CARMIGNAC'S NOTE

DECLINING BOND YIELDS CALL FOR GREATER DIVERSIFICATION

23/11/2023 | FRÉDÉRIC LEROUX

Economic growth and inflation figures should soon start easing downwards, paving the way to lower bond yields and ushering in a new landscape for stock and bond markets.

Earlier we examined how bond yields behave in structurally inflationary environments and concluded that, during periods of temporary disinflation, these yields are slow to follow the downward trend (see our September Note). In the US, inflation has been receding for over a year (falling from 9% to 3%), yet the 10-year Treasury yield has been climbing since April, rising from 3.25% to 5%. However, this yield has recently reversed trend and gave up 50 bp[1] after peaking on 23 October. Does this mean bond yields are finally heading downwards, and that we should start thinking about how this will affect stock markets in the coming months?

> *Several segments of the equity market should regain their appeal*

Economic indicators point to a slowdown in economic output

The eagerly awaited turnaround in long-term bond yields (awaited so eagerly that we "spotted it" too soon in our September Note!) seems to have been triggered by the latest figures on the US jobs market and manufacturing outlook. Looking at the manufacturing PMI index – an indicator that analysts track closely for clues on the future trajectory of US manufacturing output – the new orders and employment components fell unexpectedly in the past few weeks while net new job creation came in lower than expected and hourly wages rose at a slower pace. The country's jobs market is the bedrock of its economy, and these first signs of weakening haven't gone unnoticed. This could prompt the Federal Reserve to gradually shift its hawkish stance on inflation, despite noises to the contrary from the central bank.

The reversal in bond yields will probably be confirmed next month, corroborating the view that a slowdown is taking hold in the US economy. And such a slowdown should cause long-term bond yields to finally track the decline in inflation observed over the past 12 months. This means the US jobs market could lose some of its resilience – which is being driven mainly by the fiscal stimulus introduced during the pandemic and the skills mismatch between worker supply and demand – prompting the economy to normalise and increasing the prospect of a slowdown accompanied by transitory disinflation. Our own analyses point to a very soft landing of the economy and a very gradual easing of inflation.

These turning points will probably be steep enough to cause a new landscape to emerge for stock and bond markets, marking a change from the past three months when bond prices slid further – extending a two-year bear market – and stock markets experienced a correction. Only the strongest listed companies emerged unscathed from a climate where investors widely believed an economic slowdown coupled with higher interest rates was on the cards. Accordingly, the stock prices of the "Magnificent Seven" – Apple, Microsoft, Alphabet, Amazon, Meta, Nvidia, and Tesla, which together make up nearly 30% of the S&P 500[2] – almost doubled on average so far this year, while the rest of the market treaded water.

(1) bp = basis point, equivalent to 1/100th of a percentage point (1% = 100 bp). Basis points are used widely to measure changes in the prices of financial assets. (2) S&P 500 = an index of the 500 largest listed companies in the US, weighted by market capitalisation.

Several segments of the equity market should regain their appeal

But now that bond yields are falling, a number of other opportunities will arise for equity investors once they're certain that the slowdown in output has passed. Many companies and industries had seen their stock prices plunge as analysts deemed them less able to withstand the headwinds. Today, however, these companies could deliver handsome gains to those investors bold enough to seize and cultivate the opportunities. Such companies include loss-making tech firms whose valuations had been battered by the effects of high interest rates on the current value of future earnings, as well as indebted businesses and real-estate developers, both of which will get some much-needed breathing room. Small-cap firms may also get a temporary respite from their underperformance relative to large-cap firms. And if the US dollar weakens, emerging market stocks could become more attractive relative to those in the developed world.

Therefore companies beyond just the "Magnificent Seven" and those developing obesity treatments could also see their stock prices rally, although the lower interest rates will probably continue to support these large growth stocks with indisputable strengths. However, in an environment where investments are directed towards such a small circle of companies, we'll need to move carefully – and diversification will be the best way to go. After all, if the climate is right, why shouldn't we adopt this strategy? We have to be agile in our investment decisions now that the business cycle is back.

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