Rate Scare’s First Casualty in Stocks Is the Speculative Fringe

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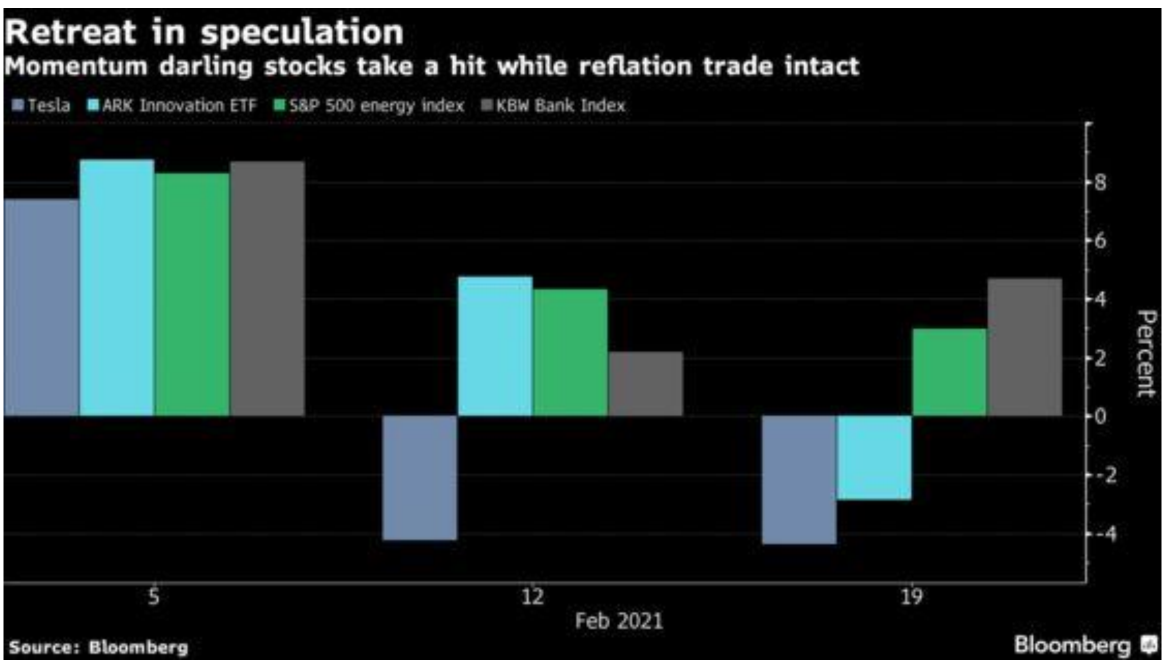
(Bloomberg) -- February’s hot equity rally cooled amid a spike in bond yields, setting off a reordering with potentially ominous implications for the market’s riskiest districts.

Momentum darlings such as Tesla Inc. and Ark Innovation ETF bore the brunt of the selling, falling at least 2.5% in a week when the broader S&P 500 index was down only 0.7%. Shares of unprofitable technology firms and stocks that only recently went public -- poster children for 2021 euphoria -- slipped for the first time since January.

Behind the reversals was a spike in Treasury yields that threatens to raise the cost of money and remove a big impetus for speculation. Thrust to the top of the winner list were industries more squarely associated with a recovering economy -- energy and bank shares extended their best monthly gains since November.



“When we saw rates spike, some of the more higher-growth areas did start to see some selling and some profit-taking,” said Jordan Kahn, chief investment officer of ACM Funds. “But I think it’s more of rotation, so we didn’t see the overall market come off too much.”

Traders continue to stand ready to buy the dip. The S&P 500 opened lower in the first three sessions of the holiday-shortened week, only to bounce back in each case to close near or above the midpoint of the daily range. The Dow Jones Industrial Average eked out a third straight weekly gain, but ended the period off its record set Wednesday.

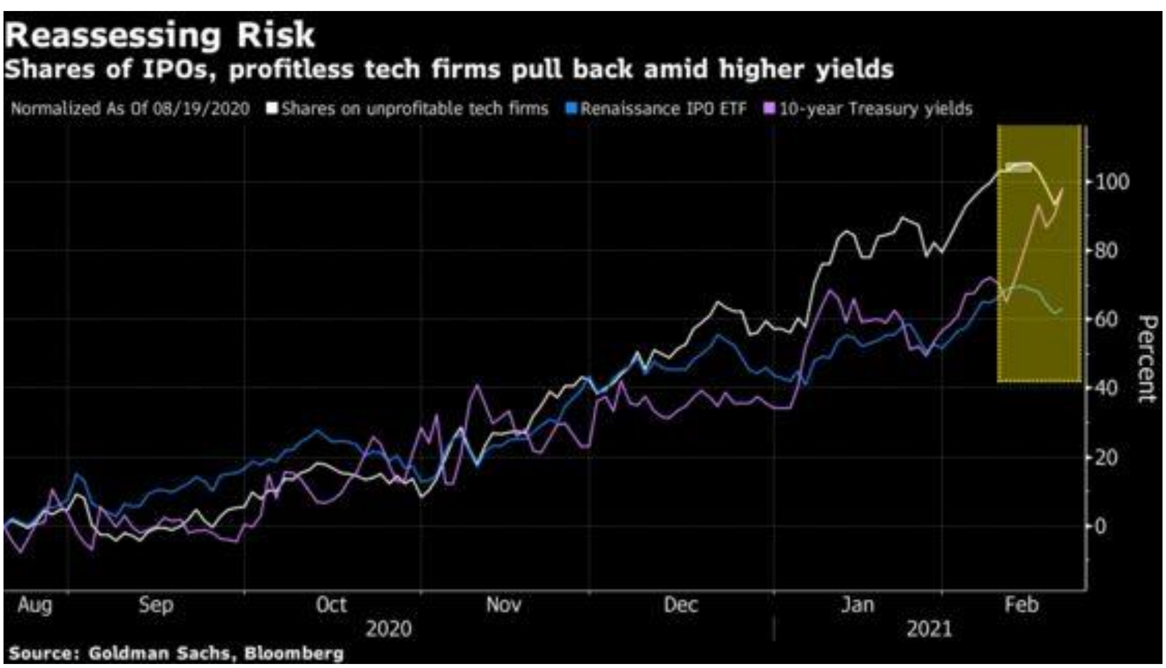
“People feel they should be buying now because, ‘hey Covid is almost over and we’re about to have this big economic recovery,’” said Matt Benkendorf, chief investment officer of Vontobel Quality Growth. “There is this fear of missing out.”

Riding momentum had been an easy route to booking profits, at least before this week. From IPOs to electric vehicles and cannabis, firms that earn little or nothing were the biggest winners in a market where money is easy to borrow and even troubled companies are allowed to stay afloat.

Now the low-yield argument buttressing the speculative excess is in jeopardy. Rates on 10-year Treasuries climbed for a third week, the longest streak of increases since October 2019. At 1.34%, yields reached levels not seen since before the pandemic.

Expensive stocks took a hit. A Goldman Sachs basket of profitless tech companies, sank 3.3% over the week, trimming its 2021 advance to 26%. The Renaissance IPO ETF and ARK Innovation ETF, both more than doubled in the past year, each slipped at least 2.5%.

“Speculation goes hand-in-hand with cheap money and as interest rates go up, money is less cheap,” said Ernesto Ramos, U.S. chief investment officer for BMO Global Asset Management. “By default, as rates go higher, you’re going to put a damper on speculation.”



For months, stretched valuations and overly bullish sentiment have been cited as a reasons for caution. Earlier this week, Citigroup Inc.'s strategy Tobias Levkovich warned that a 10% pullback in U.S. shares seems “very plausible.”

Others see further upside for the 11-month old bull market. Among positive factors, they pointed to the $4.3 trillion sitting in money market funds -- an amount that's twice as high as the 20-year average -- as a pool of unspent money that bodes well for stocks.

“We're still early in terms of the flow story,” said Liz Ann Sonders, Charles Schwab's chief investment strategist. “I'm not sure we're anywhere near the exhaustion point in terms of everyone that can buy in and has liquidity is already in and therefore were at some imminent inflection point.”