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MACROCOSM

Are Bonds a Threat to Stocks?

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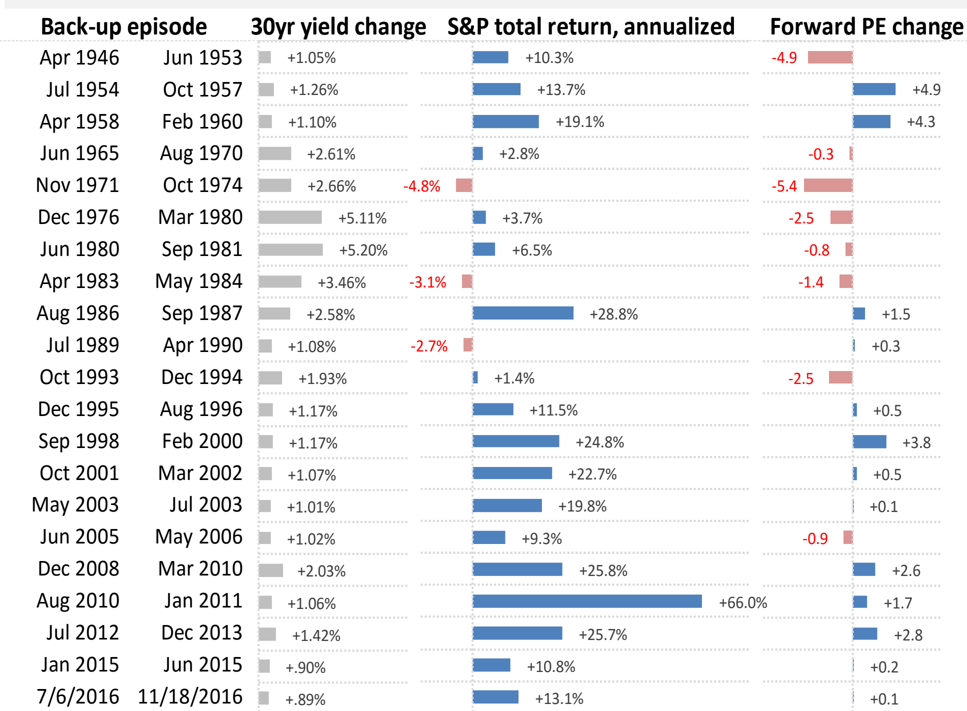
Higher yields point to a better environment for equities, and a falling equity risk premium.

We called the bottom on global government yields in early July, at the worst of the phony Brexit panic (see "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016) – but we were wrong not to foresee that the yield back-up could carry so far, so fast (see "Gundlach and Load" September 12, 2016). *With this report we'll follow up on concerns we raised in a report last week about a possible negative impact of higher yields on equity markets* (see "Trump and the 'Reflation Trade'" November 15, 2016).

- There's an intuitive knee-jerk reaction that higher yields ought to be negative for equity prices. *But so far, so good.* Since the post-Brexit bottom in early July, the US 30-year yield has backed up 89 basis points, while the S&P 500 total return has been 4.7%.
- *This positive relationship is the rule, not the exception* (please see the chart below). In 21 episodes of major back-ups in the US 30-year yield, the S&P 500 had positive total returns in all but three.

S&P 500 total return (annual basis) and PE change: back-ups in US 30-year



Month-end data, except for latest episode. Source: Various, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, US MACRO: So far stock prices have advanced during the back-up in long-term yields from early July. This is indeed the historical norm, with stocks having fallen in only three of 21 post-war yield back-ups. The S&P 500's total return has been higher during yield back-ups, versus the historical average. Rising yields imply higher inflation, faster growth and less systemic risk – all of which raise expected earnings and protect the present high equity risk premium. But in that better environment, investors need not demand such a high risk premium as the price of risk-bearing. So the ERP can be expected to fall, and stock prices need not decline to maintain it. The biggest immediate risk is that some "risk parity" player, or someone else habituated to the "new normal" of low yields, blows up and creates a systemic threat.

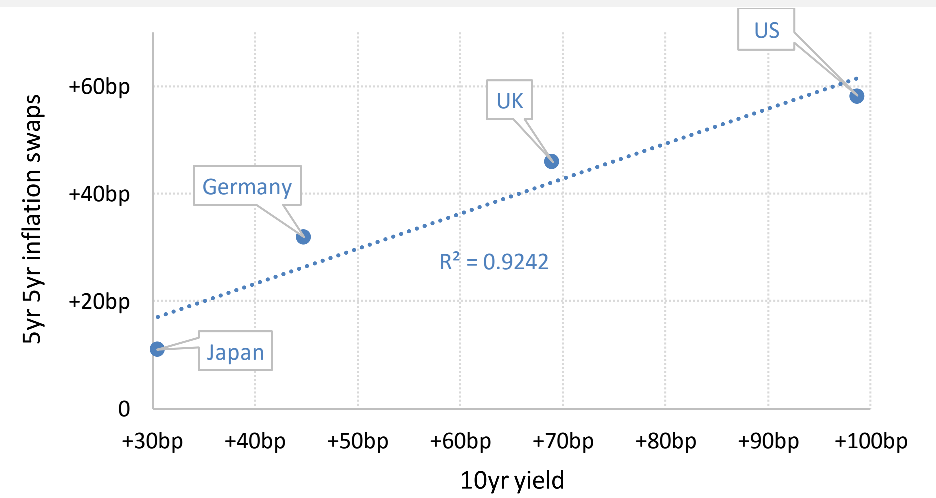
[Strategy dashboard]

- The average S&P 500 total return over these episodes was 14.5%. This exceeds the *overall* average return, including *all* periods regardless of the change in the 30-year yield, of only 10.9%.
- If this seems counterintuitive, perhaps it's because we've been conditioned by central bankers to expect quantitative easing to "stimulate" the economy by lowering long-term yields – requiring us to believe that long-term yields must be a good thing, to be obtained artificially, if necessary.
- *But the reality is that low long-term yields are not "stimulating," but instead are evidence of systemic fragility, economic sluggishness and monetary deflation. If low yields are so great, then we should have been in a boom for the last eight years, not "secular stagnation."*
- *This reality is captured in the older and deeper intuition that flat or negative yield curves imply recession, and that positively sloped curves imply expansion.*
- *It should not be surprising that equities perform especially well when long-term yields are backing up and the curve is steepening.*

But is this time different? We often hear from clients the concern that today's equity valuations are supported by low long-term yields. Low long-term Treasury yields are uncompetitive with the earnings-yields of equities – or in our language, the equity risk premium is quite high, making equities an attractive value proposition (please see the chart on the following page). If yields rise, it is feared, in order for stocks to remain no less attractive – that is, for the ERP to be maintained – stock prices would have to fall in order to raise earnings-yields.

- Well, maybe. But inflation is one counterbalance. Of the 30-year Treasury's 89 basis points back-up since early July, 58 bp are explained by a rise in long-term steady-state inflation expectations. A similar and proportional relation is true for major bond markets globally (please see the chart below).

Changes in 10-yr yields and inflation expectations From July 6, 2016



Source: Bloomberg, TrendMacro calculations

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[About us]

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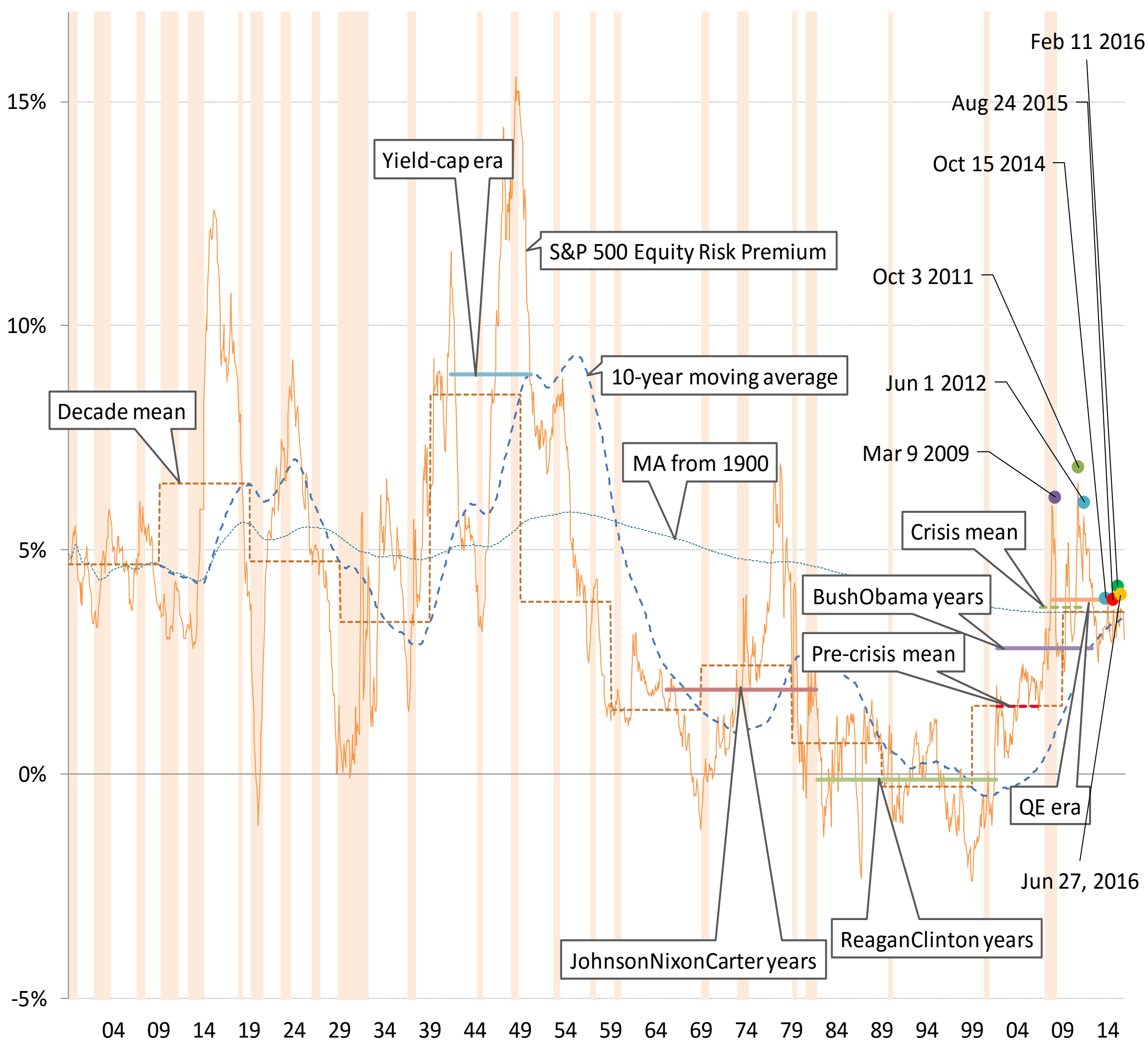
[Reading home]

- Earnings are nominal, just as bond yields are. So any inflationary increment applied to yields in the calculation of the ERP must also be applied to earnings. In the arithmetic, that's a perfect offset.
- *[Technical note: In the deliberately simple and transparent model we use to estimate the ERP, the inflation premium in bond yields is treated as perpetual. But the earnings input looks just one year ahead, and so impounds only **a single year's** inflation. This is a blind-spot in our model which, in the present environment, will put a downward bias into our estimate.]*
- Another counterbalance is that, again, rising bond yields imply an improving growth outlook. That outlook, in turn, implies higher *real* forward earnings.
- *[Technical note: The downward bias in our model imparted by considering a single year's higher inflation may be offset by an upward bias imparted by considering only a single year's real earnings growth.]*
- These points argue that just because yields rise, the ERP doesn't necessarily have to fall. So stocks don't have to become less

S&P 500 equity risk premium Forward earnings yield minus 30-year **Recession**



Source: Various, TrendMacro calculations relatively attractive to bonds.

- *But that said, what's so bad about having the equity risk premium fall?*
- Why should we believe that stocks, in order to be attractive, must continue to offer the unusually high ERP they have offered since the onset of the Great Recession?
- Such a risk premium is appropriate for an era of secular stagnation and a lingering sense of imminent systemic risk (again, please see the chart on the previous page). But if higher bond yields are signaling that this era – this "new normal" – is over (see "Trump and the 'Reflation Trade'"), then why shouldn't the equity risk premium revert back to a level more appropriate to faster growth and less systemic risk?
- To be sure, we have to bear in mind that stocks are starting with relatively high forward PE multiples. But multiples have expanded so far in the present yield back-up since early July. And they have expanded in nine of the ten most recent back-ups, and in all but eight of the 21 post-war back-ups (again, please see the chart on the first page).
- *Yes, there are reasons for liking a high ERP.* It means you're probably getting paid for taking equity risk – but that begs the question of whether, for any given ERP, you are in fact getting paid *enough* for the then-current level of actual risk. When the ERP is *extremely* high – when it is more than compensating for any rational conception of risk – then it can be a market-timing buy signal (as it has been, *brilliantly* if we do say so ourselves, several times since the onset of the Great Recession).
- *That said, there are reasons for liking a low ERP, too.* It might mean you aren't getting paid for taking equity risk, but if it correctly reflects a very low then-current level of actual risk, then it is appropriate – and it signals that you are in a low-risk era that might be especially conducive to growth. The 1980s and the 1990s – during which the ERP hovered around zero much of the time – were such an era. Even then, at moments when the ERP got *extremely* low – when it couldn't possibly have compensated for any risk at all – then it can be a market-timing sell signal (as it was just before the Crash of October 1987, back in the good ol' days when we were at Wells Fargo Investment Advisers using the ERP to get our "tactical asset allocation" strategy out of stocks and into bonds).
- *The thing to be feared from the ERP is its rising, not its falling.* When it rises, stocks are in the process of becoming cheap relative to bonds – that is, they are underperforming.
- *Fear not the ERP falling.* When it falls, as it is doing now, stocks are in the process of becoming richer relative to bonds – that is, they are outperforming.
- Again, that's exactly what's been happening so far in the present episode of long-term yields backing up. Equity investors have done fine – except those who invested in equities deliberately chosen because they are like bonds.
- It's bonds and bond-like stocks that have gotten hurt. In fact, as we look at the magnitude and speed of the back-up since early July,

we have to wonder whether there's a "pain trade" involved. There usually is. In this case, it's likely the "risk parity" strategies that have used leverage to buy duration, underestimating its risk, and are now automatically required to scramble to reduce those positions to bring their "risk" back into "parity" (as long as we are reminiscing about the Crash of 1987, these strategies seem to us no different than "portfolio insurance").

- If we were looking for something bearish for equities in the present environment it would be this, or something related to it. When any given investment regime has persisted for several years, investors adapt to it, exploit it – and eventually over-exploit it by assuming it will last forever. When it suddenly ends, somebody always takes big losses. If the losses are big enough and the somebody is levered enough, there can potentially be systemic consequences.
- So far we are seeing almost no evidence in credit markets that there is any particular stress.

Bottom line

So far stock prices have advanced during the back-up in long-term yields from early July. This is indeed the historical norm, with stocks having fallen in only three of 21 post-war yield back-ups. The S&P 500's total return has been higher during yield back-ups, versus the historical average. Rising yields imply higher inflation, faster growth and less systemic risk – all of which raise expected earnings and protect the present high equity risk premium. But in that better environment, investors need not demand such a high risk premium as the price of risk-bearing. So the ERP can be expected to fall, and stock prices need not decline to maintain it. The biggest immediate risk is that some "risk parity" player, or someone else habituated to the "new normal" of low yields, blows up and creates a systemic threat.