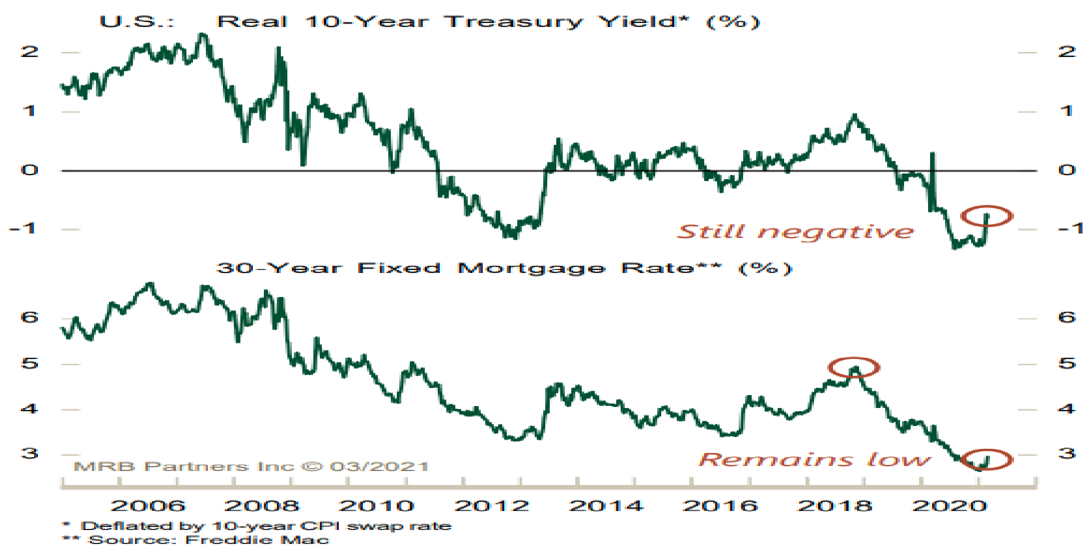
BRIEF INSIGHTS **MARCH, 2021**

IN BRIEF: Implications of the Bond Market Rout for U.S. Equities

The sell-off in the U.S. treasury market has reached a near-term extreme. Bond yields should soon stabilize. Despite the recent backup in bond yields, financial and monetary conditions remain expansionary. The combination of improving economic prospects and rising inflation expectations should put further upward pressure on bond yields.

Exhibit I



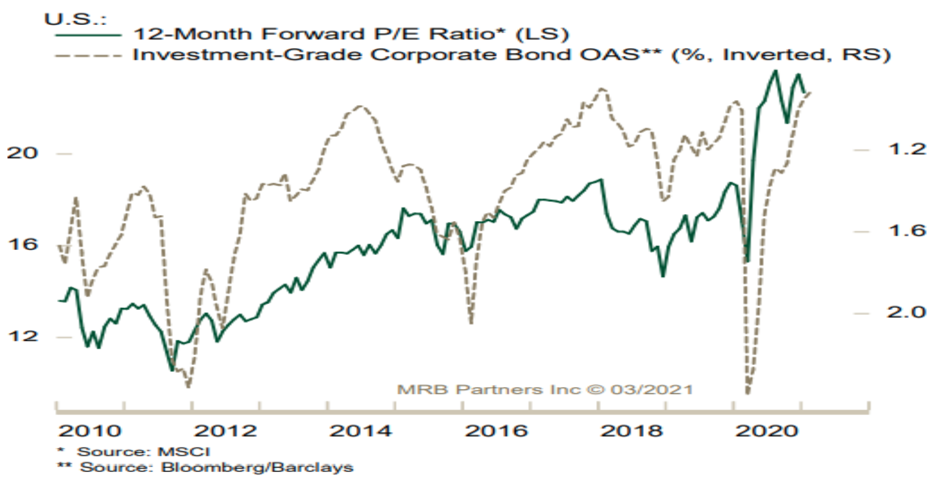
U.S. equity prices may come under some near-term pressure due to a rapid rise in bond yields as government fixed-income markets have begun to discount stronger-than-expected economic growth and higher inflation.

The move in long-term interest rates has the potential to unnerve some equity investors given the high valuations for stocks, although financial markets have been calmer in recent days. We remain cautious on the near-run outlook for the equity markets overall given overbought technical conditions. However, with economic prospects improving and 12-month forward earnings likely to continue climbing - as vaccines enable the global economy to re-open - the longer-term outlook remains positive, although high valuations will limit returns.

While surging bond yields create uncertainty for the equity market, it is important to put the recent spike in long-term interest rates into perspective. Rising bond yields become problematic for equities when they restrict economic growth and begin to slow earnings momentum. Monetary conditions remain expansionary and the Fed's commitment to maintaining hyper-accommodative policy should keep bond yields anchored at historically low levels.

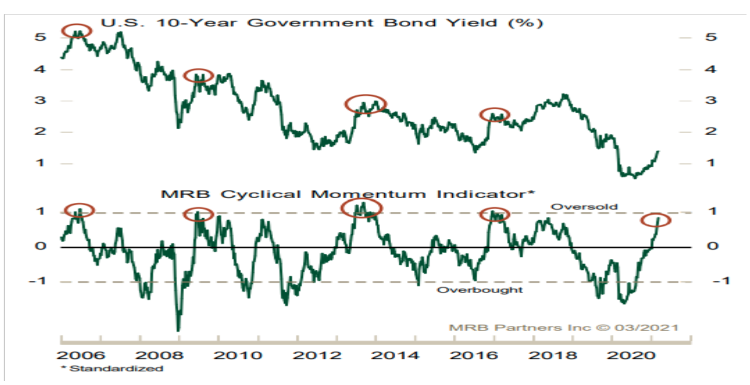
Real bond yields, as measured by the spread between the 10-yr treasury yield and the 10yr CPI swap rate, are still deeply negative (Exhibit I). At 3.00%, the average rate on a 30-year fixed mortgage remains low by historical standards and is well below the 5.00% level reached in late 2018 when a backup in bond yields slowed the housing recovery. As such, there is significant room for mortgage rates to climb further before they crimp housing demand. The 10yr/2yr treasury curve remains on a steepening trend and earnings estimates for the S&P 500 are continuing to be upgraded. Both reflect that confidence in the economic outlook remains high.

EXHIBIT II



Investment grade and high-yield spreads are near their cyclical lows, thus indicating that sentiment towards risk assets remains healthy. This last point is especially important since the market P/E multiple tends to be driven by investor sentiment and significant flare-outs in corporate bond spreads have usually corresponded with meaningful valuation corrections in the equity market (Exhibit II). The U.S. government bond market is currently oversold, implying that the slide in treasury prices is likely to abate in the near run (as indicated in below). The recent bounce in treasury prices is perhaps an indication that the selling pressure in the government bond market has reached a near-term extreme and yields may soon stabilize.

EXHIBIT III



That said, the improving economic outlook and rising inflation expectations point to further upward pressure on bond yields once oversold technical conditions in the bond market unwind. Our base-case scenario is that bond yields will rise in a series of digestible phases. However, there is a risk that bond yields could move up in a more disruptive fashion. The combination of pent-up demand unleashed by a successful vaccination program and open-ended monetary and fiscal policy is beginning to make bond market participants nervous about upside risks to economic growth and inflation.

The recent market action is a warning sign that the current path of monetary and fiscal policy may create some near-term financial market instability. The macro backdrop of improving economic prospects, rising bond yields, and firming inflation expectations, continues however to favor cyclical over defensive plays, and Value stocks over their Growth counterparts. However, with many cyclical sectors and industry sub-groups having already priced in an economic recovery, we remain selective in increasing our exposure to the cyclicals.

We continue to recommend overweight positions in the Financial and Energy sectors, which offer better value than other cyclical plays such as Industrials and Materials. Given the overbought nature of the equity market and the prospect of additional volatility as the government bond market reprices, we also favor maintaining some defensive exposure via an overweight allocation to the Healthcare sector. Although we have an underweight position in Technology versus the Standard and Poor's 500 index, we still maintain a healthy exposure in portfolios to balance out economic risk.

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