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Rising government bond yields unnerve global markets

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Article Highlights

- The S&P 500 and Europe's STOXX 600 Index both track lower for the week.
- Government bond prices retreat amid inflationary pressures and concerns about the longevity of central bank accommodation.
- Third-quarter GDP growth tops expectations, capping a week of mixed data releases.
- We remain cautiously optimistic about the S&P's upward path for the rest of the year.

Equities

A mixed batch of corporate earnings announcements during the past week created an air of uncertainty around equity markets. However, a selloff in sovereign bonds—particularly in the U.K. and Eurozone—soured investor sentiment, sending global shares lower. A better-than-forecast U.S. GDP report, released on October 28, failed to pare those losses.

In the U.S., the S&P 500 Index fell about 0.7%. Despite an initially strong start to the third-quarter earnings season, results have become mixed, with the Industrials and Energy sectors delivering negative earnings growth, while Technology and Financials have outperformed.

Europe's broad STOXX 600 Index lost ground after a solid gain the previous week, losing 1% (in local currency terms). On a positive note, the U.K.'s economy demonstrated unexpected resilience by expanding 0.5% in the quarter following the late June Brexit vote. Key Eurozone economic reports also outstripped forecasts. Preliminary data for the region's manufacturing and services sectors surged in October to a 10-month high. An upturn in Germany, where business confidence reached its best level in 2½ years, drove the improvement. Importantly, Eurozone inflation appears to be picking up—welcome news for the European Central Bank, whose quantitative easing program has been aimed at jump-starting demand and higher prices.

Current updates to the week's market results are available here.

Fixed income

During the week, global sovereign bond yields climbed to multi-month highs on the back of budding inflationary pressures and the market's realization that central banks—even the Bank of England, which was expected to launch fresh stimulus—may have begun to recalibrate their extraordinary monetary stimulus that have helped pin yields at record lows.

In Europe, the yield on 10-year U.K. government debt hit its highest level (+1.26%) since Brexit. (Yield and price move in opposite directions.) Meanwhile, Germany's 10-year *bund,* which briefly traded in negative territory as recently as October 24, jumped to 0.17% by Friday.

The bellwether 10-year U.S. Treasury yield also climbed, touching 1.85% to end the week, 25 basis points (0.25%) above its October 1 level. This increase, along with markets now seeing about a 70% chance that the Federal Reserve will raise rates in December (up from about 60% a month ago), has fueled a rise in the dollar.

Returns for non-Treasury "spread sectors," were broadly negative for the week through October 27, but in many cases marginally higher than Treasury returns. Overall, despite the past week's rough price action, fixed-income markets held up relatively well, in no way duplicating the selloff that accompanied 2013's "taper tantrum."

The U.S. economy rebounds in the third quarter

Third-quarter GDP grew at a 2.9% annual pace, according to the government's advance estimate. This was a significant improvement over the 1.4% second-quarter gain and the economy's best showing in two years. A big jump in net exports and higher levels of gross domestic private investment, along with a slight positive from government spending, more than offset a smaller contribution from consumer spending. The government will release its second and third estimates of third-quarter GDP growth on November 29 and December 22, respectively.

Other economic reports included positive jobs and housing data, mixed in with disappointing consumer outlooks.

- **First-time unemployment claims** fell by 3,000, to 258,000, and the less-volatile four-week moving average edged up by 1,000, to 253,000. Initial claims have been below the key 300,000 threshold for 86 straight weeks, the longest such streak since 1970.

- **New home sales** rose 3.1% in September, from August's downwardly revised pace, and they surged 29.8% compared to a year ago. **Pending home sales** rebounded 1.2% in September, while **home prices** increased 0.4% in August and 5.1% versus last year, according to the S&P/Case-Shiller 20-City Composite Index.

- **Consumers' outlooks** dimmed in September, with both The Conference Board's consumer confidence index and the University of Michigan consumer sentiment gauge ticking lower.
- Orders for **durable goods** (aircraft, machinery, and other big-ticket items) dipped 0.1% in September. Orders for core capital goods, often viewed as a proxy for business investment, declined 1.2% after three straight months of strong gains.

Outlook

Rising yields have often disrupted equity markets, and this recent bout has been no exception. However, we still believe the S&P 500 can rally heading into year-end against a favorable backdrop of improving global growth, a healthy pickup in inflation, and highly accommodative central banks, even as they have begun to pivot away from the dovish end of the policy spectrum. Moreover, investors have become more bearish, pulling some $15 billion out of equity mutual funds and ETFs over the past week. This pessimism, a contrarian indicator, often presages a market advance.

We caution, though, that our outlook is based on a number of factors coming to pass. These include slowing increases in sovereign bond yields and a modest rate hike by the Fed in December, accompanied by guidance confirming a gradual path of rate hikes. On the currency front, a halt in the dollar's recent advance could ease pressure on U.S. corporate earnings, while a decision by the Chinese government to end the yuan's depreciation may help sidestep fears of capital flight and a slowdown in the world's second-largest economy.

Volatility remains low in fixed-income markets. It may increase before year-end—particularly as we approach the Fed's December meeting—if investor sentiment shifts strongly or equity market turbulence accelerates. While today's relatively sedate environment provides a better backdrop for locking in profits on select higher-risk credits, periods of wide price swings offer superior opportunities for active managers to buy bonds at attractive prices.

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