The Canary in the Coal Mine Is Doing Just Fine

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Despite the recent equity market sell off, the bond market is reminding investors that the economy is actually doing quite well. Given all the background noise, it is easy for investors to confuse how the economy is doing with short term movements in the equity markets. Despite two 10%+ stock market corrections in 2018, the bond market really hasn't blinked. Interest rates continue to rise on strong GDP growth, moderate inflation, and a low unemployment rate.

The bond market is telling investors that the Fed is justified in continued moderate interest rate hikes after spending a full seven years, from December 2009 thru December 2015, at literally a 0% Federal Funds rate. Investors perhaps are suffering from anchor bias combined with all the talking heads discussing the 'threat' of rising interest rates. Some people and many reporters just like to create drama, and this can cause investors to forget the Fed Funds rate is still only at 2-2.25%. By any historical measure, 2-2.25% is still very low for a strong, growing economy. The Fed appreciates this point, which is why it is sticking with its methodical 25 basis point per quarter rate increase regime.

The treasury market is typically an excellent reflection of the economic outlook and investor sentiment. When the economy looks weak or when investors have a legitimate reason for concern, the bond market typically rallies and yields fall. A look at the 10-year Treasury, in the graph below, highlights the bond market's reaction to economic concerns. The bond market started rallying and yields began falling in June 2007 in anticipation of the financial crisis. The equity market, on the other hand, did not react significantly until 2008. Additionally, the bond market showed legitimate concerns during the summer of 2011 (European debt crisis) and in late-2015 through early-2016 (high yield market freeze).

While growth may not be accelerating, the economy is still growing at a reasonably healthy rate, providing an economic tailwind for companies. In a 'normal' interest rate environment, in which investors evaluate future cash flows and when bond yields offer a return well above 0% (and usually well above the rate of inflation), growth has to be discounted to properly assess the compensation being offered to investors to hold risky assets. A healthy, rational equity market regularly goes through corrections as investors reassess asset allocations and sector positioning.

The bond market continues to offer compelling risk/reward investment opportunities for a carefully constructed portfolio. Additionally, in 2018, the fixed income markets are benefitting from two major tailwinds. First, the new lower corporate tax rate provides companies with significant additional cash flow to service debt. Second, the majority of corporate debt is fixed-rate debt so the recent interest rate increases will not dramatically impact most companies' interest payments for many years. While long-dated bonds offer interest rate protection for the issuers, fixed income investors can be negatively impacted if they do not keep the duration of their portfolios relatively low. This is the main reason we continue to highlight the importance of keeping duration low. While short-term movements in the equity markets typically dominate the headlines, investors should not forget to look also at what the bond market is trying to tell them about the health of the economy. And the message from bond markets is clear: the U.S. economy continues to provide a healthy environment for investors.

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