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Will spiking bonds yields disrupt the rally in stocks?

- **Market expectations for interest rate moves have changed materially**
- **Other policy measures are also being discounted**
- **The shift to value will be helped by higher rates**
- **Low duration fixed income is still the place to be, with patience required in the near term**

We are through the first fortnight of 2022 and it felt wilder than some of the numbers indicate: the S&P500 dropped 2.2%, the Dow Jones fell 1.2%, and the US 10Y yield inched up 3 basis points. While on the face of it, it is not so frenetic at all, it is the shuddering beneath the surface that we need to take note of. The outlook for 2022 is already quite different from the scenarios most investors were anticipating to unfold less than a month ago.

The market is pricing in many more rate hikes than before. Within the first two weeks of the year, the market has shifted its stance to expecting four rate hikes from the Fed this year. That's quite a departure from just months ago when the debate was whether there would be any hikes in 2022. Then it was gradually accepted that a lift-off would occur by the summer. Now, it is widely considered that the Fed will begin to hike in Q1, and that there will four hikes in total this year.

Quick tapering has been discounted, but what about a run-off? As the Fed has deliberately signalled, it will commence rate hikes once it has stopped buying new bonds as part of its QE program. March is widely expected to be the time for this to happen. What is not yet fully transparent is whether or when the process of a run-off will begin: the time when the Central Bank goes from keeping the size of its balance sheet stable to actively reducing it.

The previous attempt at run-off ended with a market tantrum. This time could be at least somewhat different. The Fed has learnt that it needs to be ultra vigilant to contain any short-term liquidity strains that could appear in the money market. The tools exist and the experience is in place. Add to that the fact that the starting point this time around is a much larger level of liquidity – around \$1 trillion more – and the idea is that there are enough buffers to allow a run-off to be less disruptive and safer than the previous effort.

Where does this leave bond yields and stocks? We have argued several times earlier that the level of current bond yields does not rhyme with the level of expected inflation, let alone current inflation. The US 10Y rate has often been at current levels (between 1.75% and 1.80%) but then failed to drift any higher. While we remain long-term bearish on bonds, the short-term market dynamics caution against positioning away from bonds too aggressively. Inflation numbers should begin to moderate slightly. There is likely to be a short growth pause globally as the restrictions induced by the Omicron strain take hold but then arguably fade quickly again. After that, all bets are off, and yields could be free to rise once more.

The rotation from tech (and growth) to value. One sector that possibly faces the biggest headwind from rising long-term rates is the technology sector. As the market went into the reset in rate expectations, technology stocks were already trading at fairly demanding valuations (they were expensive!). Put another way, they were being given the benefit of the doubt that they would be able to produce earnings over a long period into the future. The profits thus made were discounted at a very low rate, and therefore they resembled something akin to a long-duration bond. Little surprise then that tech stocks are not fond of interest rate increases. The same argument could be applied to growth stocks more generally: they look and feel like long-duration bonds and are more vulnerable to changes in the discount rate applied to their expected earnings.

On the other hand, REITs, not exactly the most exciting of sectors, may benefit from the current environment in ways that tech cannot. First, their income streams are far more visible and current, making their valuations less vulnerable to aggressive assumptions of low interest rates for longer periods. Second, the current environment of rising inflation benefits the underlying assets held by most REITs: property. Investors with long memories may recall that real assets perform well under conditions of inflation. In an inflationary environment, demand for these asset surges, as we have already seen, causing the price of the underlying assets to rise. In the current environment there has also been an observable increase in demand for rental properties in many cities – another plus for owners of the underlying properties.

Other value sectors could resemble REITs and investors are already searching for opportunities there. It suggests that while some sectors will be struggling in the new rate normal, the overall market could still be in sync with the new reality.

In the fixed income market, there have been stirrings along exactly the same lines. As the market begins to understand with clarity the steepness of the upward cycle of short rates, flows into short-duration bonds have ramped up. For example, leveraged loan funds have seen a flow of \$1.84 billion over the past week (as reported by JP Morgan), the second highest on record. Investors were right to do so, as loan prices rose by 0.5%, compared to losses of the same magnitude for high yield and a loss of 1.5% in investment-grade bonds due to the rise in base yields.

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