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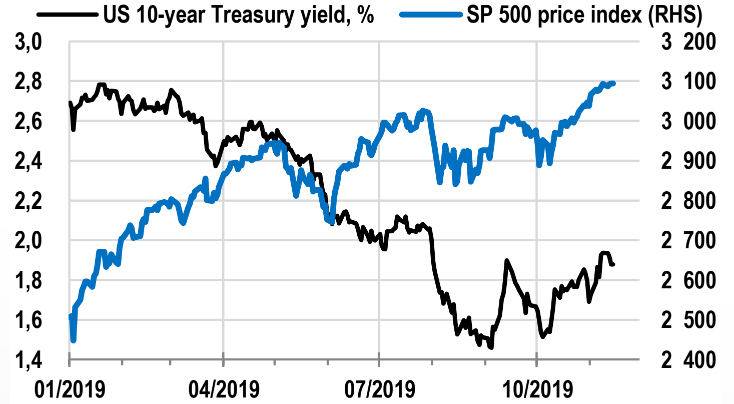
What drives the recent rise in bond yields and equity markets?

■In recent weeks, equity markets performed well. Focussing on the US, it is hard to argue that this reflects an improvement in the earnings outlook or a perspective of more rate cuts than hitherto expected. This would imply that a decline in the required risk premium was the key driver ■ US treasury yields also increased significantly, which probably reflects to a large degree an increase in the term premium ■ The decline in the equity risk premium and the increase in the bond term premium were driven by a common factor, namely a reduction in economic tail risk on the back of progress in the trade negotiations between the US and China and a stabilisation of certain survey data.
■ The reduced likelihood of very negative economic developments, which has boosted equity markets, has also reduced the attraction of bonds as a hedge against equity risk. As a consequence, bond yields have moved up in sync with equity markets.

US equity markets performed particularly well in recent weeks (chart 1) and the same holds for European equities. This could reflect an improvement in expected earnings growth, a downward reassessment of the interest rate outlook or a decline in the risk premium demanded by investors. Focussing on the US, the first explanation probably doesn't play a significant role considering that, in recent months, net revisions to the earnings outlook have become increasingly negative (chart 2). Moreover, analysts expect a slight decline in earnings per share next year (chart 3). With respect to the interest rate outlook, the recent message from the FOMC, which was reiterated by Fed Chair Powell when speaking before the Joint Economic Committee of the US Congress this week, is that it will require a material change in the outlook for there to be any change in the federal funds rate.

US 10-YEAR INTEREST RATE vs SP 500



Source: Datastream, BNP Paribas

This did not stop treasury yields from moving higher as of late, as shown in chart 1. Calculations by the Federal Reserve Board provide a decomposition of treasury yields into a risk-neutral yield (which reflects expectations of the future path of short-term treasury yields) and a term premium (which is a reward for investors in long-maturity bonds that the future path of short-term rates could turn out to be different from what was expected). As shown in chart 4, the increase in treasury yields is almost exclusively due to a pick-up in the term premium, which has become less negative[1]. In Europe, Bund yields have tracked, to a large degree, the movements of treasury yields (chart 5) and, given the state-dependent forward guidance of the ECB, one can assume that this also reflects an increase in the term premium.

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[1] In chart 4, the fitted yield represents the estimated treasury yield, based on a statistical model. The differences with the observed yield are small. The model is used to decompose the bond yield in a risk neutral yield and a term premium.

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This implies that the very high correlation between equity and bond markets in recent weeks (chart 1) reflects a decline in the equity risk premium and an increase in the bond term premium. The former is, quite likely, related to news on the Sino-US trade negotiations and the stabilisation of economic survey data: both would imply that the likelihood of very negative developments in the economy has declined. This in turn reduces the attraction of government bonds as a tail risk hedge for investors who predominantly invest in equities: when tail risk is deemed to be declining, the demand for insurance will drop, hence the demand for government bonds declines. This in turn pushes up bond yields which, for unchanged expectations about monetary policy, causes an increase in the term premium.

William De Vijlder

REVISIONS OF EPS FOR US COMPANIES

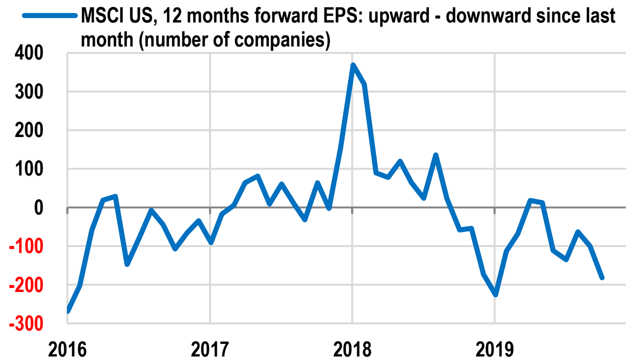

Chart 2 Source: IBES, Datastream, BNP Paribas

EXPECTED EARNINGS PER SHARE GROWTH OF US COMPANIES

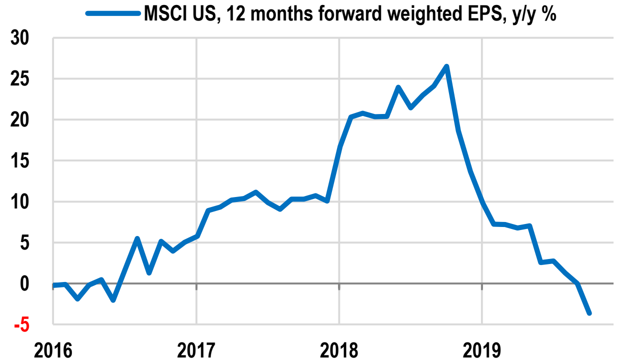

Chart 3 Source: IBES, Datastream, BNP Paribas

DECOMPOSITION OF US 10-YEAR TREASURY YIELD

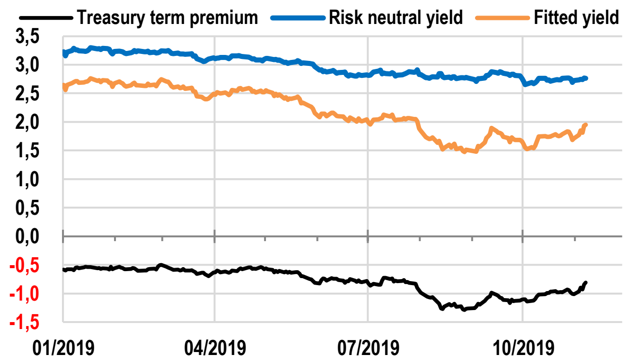

Chart 4 Source: Bloomberg, BNP Paribas

10-YEAR INTEREST RATE: US VS GERMANY

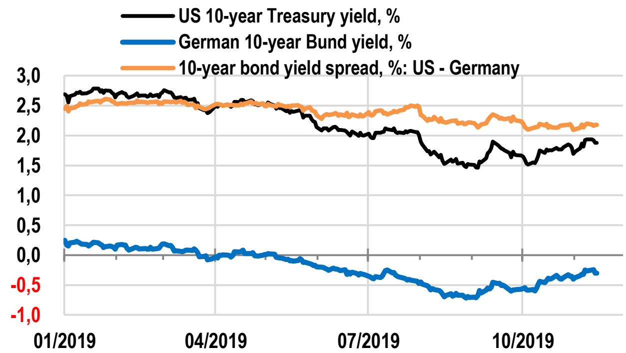

Chart 5 Source: Bloomberg, BNP Paribas