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Bonds and Equities - Is the Honeymoon Over?

Our weekly view on asset allocation.

1 March 2021

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Strain in the Relationship

Long-term interest rates have risen significantly in recent months. Equities have, for the most part, continued their impressive uptrend despite the rise in bond yields, but signs of strain in the relationship are starting to emerge.

Many equity investors are beginning to look nervously at the rise in bond yields and contemplate both the near-term and longer-term implications for the equity market with a rise in the market's discount rate.

A common question from investors is why have equities (at least so far) digested the rise in long-term interest rates fairly comfortably?

We believe there are 2 key reasons.

Firstly, the rise in the all-important US 10 year bond yield has been from an all-time low of 0.5% in August 2020. While the move up in the bond yield has been rapid, the current yield of 1.4% is still extremely low in a long-term context (10-year average is 2.1%) and is still below the yield prevailing in early 2020 – immediately pre the COVID-19 market correction (1.6%-1.8%).

Secondly, the recent rise in bond yields has been associated with an improvement in the economic growth outlook, alongside a normalisation in inflation expectations. In short, what we have witnessed is a shift in market thinking towards reflation but not outright inflation.

With economic growth prospects brightening, earnings expectations have also improved. Consensus earnings estimates have been revised up in recent months (6 months in a row), which has helped buoy the equity market.

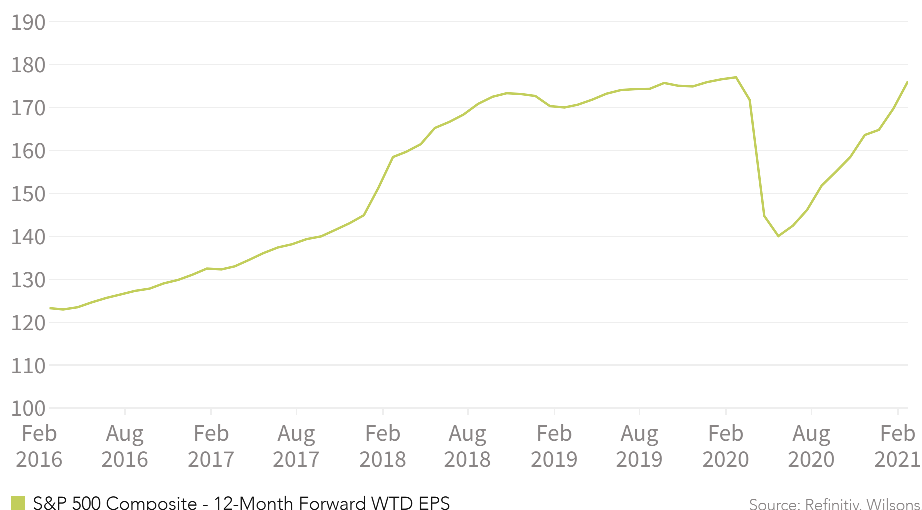
Exhibit 1: Bonds have been in a 40-year bull market

Source: Refinitiv, Wilsons.

Exhibit 2: Equities have (so far) been able to rise with bonds yields

Source: Refinitiv, Wilsons.

Exhibit 3: US expected EPS estimates have staged a dramatic recovery to pre-COVID-19 levels



Source: Refinitiv, Wilsons.

A Volatile Relationship

The recent, mostly positive correlation between bond yields and equity performance is not uncommon. An environment of improving growth alongside a moderate rise in inflationary expectations is typically a good backdrop for stocks.

However, the bond and equity relationship is a volatile one. Reflationary optimism can sometimes tilt over to inflationary fears, shifting the bond yield and equity correlation from positive to negative.

Bond Equity Breakups – What Does History Say?

It is difficult to judge exactly when the bond yield becomes a significant problem for the stock market. History offers some guide, although it is far from conclusive.

In terms of historical levels, the last couple of times bond yields have induced an equity correction, the US 10-year yield has been in the 2% to 3% zone. Interestingly, these bond market-driven equity corrections have occurred a couple of times in the last 10 years at a significantly lower pinch point than in earlier cycles. We expect the pinch-point (at least initially) could come at an earlier level (possibly quite soon if the current bond sell-off continues unabated). The market has become conditioned to very low rates, and valuations are very stretched in an absolute sense. The increase in bond yields in recent months has been quite dramatic, even though it is off a very low base.

De-coupling and Re-coupling

However, even if we see a bond market-induced equity pullback, it is quite likely to be temporary. We also expect any risk asset sell-off would likely short circuit the rise in bond yields (at least temporarily). After a period of consolidation, the equity market would move back to focus on the improving growth backdrop, which is still very much in its infancy.

We could see this stop-start response to higher bond yields within an ongoing bull market for stocks playing out over a multi-year period.

Exhibit 4: 2% yields and a planned Fed QE taper drove an equity correction in 2013

Source: Refinitiv, Wilsons.

Seeking the Fed's Council and Support

In large part, the equity market's response to higher bond yields will be a function of what else is happening – particularly in respect of the monetary policy backdrop.

The market's expectations around US Fed quantitative easing (QE) tapering will be important. The QE "taper tantrum" of 2013 is a case in point. A sharp move in bond yields through the 2% mark (1.6% to 2.6% in total) induced a sharp but short-lived equity correction (6% in the US and 10% in Australia in just one month).

The Fed's cash rate guidance will also be very important. A (temporarily) hawkish Fed spurred a 20% US equity correction in the final quarter of 2018 as the market worried about the overly tight US monetary policy. Of course, the Fed quickly pivoted back to a dovish stance at the end of 2018 and drove a big rally in equities in 2019.

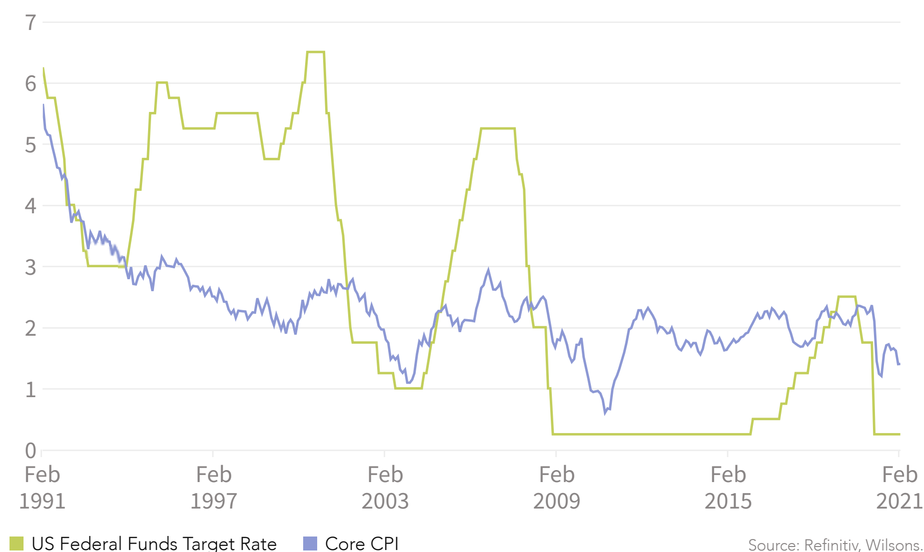
Exhibit 5: 3% yields and a hawkish Fed drove a 20% equity correction in 2018

Source: Refinitiv, Wilsons.

At this stage, central banks are at pains to anchor market expectations for a very gradual withdrawal of QE and a sustained zero cash rate period. Guidance affirms that there should not be a rise in the cash rate until mid-2023 for the US Fed and 2024 for the RBA.

This could change if fundamentals shift dramatically, but we think central banks will try very hard to stick to their forward guidance. This suggests the yield curve may find it difficult to steepen too much from here (at least for a while), and the equity market may not agonise too much, or too long, about a further rise in bond yields.

Exhibit 6: Inflation is low and policy rates are anchored at near zero



Source: Refinitiv, Wilsons.

Bonds and Inflation (It's Nothing Serious...Yet)

While this is the current central bank game plan, the path of inflation will ultimately be critical for both central bank policy and the path of the bond market. Inflation expectations have risen, but genuine pressure still looks a fair way off.

Central banks are also guiding that they will be prepared to let inflation push above the target given the long period inflation has been below target. A hawkish response to increasing inflation is likely to be a very long way off – unless inflation outcomes start surprising dramatically. There seems enough spare capacity in production and (particularly) labour markets to suggest inflation outcomes over the next 1 or 2 years will remain subdued.

We believe bond yields will push higher, but it is likely to be in a stop-start fashion and a bull market-ending surge in bond yields looks some way off.

Certainly, the rapid rise in bond yields is beginning to impact equity markets, particularly in terms of rotation (from growth to value). We see more scope for this through the coming year and have positioned portfolios for a significant cyclical revival in value.

The recent shift in bond yields has been driven by an improved growth outlook and a normalisation in inflation expectations. Bond yields are likely to rise significantly over the next 12 to 24 months, though it is unlikely to be a straight line sell-off.

Volatility is likely to increase, but significant and sustained pressure on stocks from the long bond is some way off in our view. Key signposts are QE tapering (likely 2022) and Fed cash rate tingeing (likely 2023), married with concerns of a sustained phase of above-trend inflation – although this is not likely to be a genuine concern for 2021.

We stay moderately overweight equities with some diversification across other risk assets (private equity, commodities, infrastructure) and remain significantly underweight traditional fixed interest. Within equities, we favour value/cycle over growth on a 12-month view.

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