a year ago



Source: St Louis Fed, FRED

The only other period of similar contraction in credit extension in 50 years occurred during the Financial Crisis. Reasons for this include lack of demand due to high interest rates, but also likely bank caution. Banks have tightened credit standards, presented in Chart 2 below.

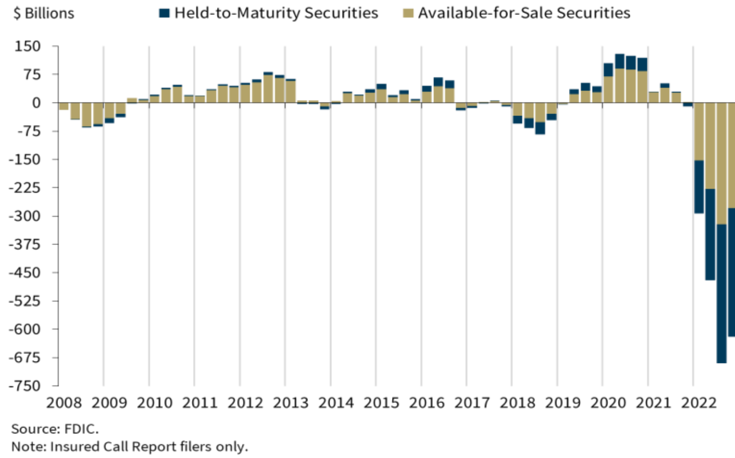
Chart 2. % of US banks tightening credit standards for commercial and industrial loans



Source: St Louis Fed, FRED

US banks are also nursing heavy unrealised losses on their bond portfolios, threatening bank capital adequacy. This is set out in Chart 3 below.

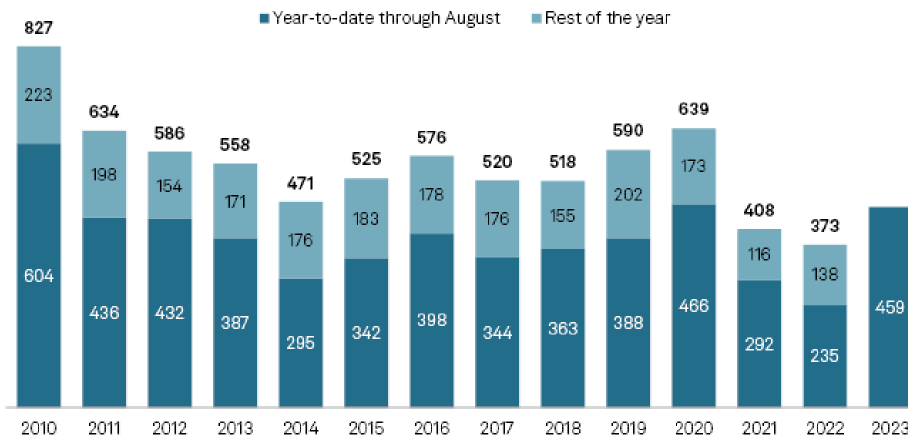
Chart 3. Banks unrealised losses on investment securities



Bankruptcies have risen to Covid levels

Bankruptcies are also rising. Chart 4 below presents US bankruptcy filings by year. The level of bankruptcies so far in 2023 has reached levels seen in 2020 during the Covid period and on a trajectory to those last seen during the Financial Crisis.

Chart 4. US bankruptcy filings by year

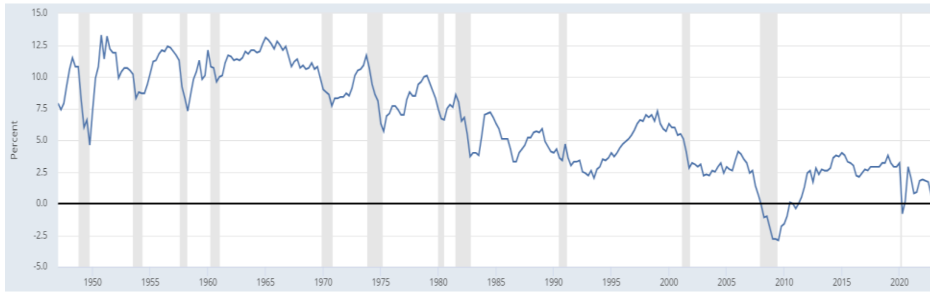


Source: S&P Global

Savings have been depleted

Finally, what seems to be a well-covered point, is that savings, presented in Chart 5 below, have been depleted.

Chart 5. Net saving as a % of gross national income



Source: St Louis Fed, FRED

What will the impact on equity markets be?

Two variables impact equity values – long interest rates and profit growth. Declining yields will be supportive of equity valuations. Profit growth however is likely to suffer.

If this scenario materialises we are likely to see dynamics opposite to those at play since 2022. Declining profits and interest rates are likely to impact Value shares the most since their profitability, on average, tends to be poorer. Growth shares are also likely to not impress since there is likely to be little growth. Which leaves so-called "quality" shares, or companies with established track records of operating performance.

A counter-indicator to this scenario is that equity analysts are currently forecasting profit growth for the next 12 months. Perhaps they are right. Should the described scenario of economic deterioration materialise however, these forecasts could prove to be wrong, in which case the market correction is likely to be sharp.