The Great Rotation Is Beginning

After a multi-decade decline, bond yields appear to be on the rise. Recently, the 10-year Treasury bond yield broke out above its declining trendline, signaling what may be a major reversal in the bond market. This could be the start of what we have called the Great Rotation from fixed income into equities.

10-Year Treasury Bond Yield Breaks Out

Source: FactSet as of 2/20/18.

- We have previously discussed our expectations of what would happen when economic and political events lead to the replacement of expansionary monetary policy with fiscal stimulus (see Alger On the Money "Bail on Bonds: The Great Rotation into Equities"). A rotation from bonds into equities is the result we anticipated and it now appears to be taking shape.
- Economic growth expectations and mounting inflation are driving a rise in interest rates. For context, a 100 bp increase in the yield of a typical 10-year bond would reduce its value approximately 8%.
- According to Morningstar, in the last 10 years over eight times as much money has flowed into taxable U.S. bond funds and ETFs versus U.S. equity funds and ETFs. As bond performance weakens, flows may rotate into equities.
- Stock valuations are attractive relative to bonds. The earnings yield of equities, as measured by the S&P 500, is approximately 300 bps greater than the yield of 10-year Treasury notes. By comparison, the median difference between the two yields was 55 bps during the past half-century prior to the Global Financial Crisis (see Alger Capital Markets, page 23).
- Continuing to seek out yield may carry the risk of capital loss; we expect investors to turn their attention to the equity markets as a viable alternative to fixed income.

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