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Finally Market Breaks Stalemate; Stocks will Beat Bonds if Rates Rise

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It was bound to happen sometime. Finally a 1%+ move in stocks, and it is to the downside. The main cause is a sharp upward movement in long-term yields, both in the US and abroad. The sell-off began yesterday when Mario Draghi did not commit to further stimulus, raising the specter that the ECB's QE program will end next March. And recent statements by Williams of the SF Fed and Rosengren of the Boston Fed that it is time to raise rates have added fuel to the downturn.

I still maintain that absent some very inflationary developments, the Fed will not move in September but will set market expectations for a December rate hike. No Fed official has recently voiced an "urgency" to raise rates. We are certainly at or very near full employment and the deflationary threat that was so scary early this year has vanished. Actually, recent data have been conflicting. The somewhat soft labor report last Friday and the very weak ISM data contrasts with the continued strength from the jobless claims and GDP growth this quarter which is running over 3%, three times the rate in the first half. There is no sign the economy is "running away" from the Fed.

As expected when yields go up, the interest sensitive stocks, such as utilities, telecom, and particularly REITS are the hardest hit while the financials, which, if the Fed raises rates will immediately receive a multi-billion dollar injection of higher interest on their reserves, have been hurt the least. Does yesterday or today signal a "tipping point," as bond guru Jeff Gundlach believes? Perhaps, but let us not forget that when the Fed stopped QE, two years ago and then increased rates last December, many pundits believed a "turning point" had been reached. Instead yields, after initially rising, turned around and went even lower. Perhaps we will see higher yields, but that is not necessarily bad and it is most likely to be the result of an improving real economy. I once thought that ten year yield on the US Treasury would top off at about 3 ½%. Now I think that 2 ½% may be the top. And if yields go up, I much rather be in stocks, whose earnings will improve as real growth (and mild inflation) return rather than in bonds whose coupons are fixed.
