

Equity markets enjoyed a relatively calm end to summer, as August gave investors a reprieve from recent volatility and offered some time to relax. However, once the calendar turned to September and schools reopened, it seemed a switch was flipped. The first signs showed up in the US bond market. We believe stubborn inflation, increasing deficits and a flood of AI bond issuance became too much to handle, and yields shot higher. All of this resulted in the bond market teaching the first lesson of the new school year to investors.

Everyone gets caught up with how equity markets are performing, but at the end of the day, the bond market is, in our view, what everyone should be paying attention to. The benchmark US 10 year bond touched a yield of 5.25% during the month, which is a level that we haven't seen since 2007 during the Global Financial crisis. What was also notable was the rate of change of this move, as it was much faster than usual, which normally coincides with some sort of economic crisis. This has everyone on edge and trying to decide what this means for their portfolios.

There is nothing magical about 5% yields, but as that level was surpassed, other parts of the financial market began to take notice. In Finance 101 you learn that when yields rise you put a higher discount rate on everything else you value. If you can get 5% by holding a government bond which is supposed to be 'risk free' then you should require a higher return from assets that are further along the risk spectrum and pay a cheaper valuation for them. This results in the normal relationship that when yields increase equity markets fall, as valuations become compressed.

Throughout the year we have seen yields move higher, but for the most part this was ignored as much of this increase was attributed to higher energy prices driving up inflation. Given the war with Iran this was thought to be 'temporary', most expected this to reverse by the end of the year. However, during the month of September, it became clear that we are heading into a 'higher for longer' period for yields as factors outside of energy are pushing inflation. Equities started to take note, particularly in the banking sector.

So far not all sectors have been affected by the increase in bond yields, and that has made the performance for many markets at an index level better than how individual stocks are acting. Canadian and European markets that have a larger exposure to the financial and material sectors, have fallen nearly 5% from their highs, while US markets remain at record levels. This comes back to the AI trade. After the selloff that took down many of the large technology stocks in March, the share prices of most of these companies are back to their all-time highs. The AI Data Centre build out continues at a rapid pace, and investors are giving the benefit of the doubt the Hyperscaler business models will prove out over time. Given the concentration of these stocks in several markets, this strength is overshadowing the weakness that other sectors are seeing as a result of the higher yields, keeping broader indices near record levels.

The outperformance of equities versus fixed income during this rally is pushing the spread between equities and fixed income to extreme levels, which is starting to throw asset mixes out of balance. After several years of strong equity performance and meager returns from traditional fixed income, many portfolios are well above levels that they would normally hold in equities. And now given the performance of several large technology companies, within those equity holdings there is now the additional risk of concentration. When these positions will be unwound and normalized is anyone's guess, but these moves can't go on forever and will need to be adjusted at some point.

With the bond market signaling risk and equity markets very concentrated along a single theme, the next few months have the potential to be very tricky. The US High Yield Bond Index just had its worst month since December 2018 (down 2.5%) and investors are in desperate need of good news. Throughout the year the correlation between bond yields and oil prices has been high, yet halfway through September that correlation seemed to break down as a decline in oil prices didn't prevent yields from rising. Heading into a US Midterm election that is increasingly becoming centered on the

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cost of living, expect frequent headlines claiming ways to lower the cost of diesel and end the war. Headline risk remains high in both ways and will add to the volatility.

As we enter the last quarter of what has been a strong year for equity markets, it's again not the time to get complacent. The stress in the fixed income market started to cross over into equities last month and could get worse. Corporate earnings will begin to be reported mid-month, and we will learn the effect higher energy prices and interest rates are having on the economy. Earnings growth has saved the market so far, albeit a few very narrow sectors, and need to keep expanding to push markets higher. Of course, the Bull case for all asset classes is for bond yields to peak and move lower for the balance of the year. That would set off a powerful rally. The two outcomes are very divergent paths. Once again, equity markets won't be leading, it's time to focus on yields, they will determine the outcome.

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