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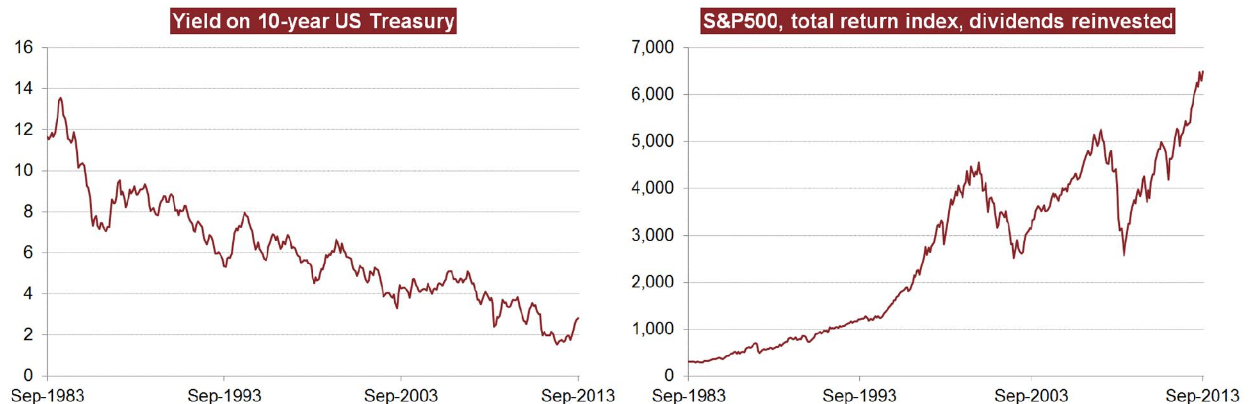
From bonds drive stocks to stocks drive bonds

- **For the past 30 years, bond markets have generally driven stock markets**
- **This may now be reversed**
- **If so, it changes the dynamics of financial markets and affects investment strategies**

For much of the past 30 years, the secular trend has been that bond markets drive stock markets. A long bull market in bonds pushed down global long-term interest rates, underpinning a booming stock market which could operate with a lower discount factor. But 'secular' is a key word. Although overall, bond markets drove stock markets this can very much be a layered process, where a secular trend is overlaid by a cyclical – and potentially opposite – trend, with a further layer of day-to-day movements which can be very much sentiment-determined. Also, it is important to remember that causality does not necessarily imply bull or bear markets. If, eg, bonds drive stocks and bond markets are falling, that is bad news for equity markets as well.

That being said, this has been a good time for investors. The yield on the 10-year US Treasury averaged 13% in 1982; by 2013, the average so far was 2.2% – and that includes the surge from May onwards following the Fed's 'taper terror'. While the fall in bond yields was not a smooth uninterrupted process, it nevertheless dominated the period; just as the rise in yields dominated the previous thirty year period.



The period has also been good for equities; as it should have been. When bonds drive stocks, both markets should move in the same direction – lower interest rates and bond yields spur equities, higher interest rates and bond yields dampen equity ardour.

By contrast, when stocks drive bonds, the two markets tend to move in opposite directions – strong equity markets lead to higher bond yields as markets worry about overheating; weak equity markets lead bond markets to expect easier monetary policy. This is the kind of universe we may now be headed towards. There are a number of reasons for this.

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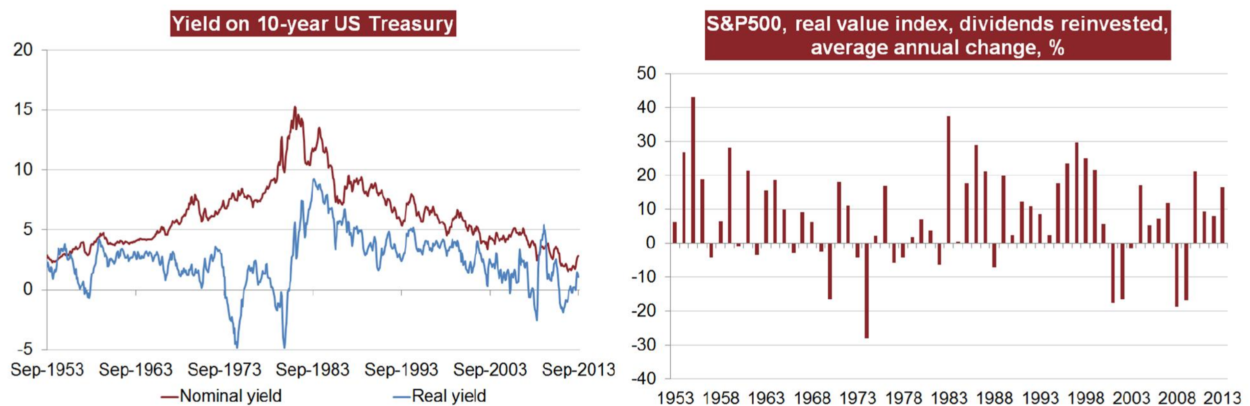
The previous switch very much came as a result of a policy break and the determination, in the US and elsewhere, to bring inflation under control, personified by the appointment of Paul Volcker as Chairman of the Federal Reserve and his 'Saturday night special' increase in the Fed Funds rate in October 1979. By the mid-1990s, inflation-taming was achieved in most countries. Although monetary policy is likely to remain broadly focused on inflation, we are in a number of countries (notably the US and the UK) seeing a shift towards a broader remit, which, if not explicitly including unemployment, at least ties policy to labour market developments.

One risk here is if central bankers are prepared to accept higher inflation in the expectation that this also means higher GDP growth. However, it would not necessarily change the causation. It would be good for equities – until such time as inflation concerns rose too high and bond yields shot up enough to avert this future – but bad for bonds as it would entail expectations of higher interest rates. Again, stocks would drive bonds.

Moreover, while admittedly bond yields in developed markets can fall further – after all, they have recently been lower – unless you are prepared to believe that current interest rate levels are 'the new normal', interest rates will eventually rise. As a very rough generalisation, real policy interest rates in most developed markets have historically averaged ¾-2%. Assuming trend growth rates ranging from ½% per annum (eg, Italy) to – perhaps – 3% per annum (eg, Australia), developed market neutral policy interest rates should be 200-300bps higher than they currently are. Assuming further an upward sloping yield curve and long bond yields will eventually also rise quite substantially.



How much bond yields will rise is a different matter. The average real yield on the 10-year Treasury since 1953 (deflated with the 12-month change in the headline CPI) is 2.44%. Assume that the Fed (and by extension other central banks) broadly speaking remains focused on prices and continues to maintain a (roughly) 2% aim for inflation. Then, subject to the vagaries of the business cycle, the 10-year Treasury yield will probably oscillate between 3% and 6% as it did for the period 1953 to 1968, before the US government's 'guns-and-butter' policy led to accelerating inflation, exacerbated by the first Oil Shock in 1973/74. Crucially, however, this rise will come about precisely because the world economy is doing

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better and central banks can normalise interest rates. That is good news for stocks – or, rather, it is a consequence of good news for stocks, at least until interest rates eventually move above the 'neutral' rate and cause the cycle to turn.

What about if stocks do badly? Leaving aside politics like the on-going fiscal debate in the US, stocks will do badly for one of two reasons. One is if they go through a correction because markets have risen too high, ie, following on from good news. Another is if the economic outlook deteriorates. In the latter case, bonds will do well as markets assume a continued ultra-loose monetary policy (or, if in the future, an easier monetary policy). But this does not change the underlying causation between stocks and bonds. All it means is that the direction of markets change; but bonds will do well precisely because stocks are doing badly. Moreover, since this is a long-term shift in underlying market drivers with the new pattern likely to last for decades, there will be cyclical bull and bear markets as there were even in the long bear market from 1973 to 1982, again, most likely with multiple layers as noted above. But, crucially, over the past 30 years, bond and equity markets have generally moved in tandem; if the causation does indeed change, then over the next cycle – probably also lasting a few decades – they will move in opposite directions from each other. That clearly affects long-term investment strategies.

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