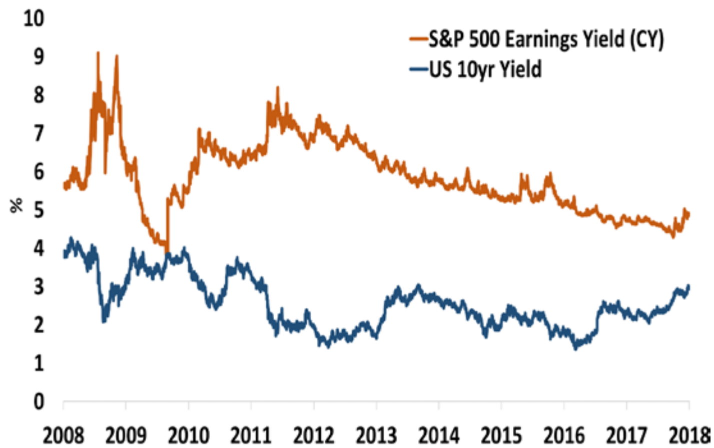
Mind the Gap

On April 24th, the 10-year US Treasury bond yield reached 3.0%. The last time the 10-year government bond traded at that level was in January, 2014. At that time, comments by then US Federal Reserve Bank Chair Ben Bernanke on the prospective end to its quantitative easing program led investors to wrongly assume that monetary conditions in the US would tighten prematurely. Commonly known as the “taper tantrum”, this overreaction caused bond yields to rise. However, they soon fell below 3.0% when the Federal Reserve clarified that their bond buying program would continue until US employment conditions improved.

Four years later, US unemployment is at 3.9%, the lowest level in 17 years. Annual wage growth is also improving, albeit modestly at 2.6%. The US central bank has ended outright bond purchases and has slowly raised its policy rate to 1.75%. The Federal Reserve Bank, now under the chairmanship of Jerome Powell, has communicated that it will continue on the slow policy normalization path started under former Chair Janet Yellen. With inflation running at 2.1%, and within central bank targets, a 3.0% US 10-year Treasury bond yield seems more representative given the current environment. For some historical perspective, the average yield for the 10-year US Treasury bond over the past 50 years is approximately 6.4%. At 3.0%, the 10-year benchmark bond yield is still low by historical standards.

Year to date, the US stock market has experienced significant volatility. Mixed earnings results and the government’s imposition of tariffs on China and other trading partners appear to have unnerved equity investors. However, the future direction of bond yields and the rate of change has also contributed to the volatility. Inflation expectations are rising, thanks to higher wage growth and commodity prices. Further, US fiscal stimulus in the form of tax cuts and deficit spending is also raising inflation expectations and the targets for US bond yields. In 2014, the move in bond yields was not backed up by economic data. Today, the opposite is true.

For equity investors, the level of expected interest rates serves as a discount mechanism for valuing stocks. The higher the interest rates, the lower the present value of future expected cash flows. Since the era of zero-bound interest rates and unprecedented monetary stimulus began, higher equity allocations have been justified by a large differential between earnings yields relative to bond yields. Investors were being rewarded for taking on more equity risk. Now, this gap has narrowed, as illustrated by the chart below, and safer bond investments are beginning to offer more competition to equities.



Source: Federal Reserve Economic Data

As bond yields continue to rise, the most vulnerable companies will be those trading at high multiples, without the earnings growth to support their lofty valuations. We should also expect higher interest costs and wages to impact profit margins. If this yield gap continues to narrow, we need to be mindful that investors may demand a higher return for investing in equities, given the safer yield now being earned in the bond market. This alone may cause equity valuation multiples to contract.

QV’s equity strategies trade at lower valuations than the market, providing better downside protection if valuation multiples do contract. We remain positioned with a neutral 50:50 asset mix in our balanced strategies. High equity valuations have warranted this conservative positioning for some time. We expect bond yields to continue their slow rise, offering some competition to equities for the first time in 9 years.

Mindful of this narrowing gap, we will need to see higher earnings yields to justify an increase in our equity exposure.