Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Bitcoin	Gold	Crude Oil
34,641	4,525	14,204	2,045	2.56%	46,056	$1,924	$100.43

Investment Strategy Report

Stocks Recover From March Lows While Bonds Get Slammed

I warned you last month that stock market volatility could remain high, and it has. I also mentioned that hopefully, some of the volatility could be to the upside, and over the past 3 weeks, that's what we've gotten.

After a rough start to the year, stocks bottomed on Feb. 23rd, the day before the Russian invasion of Ukraine. Stocks then rallied for a week, beginning on Feb. 24th, but then continued their decline to hit their ultimate bottoms (we hope) on March 8th and 14th. Since then, we have seen the S&P 500 rally 9.8% and the Nasdaq rally 15.5%, before falling 1.3% and 2.3%, respectively, today. The rallies have been nice, but as today's resumption of the selling indicates, stocks have to contend with a multitude of problems.

To begin with, while the Ukrainians are bravely defending their country, the war rages on. This has caused energy and commodity prices to soar. Stocks don't like uncertainty, and the uncertainty involving shortages of energy, food, and other commodities is taking its toll. However, probably the biggest threat to the current stock market uptrend is the threat of inflation, and the measures that the Federal Reserve will undertake to slow down the economy in its effort to stem inflation.

When comparing this month's stock market data (top line above) with last month's, the biggest change has occurred in the yield of the 10 year Treasury (from 1.72% to 2.56%). This huge spike in interest rates is a reflection of the surge in the Consumer Price Index (CPI), from a very comfortable range of 1.5 to 2.0% for many years, to its current levels, ranging from 6 to 8%. When trillions of dollars of Covid relief money is injected into the system, it has to go somewhere, and it has resulted in higher prices across the board. This has set off alarm bells among investors, as the fear is that the Fed, in its efforts to stem inflation, will cause a recession. This has caused volatility not only in the stock market, but the rise in interest rates has caused a substantial decline in bond prices.

So with volatility high in both the stock and bond markets, what is my investment strategy going forward. Let me begin with the bond market. I've noted that the 10 year Treasury yield is currently at 2.56%. However, the 5 year Treasury yield, which you would expect to be lower, is in fact at 2.70%, i.e., the curve is inverted. Now why would any investor invest in a 10 year Treasury, yielding 2.56%, when he could get a higher yield with less risk in a 5 year Treasury? The answer is that he expects rates to fall, resulting in a larger capital gain with a 10 year Treasury. That is the message of the bond market. And while rates might continue to rise in the short term, longer term, we can easily see rates stabilize and move lower. This view is corroborated with a study in one of today's columns at Sentimentrader.com. Dean Christians states that their optimism index for investment grade bonds reversed higher relative to its recent range. Bonds have rallied 75% of the time following other similar setups. He also points out that "seasonality trends suggest a favorable tailwind through the end of the summer". Steve Sjuggerud (Stansberryresearch.com 3/30/22) also feels that sentiment in the bond market as indicated in the Bond Commitment of Traders report is so negative that a rebound in bond prices can soon be forthcoming.

As for stocks, the analysts at Sentimentrader.com have provided substantial evidence to suggest that the strong rebound in stocks over the past few weeks indicates that stocks have further room to run on the upside. Jason Goepfert authored a study today that he summarized as follows: "There have been ample signs of thrust in the major indexes and individual stocks over the past few weeks. Essentially every study we've published about them have shown a significant bullish edge over the medium-term time frame. The thrusts have enabled the Nasdaq to claw back more than half its losses, only 3 weeks removed from its 52 week low. Behavior like this has consistently shown a positive edge in the weeks and months ahead".

So yes, the investment environment for both stocks and bonds seems pretty scary right now. But some indicators appear to be suggesting that investors who endure the short term volatility will eventually be rewarded. *Jeff Feldman*

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