US: RISING BOND YIELDS, A CONCERN FOR EQUITY INVESTORS?

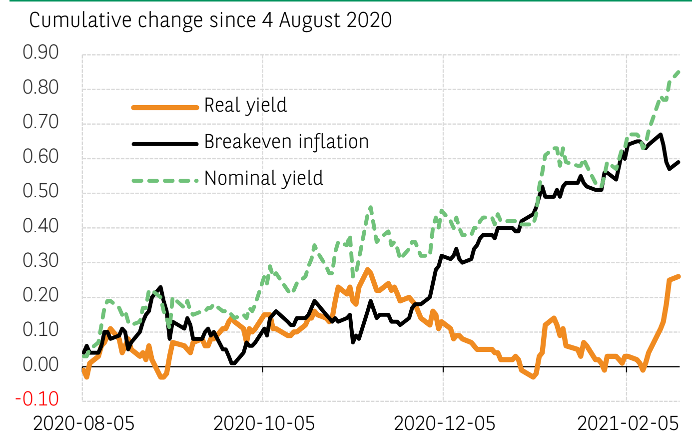
Until recently, the rise in long-term interest rates did not stop the equity market from moving higher, but events this week suggest investors are becoming increasingly concerned. The possible impact of higher bond yields on share prices, depends on what causes the increase: faster growth, a decline in uncertainty, rising inflation expectations. The last factor is the trickiest one because it may cause a profound reassessment of the outlook for monetary policy. Over the past two decades, the relationship between rising rates and the equity market has not been statistically significant. Gradualism in monetary policy has played a role. Recent statements by Jerome Powell show he is very much aware of the importance of avoiding to create surprises.

Last year, US Treasury yields saw a huge decline as the Covid-19 pandemic caused a flight to safety. Other factors, such as Federal Reserve policy and the inflation outlook, also played a role. The 10- year yield reached a low for the year early August, at 0.52%. Since then, long-term interest rates have been on a rising trend. The decomposition of the cumulative change in nominal Treasury yields shows that at the end of January, the increase in nominal yields was more or less equivalent to the increase in breakeven inflation, i.e. the spread between nominal and inflation- linked bonds. The real bond yield –the yield on inflation-linked securities-, after rising until early November, had moved back to its August level. In February however, the increase in nominal yields was fueled by an increase in real yields whereas breakeven inflation actually declined slightly.

Although until recently, the rise in long-term interest rates did not stop the equity market from moving higher, the recent acceleration in the increase in bond yields has raised concern about the possible impact on the stock market. This is illustrated by market developments this week whereby a global rise in bond yields has pushed equity markets lower. Everything else being the same, a lasting increase in bond yields corresponds to an increase in the discount rate used for calculating the net present value of future dividends and hence triggers a decline in share prices. However, not all increases in bond yields are the same. To the extent that they reflect expectations of faster real GDP growth, the path of future dividends should also be revised upwards. With the numerator and the denominator rising, share prices do not necessarily have to decline in reaction to an increase in yields. Higher long-term rates could also reflect a feeling that uncertainty is declining and that the likelihood of very negative economic outcomes has shrunk. This should cause a reduction in the other component of the discount rate, namely the required equity risk premium. Yields could also increase on the back of higher inflation expectations. The impact on equity prices is ambiguous. Faster price increases could mean higher nominal earnings, but that supposes there are no changes in relative prices. More importantly, rising inflation expectations could raise concern about tighter monetary policy, which normally should weigh on equity prices.

As shown in the table, the observed relationship between bond yields and the equity market has evolved over time. For the period starting in 1983, a lasting increase in 1 and 10 year yields –'lasting' being defined as an increase over a 4-week period- as well as a steepening of the yield curve were associated with a statistically significant decline of the equity market. For the observations starting in 1990, the 10-year yield is no longer significant and the yield curve slope has become less significant. For the most recent period, which starts in 2000, the three variables no longer have any significant explanatory power for the behaviour of the equity market. The past two decades saw a long bull market interrupted by two recessions. Periods of rising bond yields or the two Fed tightening cycles didn't matter that much. Gradualism in monetary policy and the effort of avoiding to create surprises also have played a role. The taper tantrum of May 2013 caused a surprise, but it took the S&P500 less than two months to recoup its losses. Investors realised that slowing down the pace of asset purchases by the Fed was not going to kill the economic expansion.

10 YEAR US TREASURY YIELDS AND BREAKEVEN INFLATION



SOURCE: FRED, BNP PARIBAS

> Barring major inflation surprises, the focus of the equity market in the coming months will probably be more on what happens to earnings growth rather than to interest rates.

The Federal Reserve is very much aware of the importance of avoiding surprises, a point which was emphasized by Chairman Jerome Powell in his testimony to Congress this week. Not only did he insist on being relaxed about the inflation outlook but also that the FOMC would "*clearly communicate [its] assessment of progress toward [its] goals well in advance of any change in the pace of purchases*[1]" . Barring major inflation surprises, the focus of the equity market will probably be more on what happens to earnings growth rather than to interest rates.

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EQUITY MARKET AND BOND YIELDS

Dependent variable: 4 week change of S&P500 (in %)

Independent variable	since 1983		since 1990		since 2000	
	coefficient	t-statistic	coefficient	t-statistic	coefficient	t-statistic
1 year US Treasury yield (4 week change)	-4.13	-4.42	-3.72	-2.44	-2.23	-0.98
10 year US Treasury yield (4 week change)	-2.96	-3.11	-1.71	-1.48	1.16	0.79
US Treasury yield curve slope (10 year minus 1 year) (4 week change)	-4.64	-1.95	-4.97	-1.81	-5.18	-1.57

Regressions were conducted with a distinction between positive changes in the explanatory variables and negative changes. Coefficients shown are those for positive changes. To take into account the serial correlation of the variables due to a 4 week moving window, a Newey-West estimation was used.

SOURCES : REFINITIV, BNP PARIBAS

1. Statement by Jerome H. Powell, Chair Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs U.S. Senate, 23 February 2021