

ECONOMIC VIEWPOINT



A 10-Year Yield Slightly Over 3% Would Not Be Disastrous for the U.S. Stock Market

Concerns about accelerating inflation and rising bond yields recently triggered a more than 10% correction on several major stock markets. Some worry that a U.S. 10-year yield above 3% would mean the end of the S&P 500 bull market. These concerns seem exaggerated. Bond yields would have to post much steeper increases to convince investors to turn their back to the stock markets, especially against the backdrop of excellent prospects for earnings growth.

A Market Correction that Surprised No One

2017 was another excellent year for the U.S. stock markets—the S&P 500 soared almost 20% and the Dow Jones and NASDAQ did even better. Far from quieting down, U.S. stock markets roared out of the gates as 2018 began. Capitalizing on a major tax reform, the S&P 500 jumped more than 7% in just a few weeks, setting a new record at 2,873 points on January 26. At that moment, the bull market in the U.S. was up 325% since the S&P 500 reached its low point in March 2009.

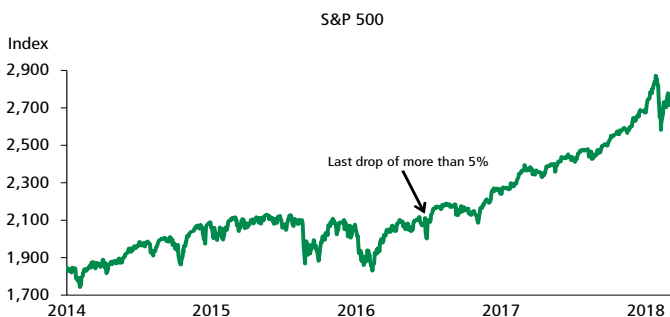
A 20% stock market drop—or the end of a bull market—is a rare event. Seeing a 5% or greater pullback in the stock markets is not unusual, however, given their inherent volatility. This volatility was almost non-existent in the last few quarters, with the S&P 500 suffering no significant decline since mid-2016 (graph 1). A growing number of observers believed that

the straight line advances in the U.S. markets could not last indefinitely, though it is always difficult to predict the exact timing of a trend reversal.

This reversal finally took place at the very beginning of February when accelerating wage growth in the United States reignited fears of inflation, driving up bond yields. Markets around the world plunged quickly, fuelling spectacular volatility. After falling to a historic low, the VIX index—which measures the implicit volatility of the S&P 500—literally exploded, reaching a level rarely seen since the financial crisis of 2008 (graph 2). However, it quickly became clear that technical factors magnified this thrust in the VIX index, including the collapse of some products used to bet on a drop in volatility.

GRAPH 1

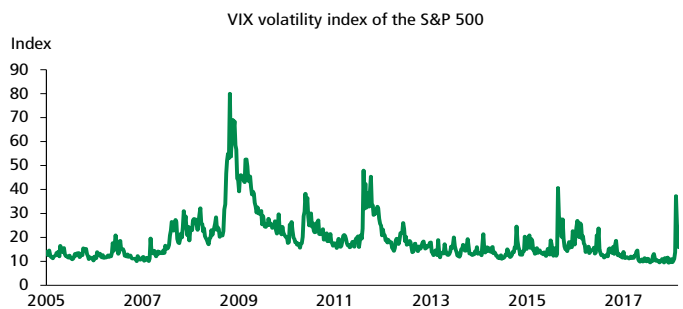
The U.S. stock market was ripe for a correction



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2

A spectacular flare-up in volatility rocked the stock markets



Sources: Datastream and Desjardins, Economic Studies

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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Do Rising Bond Yields Signal the End of the High-Flying U.S. Market?

After a very difficult week that saw most major stock markets shed more than 10%, thus entering correction territory, calm was restored on the markets. The VIX fell back to about 20 and most stock indexes, including the S&P 500, erased a significant chunk of their losses. In spite of this, several investors are still preoccupied by the negative impact rising bond yields could have on the stock markets. Even before this recent correction, some observers argued that U.S. 10-year yields above 3% could signal the end of the bull market.

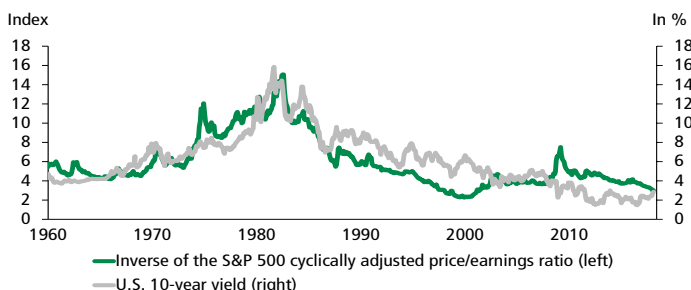
We are moving closer to this 3% level and an uptrend in bond yields is expected in the coming months, as noted in our most recent issue of *The Yield Curve*. In this environment, should investors get ready to deal with an imminent bear market in the United States?

Bonds and Stocks in Competition

The extremely low interest rates in advanced countries has undoubtedly contributed to the stellar performance on stock markets in recent years. One reason is that equities and bonds represent the two biggest asset classes available to investors. Several other financial assets are available, including cash, commodities and private placements, but this is the biggest question most investors wrestle with: Is this a good time to overweight equities vs. bonds?

The bond and equity markets can thus be viewed as competitors, with both trying to attract investors. All things being equal, if the return outlook for bonds is vastly improving, investors could very well sell some of their equities to buy more bonds. For the medium term, the yield to maturity provides the best estimate of a bond's future return. The relationship between stock market required returns and bond yields is illustrated in the Fed Model. It shows the strong correlation between the U.S. 10-year yield and the inverse S&P 500 price/earnings ratio (graph 3). Based on this relationship, the spectacular drop in bond yields in the last few years justified the substantial rise in price/earnings ratios,

GRAPH 3
The return offered on bonds is getting closer to the one of the U.S. stock market



Sources: Robert J. Shiller, Yale University, Datastream and Desjardins, Economic Studies

reflecting a widespread drop in the expected returns of all financial assets.

It is thus normal for a new and clearer uptrend in bond yields to raise concerns. At minimum, this new trend suggests that we can no longer look to the bond market to justify an unimpeded rise in price/earnings ratios. We doubt however that the recent increase in yields will be enough to make most investors turn their backs on the stock markets. A 3% yield on 10-year bonds is still extremely low. For example, a monthly series for the U.S. federal 10-year yield starting in 1962 showed less than a 3% yield in only 88 months out of 674 (graph 4), while the average and median yields for the series were closer to 6%. Before the financial crisis in 2008, a month with an average of less than 3% had not been recorded. Even after the recent increase, bond yields are thus still very low, meaning that investors can only hope for modest returns.

GRAPH 4
Bond yields are still very low historically speaking



Sources: Datastream and Desjardins, Economic Studies

From a tactical standpoint, investors could also think that the best time to overweight bonds is not when bond yields start rising. If rate normalization continues, the bond market could deliver a negative performance in the next few quarters.

Impact on Fundamental Stock Market Valuations

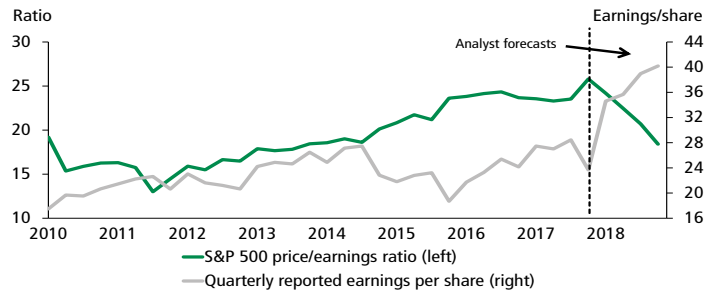
From a more fundamental perspective, the value of a share is equal to the discounted value of future cash flows to which the shareholder is entitled, i.e. a dividend or a capital gain. By the same token, the fundamental value of a stock index like the S&P 500 is equal to the discounted value of future earnings per share. The discount rate used in this calculation is a deciding factor. For an investor, this should represent the required return from a stock market investment, which is usually equal to a risk-free rate to which a risk premium is added.

The main takeaway: All things being equal, an interest rate increase reduces the fundamental value of equities by reducing the current value of future earnings. To provide a simple example, let's use an equity that is expected to pay a perpetual dividend

of \$2. In a low-rate environment, this share required return could be 5%, meaning a fundamental value of \$40 per share. This same share would only be worth \$25 in a high-interest rate environment where the required return would be 8%.

In real life, things rarely end up being equal. The recent uptrend in interest rates stems from several factors, including a marked improvement in the economic growth outlook, which the wide-ranging tax reform in Washington has magnified. In this context, analysts recently significantly upgraded their earnings growth outlook for companies making up the S&P 500 index (graph 5). Faster profit growth could very well offset the negative impact of a higher discount rate on the U.S. stock market's fundamental value.

GRAPH 6
Soaring profits could push down market valuation metrics



Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies

GRAPH 5
Earnings expectations have jumped in recent months



Sources: I/B/E/S, Datastream and Desjardins, Economic Studies

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Too Early to Sour on the U.S. Stock Market

We cannot deny that higher interest rates could put a dent in the stock market's appeal from both a relative and fundamental standpoint. That said, thinking that U.S. 10-year bond yields over 3% would lead to a long period of decline in the stock market is a mistake. In our view, interest rate normalization would have to be much sharper to steer investors away from the U.S. stock market. This is particularly true in a context of sharp profit growth that is expected to last for some time to come. In this environment, any market decline would quickly bring the valuation metrics of the S&P 500 back to attractive levels (graph 6).

The bull market in the United States is more likely to end when the corporate earnings outlook will start to deteriorate. A marked increase in inflation pressures and interest rates could contribute to such deterioration by increasing corporate costs or by curbing economic activity but, right now, the outlook remains very favourable. The stock markets would especially be in for a rough ride if the United States was to slide into a recession. Investors thus need to be on the lookout for any signs of a potential deterioration in economic conditions. But until then, the U.S. stock market could keep climbing for some time.