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One hike from the Fed, two from the bond market

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James Carville, the political strategist, once said he wanted to be reincarnated as the president or the pope or as a .400 baseball hitter, and then changed his mind. Instead, he wanted to return as the bond market, because the bond market can intimidate everybody. That was 1993. It is still true.

On Sept. 16, the Federal Reserve raised interest rates for the first time in more than three years, by a quarter point, to a range of 3.75 percent to 4 percent. The bond market, which answers to no committee, raised rates twice as much. The yield for the 10-year Treasury note closed above 5 percent for the first time since 2007 and finished the month at 5.28 percent, up more than half a point. The Fed moved a quarter; the market moved a half. Guess which one your mortgage follows.

The stock market took the news four different ways. The S&P 500 slipped 0.4 percent to 7,652, about 2 percent below the record it set in August. The Nasdaq gained 1.9 percent and reached a new high on Sept. 22. The Dow Jones Industrial Average fell 4.3 percent, and the Russell 2000, the index of smaller companies, lost 5.3 percent. Same month, same economy, four different answers.

Here's why. Picture a neighborhood where the three biggest houses doubled in value this year and everyone else's lost a little. The average home price went up. Most homeowners lost money. The S&P 500 works like that neighborhood. It accounts for every company by size, so its 10 largest members, nearly all of them technology, make up close to 40 percent of the index. The Nasdaq is heavier still in technology, which is why it rose. The Dow is just 30 companies with far less technology, and the Russell 2000 is 2,000 small companies that borrow at floating rates and feel a higher Treasury yield before anyone else. Only two of 11 sectors rose: technology and communication services, while financials, materials and real estate each fell 6 percent to 7 percent. The headline index was flat, because a dozen very large companies were up. Everyone else had a correction.

Fed Chairman Kevin Warsh told us in August at Jackson Hole that he was committed to a discipline, not a decision: inflation had to be moving toward 2 percent "clearly, and at sufficient speed." In September the committee decided it was not, and the vote was unanimous. The August

consumer price index showed prices up 3.4 percent from a year earlier, but strip out food and energy, and the figure was a mild 2.4 percent. The Fed watches that second number, because food and energy swing with the weather and the news, and the news out of the Middle East was all bad. Houthi forces seized a port near the southern mouth of the Red Sea on Sept. 11. Tanker traffic through the Strait of Hormuz ran at fewer than six ships per day, down 96 percent from before the war. Brent crude touched \$109 and finished near \$100, up about 14 percent. Regular gasoline averaged \$4.41 a gallon at month's end, against \$2.93 before the Iran conflict began. Warsh conceded that a rate increase cannot produce a barrel of oil. What it can do is keep the price of oil from becoming the price of everything.

That explains the Fed's quarter point. The bond market's half-point response requires a little more explanation. Suppose your brother-in-law asks to borrow money for 10 years. You will want three things: enough interest to cover the inflation you expect, something on top of that for doing without your money for a decade, and a little extra because you cannot be sure about him. Treasury yields work the same way. In September the inflation piece held steady near 2.4 percent and the little extra barely moved. Almost the entire rise came from the middle piece, what economists call the real yield, now at its highest in about 20 years.

The bond market was not saying it feared inflation. It was saying there is a line out the door at the bank. The six largest cloud companies plan to spend \$817 billion on data centers this fiscal year, nearly double the amount of last year. The federal government is borrowing more than 6 percent of GDP in a year with no recession. When Washington and Silicon Valley show up at the same teller window on the same morning, the price of money goes up for everybody, including the family in Beaverton shopping for a 30-year mortgage, which averaged 7.28 percent in early October. That's the highest rate since 2023.

Then the data turned. On Sept. 30 the Fed's preferred inflation gauge, the PCE index, came in below forecasts at 3.4 percent, with the core rate at 3 percent. Two days later, the September jobs report showed 29,000 new jobs against 90,000 expected, unemployment ticked up to 4.2 percent, and July jobs were revised to a loss. Two weeks after Warsh called the labor market "in good shape," the odds of another hike in October fell from about 70 percent to 20 percent. Warsh had cautioned that trends matter and data points are noisy. September got noisy. He will now find out which it was.

History offers comfort, with a footnote. The 10-year yield has broken out like this seven times since 1985, and a year later stocks were higher on average. The footnote is 1994, 1999 and 2022, the years the Fed kept hiking, when they were not. The soft jobs report made that less likely.

Washington and Beijing agreed to keep talking. President Xi's state visit extended the trade truce by two months and trimmed tariffs on \$30 billion of goods each way, while semiconductors, rare

earths and Taiwan went unmentioned. One analyst called it tactical autopilot, which these days counts as diplomacy.

The lesson of a 5 percent Treasury is an old one. Higher rates sort companies the way a hard winter sorts a garden. A business with recurring revenues, little debt and cash in the bank earns more on that cash and pays no more for its growth. A business built on borrowed money at 2021 rates will find out what 2027 rates look like when the loans come due. Carville was right that the bond market can intimidate everybody. It has a harder time intimidating a company that does not need to borrow. History says the market rewards patient owners of quality companies with strong cash flow and balance sheets through cycles like this one. Remember, a month is a data point; a decade is a trend.

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