February 25, 2021

Bond yields: A rising tide is not lifting all (asset) boats

Key takeaways

- Global capital markets sold off Thursday, keying off interest rates moving significantly higher and bond prices moving lower
- The U.S. 10-year Treasury note yield, a key barometer of global interest rates, surpassed 1.5 percent after starting the year near 0.90 percent
- Investors are encouraged by vaccine and economic reopening progress but remain concerned about potential inflation impacts changing central bank attitudes towards pro-growth policies

The global economy continues to recover from pandemic-related shutdowns. The Federal Reserve's bond purchase program, intended to restrain borrowing costs, and Congress's progress toward a $1.9 trillion fiscal stimulus package are leading to rising growth and inflation expectations across markets. Rising inflation expectations have pushed interest rates higher, with the 10-year U.S. Treasury note yielding above 1.5 percent for the first time in a year. Ten-year yields have increased steadily this year, rising in 16 of the past 20 trading sessions. In reaction to today's most recent move higher, the S&P 500 fell more than 2.4 percent, with all equity sectors declining.

Investors will likely wonder if this is a buyable correction or if market prices remain too high given the recent increase in interest rates. To answer this question, we look back to our investment process, reviewing the economic environment and fixed income prices and values, along with equity market prices and values and investor sentiment.

We believe the macroeconomic environment remains positive for equities through the first half of the year, with both growth and inflation still rising. The increase in interest rates has been large, but generally reflects these constructive growth expectations. Accelerating durable goods orders and robust business surveys indicate business activity is set to increase. While the labor market remains impaired due to pandemic-related shutdowns, consumer sentiment and spending remain steady, with strong retail sales indicating current fiscal stimulus measures have been effective in supporting consumers. We see some risks as we look toward the second half of 2021, but additional fiscal stimulus and economic reopening as vaccinations reach most of the population this summer remain positives.

While interest rates remain low, bonds are under pressure this year. The rise in interest rates have driven a 3 percent decline in the Bloomberg Barclays Aggregate Bond Index. Recent bond yields reflect increasing market inflation expectations of around 2.2 percent per year over the next decade, while the most recent consumer price inflation report for the year ending in January indicated prices rose only 1.4 percent. Inflation expectations are not

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exorbitant; consumer price inflation totaled 2.3 percent for the year ending in February 2020. Fundamental improvements in inflation and growth could lead to modestly higher interest rates over the course of this year, but much of the decline during the pandemic has already unwound.

Equity prices have been strong, with the S&P 500 gaining 17.8 percent in 2020 and adding another 2 percent in 2021 through today's close. Fourth quarter 2020 earnings were stronger than expected and rising earnings estimates for this year have supported higher prices. Today's price decline reflects some investor caution that higher interest rates may inhibit forward growth prospects, especially for companies that may have performed best during the pandemic. This includes companies in the technology and communication sector, which supported much of the work-from-home environment. While price multiples of 22 times 2021 earnings of $170 per share are relatively high compared to history, they appear fair given still low interest rates, the accelerating growth environment and rising but modest inflation.

Generally, we remain positive in the current environment, with a preference toward equities relative to fixed income, given accelerating global growth. In coming days, both Federal Reserve and government actions and communications will be important factors as investors deal with this recent slippage in sentiment. Should we update our guidance, we will provide additional updates. In the meantime, your investment professional can provide guidance relative to your current financial needs and goals.

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