PCM
PEAK CAPITAL MANAGEMENT

Deciphering the Bond Market

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Brian Lockhart

The Fed boldly cut rates by a ½ point on September 18th to initiate a change to accommodative monetary policy. Lower rates, it was assumed, would support continued economic and job growth while bringing down mortgage rates to support housing. The best laid plans. Instead of seeing commercial rates fall in tandem with short-term rates, long-term rates have moved substantially higher raising serious questions for those in the financial markets.

It possible that the Fed's ability to influence economic behavior with "normal" policy tools like short-term rates is forever lost after the unprecedented experimentation in 2020? It has always been assumed that the Fed can conjure the consumers "animal spirits" to drive the economy by hinting at rate cuts, let alone ½ point cuts. Is the Fed now powerless or did they simply, once again, misread the economic tea leaves and no rate cuts were necessary to keep the economic engine churning? The long duration US Treasury bond proxy, TLT, is trading below its 200-day moving average six weeks following the rate cut and appears to be headed to finish the year at a lower price for the 4th consecutive year. This is occurring at the same time investor flows into long duration bonds are at record levels with TLT going from $10 billion in assets in 2019 to over $60 billion today. It begs the question, what are bond traders telling us that investors are not comprehending?

1. **It's the Economy Stupid.** Coined by Bill Clinton strategist, James Carville in 1992, this became the theme for Clinton's first successful campaign for President and has remained a salient talking point in every election since. Long-term rates have gone up, in spite of the Fed's actions, because the economy remains on solid footing and bond traders are concerned rate cuts will have unpleasant unintended consequences. The second shoe from the corporate real estate debacle has not fallen. Banks, and consumers, have repaired their balance sheets and real estate did not collapse under the weight of high rates as some forecasted. We might see some economic weakness as a result of recent catastrophic storms but those effects tend to be transitory, not long-term.

2. **Fiscal Irresponsibility.** Government spending is skyrocketing and debt is out of control. Deficits are at record peacetime levels and yet the government is creating new ways to engage in debt (student debt payoffs, money for down payments, etc.). Neither party or candidate has addressed the debt so it remains the 800 pound gorilla in the corner waiting to devour. The IMF has forecasted the US spending $13 trillion in 2029 when the US never breeched $10 trillion before COVID spending in 2021, and that will require a massive level of new government bond issuance and likely higher interest rates to sell the bonds.

3. **Inflation is Not Dead.** While I do not expect a return to double-digit inflation at this point, I also do not see the Fed hitting their 2% target in the foreseeable future. There are multiple sources of upward pressure on inflation like energy. The US (and the world) is severely under invested in new production and US reserves are currently at 40-year lows according to Bloomberg. The Strategic Petroleum Reserve, created in 1975, to maintain an emergency reserve of hundreds of millions of barrels of oil, has nowhere near that amount. Energy costs could rise with geopolitical uncertainty in the Middle East driving inflation higher while the possibility of tariffs on low cost Chinese manufactured goods could also lead to higher domestic prices.

While these are 3 primary reasons I believe the bond market has sold off following the Fed rate cuts, it does not mean this trend will continue. While the markets have celebrated the elusive "soft landing" and the Fed has taken a bow for what they have engineered, a hard landing (recession) is not out of the question and that would drive rates much lower than today's levels. Massive debt levels will eventually squash economic growth (unless you are modern monetary theorist) and lead to deflation and contraction. The Fed will also come under tremendous pressure to keep rates artificially low for the Treasury to simply pay interest on the debt.

> "...what are bond traders telling us that investors are not comprehending?"

Any bet on long duration bonds seems risky today, they will either be really good or really bad in my opinion. If investors are looking for income, short duration T-bills with higher rates than long bonds seem a much safer play. If you are looking to speculate or hedge a collapse in equity prices, consider using zero coupon Treasuries. If rates fall under economic weakness they will likely shine.

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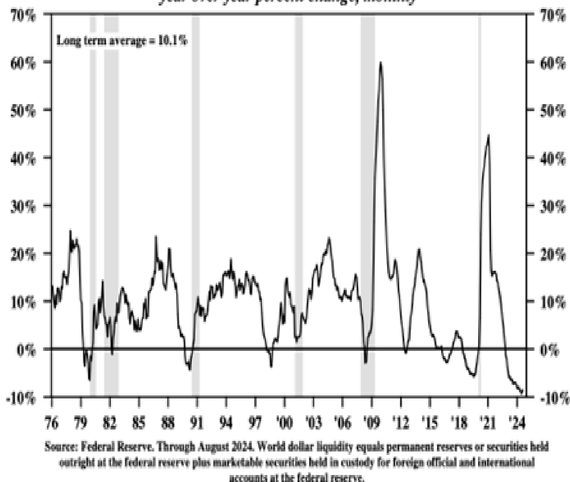
Do Not Ignore the Money Supply



Treasury bonds may remain under pressure for the foreseeable future, however, there are data points that suggest the recent rise in yields in 20-year Government bonds represents a generational buying opportunity. As detailed by brilliant economist Lacy Hunt, there have been three currency regimes that largely dictated global economic growth. We had the gold standard up until Bretton Woods in 1933. Bretton Woods brought a fixed exchange rate until Nixon closed the gold window in 1971 when we transitioned to floating rate global currencies. The Feds holdings of US Treasury securities along with the foreign holdings of US Treasuries is the best proxy for the global money supply. When money supply is equal to economic growth, prices tend to remain stable or equilibrium. When money supply exceeds growth, economies overheat and create inflation. When money supply lags economic growth, it results in contraction and deflation.

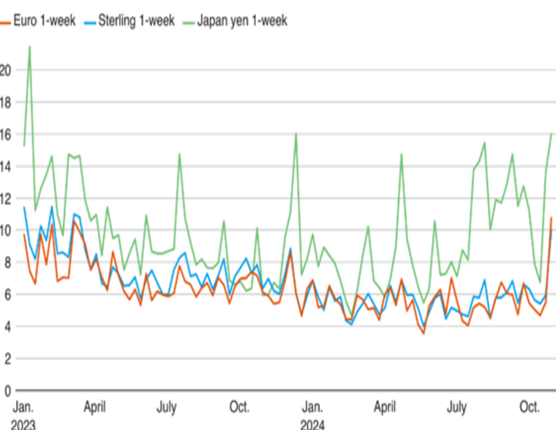
- All 5 major economic regions (US, UK, EU, Japan, China) have registered record contractions in their money supply growth rates with the UK, US and China showing greatest rates of decline.
- The most reliable global monetary indicator indicates the current environment is the most restrictive since 2000 and suggests a strong likelihood of global economic contraction at some point in the near future.
- Based on data going back to 1976, every time global money supply dipped below 0% growth there was a recession within 3 years. At -10% growth, it is the lowest level in history and has been below 0% since 2022.

Utility Surge

The utility sector is leading the market higher this year. Contrary to recent market trends, which have been dominated by technology names such as Nvidia, utility stocks have attracted investor capital in 2024. The S&P 500 Utilities Index is higher by roughly 29% year-to-date versus a return of roughly 24% for the broader S&P 500 Index over the same period. The change in market leadership is somewhat surprising considering that since the onset of Covid (March 2020), the utility sector has lagged the broader S&P 500 Index by a cumulative 62%. The current yield for the average utility stock is roughly 2.3% versus 1.2% for the S&P 500 Index and 4.3% for the ten-year U.S. Treasury yield.

- The recent surge for the utility sector is driven in part by the continued rollout of AI, which will require a significant investment in infrastructure, such as upgraded power grids and new data centers. The overall spending commitment could exceed trillions of dollars over the next ten years.
- The sector could have further room to run as well, considering that the forward P/E estimate for the sector is roughly 18 times 2026 earnings with roughly 10% earnings growth. By comparison the forward P/E multiple for the technology sector is approximately 28 times.

Rising Dollar



Currency volatility indicators surged earlier this week as investors prepared for potential shifts following the U.S. presidential election, which could impact economic policy and the dollar's trajectory. Implied one-week volatility in key currency pairs, such as euro-dollar, reached levels unseen since March, underscoring market uncertainty. Barclays strategist Marek Raczko noted that “the bulk of the FX reaction” may occur around the election and the Federal Reserve's upcoming meeting. Increased odds of a Trump victory suggest higher tariffs and fiscal deficits could boost U.S. interest rates and strengthen the dollar. Conversely, a Harris presidency might yield a weaker dollar outlook, due to expectations of slightly slower growth and less aggressive trade policy.

- The U.S. dollar is primarily influenced by interest rates, economic data, Federal Reserve policy, global risk sentiment, and trade and fiscal policies, which collectively impact demand and investment in the currency.
- The dollar index rose to a three-month high of 104.63 on Tuesday, October 29, driven partly by recent strong U.S data and partly by investors' rising expectations of a Trump election victory. Previous U.S. elections have triggered even stronger market reactions. For example, in the week leading up to the 2016 election, one-week euro implied volatility nearly reached 14%, while sterling implied volatility topped 13%.

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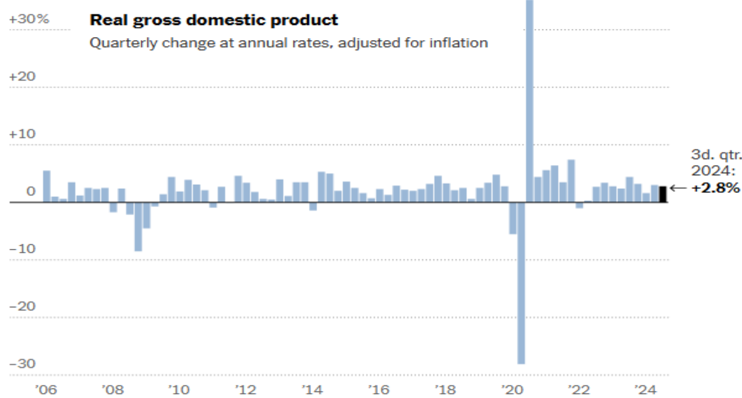
Quinn VandeKoppel

Macro View – Resilient U.S. Economic Growth

The U.S. economy saw strong growth in Q3, driven by resilient consumer spending despite concerns of a slowdown. GDP grew at an annualized rate of 2.8%, slightly below economists' forecasts of 3.1%. Consumer spending, accounting for two-thirds of economic activity, rose 3.7% and was a major contributor to GDP growth. Federal spending also boosted growth, particularly with a 14.9% increase in defense expenditures. However, growth was partially offset by a surge in imports, which weighed on the GDP figure. Inflation showed signs of cooling, as the personal consumption expenditures (PCE) price index rose just 1.5% for the quarter, below the Fed's 2% target. The Federal Reserve is expected to continue cutting interest rates, with markets anticipating a 0.25% reduction at its November meeting, according to the CME Group FedWatch Tool.



Fixed Income – Rising Yields

Earlier this week, the yield on the 10-year Treasury note hovered near levels not seen since July as traders analyzed a fresh batch of mixed economic data and looked for clues on potential rate cuts. Since hitting a low in September, the yield has risen 19%, from 3.6% to 4.3%. Leading up to the October jobs report, investors reviewed mixed data throughout the week. The ADP private payrolls report for October showed 233,000 new jobs, significantly exceeding the Dow Jones estimate of 113,000. Additionally, the first preliminary reading of third-quarter U.S. GDP indicated a 2.8% growth rate, slightly below the 3.1% forecast from Dow Jones. The Federal Reserve is widely expected to reduce interest rates by 25 basis points next week, though unexpectedly poor data in the interim could complicate policymakers' decisions.

Taking Stock – Potential Semi Acquisition

In recent weeks, legal betting on the 2024 Presidential Election has surged after a federal appeals court allowed KalshiEX LLC, an online betting company, to open an election prediction market. Former President Donald Trump currently leads in betting markets, marking the first time he's held a significant advantage at the betting window just a week before Election Day. To date, $2.5 billion has been wagered on the election through platforms like Polymarket, where Trump has a 66% implied chance of victory. Rajiv Sethi, an economics professor at Barnard College who studies these markets, notes that while it's uncertain if prediction markets outperform traditional polling, they are close. With Election Day approaching, platforms like RealClear Polling and Polymarket show Trump leading by 30 percentage points, while most political polls still indicate a statistical tie between Trump and Harris.

Betting Odds Data

BETTING ODDS	TRUMP	HARRIS
RCP Average	63.6	35.0
BetOnline	64	35
Betfair	61	34
Betsson	64	37
Bovada	63	37
Bwin	66	35
Points Bet	66	35
Polymarket	64	32
Smarkets	61	35

Technical – Wait and See

Over the coming week, global investors will be closely watching U.S. markets as both the U.S. presidential election and the Federal Open Market Committee (FOMC) meeting take place. Major indices, like the S&P 500, have recently reached record highs; however, the uncertainty surrounding the Nov. 5 election could potentially stall a year-end rally. The S&P 500, represented in the chart below by the SPDR S&P 500 ETF (SPY), is currently less than 1% from its all-time high. Recently, the ETF broke below its upward trend line but is still supported by the 20-day simple moving average (SMA). If economic data and earnings reports are favorable, the market may continue to trend higher. Conversely, if earnings and data disappoint and the 20-day and 50-day moving averages don't hold, a pullback to the $560–$565 range is possible.

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Equity Valuations

Clint Pekrul, CFA

Headlines today seem to be dominated by the narrative that equities, as measured by the S&P 500 Index, are expensive. Considering the run we have had this year, with the index higher by roughly 24%, it's logical that investors would question current valuations.

The weighted-average P/E ratio for the S&P 500 today is approximately 27x, which is elevated relative to history and above the long-run median P/E of roughly 19x. However, as always, the truth is in the details. If earnings can continue to grow and materialize as forecasted, then we could make an argument that stocks are reasonably valued.

It's helpful to break out the S&P 500 by sector and evaluate P/E multiples based on the median observation and the weighted average, given that the index is capitalization weighted. The table below provides a snapshot by sector using the average earnings estimates out to 2026.

Table 1 – Median Sector P/E Based on Average Estimates

Sector Index	2024 EST	2025 EST	2026 EST
S&P 500 Energy Index	14.6	12.6	11.0
S&P 500 Telecom Services Index	18.5	16.5	15.5
S&P 500 Utilities Index	19.0	17.7	16.6
S&P 500 Financial Services Index	14.1	13.1	12.3
S&P 500 Industrials Index	24.7	22.0	19.2
S&P 500 Healthcare Index	18.6	15.6	14.9
S&P 500 Consumer Staples Index	18.4	17.3	16.1
S&P 500 Basic Materials Index	21.7	17.7	14.1
S&P 500 Discretionary Index	18.8	18.2	16.5
S&P 500 Technology Index	27.1	22.4	19.5

Source: Ycharts

When evaluated based on forward estimates, sector P/E multiple levels don't seem overly egregious. The figures in Table 1 above use the median analyst earnings forecast for companies in each sector. These estimates are then compared to current stock prices to derive the P/E ratio. The median represents the middle observation across all estimates.

In general, earnings multiples are expected to come down from current levels. In other words, earnings are expected to grow through 2026 at such a pace that the median P/E multiple across all sectors declines to 15.8. As mentioned earlier, the historical median P/E multiple for the S&P 500 Index is roughly 19.

It is also noteworthy that when evaluating earnings multiples using median estimates, we weigh each company the same. In other words, it is an equal-weight methodology whereby Nvidia's earnings count as much as News Corp's (the smallest holding in the S&P 500 Index).

Using medians to evaluate earnings estimates can paint a much different picture than using weighted averages. Table 2 provides the same analysis as Table one, except it uses weighted average estimates rather than medians.

Table 2 – Median P/E Based on Weighted Average Estimates

Sector Index	2024 EST	2025 EST	2026 EST
S&P 500 Energy Index	15.6	13.8	12.2
S&P 500 Telecom Services Index	23.5	18.4	16.1
S&P 500 Utilities Index	20.8	19.0	17.7
S&P 500 Financial Services Index	19.7	18.0	16.4
S&P 500 Industrials Index	26.8	24.7	20.9
S&P 500 Healthcare Index	28.3	21.5	18.8
S&P 500 Consumer Staples Index	23.7	21.9	20.1
S&P 500 Basic Materials Index	24.4	20.6	18.3
S&P 500 Discretionary Index	39.5	33.0	27.5
S&P 500 Technology Index	34.4	28.4	24.9

Source: Ycharts

When using weighted-average estimates to calculate earnings multiples, we get a different picture. The S&P 500 is a capitalization weighted benchmark. When you buy the index, the top ten holdings represent roughly one-third of the index's total market capitalization. Some of these mega-cap stocks carry hefty multiples compared to the median P/E estimates from Table 1.

Recall that the median 2026 P/E estimate across all sectors is 15.8. However, the weighted average P/E estimate for 2026 is 19.8 due to the influence of mega-cap stocks in the benchmark. Broadcom, for example, carries a forward P/E ratio of 36 with a market cap of $828 billion. Likewise, Tesla trades a forward P/E of 104 with a market cap of $837 billion.

It is also helpful to consider earnings yield (the reciprocal of the P/E estimate) in relation to U.S. Treasuries. Using the 2026 median estimates, the expected earnings yield for the S&P 500 sectors is roughly 6.4%, which is greater than the current yield-to-maturity of 4.2% for the ten-year U.S. Treasury bond. As expected, the weighted average expected earnings yield for 2026 is lower at roughly 5.3%.

Conclusions

The question of whether stocks are expensive or reasonably priced depends on how you examine the S&P 500 and the underlying sectors and securities. There could be reasonable buying opportunities in sectors such as energy, healthcare and financial services, which carry relatively low P/E estimates.

Buying passive, capitalization weighted indexes will expose you to a higher P/E multiple today (you will pay a higher premium for future earnings growth) compared to long-term history. However, there is no what of knowing how long P/E multiples will remain elevated.

A strategy that actively picks stocks or follows a factor discipline such as value could be better positioned over the intermediate term to deliver both better absolute and relative returns.

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Q: How would you handicap the election today and impact for the markets?

The question seems appropriate for a Yogi Berra quote: "It's tough to make predictions, especially about the future." If you look at the most recent polling, the election appears very close and certainly within the margin of error on virtually every poll. That said, I do not believe there was a single poll in 2016 that showed Trump within 5% of Clinton going into election day. Political pundits agree that this election will come down to a handful of "swing states" and Trump seems to be polling well in those states. The largest betting site for politics is PredictIt and it overwhelmingly suggest Trump will win the election. As of October 28th, you have to wager $61 to win $100 on a Trump victory while you only need to bet $41 to win a $100 with a Harris victory. This would suggest the likelihood of Trump winning is 50% than for Harris, much wider than any polling suggests. Given that someone has to "cover" the bets, the odds suggest Trump will be elected in early November.

As polar opposite as most of the policy positions for the candidates, the impact on the financial markets is much more difficult to ascertain. Harris would certainly be seen as the "status quo" candidate or a 4 year extension of Biden's policies and priorities. Trump would certainly be considered the disruptive candidate that is much more difficult to quantify. In his first term, the focus was on the US becoming energy independent so easy to assume the resumption of "Drill, Baby Drill". Trump also oversaw the greatest level of deregulation in the Federal government since Reagan and talks about continuing on that path. The stock market has risen, or fallen, under both party's control but the specific winners and losers would likely be quite different.

Based on recent polling data, it seems like Donald Trump is gaining some momentum heading into the final week before election day. Of course, national polls pushed by the media are notoriously inaccurate. I wouldn't be surprised if we had similar results to 2016 when Trump first got elected. I think Kamala could end up winning the popular vote while Trump wins the electoral college, which is what ultimately matters. It seems like the sugar high that the Democrats experienced when they removed Biden, and installed Harris has faded somewhat. The advantage Trump has is that we've experienced four years under his presidency, and despite the onset of Covid, those years were not that bad. We had relative peace, and inflation was below two percent. Harris must convince voters that she's simply not another version of Biden, and she's running out of time.

As for the election's impact on the markets, I don't think the results are all that meaningful in terms of expected returns. There was a study conducted by State Street that suggests that market returns around presidential elections are more-or-less random. There is no statistical evidence that election results hold sway over market performance. I think a Trump presidency would be viewed more favorably by investors, given his policy stance on taxes and regulation. But ultimately, I don't think the election outcome should play a part in the investment decision making process.

Q: Do oil and commodities look safe given the potential resurgence of inflation?

It is understandable that investors seek investments with relative safety, but I am not sure that exists today. As noted in the Introduction, the proxy for 20-year US Treasury bonds is nearing a string of 4 consecutive negative years. The proxy ETF traded at $171 in late 2020 and trades at $92 at the time of this writing. If an investor owning government guaranteed bonds can lose almost 50% of their principle in 4 years, I am not sure anything could be categorized as safe.

Commodities have bifurcated like we have seldom seen before. Gold is at all-time highs while other commodities are at multi-decade lows. Oil will probably be as impacted by the election as any asset class. Trump will support massive levels of exploration to increase the supply of oil with the goal to drive down oil prices and stimulate the economy. High production levels will favor oil field service companies but corresponding lower prices may hurt the large oil companies unless prices only fall slightly and demand moves materially higher. Trump has discussed wanting to see the US dollar fall from recent highs that facilitates growth in exports and lower dollar typically means higher commodities. At the end of the day, differences tend to be more political than financial in my opinion.

Commodities such as precious metals (gold, silver, etc.) have historically been considered inflation hedges given their limited supply. Indeed, the price of gold is currently trading at roughly $2,700 per ounce and is higher by 32% year-to-date. I think the surge in gold is a direct reflection of the market's view on U.S. fiscal policy. The trillions in spending out of Washington comes at a time when we have GDP expansion (we will hopefully avoid a recession) and full employment (the unemployment rate is below 5%). The perception is that such spending will overstimulate the economy and push overall prices higher, much like after Covid. If anything, the government should be curtailing spending under such conditions.

The risk is that we will experience further erosion in the value of the U.S. dollar (i.e., reduced purchasing power). Given its scarcity, gold could potentially hedge this decline and provide a positive, real rate of return, which is not necessarily the case for dollar-based assets such as stocks and bonds. If there is no prospect of greater fiscal responsibility out of Washington, then gold could continue its current run and surpass $3000 per ounce. This could especially be the case if election results are contested in November. Oil, meanwhile, has held somewhat steady since early September, but is well off its April high for the year. Perhaps oil is trading lower on the prospect of slower than expected GDP growth and lower overall aggregate demand.

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9250 E. Costilla Avenue, Suite 110.

Greenwood Village, CO 80112

Phone: 720.361.4016

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

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