

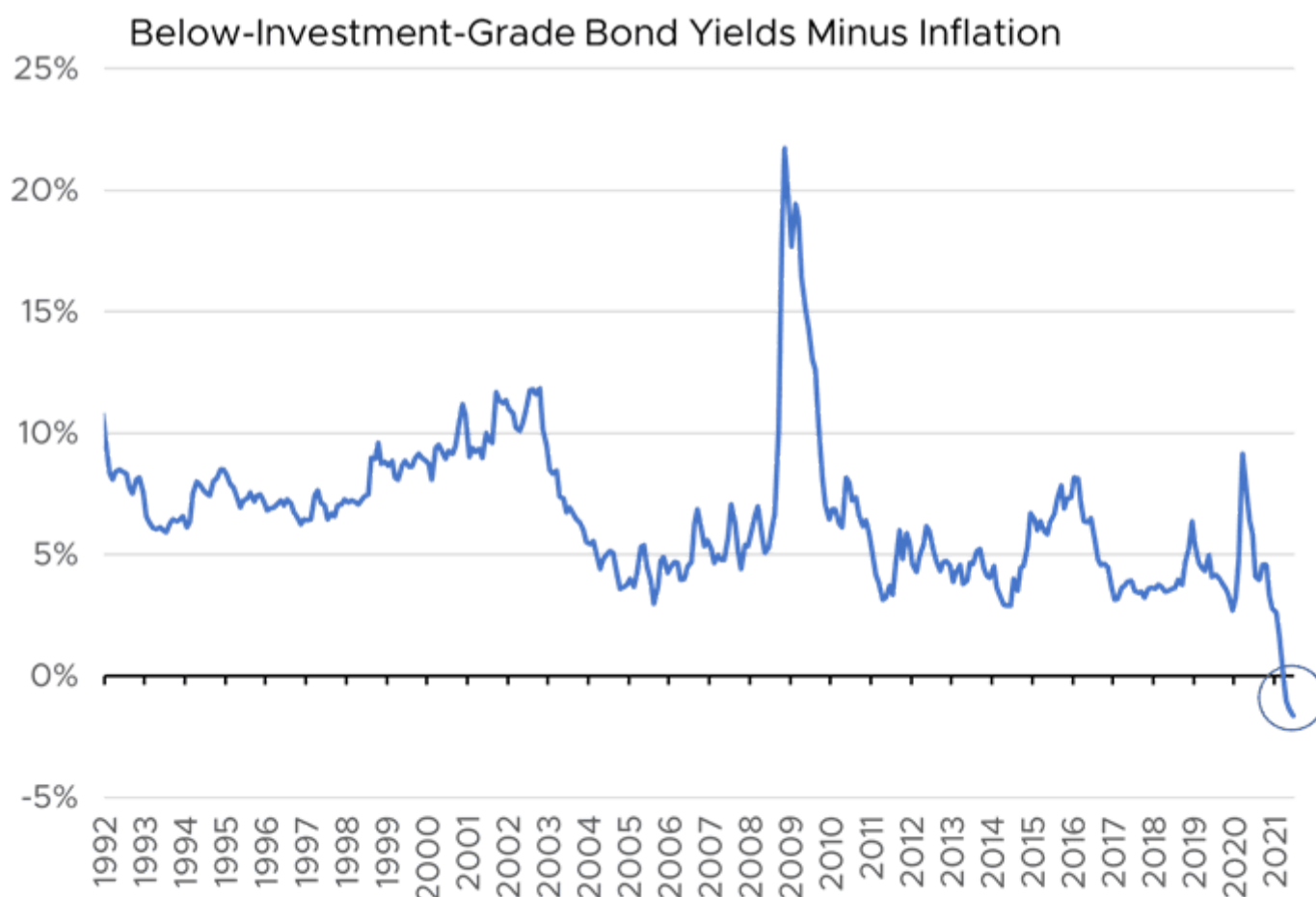


<https://cressetcapital.com/post/what-is-the-bond-market-telling-us/>

# WHAT IS THE BOND MARKET TELLING US?

MARKET COMMENTARY | JACK ABLIN | 7/22/21

The benchmark 10-year yield slid nearly .60 per cent since the end of March against a backdrop of robust economic growth and the highest inflation readings in years. At 1.2 per cent, the 10-year is back to levels we haven't seen since February. With year-over-year inflation running at 5.4 per cent, the "real" rate – the 10-year yield adjusted for inflation – is -4.2 per cent, more than one percentage point more negative than any of our developed market counterparts. The 10-year "junk" bond yield is negative also, for the first time in history. Same for the real earnings yield of the S&P 500, which has never before been negative. Bond holders, unable to earn a yield higher than the inflation rate, are effectively locking in a lower standard of living as the potential growth of their investment trail the cost of living. While negative real rates have occurred historically, they are generally associated with extraordinary events, like an inflation shock or emergency monetary policy, not a recovering economy.



Bond investors tend to see the glass half empty, since bad news is usually good news for fixed-income investors. But several issues are keeping today's bond holders awake at night. The Delta variant is gaining strength, particularly among the unvaccinated. While the US leads much of the world in vaccinations, we're falling behind projections made earlier this year. President Biden had to walk back his pledge that 70 per cent of US adults would be fully vaccinated by July 4. Credit market investors worry that inadequate vaccination rates could stall reopening efforts in parts of the US where vaccinations trail and in many parts of the developed world. Vaccination rates in Japan, Mexico and South Korea remain at or below 20 per cent of their populations.

Fixed-income investors also worry about waning fiscal support. President Biden's \$2 trillion COVID-19 relief package went a long way to support households and unemployed Americans beset with the ravages of the pandemic. Relief in the form of stimulus checks and unemployment benefits are set to expire this fall, leaving a hole in disposable income. Bond investors worry that demand will fall without government support. The economy is expected to have expanded 9 per cent last quarter, fueled in part by government stimulus checks. While economists anticipate growth to continue, it would be at a slower pace. Longer term, growth is expected to trend back to a 2.5 per cent annualized rate.

Federal Reserve governors are tasked with balancing full employment with price stability. Prices are rising even though millions of Americans remain without work. Bond investors worry that the Federal Open Market Committee will tighten monetary policy too soon, quashing the incipient recovery. Bond yields reversed in June, when the Fed updated its “dot plot,” signaling an acceleration of its rate-tightening program. Bond investors now expect the Fed to commence raising its overnight rate next year. That stands in contrast to Chairman Powell’s pledge earlier this year of no rate hikes through 2022.

From a growth perspective, bond investors are concerned today’s growth is situated on the North Pole, where any step taken must be south. They believe we are experiencing peak growth in economic activity, corporate profits and inflation, as the reopening and recovery converge. Inflation is currently running at over 5 per cent year over year, but it’s largely a reflection of pandemic pricing last year, particularly for used car and hotel rooms. Investors expect pricing pressure to retreat, with 5-year inflation expected to average 2.5 per cent and 10-year inflation to average 2.1 per cent. That implies the 5-year rate five years from now is expected to be 1.8 per cent, below the Fed’s 2 per cent inflation target. It remains to be seen if today’s pricing pressure is temporary or longer lasting. A lot depends on what happens to wages and housing costs. Higher wages are needed to fuel demand at higher prices while housing costs, which typically don’t retreat, comprise nearly half of the government’s CPI calculation.

Bond investors worry that profit growth is also peaking. S&P 500 investors are expected to harvest 60+ per cent profit growth this quarter, representing the strongest year-over-year gain since Q4/09, when companies rebounded from the financial crisis. Wary investors understand current profit trends won't last indefinitely. Next quarter, for example, S&P profits are expected to grow 24 per cent from a year earlier, leveling to 14 per cent toward the middle of next year. While mid-teens profit growth is respectable by historical standards, glass-half-empty investors look at growth trends, and see them slowing.

### Investment implications

The bond market is sending strong but inconsistent signals. Harried investors should be justifiably worried about the escalation of the Delta variant, especially given the low vaccination rates in certain

parts of the world. However, the yield differential between short-term and intermediate-term maturities, albeit narrower, still implies growth. The yield differential touched zero in H2/19 but remains over one per cent today. Financial conditions – an index comprising a combination of credit spreads (the premium lenders require to extend credit to lower-quality borrowers) and market volatility – remain favorable for risk takers as well. Notwithstanding the pullback in growth expectations, lenders have not pulled in their horns.

Putting the pieces together suggests the evolving view of the bond market should not be interpreted as a threat to long-term equity investors. It remains to be seen whether equity investors were justified in driving the S&P 500 to more than 30 all-time highs this year, but in our view a downgrade in growth estimates shouldn't prompt anything worse than a correction. An extended, flatter recovery still leaves bond yields that carry negative real interest rates too low for projected, stable-state conditions. That means that a physical asset, like gold, would do a better job than financial assets in helping short-term bond investors maintain their purchasing power. Persistently negative real rates also mean that equity investors can no longer rely on valuation expansion to help fuel future market returns, a benefit that drove most of the market gains over the last 10 years. Instead, equity investors must rely on organic earnings growth and dividends for returns. From that perspective, cheaper, value-oriented sectors with higher earnings yields, like health care, industrials and materials, will likely be a more important source of investment returns over the coming years.

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