Interesting Change

Bottom Line:

Equity markets moved higher this week as February inflation data remained muted and Treasury auctions went as expected. The rapid rise in interest rates over the last month continues to cause volatility in technology stocks and other "risk-on" growth-style equities. These companies carry the weight of higher expected borrowing costs and higher equity valuations. It's leading to sector rotations and disparities that investors may be unaccustomed to seeing. The rise in rates is also having a direct impact on the prices of bonds, although there are some sectors that have managed to weather the storm.

The Full Story:

The recalibration of interest rates in a recovering and freshly stimulated economy continues to drive capital markets. As a refresher, interest rates, as measured by the 10-year US Treasury note yield, closed 2019 at 1.919%. During the initial COVID-19 outbreak in March, interest rates plummeted as investors piled into the safe haven asset and the economy ground to a halt, which drove the yield to historic lows. The 10-year Treasury note yield closed at 0.515% on August 3, 2020, which was an all-time closing low (although panic-level intraday and after hours trading between March 5 – 9th briefly tdrove yields lower). According to Deutsche Bank, that record low stretches back 234 years, based on data pulled together from the various times the U.S. government has borrowed money in the past.

Interest rates would remain subdued until early November when the trajectory shifted as the result of two main catalysts: 1) wildly positive vaccine trial results from Pfizer/BioNTech and 2) the election of Joe Biden and an almost assured large scale stimulus package. Interest rates have continued to move upward swiftly in 2021 as vaccine rollouts progress and coronavirus case counts come down.

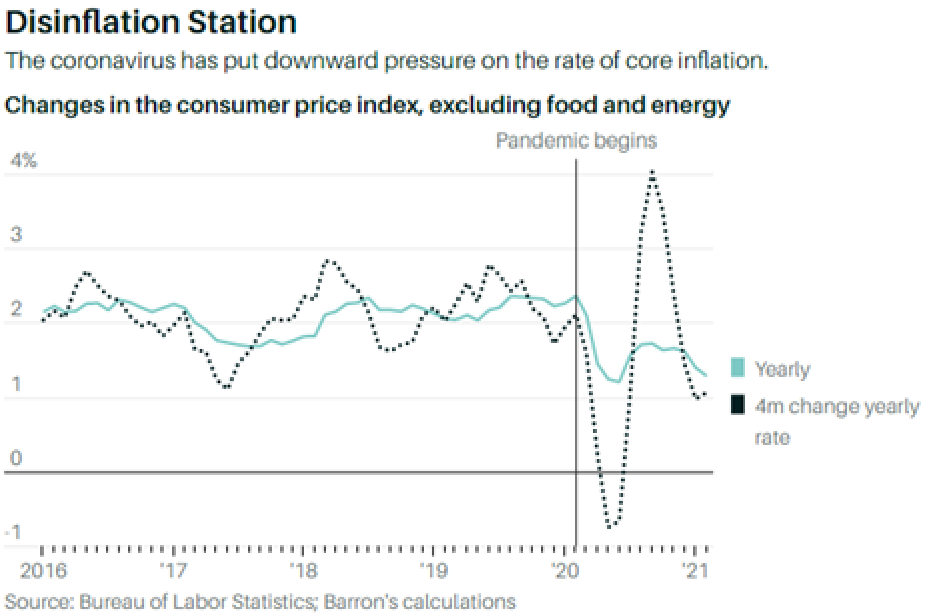
The 10-year Treasury yield opened over 1.6% on Friday. Although that interest rate level is still low compared to historical standards, it is the rate of change that has caused ripples through capital markets.

David covered the relative comparisons of bond yields to stock earnings yield in our WSI last week. If interest rates continue to rise at a rapid pace, the stocks with the weakest earnings yield look suspect. Why take the volatility risk if you don’t have to?

This has recently translated to a high inverse correlation between interest rates and technology/growth-style stocks. When interest rates have been up, tech/growth stocks have typically been down and vice versa. Studying the NASDAQ 100 (mostly tech and tech-related consumer discretionary stocks) over the last 3 months, if the value of Treasury notes is down 1% (i.e., interest rates are up), the NASDAQ 100 will be down 2.82%. As shown in the chart below, the rolling 3-month beta is at a level only surpassed by late 1990, with the 1999 tech bubble the only other period of consequence. In other words, this degree of exposure for tech stocks to interest rates is incredibly unusual; however, it is somewhat predictable as the COVID-19 “stay-at-home” trade winds down.

It is the pace of the rise in rates that is causing the upheaval in the risk-on assets, not necessarily the overall level. Historically, the 10-year Treasury note yield has moved to 4-5% without affecting equity market directional correlations. Today, we are starting at lower yields and higher valuations, so a better corollary is probably late 2018. On November 7, 2018, the 10-year Treasury note yield reached 3.23% before the Federal Reserve overtightened the fed funds rate and sent the market into a correction.

If inflation data looks healthy but contained and demand for Treasury bonds is steady, interest rates should stabilize. On the first point, the Labor Department released February Consumer Price Index (CPI) data on Wednesday. CPI increased 1.7% over the trailing year, but more than half of the gain in February was due to increasing gas prices. Core CPI, which excludes the more volatile food and energy price fluctuations, was up only 1.3% year-over-year and slightly lower than January. Some economists have theorized that incoming stimulus payments will cause a rise in prices, but you also have to weigh that against an uptick in the personal savings rate and other surge items (e.g., vehicles, housing, durable goods) stabilizing.



What about the bond market?

Although interest rates are having an impact on equity markets, the direct impact is on the bond market. As interest rates rise, bond prices fall because investors can purchase newer, higher yielding bonds. The most interest rate risk generally resides with long-term Treasury bonds (no real default risk to price in), and short term and floating rate fixed income securities represent the lower-risk end of the spectrum.

The most prominent bond market index is the Bloomberg Barclays U.S. Aggregate Bond Index. Its sector allocation is approximately 38% Treasuries, 28% corporate bonds, 29% securitized bonds, and 5% government-related bonds. It also has a weighted average effective maturity of 8 years. Both the heavy allocation to Treasuries and the intermediate-term nature of its securities carry interest rate risks that have played out this year. As you will note in the chart below, the AGG ETF is negative on the year at -2.85% and down almost 3% since the interest rate bottom in August.

Group/Investment	Ticker	Morningstar Category	Average Effective Duration	Current Yield at NAV %	YTD 1/1/2021 3/11/2021 Return	Since 10-year UST Bottom 8/4/2020 3/11/2021 Return	2020 1/1/2020 12/31/2020 Return
Invesco Senior Loan ETF	BKLN	Bank Loan	0.11	3.41	0.89	4.82	1.17
SPDR® Blmbg Barclays High Yield Bd ETF	JNK	High Yield Bond	3.40	4.45	0.32	5.61	4.66
SPDR® Blmbg Barclays 1-3 Mth T-Bill ETF	BIL	Ultrashort Bond	0.07	0.04	-0.01	-0.03	0.39
Vanguard Short-Term Bond ETF	BSV	Short-Term Bond	2.76	1.23	-0.48	-0.20	4.67
iShares MBS ETF	MBB	Intermediate Government	2.02	2.16	-0.66	-0.50	4.03
iShares TIPS Bond ETF	TIP	Inflation-Protected Bond	7.84	0.22	-1.31	0.78	10.91
iShares CMBS ETF	CMBS	Intermediate Core Bond	5.06	2.27	-1.58	-0.05	7.84
iShares Core US Aggregate Bond ETF	AGG	Intermediate Core Bond	5.93	1.98	-2.85	-2.96	7.42
iShares iBoxx $ Invmt Grade Corp Bd ETF	LQD	Corporate Bond	9.62	2.45	-5.25	-3.95	11.14
iShares 20+ Year Treasury Bond ETF	TLT	Long Government	19.07	1.46	-11.77	-17.28	17.92

source: Morningstar Direct

The rise in interest rates reverberates through most of the fixed income market, but there were returns to be had in floating rate bank loans, higher yielding corporate bonds, securitized bonds (mortgage-backed, asset-backed, etc.), short-term bonds, and other select corporate bonds. It's a time to be strategic and flexible in your fixed income allocation, while also being mindful of correlations to equity markets if there is a correction on the horizon.

Have a great Sunday!

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Sources: Bespoke Investment Group, CNBC, Barron's, Morningstar, Reuters