Seeking Alpha α

Are Bonds Signaling A Stock Decline?

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Summary

- Many investors are expressing the concern that the recent fall in bond yields may bode ill for stocks.
- Comparing the financial media narrative to the underlying data.
- Stocks OR Bonds? Perhaps Stocks AND Bonds.

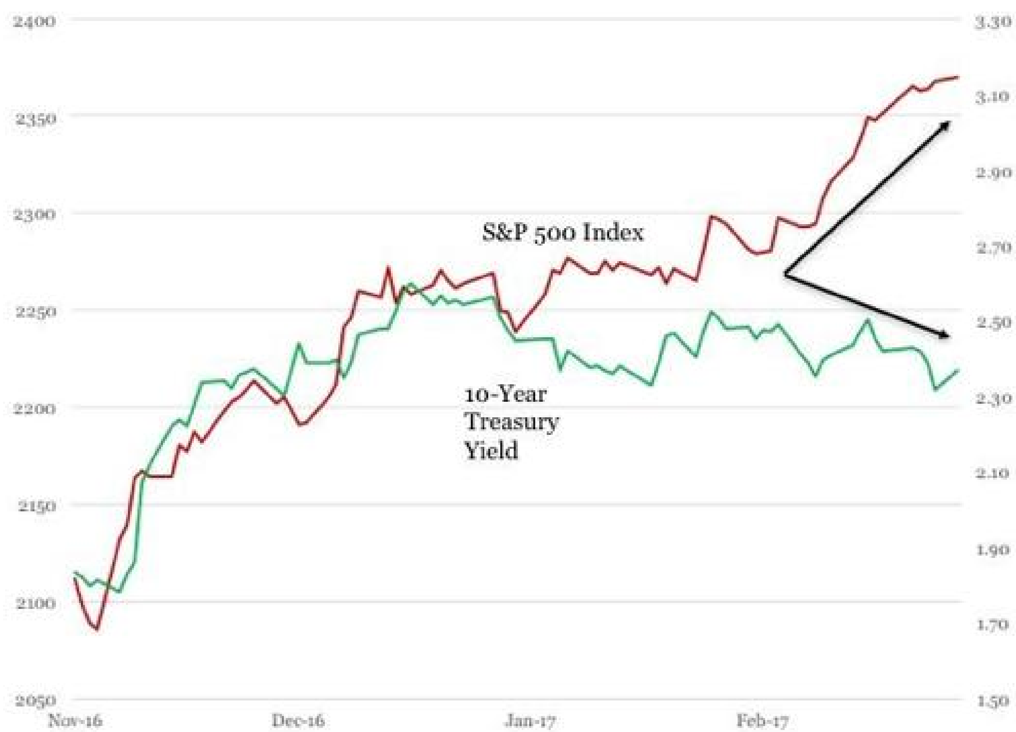
The stock market rally remains unrelenting. The primary narrative behind this rally has been expectations for accelerating economic growth thanks to less regulation and more pro-growth fiscal policies out of Washington. But a potential warning flag has surfaced in recent weeks that is casting doubts on the sustainability of the recent stock advance. The bond market is also showing increasing signs of strength, which to many contradicts the stock market advance as it reflects an investor flight to safety. Does the recent firming of the bond market suggest that the curtain is about to fall on the stock market rally?

Stocks OR Bonds?

Stocks as measured by the S&P 500 Index (NYSEARCA:SPY) are not only expensive today, but they also recently reached their most overbought levels on a Relative Strength Index basis in more than a decade. Given the lofty perch upon which stocks currently sit, it would seem natural to believe that the recent and accelerating strength in the bond market is signaling that the recent stock rally may soon be running out of steam. After all, if investors are still willing to pile back into bonds at already low yields, it suggests a flight to safety may be forming for reasons such as investors losing confidence about the timing of pro-growth fiscal policy themes that sparked so much excited in recent months.

To many, the recent divergence between the still rising stock market (NYSEARCA:DIA) and bond yields that first peaked all the way back in mid-December and have been grinding sideways if not working their way lower since provides further confirmation a potentially widening fundamental disconnect that will require resolution either with stocks falling or bonds rising before it is all said and done.

Divergence Between Stock Prices & Bond Yields



Source: Gerring Capital Partners, Yahoo Finance

Stocks AND Bonds

For those that have read my articles on Seeking Alpha, I certainly have no shortage of skepticism about the fundamentals behind the stock market (NASDAQ:QQQ) rally during the post-crisis period. But I do not believe that the recent strength in bonds is signaling a turning point for the stock market any time soon.

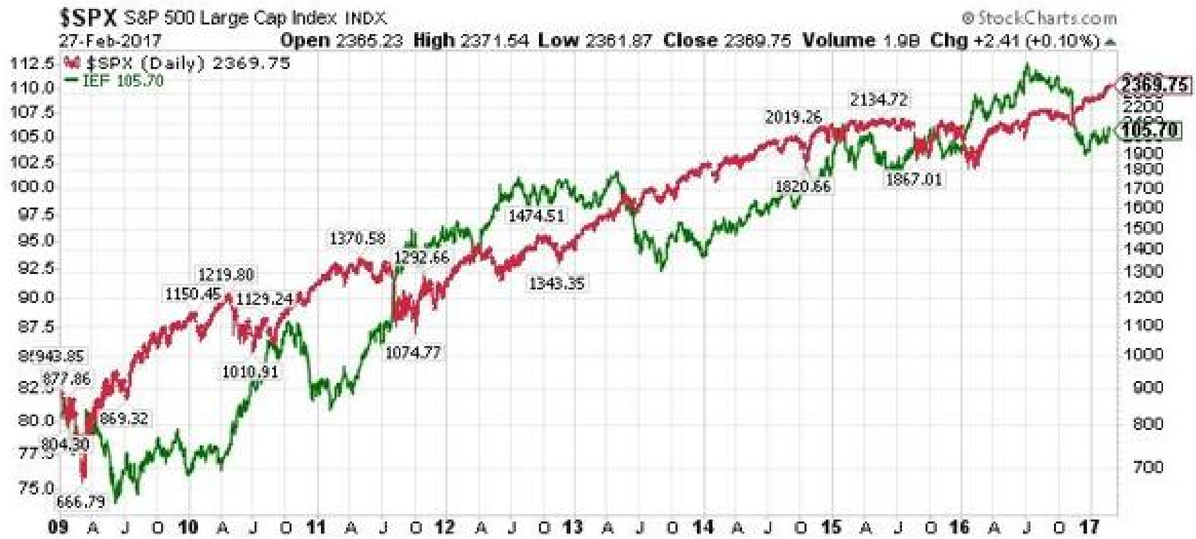
Don't get me wrong - I continue to believe that the stock market is overdue for a short-term correction in the -3% to -10% range at any time now. But barring something extraordinary taking place along the way, any such pullback is likely to be short-lived and would likely be followed by the rally resuming and stocks quickly pushing back to fresh new highs.

Why do I believe stocks can continue to rally beyond any short-term correction? Because markets that are as full of optimism and void of volatility as they are today, whether justified based on fundamentals or not, do not simply stop on a dime and suddenly fall apart. Instead, such a deterioration takes time to evolve. And we are currently in a market phase right now where investors cannot even get a dip to buy on any given trading day much less a sustained correction to begin having any anxieties about. Thus, even if stocks fall into correction for a handful of trading days, there will almost certainly be no shortage of buyers that have felt left behind since Election Day to fill the void and bid stocks back higher.

Still, what about the recent strengths in bonds and the divergence between the two?

First, while it may seem counterintuitive when thinking about it qualitatively, who said that stocks and bonds cannot move higher at the same time? Consider the price performance of the S&P 500 Index and the iShares 7-10 Year Treasury Bond ETF (NYSEARCA:IEF) dating back to 2009. Over the past eight years, both have performed well despite the success of the other. Such are the wonders of a market that is completely flooded with central bank liquidity, as investors will buy up just about everything in sight.

Stocks AND Bonds



Source: Gerring Capital Partners, StockCharts.com

Second, it is important to understand the reason why bonds (NYSEARCA:BND) were being sold off in the first place prior to their recent rally. The mainstream financial media likes to repeatedly cite the narrative that the sell-off in bonds (NYSEARCA:AGG) during the post-election period was a reflection of investors rotating out of bonds and into stocks amid optimism about the pro-growth policies that were set to come with the new administration. As a result, with bonds now increasingly on the mend, the narrative subsequently and understandably evolves that investors are now rotating back into bonds amid concerns about the sustainability of the stock rally and the pace of fiscal policy changes out of Washington.

The only problem with these narratives is that none are true in any substantive way.

To begin with, institutional and retail investors in the U.S. were never rotating out of bonds (NYSEARCA:TLT) and into stocks (NYSEARCA:IVV) in the first place. Consider the following. According to the Combined Estimated Long-Term Flows and ETF Net Issuance

Data from the Investment Company Institute, the taxable bond market has had exactly two weeks where it experienced net outflows since Election Day. The first was the $5 billion that shifted out of bonds in the week immediately following the election that ended November 16. The next came two weeks later during the week ended November 30 when a scant net of $623 million with an "m" moved out of the taxable bond market, which largely offset the equally meager $792 million that had flowed into taxable bonds the prior week ended November 23. And since that time, a whopping $62 billion on net has poured back into the taxable bond market since the start of December. In total, more than $60 billion on net has flowed into the taxable bond market since Election Day. Put simply, there was NEVER a rotation out of bonds by retail and institutional investors in the first place.

What is often overlooked is the fact that the bond market correction had already been well underway since last July and only accelerated after the election. What was notable is that the pre-election bond market correction was taking place despite the fact that retail and institutional investors had poured $83 billion on net into the taxable bond market during this period from July to October 2016.

Bond Sell Off Ended In December

Source: Gerring Capital Partners, StockCharts.com

What then explains the correction in bond prices dating back to July 2016 and thus the sharp rise in yields since Election Day? First, it is important to reemphasize that the bond market correction that began in early July effectively ended in mid-December. So while much is being made of the recent bond market strength relative to stocks, the fact of the matter is that bonds have been gradually moving higher for more than two months now. As for the driver of the weakness from early July to mid December, it had nothing to do with U.S. investors rotating out of bonds and into stocks and instead had everything to do with the fact that China was selling Treasuries in size in order to raise cash in coping with massive capital flows out of the country and a liquidity squeeze impacting its domestic Chinese banks.

One has to look no further than the Major Foreign Holders of Treasury Securities data from the Department of the Treasury and the Federal Reserve Board to confirm this point. In June 2016, the countries of China and Belgium combined held $1.397 trillion in U.S. Treasuries. Why Belgium? Because it has been widely documented that Belgium is a destination where China investors have used to hide their purchases of U.S. Treasuries. Just four months later in October 2016 in the days leading up to the election, this number had fallen to $1.232 trillion. And in the immediate aftermath of the election in November 2016, it dipped even further to just $1.163 trillion. In other words, we saw $165 billion in U.S. Treasury securities dumped by China into global capital markets in just four months leading up to the election followed by another $69 billion sold in the wake of the votes being counted in the U.S. That's $234 billion in U.S. Treasuries being sold over the five-month period from July to November 2016. And adding further confirmation to the fact that this was the primary driver of bond market downside is the fact that in December 2016 when the U.S. bond market finally bottomed, China had quit its mass selling of Treasuries and instead purchased a net $15 billion during the month.

Thus, if the sale of bonds had nothing to do with retail and institutional investors rotating out of bonds and into stocks, the subsequent recovery in bond has equally nothing to do with investors pulling out of stocks and shifting back into bonds. In fact, retail and institutional investors never really stopped buying bonds. The bond selling had nothing to do with sentiment or a point of view held by investors. Instead, it was a period of massive liquidation by a foreign government on the other side of the world dealing with its own domestic economic challenges and needing cash to fight the problem.

But maybe investors are still getting jittery about the outlook for stocks. Are they at least rotating out of stocks? The answer here also appears to be no.

A notable characteristic about stocks throughout the post-crisis period has been the fact that more than $1 trillion in retail and institutional investor money has flowed out of the domestic stock market on net, yet the benchmark indices have more than tripled from their lows over the same time period since early 2009. What then has been supporting higher stock prices throughout this entire period? The steady flow of central bank liquidity into the global financial system along with corporate buyback activity that has more than outpaced the rate of net outflows out of stocks over this time period are two primary contributors.

A promising development for stocks the weeks following the election was the fact that we were finally beginning to see a reversal in net outflow trend from stocks, with more than $42 billion moving back into stocks during November and December 2016. But this quickly stalled in January 2017, with a net $11 billion flowing back out of domestic stocks. Put simply, it appeared that the long-awaited return of the retail and institutional investor back into U.S. stocks, much like the long-awaited sustained economic recovery, would be providing yet another false start.

But trends so far in February are providing new reassurances that retail and institutional investors may finally be warming in a sustainable way to U.S. stocks, as another $21 billion has flowed back in since the start of the month, bringing the net total inflows into domestic stocks to $52 billion since the election. It's not the net $60 billion that has flowed into bonds over this same time period. Nor does this answer the question as to whether retail and institutional investors may finally be buying back into stocks at a time when global central banks are now looking to withdraw liquidity and corporate share buyback activity is on the wane (read: the wrong time). For now, retail and institutional investors are buying back into stocks for the first time in a long time, and as long as this trend continues, it is supportive for stocks.

The Bottom Line

The recent strength of the bond market and the deviation of stock prices from Treasury yields should not be viewed as a cause for concern for stocks. Both asset classes have demonstrated the ability to rise over long-term periods of time. And the drivers of the recent bond market rally are not a reflection of a suddenly renewed need by investors to flee to safety out of stocks. Instead, it is the continued transition from a period a few months ago when a major foreign holder of Treasuries needed to raise cash to fight their own domestic challenges. In short, the recent rise in bond prices and associated decline in bond yields have little to nothing to do with the stock market.

At some point, a day of reckoning will arrive for the U.S. stock market and it will enter into a new bear market. And the fact that they are becoming increasingly disconnected from underlying economic and corporate fundamentals has the potential to result in a particularly angry bear the next time around. But there is little evidence at the present time that we are on the brink of any such transition. We are overdue for a short-term pullback in stocks, but any such pullback is likely to be fleeting and will likely have nothing to do with anything that is currently being signaled by the bond market.

Both stocks and bonds can rise in tandem, and investors should expect that both may continue to do so over the short term and into the intermediate term.

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Disclosure: I am/we are long IEF,TLT.

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Additional disclosure: I am long selected stocks as part of a broadly diversified asset allocation strategy.