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BOND MARKETS' SIGNAL TO STOCKS

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KEY TAKEAWAYS

Worrisome signals from the bond market contributed to stocks' first monthly decline of 2019.

While we expect rates to end the year solidly above current levels, until we get some good news on the trade front, rates are likely to remain stubbornly low.

If rates reverse higher as we expect, stocks may enjoy some tailwinds.

Should stock investors be concerned about the signals coming from the bond market? Trade tensions were the biggest reason stocks suffered their first down month of 2019 in May, but worrisome signals from the bond market contributed. This week we look at what the bond market signals mean for the stock market and examine the disconnect between the bond market and economic and stock market fundamentals.

WHY ARE YIELDS FALLING?

Before we look at what lower interest rates mean for stocks, let's look at why they are so low in the first place. For one, inflation has been stubbornly low and will likely remain so based on market indicators of future inflation. The latest reading of the Federal Reserve's (Fed) preferred inflation measure, the core personal consumption expenditures (PCE) index, was 1.6% in April, a fair amount below the Fed's 2% target.

Second, global economic growth has been slowing, and it may slow further depending on how the U.S.-China trade dispute shakes out. European economic growth, based on gross domestic product, is expected to grow 1.5% in 2019, down from 2% in 2018, according to the Bloomberg economists' consensus. The United States, Japan, and emerging market (EM) economies are also slowing, although more modestly.

Third, interest rates are historically low internationally. Central banks have bought massive amounts of bonds—so called quantitative easing—which has put downward pressure on yields in Europe, Japan, and throughout the world. Low rates internationally have capped gains in U.S. interest rates.

STOCK MARKET IMPLICATIONS

So what do falling yields mean for stocks? We looked at periods of falling interest rates over the past few decades to see how stocks performed.

The good news is stocks rose on average, but stock gains have moderated in recent years. During the last 20 falling interest rate periods going back to 1973 (excluding the current episode), as the 10-year Treasury yield fell an average of 2.4% over 16 months, the S&P 500 Index gained an average of 13.7% and

was higher 67% of the time [Figure 1]. That stock performance is about average, so stocks historically have done just fine as rates have fallen.

Looking at more recent history, we see stock performance has still been positive, but not as strongly positive. In the 10 instances of falling interest rates since 1998, as the yield on the

1 MORE MODEST RECENT STOCK GAINS IN FALLING RATE PERIODS

Average S&P 500 Gain/Loss During Rising Rate Periods (1973–2018)	13.7%
Average Duration (Months)	16
Average Change in 10-Year Treasury Yield	-2.4%
Percent Positive Periods	67%
Average S&P 500 Gain/Loss During Falling Rate Periods (1998–2018)	1.7%
Average Duration (Months)	17
Average Change in 10-Year Treasury Yield	-1.7%
Percent Positive Periods	60%

Source: LPL Research, Bloomberg 05/30/19
All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

2 POSITIVE CORRELATION BETWEEN STOCKS AND BOND YIELDS HAS BEEN STRENGTHENING

● One-Year Rolling Correlations:
S&P 500 Index and 10-Year U.S. Treasury Yield



Source: LPL Research, Bloomberg 05/31/19
All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

10-year Treasury fell by an average of 1.7% over 17 months, the S&P 500 produced an average gain of just 1.7% and was higher 60% of the time.

For comparison, in periods of rising rates during the past 20 years, the S&P 500 produced an average gain of 9.8% and the Index was higher in all 10 periods. This analysis suggests that stocks may be able to hold up even if rates fall further while we wait for rates to reverse course and move higher, which may provide a more favorable stock market environment.

It makes sense that stocks have fallen along with rates given the discouraging developments on trade in recent weeks. While we expect rates to end the year solidly above current levels, until we get some good news on the trade front, rates are likely to remain stubbornly low, and may fall further.

STOCK-BOND YIELD CORRELATIONS

We can also look at the correlation between stocks and bond yields for clues on where stocks might go if rates reverse higher. Stock prices and rising bond yields have been solidly positively correlated during this economic expansion, which means they have risen and fallen together [Figure 2]. The correlation between the S&P 500 and yields on the 10-year Treasury is currently just over 0.5—relatively high on the -1 to +1 correlation scale—and is rising. That means if rates reverse and move higher, as we expect, stocks may enjoy some tailwinds.

Keep in mind that correlations between stocks and bond yields historically have reversed at higher yield levels, so eventually investors won't like higher yields. We just don't think we are anywhere near that point yet.

YIELD CURVE

You may be thinking that we can't write a commentary about the relationship between stocks and bond yields without mentioning the yield curve, and you are correct. As we discussed in last

week's [Weekly Economic Commentary](#), we do not believe the yield curve inversion signal (shorter-term yields above longer-term yields) is strong enough to materially increase the risk of recession over the next 12 months given: 1) the short duration of the signal (off and on for a few months); 2) its limited magnitude (just a few basis points); 3) no confirming signals from the credit markets; and 4) only part of the yield curve is inverted.

CONCLUSION

The signals from the bond market are of some concern, and we may need interest rates to rise before stocks can sustain enough of a rally to push stocks to new highs. However, we do see several reasons to be encouraged.

First, rates should fundamentally be higher based on the pace of economic growth and level of inflation. Second, we expect mid-single-digit earnings growth in 2019 amid steady U.S. economic growth, which we believe is sufficient for stocks to reach new

highs later this year. And third, we still expect the United States and China will be able to strike a trade deal, or at least a truce, sometime this summer. We're not dismissing the possibility of a prolonged trade war, but we think cooler heads will eventually prevail. In addition, we expect an agreement soon with Mexico to remove or limit the tariffs that were announced last week.

We maintain our year-end S&P 500 fair value target of 3,000, though we probably won't get there in a straight line. That target is based on a price-to-earnings ratio of 17.5 and our 2019 S&P 500 earnings forecast of \$172.50. Trade policy remains a wildcard, but stock valuations may garner some support from low interest rates.

Bonds continue to offer a good cushion against potential stock market declines. We recommend suitable investors maintain market weight allocations (benchmark level) to both equities and fixed income. We would be buyers of equities on any material weakness assuming fundamentals remain consistent with what we see today. ■

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DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Forward price to earnings (Forward P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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