BALLENTINE
PARTNERS

OCTOBER 15, 2018

The Message from the Bond Market

Bruce D. Simon, CFA, CPWA®, Partner & Director of Research

Last week's extreme turbulence in global stock markets was preceded by a sharp rise in US interest rates. After fluctuating in a narrow range around 3% for most of the year, the bellwether 10 year US Treasury note yield spurted from 2.87% on August 31 to 3.23% on October 5, the highest level since July 2011. The rapid rise in yield was one of the reasons cited for last week's brutal two-day selloff in stocks, which drove the S&P 500 down by nearly 5% and sent global stocks tumbling. Other factors contributing to the decline were the ongoing trade dispute with China and nervousness about high valuations of technology stocks, long viewed as market darlings. Neither of these last two factors could be considered new news, so the spike in bond yields was viewed as the primary culprit.

What is the bond market telling us about the strength of the US economy and the outlook for inflation?

The bond market often provides important clues about investor expectations that are harder to discern from the daily vacillations of stock prices. Only six weeks ago, market observers were lamenting the likelihood of an inverted yield curve (when short-term yields (typically the 2-year Treasury note) exceed the yield on 10 year notes.) The spread between 2's and 10's fell from 123 basis points at the start of 2017 to just 18 basis points on August 27, 2018. An inverted yield often presages an economic slowdown, although the onset of the actual decline can vary widely. Anticipating that interest rates will fall in an upcoming economic slowdown, investors accumulate longer-term bonds hoping to lock in the higher rates available today. Depending on the depth and magnitude of the downturn, equities would be expected to suffer significant losses under this scenario.

Fast forward to today. The jump in 10-year yields has widened the spread between 2's and 10's to 34 basis points, moving further away from the feared inverted yield curve condition. And based upon little change in the outlook for inflation (as measured by the gap between nominal bond yields and the yield on treasury inflation-protected securities), the rise in long-term rates is due entirely to an increase in the "term premium," the additional compensation that bond investors require for owning long-term bonds. In other words, the bond market is now anticipating stronger, more sustainable growth in the economy than it had only a month ago. If the economy is generating strong non-inflationary growth, why are stock investors flipping out (technical term)?

There are probably three reasons. First, the speed of the backup in yields caught investors by surprise. While most forecasters have expected rates to move higher as the Fed continues its rate normalization program and slowly unwinds its holdings of Treasury securities accumulated over the last 9 years, investors prefer a more deliberate pace of change. A sharp move over such a short period of time may have caused investors to raise their longer-term forecast for rates, putting pressure on equities (whose price is in part determined by discounting future earnings by current interest rates).

Secondly, higher interest rates on bonds create additional competition for investors' funds, and encourage people to switch from volatile equities to the perceived safety of fixed income. Higher rates give investors a stronger argument for protecting their equity gains by shifting money into bonds.

And finally, higher interest rates act as real handbrake on economic growth. Higher rates increase the cost of borrowing for consumers and businesses. The impact can be observed in the slowdown in the housing market over the last several months, as rates on 30-year mortgages have crept up to near 5%. Slowing growth is not good for stocks.

Even with the recent rise, US interest rates are low by historical standards, US economic growth remains robust, and stock market valuations are not excessive. Those are conditions which generally do not presage a meaningful market decline.

While we are concerned about the impact of accelerating federal deficits on US interest rates, those effects are likely to remain a ways off. In the meantime, the US remains a magnet for overseas funds because of our high rates relative to other developed nations, our strong economic growth, and the safety of the US dollar. The message from the bond market is that economic growth is stronger, and more sustainable, than it was before. That should continue to provide a supportive environment for equities.

Bruce D. Simon, CFA, CPWA®, Partner and Director of Research

Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.