Key Questions

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Is the Backup in Bond Yields Bad for Stocks?

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For some, it depends.

Last week, the yield on the benchmark 10-year US Treasury note jumped to 1.54%, surging 50 basis points (0.50%) in the past month for one of the fastest monthly increases on record. The advance brought the yield up 60 basis points since the year began and 100 basis points (1%) since interest rates troughed in the spring of 2020 at the height of the pandemic.

Stocks also fell. Broad stock market indexes declined more than 2%, technology shares slumped more than 3%, and some of the stocks that had previously posted the most spectacular gains fell even further. The recent spike in interest rates has some wondering if the backup in yields is bad for stocks. As with many things, it depends.

Rising bond yields are commonly assumed to pose problems for stocks as they arguably compete against equities for investors' capital. And the higher the inducement to invest in fixed income and higher interest rates, the more attractive bonds might appear relative to other investments.

Viewed through a financial prism, one might conclude the same thing. After all, the value of a stock is said to be the summation of the underlying company's future cash flows (i.e., earnings and dividends) discounted to the present. And as the discount rate rises, the value of those cash flows declines.

As concerns over the economic fallout associated with the pandemic peaked last spring, several stocks viewed as "COVID winners" began to meaningfully outperform. A further subset of stocks was unprofitable, and many of these were some of the best performers.

To be sure, many companies had depressed earnings in 2020. Those companies with declining sales and earnings saw their stocks fall nearly 20% on average last year. In contrast, those companies that experienced negative earnings but increasing revenues saw their stock prices rise over 50%, on average.

In the case of these outperformers, market participants were theoretically choosing to focus on rapidly growing top-line revenues and ignoring bottom-line losses. The key variable in their determination of value was the low level of interest rates. Now that interest rates are rising, however, these same stocks are underperforming.

Moreover, an improving economic backdrop, encouraging developments involving the vaccination rollout, and additional fiscal stimulus have led to improving fortunes for companies previously viewed as "COVID losers." In our view, we generally expect this trend to continue and note that rising interest rates signal expectations of higher economic growth.

While rising interest rates can cause reverberations in certain stocks, the rate of change in interest rates can also influence stock prices. Based on empirical research, equities have generated an average return of nearly 1% per month but produced a return of -1% on average during months when rates rose by more than two standard deviations (an indicator of variability of returns). This equates to a monthly rise of 40 basis points, a threshold crossed last week that justifiably elicited concern by some investors. Hence, one should expect the market volatility experienced last week to persist.

For these reasons, we recommended avoiding “high-octane,” unprofitable growth companies and tilting toward more cyclical and high-quality companies. As a reference point, we have favored equal-weighted indexes versus capitalization-weighted indexes to increase exposure to smaller and more-cyclical companies.

We also think investors should consider diversifying strategies — or strategies beyond traditional investments — to enhance one’s overall portfolio. Such strategies may be classified as real assets that stand to benefit from a stronger global economy.

In summary, while rising interest rates can pose headwinds for stocks, some stocks are more likely to be battered by these headwinds than others. Furthermore, while the rate of the change in interest rates could foreshadow continued volatility for stocks, the absolute level of interest rates is still very low. For this reason, combined with the still nascent economic recovery and hope that COVID-19 may be brought under control later this year, we believe the oscillations in the bond market signal a change in market leadership and not a market collapse.

For more information, please contact your Key Private Bank Advisor.

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