Are falling bond yields giving equities a growth warning?

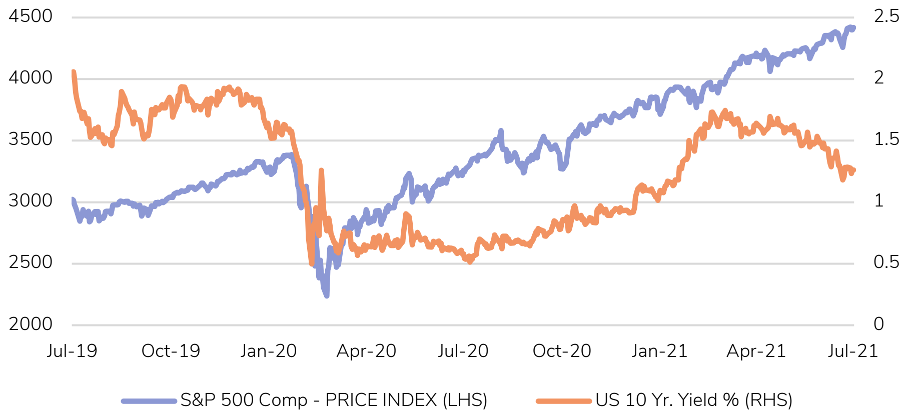
Our weekly view on Asset Allocation

2 August 2021

Falling bond yields foretelling an economic slowdown?

The significant fall in bond yields, after a sharp rise in the first quarter of the year, has surprised many investors. It is also interesting that while bond yields have fallen back to very low levels, the US and Australian equity markets have continued to push higher, reaching record highs.

Exhibit 1: The great decoupling?

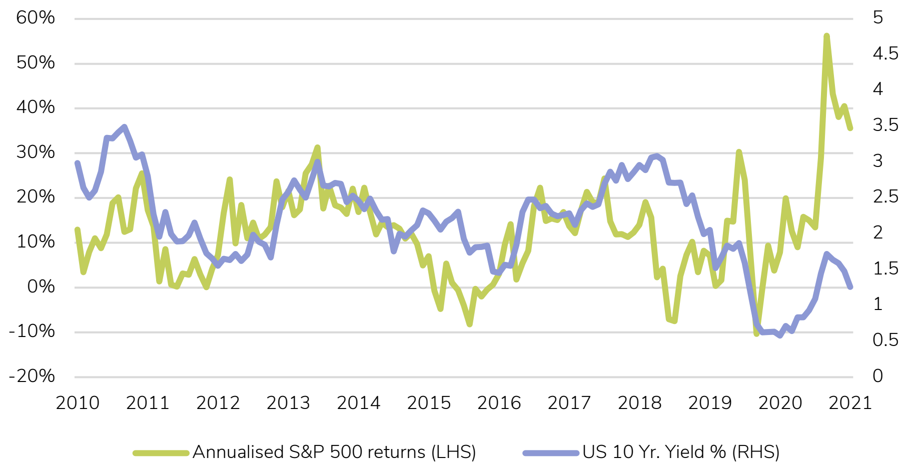


Source: Wilsons, Refinitiv

Is there a worrying inconsistency between the sharp retracement of bond yields while equities grind higher and higher? In short, are bond investors foretelling a significant slowdown in global growth that equities investors are ignoring?

Of course, lower bond yields (all things equal) increase the value of long-dated equity cashflows supporting equity valuations. Yet, a sharp decline in bond yields over a relatively short space of time (a few months) often presages a significant growth slowdown, and there is a tendency for either a coincident, or fairly imminent, decline in equities.

Exhibit 2: Stocks and bonds look to have a different view of the world?



Source: Wilsons, Refinitiv

Some recent evidence that bonds are worth watching

We saw this pattern occur in the last decade post-GFC to the onset of the pandemic in early 2020. In exhibit 2, we show that falling bond yields generally signaled a weak period for stocks. This was, of course, a decade where growth was particularly sluggish and the business cycle was very stop-start.

While there is still uncertainty around how fast the world can grow over the next 5 to 10 years, the “near term” outlook for the next 1 to 2 years is generally perceived to be one of quite robust growth as the world continues to recover from the impact of the pandemic.

Recent data flow continues to be fairly solid, albeit the extent of the rebound is moderating after the initial “bounce-back” from last year’s very deep (but very short) global recession.

Big growth slowdown or some 'Delta' hedging?

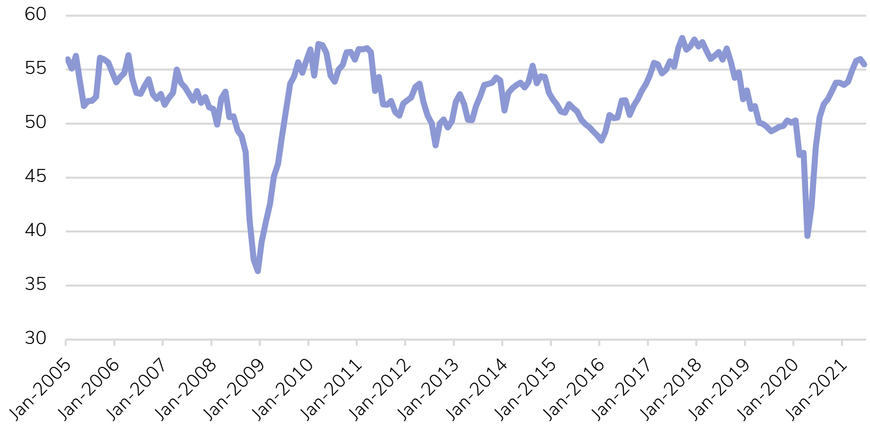
We think it is unlikely that bonds are signaling that a significant slowdown in growth is coming over the next year.

While we undoubtedly have hit peak growth in terms of the year-on-year rebound from last year's second-quarter growth collapse, this is a long way from concluding that we are in for a significant deceleration that significantly undershoots consensus.

The recent peak in growth was a mathematical certainty because of year-on-year base effects. The second quarter in 2020 was so extraordinarily weak that mid-2021 growth rates, as measured by either GDP or profit growth, were always going to mark out a top.

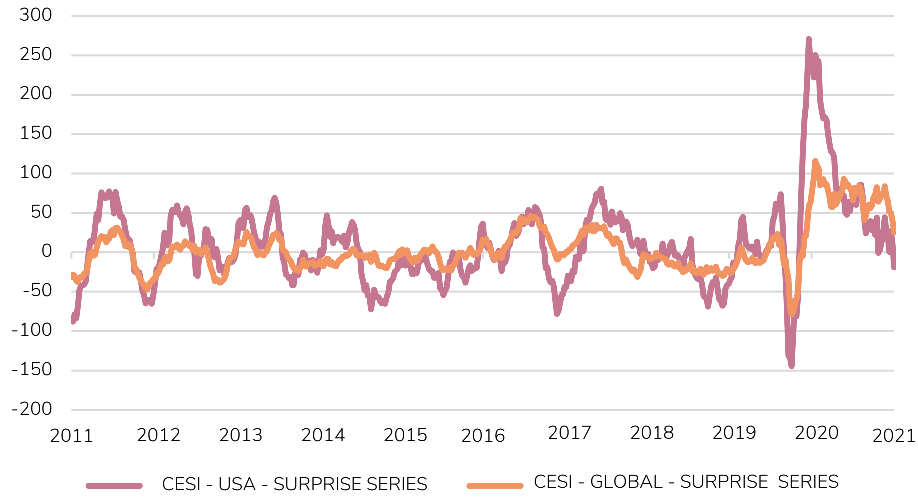
What matters more for equities is how much of a slowdown is coming. We still think economic activity over the coming year will be very robust as there is significant re-opening potential, significant pent up demand, and significant household firepower in terms of cashed-up household balance sheets. In addition, the global profit cycle continues to look very strong.

Exhibit 3: Global growth momentum has peaked but growth should broaden with re-opening



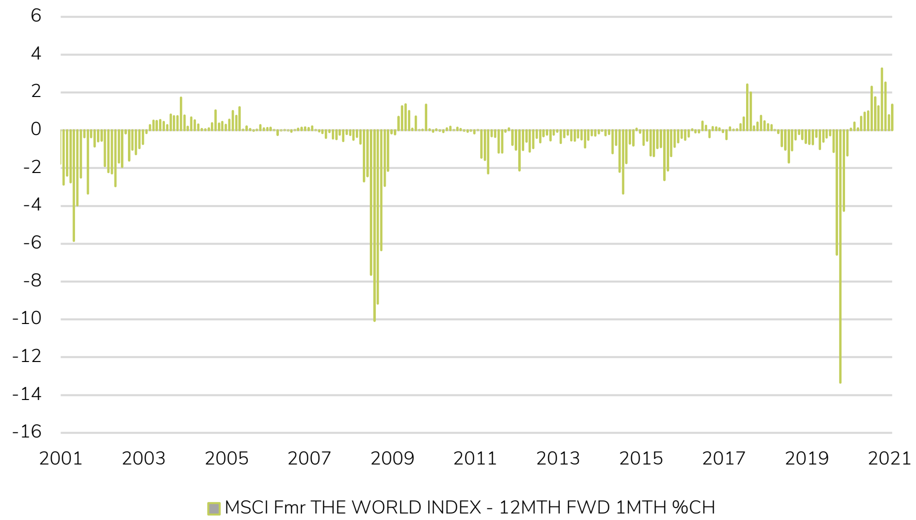
Source: Wilsons, Refinitiv

Exhibit 4: The phase of huge upside economic surprise appears over



Source: Citi, Refinitiv

Exhibit 5: Global earnings estimates have been upgraded 11 months in a row



Source: Wilsons, Refinitiv

Bonds likely grappling with Delta COVID tail risks

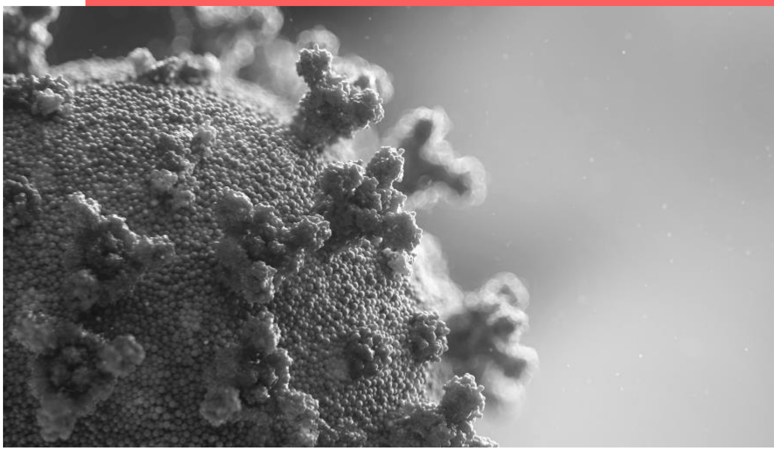
While we think the global growth outlook is robust, the major growth risk is likely to be related to a bigger drag from a resurgence in the pandemic. In short, there is now a higher risk of more periodic restrictions or a much slower normalisation in behaviours than currently projected. We believe this is a factor in the more recent shift in bond yields. Investors are likely taking out some tail risk insurance against the risk that the Delta variant becomes a bigger impediment to growth than most investors central case.

While Delta may become a significant problem for the global growth cycle, the evidence so far (at least globally) is that vaccines have dramatically changed the backdrop, if not in terms of infections rates, seemingly in terms of severe illness (hospitalisations) and deaths.

It is still early days and even more variants can't be ruled out, but at this stage we think the economic normalisation process should continue to progress, though clearly not all countries are in the same spot in respect of vaccination rates.

As we discussed recently, Australia now has its own set of near-term growth challenges due to a slow vaccination rate, but the prospect of a big rebound either in Q4 this year or at worst in 1Q22 still holds significant promise.

Globally COVID is certainly bubbling away but is not seemingly hampering the US growth recovery despite a less than optimal vaccination coverage rate. The labour market recovery over the next few months will be closely watched by the Fed and the market.



We expect it to be sufficiently strong to allow the Fed to announce an intention to "taper" bond purchases. We are pencilling in a formal announcement of an intention to taper in September, with actual tapering likely kicking off in late 2021 or early 2022.

Delta likely only part of the story for bonds

Importantly, we don't think all of the fall in bond yields since late March can be explained by Delta, particularly given that quite a lot of the decline actually happened in April and May, which is pre the rise in concern around the Delta variant.

It is difficult to quantify, but the magnitude of the pullback and the resistance of the equity market to the pullback is likely a function of several specific influences.

Extreme investor positioning at the end of the first quarter

After a very sharp Q1 selloff, bonds likely became short term oversold (as can happen in financial markets). Equally, certain reflation trades e.g. cyclical equity sectors and certain commodities, became overbought. This was likely a factor in the initial April/May adjustment.

The fed pivot calmed long term inflation fears

The US Fed's shift to a marginally more hawkish (less dovish) position in mid-June, as it brought forward rate hike guidance, also acted to send the long end of the curve lower, due to a marginally more proactive attitude toward controlling inflation.

Excess liquidity squares the bond equity performance circle?

Excess liquidity is another oft-quoted influence on both bonds and equities. Too much money chasing both safe haven (bonds) and risky assets (equities) in a world of zero cash rates.

The impact of excess liquidity is more difficult to calibrate, but it is likely that excess liquidity is jointly pushing equities and bonds. At some point there may be a significant adjustment for both asset classes, but beyond some minor near term nervousness around tapering, we think a big adjustment is some way off.

We are still in the tightening policy starting blocks with the Fed in full easing mode (QE plus zero cash rates). Equities typically run into problems when the Fed is getting well into its tightening cycle.

Watch Delta but Stay overweight equities

In summary, we expect that COVID is a risk that needs constant monitoring, our central case of robust recovery, albeit an uneven and staggered global recovery, still looks sound in our view.

Bonds are likely being influenced by multiple factors beyond the near-term growth outlook. Importantly we expect a number of these influences to wane over the coming 6 to 12 months. Ultra-low yields at the time of a broadening recovery, perky inflation, reduced central bank buying (tapering) and a resumption of heavy issuance suggests an unattractive risk-return for bonds in our view. We expect bonds yields to adjust up over the next year as evidence of a robust growth backdrop builds.

This is not to say bonds should be zero weighted in balanced portfolios (with the pandemic still a risk), but we remain underweight, preferring to supplement our bond exposure with a variety of Alternative hedges.

Equities still look attractive on a 12 month view (at least), although equities may also face headwinds later in the cycle as excess liquidity is withdrawn.

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