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DECLINING BOND YIELDS CALL FOR GREATER DIVERSIFICATION

23/11/2023 | FRÉDÉRIC LEROUX

Earlier we examined how bond yields behave in structurally inflationary environments and concluded that, during periods of temporary disinflation, these yields are slow to follow the downward trend (see our September Note). In the US, inflation has been receding for over a year (falling from 9% to 3%), yet the 10-year Treasury yield has been climbing since April, rising from 3.25% to 5%. However, this yield has recently reversed trend and gave up 50 bp after peaking on 23 October. Does this mean bond yields are finally heading downwards, and that we should start thinking about how this will affect equity markets in the coming months?

> *Our own analyses point to a very soft landing of the economy and a very gradual easing of inflation.*

This eagerly awaited turnaround in long-term bond yields (awaited so eagerly that we "spotted it" too soon in our September Note!) seems to have been triggered by the latest figures on the US job market and manufacturing outlook. Looking at the manufacturing PMI index – an indicator that analysts track closely for clues on the future trajectory of manufacturing output – the new orders and employment components fell unexpectedly in the past few weeks while net new job creation came in lower than expected and hourly wages rose at a slower pace.

The US jobs market is the bedrock of the country's economy, and these first signs of weakening haven't gone unnoticed. This could prompt the Federal Reserve to gradually shift its hawkish stance on inflation, despite noises to the contrary from the central bank. The reversal in bond yields will probably be confirmed next month, corroborating the view that a slowdown is taking hold in the US economy.

Such a slowdown is what will cause long-term bond yields to finally track the decline in inflation observed over the past 12 months. If the US jobs market loses some of its resilience – which is being driven mainly by the fiscal stimulus introduced during the pandemic and the recent skills mismatch between worker supply and demand – then the economy should normalise, making the prospect of a slowdown accompanied by transitory disinflation more likely. **Our own analyses point to a very soft landing of the economy and a very gradual easing of inflation.**

These turning points will probably be marked enough to cause a new landscape to emerge for equity and bond markets. Over the past three months, bond prices slid further – extending a two-year bear market – while equity markets experienced a correction. Only the strongest listed companies emerged unscathed from a climate where investors widely believed an economic slowdown coupled with higher interest rates was on the cards. Accordingly, the stock prices of the "Magnificent Seven" – Apple, Microsoft, Alphabet, Amazon, Meta, Nvidia, and Tesla, which together make up nearly 30% of the S&P 500 – almost doubled on average so far this year, while the rest of the market treaded water.

But now that bond yields are falling, a number of other opportunities will arise for equity investors once they're certain that the slowdown in output has passed. Many companies and industries had seen their stock prices plunge as analysts deemed them less able to withstand the headwinds. Today, however, these companies could deliver handsome gains to those investors bold enough to seize and cultivate the opportunities. Such companies include loss-making tech firms whose valuations had been battered by the effects of high discount rates on the current value of future earnings, as well as indebted businesses and real-estate developers, both of which will get some much-needed breathing room. Small-cap firms may also get a temporary respite from their underperformance relative to large-cap firms. **And emerging market stocks could become more attractive relative to those in the developed world, possibly helped by a weaker dollar.**

Therefore companies beyond just the “Magnificent Seven” and businesses developing obesity treatments could also see their stock prices rally, although the lower interest rates will probably continue to support these large growth stocks with indisputable strengths. However, in an environment where capital flows are directed towards a small circle of companies, we’ll need to move carefully – and diversification will be the best way to go. After all, if the climate is right, why shouldn’t we adopt this strategy? We have to be agile in our investment decisions now that the economic cycle is back.

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