Rising Yields, Recession and Deepseek – Market Commentary

December was a poor month for the SA market. While the ZAR return was only mildly down at -0.3%, -4.5% in USDZAR depreciation saw a similar -4.5% ALSI decline in USD terms, sharply underperforming Emerging Markets which were flat at -0.1%.

SA began 2024 by underperforming Emerging Markets, then sharply reversed course to begin outperforming from June, only to finish with a welcome but nevertheless perhaps not sufficiently exciting +2.4% outperformance margin.

Global markets were down at -2.6%, but it was a poor month for Value with the MSCI Value Index down -5.7%, and MSCI Growth slightly up at +0.4%. In the US, the S&P 500 and Nasdaq were commensurately down -2.4% and slightly up at +0.5% respectively.

Table 1 below summarises the various market returns.

Table 1. South African and global equity returns (USD) for December 2024*

	Dec-24	YTD 2024
FTSE/JSE ALSI (ZAR)	-0.3%	13.4%
FTSE/JSE ALSI (USD)	-4.5%	9.9%
MSCI World	-2.6%	18.7%
MSCI EM	-0.1%	7.5%
MSCI Value	-5.7%	11.5%
MSCI Growth	0.4%	25.9%
S&P 500	-2.4%	24.5%
Nasdaq 100	0.5%	25.9%

*Total return indices, Source: Factset

2025 has started with worries about rising yields and, news of the hour, Deepseek. Recession appears to be a minority view and is hardly discussed in media. We consider Deepseek the least worrisome and discuss it first before covering more mundane subjects such as Treasury yields.

Nvidia and Deepseek

Abundance of media with a need to produce (or reproduce) content seems to be the order of the day. Nvidia did fall reasonably substantially (-17% on the day), however this was not exceptional either for US stocks subject to a day's negative news, nor for Nvidia's own daily movements. To reinforce the point, Chart 1 below presents a 5-year Nvidia price chart.

Per Chart 1, 2024 saw several moves of comparable magnitude.

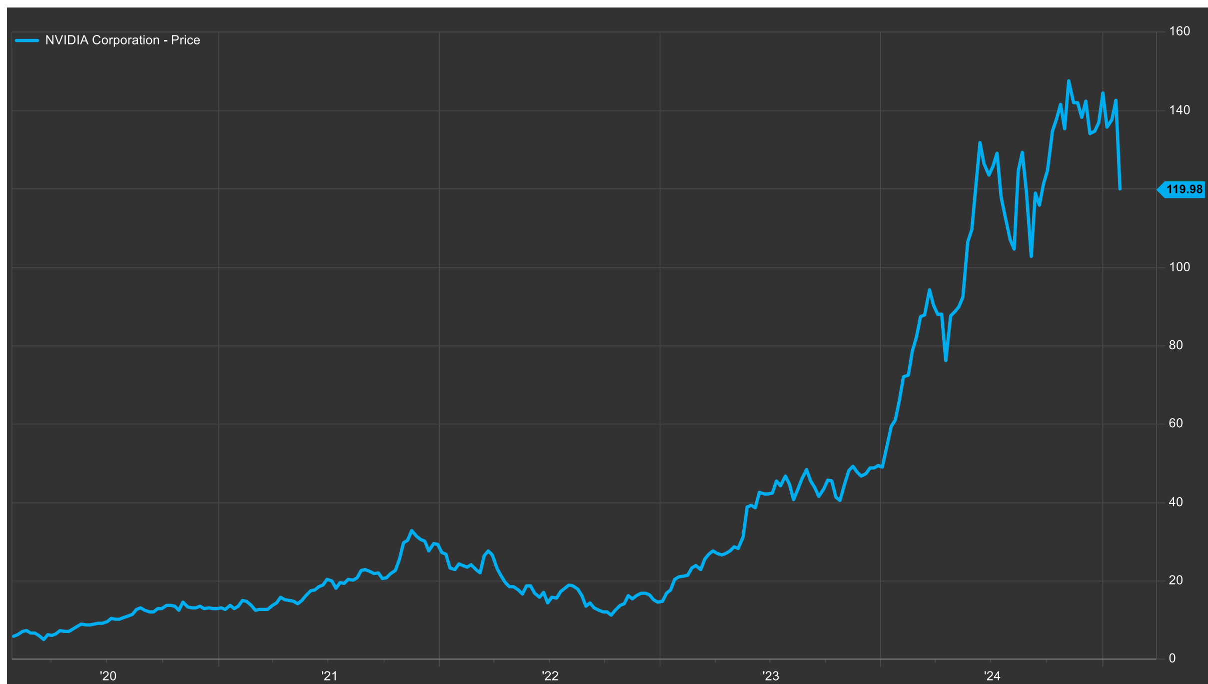
While related chip stocks were also affected, we note that Big Tech as a group was mixed. Microsoft was down -2% on the day, and Alphabet -4%, while Apple and Meta were up. the S&P 500 and Nasdaq were also down approximately -1.5% and -3.0% respectively on the day. Hardly dramatic.

Our conclusion is that the nature of the moves is reflective of the hype and sentiment built into the Nvidia stock price.

We also remind that Nvidia is not for the faint of heart. Hardly appreciated or mentioned these days is that the stock declined nearly -67% in 2022 before returning nearly 10x in

the following 2 years. The declines from 2022 appear immaterial in the context of the subsequent performance in Chart 1. A lesson in holding on to stocks and not trading too much. Also, no wonder there is hype currently – it appears investors would like a further 10x from current levels.

Chart 1. Nvidia 5-year price chart



Source: Factset

What about the general AI hype?

On this particular subject our instinctive response is to be mindful of the Financial Times covering Elliott Investment Management of the US on AI, "Many of AI's supposed uses are "never going to be cost-efficient, are never going to actually work right, will take up too much energy, or will prove to be untrustworthy", it said."

There seems to be a lot written about the uses of AI, with relatively less in terms of confirmed value-added application of what remains an iterative algorithm with a fancy name. The technology is not new. If we sound sceptical, it is because we don't see a single competitor, or set of competitors, having an advantage (everybody seems to have AI), we also think it will be some years before any real winners emerge, or if indeed the technology (ever?) works well. Anecdotal evidence of AI-powered virtual assistants with bland, unhelpful and valueless answers is abundant.

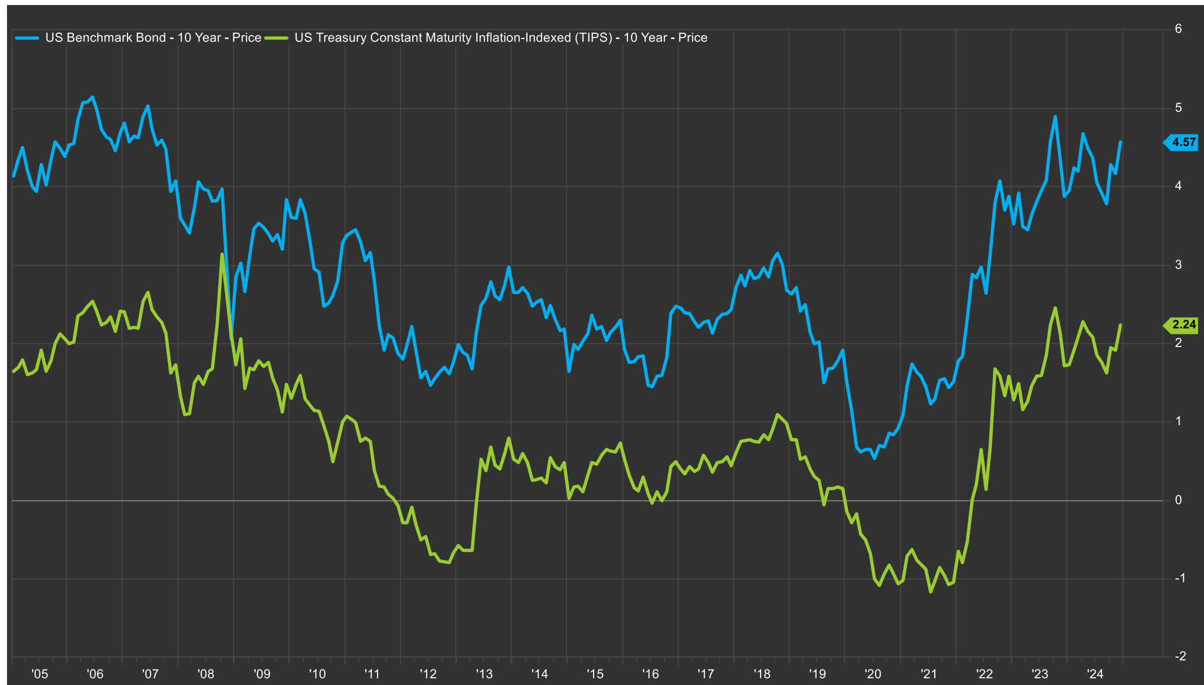
What About Treasury Yields?

Prior to Deepseek roiling (for a day) the investment world, the market was concerned with more important things such as why are interest rates rising. This is of more significance (we think) to valuations and the direction of prices.

We are told it is because the market is expecting higher inflation because it is not under control and/or the effect of expected Trump tariffs (also higher inflation). Alternatively we are also told it is because the market is expecting economic growth and so yields are rising (also higher inflation).

We present in Chart 2 below, 10-year Treasury yields and 10-year TIPS yields (inflation-linked bonds).

Chart 2. 10-year Treasury vas 10-year TIPS yields



Source: Factset

Per Chart 2, we note that real yields on TIPS are moving higher in line with Treasury yields. Breakeven inflation, or the difference between 10-year nominal and real yields, has remained unchanged at +2.3%. The inflation argument, therefore, is not valid i.e. nominal yields are rising because real yields are rising, not because the bond market is pricing in higher inflation margin.

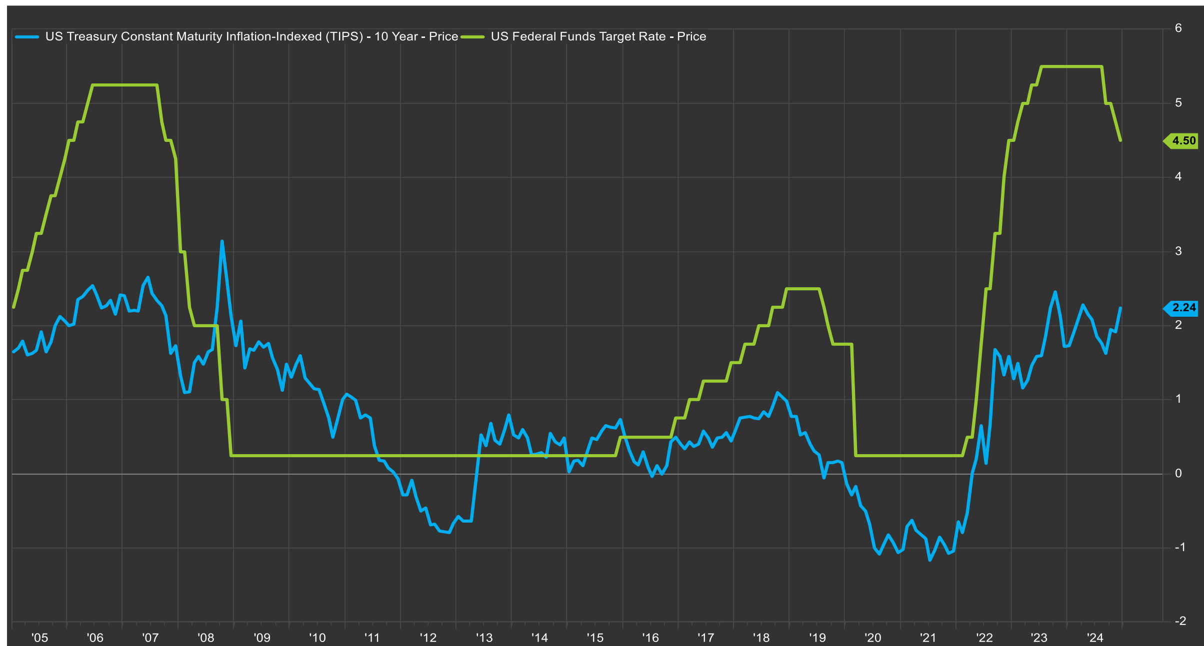
The problem remains however that real yields were meant to fall in line with falling short rates. We present in Chart 3 below, the TIPS 10-year real yield vs the Fed Funds rate.

From Chart 3 we note that in both prior easing cycles, the real rate pre-empted declines in the Fed Funds rate. This is the case, apparently, for all other historical easings, hence the market consternation as to why yields are now not falling (as a side note, we are wondering, since this has not happened before, how all-powerful and all-conquering AI is handling the problem, much like Covid, for which there was also no readily available recent history).

But back to the real yields which are refusing to fall. In December 2024 we wrote that the primary driver of real yields turns out to be the policy rate. There is indeed an obvious loose, long term correlation if one examines Chart 3. If we assume this is true, a possibly obvious conclusion might be that the bond market is, correctly, predicting the Fed Funds rate won't fall (yet). Such a prediction is being borne out with yesterday's Fed pause.

In general we think things take time to play out in markets. A development which consumes media attention is very much in the moment, yet amounts to a blip on a historical chart. We suspect something similar at play here. We expect inflation will fall, in time, and with it the Fed rate will fall, as will the real yield, but not necessarily in a straight line and not necessarily immediately.

Chart 3. US 10-yr TIPS yield vs Fed Funds rate



Source: Factset

Is recession still a risk?

We fear very much so. Potentially the biggest risk to worry about. History suggests a recession materialises on average 18 months from the peak in interest rates. We are at 18 months.

History also suggests a recession materialises after the yield curve exits inversion. We present the latter in Chart 4 below.

Per Chart 4, in 1990 the yield curve exited inversion in March 1990, and a recession began in July 1990. The yield curve also exited inversion in December 2000, and a recession began in March 2001. The yield curve exited inversion in May 2007 and a recession began in November 2007.

Uncannily, the yield curve also exited inversion in August 2019, and a short but sharp recession materialised in March 2020.

Most recently the yield curve exited inversion in November 2024, and we are now only in January 2025.

Sharp market declines accompanied each of the previous recessions, usually because they were adequately discounted.

We acknowledge recession is not the popular view right now. We also however have a healthy disrespect for economist forecasts and remain on guard.

Chart 4. Yield curve inversion and recessions