

EQUITY INVESTORS! WASTE NOT YOUR TIME WORRYING ABOUT BOND YIELDS

It is a myth rising bond yields are bad for stocks. In reality they have nothing to do with each other. Here is a flash reminder of the facts and theory why.

SUMMARY

Finance is a land of myths. One of the most enduring is higher interest rates are bad for stock prices. This in turn comes from an oft-heard story linking bond yields to earnings or dividend yields. Indeed many investors base their whole valuation narrative on this so-called “Fed model”.

Which is odd because a relationship between bond and dividend yields has no basis in fact nor in theory. None. Yet the myth lives on. Indeed, as investors today worry about rising interest rates, many are selling equities – particularly stocks with higher dividend yields. This is potentially a mistake.

To understand why, consider the chart below of US bond and dividend yields since 1950 (anything shorter is pure data-mining)¹. Look at the 1980s and 1990s when bond and dividend yields moved lower in tandem. Because these decades coincided with an explosion in share ownership, the belief that lower interest rates help equity prices became widespread.

However, it is also clear this period is far from normal. During the 1950s and 60s bond yields rose as dividend yields fell. In the 1970s *both* moved higher. A different relationship again after 2000 – with declining bond yields co-existing with rising dividend yields. Four unique periods, four unique results.

In other words, there is no historical link between interest rates and share prices (bond yields move with the former and PEs, the inverse of earnings yields, move with the latter). Nor does theory support a relationship. After all, dividends are a claim on real assets (which change with inflation) while bond coupons are nominal (so do not). Less volatile apples are being compared with volatile pears.

Another theoretical fantasy is that rising bond yields mean future dividends must be discounted at a higher interest rate, thus reducing their net present value. Amusingly, during the 1950–60s bull market – when the exact opposite relationship was a given – everyone said inflation boosted the future value of dividends. Both arguments are nonsense for the following reason. Of course future earnings are lifted by inflation (and hence a company’s ability to pay dividends). But so are future interest rates – with the two cancelling each other out. Likewise, deflation crimps the value of dividends but lower interest rates compensate.

To conclude: those claiming a link between bond and equity yields are being selective with facts and muddled on theory. It is perfectly possible for investors to make great returns on stocks over many years even as bond yields rise.

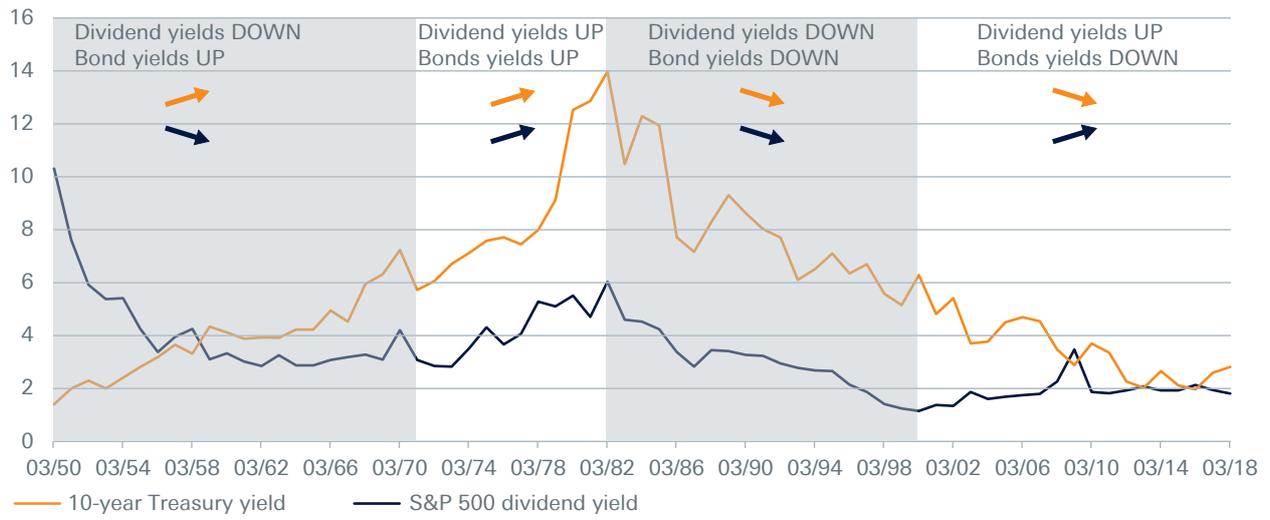


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¹ S&P 500 and ten year Treasuries. The US is used as an example because it has best long-run data but the facts and theory in this paper apply to all markets.



US bond yields and equity yields¹



¹ Source: Bloomberg, Deutsche Asset Management, as of March 2018

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