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I Invest in Stocks. Why Should I Care About Bond Yields?

BY ADAM BLAKE, AIF®, SENIOR MANAGING DIRECTOR

As some of you may know, my wife and I have four young children. I often like to think that navigating the capital markets, even with all its irrational behavior, pales in comparison to the challenges of parenting (talk about irrational behavior). Maybe you can relate. In particular with our children, it may be problematic to make a decision for one child without considering the reaction from the others. Similarly, as investors, we can sometimes have our blinders up and not consider factors that are important to other investors. Since the financial crisis, accommodative monetary policy has been supportive of economic growth and securities that benefit from that, particularly equities. This article explains why stock investors should keep an eye on bond yields and how the two relate.

The Federal Reserve

The Federal Reserve System was created in 1913 to oversee the U.S. financial system and guard against crisis. The Fed is charged with three objectives: maximize employment, stabilize prices (inflation), and moderate long-term interest rates. In 2009, the Fed reached deep into its toolbox and bought large amounts of mortgage-backed securities and treasuries. In addition, the Fed dropped the Fed Funds rate to nearly zero. Dropping the Fed Funds rate was a stimulative measure which lowered the cost of borrowing and disincentivized low-risk investments like cash.

Hartland Continues to Bolster Team with New Talent

We are pleased to announce that we have added talent to the Private Client and Administration teams with Allison Schaefer and Amber Franklin, respectively.

Allison Schaefer joined Hartland as a Client Service Associate in the Private Client Group in early March. Allison's primary responsibility is providing administrative support to managing directors and supporting various client relationships. Allison's previous employers included Cedar Brook Group and MGO, Inc. Allison holds a BA in Business Administration from Kent State University and a MBA from Baldwin Wallace.

Amber Franklin has just joined Hartland as a Business Analyst. Amber's primary responsibility is to perform business research that will improve our software platforms, processes, and various data sources. Amber's previous employers include the PA Farm Bureau and The Hershey Company. Amber holds a BS and MS in Information Sciences, both from the University of Pittsburgh.

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As the U.S. economy recovered and U.S. employment improved, the Fed started to increase the Fed Funds rate: 0.25% in December 2015. The relatively shallow economic rebound and low inflation resulted in the Fed not implementing the second 0.25% increase until a year later. Since then, there have been four additional 0.25% increases, bringing the Fed Funds Rate to a range of 1.50% to 1.75%.[1]

The table below shows the median expectation of the Fed Funds Rate by the Federal Reserve Board and Bank Presidents. By the end of 2018, the Fed Funds Rate is expected to exceed 2% and be pushing 3% by the end of 2019. The thought of earning 3% on cash may be exciting to some but not intriguing to others. After a short update on the yield curve, I'll explain why we should all be cognizant of a 3% cash yield.

Federal Reserve Board Members and Bank Presidents

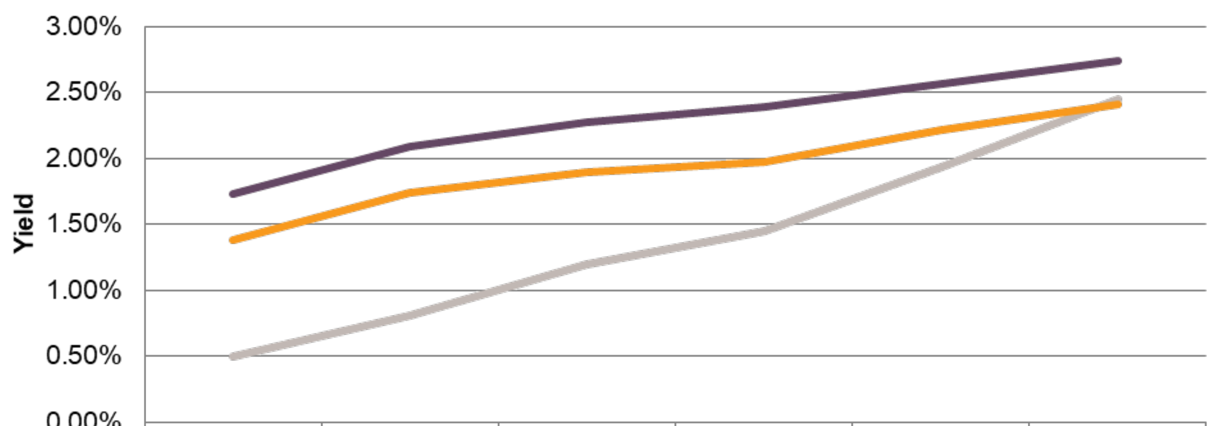
	Current	2018	2019	2020
Anticipated Fed Funds Rate	1.6%	2.1%	2.9%	3.4%
# of Implied 25 bps Rate Hikes		3	3	2

Source: Federal Reserve, 3/21/18.

Yield Curve

The chart below shows the U.S. Treasury yield curve at the end of 2016, 2017, and March 2018. The Fed directly influences shorter term rates as you can see from the meaningful movement in the last 5 quarters. Conversely, economic factors and market demand drive longer-term rates. We saw a flattening of the yield curve in 2017, but an upward shift of the curve during the first quarter of 2018. This is a sign that the bond market is taking the Fed seriously about its intention for higher rates, but also signifying stronger growth expectations and higher inflation. As you recall, the stock market did not like the shift in the yield curve in February, and hit a technical correction (-10% drawdown of the S&P 500 Index).[2] This demonstrates the stock market's sensitively to bond yields.

U.S. Treasury Yield Curve



	3-Month	1-Year	2-Year	3-Year	5-Year	10-Year
12/31/2016	0.50%	0.81%	1.19%	1.45%	1.93%	2.45%
12/31/2017	1.38%	1.74%	1.89%	1.97%	2.21%	2.41%
3/31/2018	1.73%	2.09%	2.27%	2.39%	2.56%	2.74%

Source: U.S. Department of the Treasury, 4/3/18.

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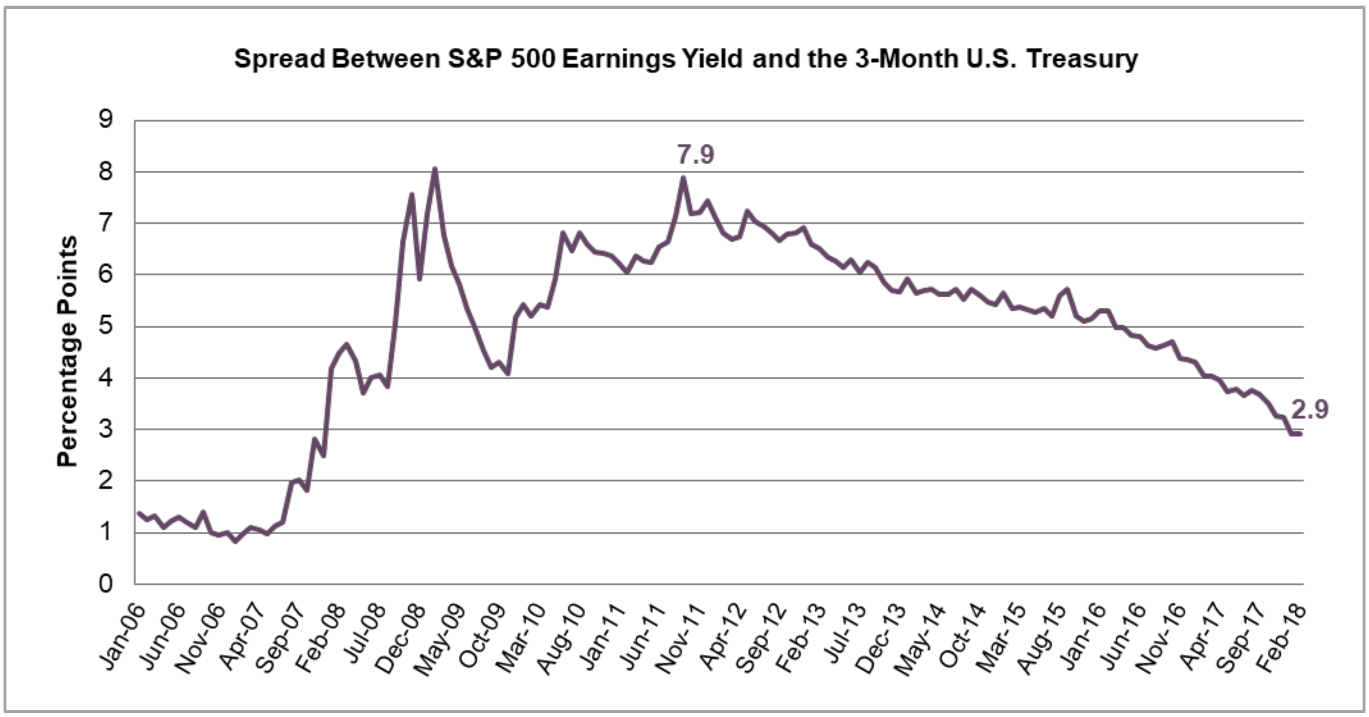
Earnings Yield

The earnings yield is a measure that can help compare the stock market to the bond market. Earnings yield = earnings per share divided by share price. This is the reciprocal of the P/E ratio (price/ earnings). If the stock market rises quicker than earnings, the earnings yield would decrease and vice versa. Importantly, the earnings yield accounts for the valuation of the stock market.

The table below shows the trailing earnings yield of the S&P 500 compared to the 3-month U.S. Treasury Bill. As the S&P 500 has appreciated and the 3-month U.S. Treasury lifted off of near zero, the spread between the two has narrowed. In other words, the equity yield premium over a “risk-free” investment has narrowed and investors are receiving less compensation for the risk they are taking.

	Dec 2012	Dec 2013	Dec 2014	Dec 2015	Dec 2016	Dec 2017
S&P 500 Earnings Yield	6.96%	5.73%	5.46%	5.32%	4.86%	4.62%
3-Month U.S. Treasury Bill	0.04%	0.07%	0.04%	0.17%	0.50%	1.38%
Spread	6.92%	5.66%	5.42%	5.15%	4.36%	3.24%

Source: U.S. Department of the Treasury, 4/3/18.



Source: S&P Earnings Yield: Bloomberg, 3/15/18.
3-Month U.S. Treasury: U.S. Department of the Treasury, 4/3/18.

Concluding Thoughts

If you could earn a guaranteed 0.5% return or have a reasonable probability of a 10% return from stocks, which would you choose? This is likely an easy decision assuming one has the ability to withstand losses. Conversely, if you could earn a guaranteed 4% return or have a reasonable probability of a 7% return in stocks, which would you choose? My guess is you would have to think a little harder about the second question with perhaps a different answer. Similarly, as the spread between the yield on stocks and bonds narrows, we may see the stock market hit periods of volatility as investors weigh this risk/return tradeoff. Note that I exaggerated this example to emphasize the point.

Higher interest rates are not all bad and will be welcome news for specific groups such as retirees, corporate pension funds, and CFOs with large cash reserves. Despite some challenges presented in this article, we are not forecasting a near-term end to the equity bull market and still feel good about risk assets in 2018. We expect economic growth to remain strong and corporate earnings are forecasted to significantly increase in 2018. The maturing economic cycle and monetary policy environment reinforce the need for broad diversification.

Sources:

(1) Federal Reserve, 3/21/18.

(2) Bloomberg.

Federal Funds Rate: *The rate at which depository institutions (banks) lend reserve balances to other banks on an overnight basis. Reserves are excess balances held at the Federal Reserve to maintain reserve requirements.*

MARKET BENCHMARK RETURNS

March 31, 2018		1M	3M	12M	YTD
US Large Cap	S&P 500	-2.5%	-0.8%	14.0%	-0.8%
US Small Cap	Russell 2000	1.3%	-0.1%	11.8%	-0.1%
Developed Intl	MSCI EAFE	-1.8%	-1.5%	14.8%	-1.5%
Emerging Intl	MSCI Em Mkt	-1.9%	1.4%	24.9%	1.4%
Real Estate	NAREIT	3.7%	-6.7%	-1.0%	-6.7%
Core Fixed	BarCap Agg	0.6%	-1.5%	1.2%	-1.5%
Short Fixed	BarCap 1-3Yr	0.2%	-0.2%	0.2%	-0.2%
Long Fixed	BarCap LT G/C	1.7%	-3.6%	5.1%	-3.6%
Corp Debt	BarCap Corp	0.3%	-2.1%	2.6%	-2.1%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.