# Mixed Signals on the Economy from Stocks and Bonds

Global Financial Private Capital

## Key Takeaways

- The stock market kicked off 2019 with a bang as investor confidence in the U.S. economy rose, due to an accommodative fed, higher corporate earnings and a truce on the trade war with China.
- At the same time the bond market is signaling gloom and doom. This week's thought explores what's driving the mixed signals in the markets and what it means for investors.

This year has been a great start for global stocks. The global stock market rally indicates investor appetite for risk has returned. Equities and lower quality fixed income investments rose sharply, recouping much of their 2018 losses and, in some cases, approaching all-time highs. The S&P 500 index marked its first record since September 2018. At the same time, however, the bond markets are reflecting much more uncertainty about the economy—even hinting at a possible recession. The yield on the benchmark 10-year Treasury note, used as a reference for setting mortgage rates to auto loans, now sits at 2.53% as of Wednesday night's close, dropping below the level from the start of the year. The U.S. Treasury yield curve continued to flatten and, for the first time since 2007, inverted between 3-month bills and 10-year treasuries. Investor demand for higher quality bonds such as Treasuries are often considered a hedge against market and economic uncertainty. Bond yield falls as bond prices rise. Lower interest rates are hence often interpreted as a sign of slower growth. Clearly, stock and bond markets are signaling a very different story, but which one is right?

## Factors Driving the Stock Market

The two key factors that made the equity markets nervous and led to the sharp sell-off in late 2018 were an aggressive Federal Reserve (Fed) and concerns over a global slowdown caused by the trade dispute with China. Each of these factors have caused a significant shift in 2019 and contributed to the rally in the equity markets. Let's start with China, which accounts for one-third of the global growth we are seeing today. China's economy has been slowing, partly due to the Chinese government's long-term plan to guide economic growth down to more sustainable levels. In 2018, however, policy tightening and rising uncertainty about trade with the United States caused a more pronounced deterioration in Chinese trade data and investor sentiment. To ease the pressure on the economy and prevent a dramatic slowdown, Chinese officials began implementing stimulus measures such as reducing taxes and infrastructure spending. The trifecta of a truce in U.S./China trade war, additional government stimulus and finally opening access to China's economy to foreign investing have eased market concerns.

In 2019, a "patient" Fed calmed fears of a potential recession as it shifted its stance away from raising interest rates. In addition, the Fed which expanded its balance sheet to stabilize the financial markets after the great recession has now begun a program to reduce the bonds it holds on its balance sheet. The Fed balance sheet expanded from $870 billion to nearly $4.5 trillion and has since reduced that balance by about $450 billion by selling the bonds beginning in October of 2017. In 2019, the Fed announced it would begin to taper its balance sheet reduction in May, and end the program all together in September 2019. This dramatic shift from potentially three interest rate hikes in 2019 to none, and the shift in slowing the balance sheet reduction have all come as welcome changes to market sentiment.

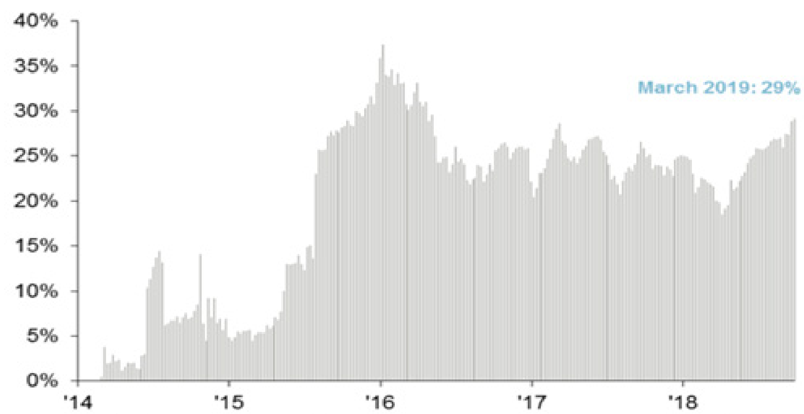
## Factors impacting the bond market

There are several factors impacting today's bond market and the yield curve. Short-term interest rates are driven by the actions of the Fed. The Fed raised short-term rates seven times over the past two years. Those rate hikes sent short-term rates higher. Longer-term interest rates, on the other hand, are driven by growth, inflation expectation, and investor sentiment. The bond market is also being influenced by negative interest rates in several international regions, which appears to be pushing investors into higher-yielding U.S. securities. According to JPMorgan, in 2019, the share of global government bonds trading with a negative yield has risen to 29%, its highest level since October 2016. They attribute the increase in negative yielding debt to falling growth prospects, a muted outlook for inflation and the subsequent response by central bankers. In fact, the yield on both the 10-year German bund and 10-year Japanese bond are negative as of Wednesday, April 24, which means investors have to pay the government to hold their money safe. A low or even negative yielding world typically leads investors to reach for yield in higher yielding fixed income, such as longer dated U.S. Treasuries, but also to embrace higher risk areas of the financial markets in equities and riskier bonds.

## Summary

It is understandable that current market signals may be confusing—U.S. equity markets approached all-time highs while the global bond yields have fallen.  What matters most is the big picture, which is that the overall U.S. economy is healthy. Corporate earnings are slowing but remain strong, wages are increasing, and inflationary pressures appear low. That doesn't mean investors should ignore the mixed messages emanating from stocks and bonds. It is imperative investors understand that we are in the late innings of this economic recovery. As such, investors would benefit from long standing disciplines of investing such as patience, diversification and periodic rebalancing, while keeping an eye on long-term goals.

Percentage of global government debt with a negative yield




Source: Bank of America, Bloomberg, Merrill Lynch, J.P. Morgan Asset Management. Index is the Bank of America Merrill Lynch Global Government Bond Index. Data as of April 1, 2019.

## Disclosures

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