Weekly Market Commentary

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Love-Hate Relationship Between Bond Yields and Stock Prices

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Highlights

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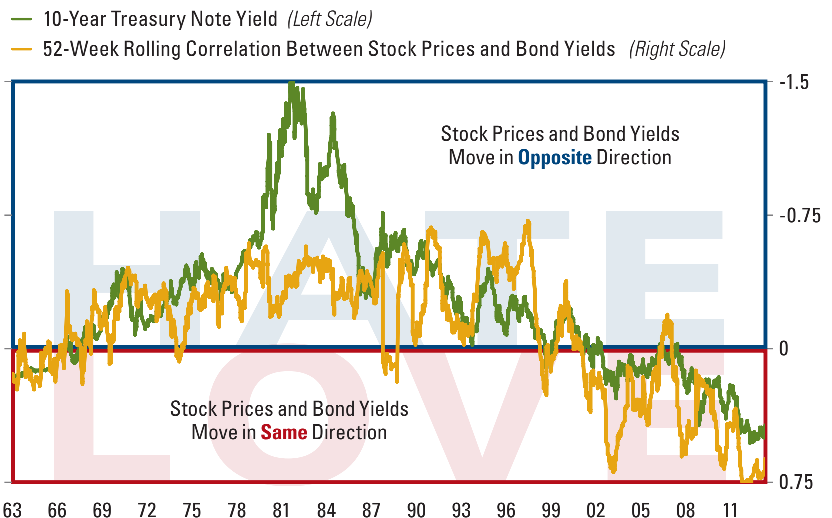
Stock prices and bond yields have historically had a love-hate relationship that would make the romantic ups and downs of any soap opera seem mild by comparison. But, currently, the relationship between them remains tight and far from crossing the line that would lead to a breakup.

With the 10-year Treasury yield rising a half of a percentage point last month, investors are beginning to wonder when rising interest rates may start to negatively affect stock prices. Higher yields can slow borrowing and spending, weighing on economic and profit growth. Although unlikely, if this pace of rising yields were to continue over the next six months, they could exceed 5% by year-end, a level not seen since July of 2007. While higher rates are bad news for bond investors, the good news is that rising yields may mean rising stock prices at least for some time yet. Historically, it has been around a yield of 5% on the 10-year Treasury where yields cross the line and begin to become a negative for stocks and the hate part of the relationship begins.

Historically, whenever the yield on the 10-year Treasury note was below 5%, stock prices and bond yields got along well and moved in the same direction, as measured by a 52-week rolling correlation above zero [Figure 1].

Correlation is a classical statistical method for measuring how closely related two series of data are. A correlation of 1.00 means they move perfectly together, while -1.00 means they are perfect opposites of each other.

1 5% Level Marks the Line in the Love-Hate Relationship Between Bond Yields and Stock Prices



Source: LPL Financial, Bloomberg data 06/03/13

Historical performance based on the S&P 500 Index and the 10-year Treasury yield.

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The opposite was true when yields were above 5%. Yields were above 5% during the period from the late 1960s through the end of the 1990s. Then, the correlation between stock prices and bond yields was below zero. In general, during that period as yields rose, stock prices fell.

The reason for the different relationship above and below 5%, and why rising yields are good news for stocks right now, has to do with economic growth and inflation. When yields are rising from a low level they reflect:

- Improving prospects for economic growth;
- Low current inflation with a falling risk of deflation—a decline in prices and wages; and
- Falling prices for bonds, which may prompt investors to sell bonds and buy stocks.

Alternatively, when yields were rising above 5%, economic growth was accompanied by higher inflation, which threatened future growth and eroded the present value of future earnings, acting as a negative for stock prices.

While rising interest rates may eventually pose a problem for stocks, the tipping point of 5% is still a very significant distance away. As economic data continue to reflect solid growth in the coming quarters, bonds yields and stock prices should continue their climb—though the rapid pace seen last month may slow.

Steeper Is Better

The yield curve is now steeper than normal and has steepened further since rates began to rise, suggesting continued growth.

Further examining the past 15-year period that the yield on the 10-year Treasury has been around 5% or below, and stocks rose along with bond yields for periods of 12 months or longer, stocks performed best when longer-term yields were rising faster that shorter-term bond yields, referred to as a steepening of the yield curve.

2 Steeper Is Better

During Periods of Rising Interest Rates Performance of S&P 500 Is Best When Yield Curve Steepens

Period of Rising Rates Start–End	Rise in 10-Year Treasury Yield		Change in 10-Year Yield	Change in Shape of Yield Curve	S&P 500 Index Price Change
	From	To			
10/5/98–1/20/00	4.16	6.79	2.63	Steeper	+46.2%
6/13/03–6/14/04	3.11	4.87	1.76	No Change	+13.8%
6/1/05–6/28/06	3.89	4.23	1.36	Flatter	+3.6%
12/30/08–4/5/10	2.05	3.99	1.94	Steeper	+33.3%
7/24/12–current	1.39	2.13	0.77	Steeper	+21.9%

Source: LPL Financial, Bloomberg data 06/03/13

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

Why does the shape of the yield curve matter? The yield curve has been a good predictor of economic growth in the past. When longer-term bonds are priced to yield less than shorter-maturity fixed-income securities, the yield curve is said to be "inverted" because it slopes downward. When longer-term yields are much higher than short-term yields, the curve is said to be "steep." Over the past 40 years, an inverted yield curve has preceded every recession while a steep curve tends to precede periods of growth. The yield curve is now steeper than normal and has steepened further since rates began to rise, suggesting continued growth.

Of course, a potential negative of a rise in rates is that it could negatively impact the housing recovery. But it is worth noting that, according to data from the U.S. census bureau on housing starts, housing began to turn up in mid-2011 when the national average of the 30-year fixed mortgage rate broke below 4.5%. Fortunately, rates are still well below that level at 4.1%. But even if the pace of housing did slow, besides suggesting better growth, lower deflation risks and potential losses for alternatives to stocks such as bonds, there are other benefits of rising interest rates for the stock market:

- A steeper yield curve is a positive for the profit margins of banks, as they are able to lend at higher rates.
- Higher long-term rates can help ease the pension liabilities and funding costs for some companies.
- Companies holding huge cash stockpiles may be able to earn a better yield.

Federal Reserve Actions

A sustained rise in yields this year would likely require not just the end of the Fed's latest stimulus program, but also the return of self-sustaining economic momentum.

The rise in yields last month had less to do with the economic data than the clarification from the Federal Reserve (Fed) of its intention to stop or slow its bond-buying program later this year. Some may believe that this introduces a new element to interpreting the rise in interest rates that may make past comparisons where a rise was driven by better economic momentum irrelevant.

However, it is important to remember that the yield on the 10-year Treasury fell (as did the stock market) following the end of the QE 1 and QE2 (quantitative easing) bond-buying programs in 2010 and 2011, as economic growth weakened and ultimately prompted the Fed to reinstate stimulus. A sustained rise in yields this year would likely require not just the end of the Fed's latest stimulus program, but also the return of self-sustaining economic momentum. If realized, this would be a favorable backdrop for the stock market, as it has been in the past when the Fed was not as active.

While they may not get along every day, bond yields and stock prices should stay well to the love side of their historically stormy love-hate relationship. ■

IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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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