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Daily Commentary

Waiting for a move in bonds

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On Friday, Wall Street closed higher, with the S&P 500 up **0.6%** at 7,811 points, the Dow Jones up **0.8%**, the Nasdaq up **0.6%**, and the S&P 500 up **1.2%** for the week.

Looking beneath the surface, it is the same story as ever: the Russell 2000 ended the week down **0.9%**, and the US 10-year yield, after a session full of swings, climbed back to **5.24%**.

The penthouse is holding up, but the floors below are not, and the reason still has the same name: **rising yields**.

Today, the **Treasury** market remains closed for Columbus Day, while the stock market is open.

This pause gives us an opportunity to look at the issue from the other side.

In recent weeks, we have asked how far yields could rise.

Today, the question is the opposite: **what if the real risk were a rise in bond prices?**

The third quarter ended with the 10-year yield up **87** basis points.

That had not happened since the first quarter of 1994.

Such a move has left behind a group of sellers rarely seen so uniformly positioned.

Market participants who, by the nature of their business, are long duration added about **100,000** short contracts on 10-year Treasury futures in the week ending September 22 alone, one of the largest moves since 2023.

Systematic funds, which follow the trend, are described by a major investment bank as “decidedly short”, with positions that, if the trend reversed, would force them to buy back quickly and in increasing quantities.



Moreover, **684.5** billion yen flowed out of foreign bonds from Japan in a single week.

Those who are long duration are hedged.

The price of protective options on the long bond is at its highest since August.

Everyone has protected themselves against a further fall in prices.

No one has protected themselves against a rise, and it takes little to trigger short covering.

When yields begin to fall, those who are short must buy back, pushing prices higher and forcing other short sellers to do the same.

In addition, those who have sold call options have negative gamma and must buy futures when prices rise, amplifying the move.

We came close on September 30 with a better-than-expected inflation reading, but the fuse was damp.

Today, something is beginning to move.

The 10-year Treasury auction on October 7 closed at **5.30%**, with demand above expectations; the following day, the 30-year bond was received equally well.

The September employment data disappointed, with **29,000 new jobs** versus 90,000 expected, and an easing of tensions in the Strait of Hormuz, according to a major investment bank, would by itself mean about **33** basis points less on the US 10-year yield.

In the stock market, speculative traders have net exposure of **46.4%**, at the **2nd** percentile of the past five years, with the ratio of long to short positions at the **1st**



percentile, yet overall leverage is at the **79**th percentile.

A lot of leverage, little direction.

They are in the game, but with their hands in their pockets.

Discretionary funds are selling the most.

On October 7, sales exceeded purchases by **25**%, and in September, technology was the only sector bought.

Balanced portfolios are suffering because, with the correlation between oil and the 10-year yield at a 35-year high, bonds no longer act as a safety net.

Among retail investors, almost one in two, according to the AAll survey, says they are bearish.

It is not panic; it is fatigue.

Another indicator, which measures how much optimism about monetary policy is priced into equities, stands at **-7.98**, close

to its all-time low of **-9.38**, meaning **equities are pricing in no help from interest rates**.

Why, then, is the stock market struggling if earnings are surging?

For the third quarter, consensus expects **29.5**% year-on-year earnings growth, with estimates revised upward when they are usually cut.

Since June 30, expected earnings over the next twelve months have risen **9.3**%, while the S&P 500 has risen only **2.0**%.

Multiples have borne the difference, falling from 22 to **19 times** because of rising yields.

At 19 times earnings, the S&P 500 has an implied yield of about **5.2**%, the same as the 10-year Treasury.

The equity risk premium has effectively



fallen to zero, and as long as the 10-year yield stays here, multiples have no room to rise, whatever earnings do.

It is like a shaken bottle of sparkling wine: the pressure inside grows quarter after quarter, but the cork (yields) holds.

With the 10-year yield **50** basis points lower, the multiple would rise toward **21.5** times and the S&P 500 would reach around 8,650 points, about **11%** above Friday's close.

Even if only half of the decline were reflected in multiples, there would still be **5.0%** growth.

In 1995, after the bond market disaster of 1994, the S&P 500 gained **34%**, while between October and December 2023, as the 10-year yield fell from 5.0% to 3.9%, the S&P 500 rose **16%** and the Russell 2000 **24%**.

In other words, it was precisely the lower floors, those suffering today, that rose the most.

Be careful, because not all declines in yields are the same.

If yields fall because short sellers cover their positions, oil prices ease, or inflation slows, the cork pops.

If they fall because the economy suddenly grinds to a halt, the denominator improves, but earnings collapse, and that is an entirely different story.

There are also those who think the cork will stay where it is.

The Fed continues to talk about further rate hikes, the FOMC minutes express concern about AI as a source of inflation, the supply of bonds remains enormous, and some see the 10-year yield



plateauing at **5.75%**.

Nevertheless, the impression is that, given this positioning, **if yields were to fall, they could do so much faster than expected, while equities have already priced in the worst-case scenario.**

That is where the asymmetry lies.

Today's trading session will probably offer little to react to, with the Treasury market closed.

The first real test comes tomorrow with the **quarterly earnings reports from JPMorgan, Citi, and Wells Fargo**, followed by the **FOMC meeting on October 27–28.**

In the meantime, it will be useful to continue building bond exposure in stages and to look at the lower floors of the stock market (the equal-weighted S&P 500, quality small caps, utilities, and financials).

They stand to gain the most if the cork pops.

The pressure in the bottle keeps rising, and when the cork pops, it is best to already have a glass in hand.



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