HSBC Global Research

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The Major bond letter

#33. Mind the gap

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Fixed Income - Rates

Global

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We were asked what would happen to bonds if the S&P500 was to end the year close to current levels? We found the question unusual, because we are conditioned to assume the causality runs from bonds, but intriguing nonetheless.

Our gut response – that bond yields would probably move higher – did not survive some further thought and analysis. More of this after we have explained why the question matters and what we need in order to answer it in a more considered way.

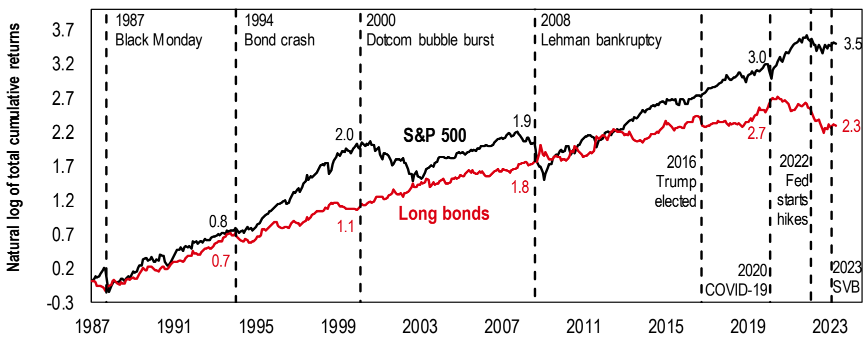
The bond versus equity question affects most of us because we are exposed to their absolute and relative performance through our investments. This may be in the form of long-term retirement investments, medium-term savings, and more speculative short-term trades. Professionals will, of course, use a wider range of valuation tools but we will limit ourselves here to returns.

Armed with a chart of historical returns we see that both bonds and equities have been rising for much of the last four decades and that, over the longer term, equities tend to outperform bonds. Intuitive thinking that equities tend to outperform is further reinforced by the big gap opening up recently in their respective performance.

The arithmetic return on an investment is the difference between its initial and final valuation, divided by the initial value. It captures change in price and the reinvestment of cashflows in the form of dividends (equities) and coupons (bonds). Our chart plots the cumulative total return using a log normalised scale. Log returns show the proportional change in an investment's value and allow us to make more accurate comparisons between time periods.

Holding period returns show the percentage change from initial value but their arithmetic average can be misleading, especially with big market moves. For example, if over two time periods an asset goes from 100 to 120 in price, and then back to 100, the arithmetic returns would be a 20% gain, followed by a 16.7% loss. The investor would have made nothing but the combination of returns incorrectly suggests there was a gain of 3.3%.

Cumulative returns for equities and long bonds



Note: Bloomberg U.S. Treasury: 20+ Year Total Return Index and S&P 500 (including dividends). Monthly data with most recent measure on RHS
Source: Bloomberg, HSBC

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So using the chart with data from the beginning of 1987 we see that the log of cumulative returns for equities stands at 3.5 today, having risen from 3.0 from when the COVID-19 pandemic was declared on 11 March 2020. Meanwhile, bonds have gone from 2.7 to 2.3. This means that the arithmetic equivalent is an approximate 70% increase in the S&P500 and 30% decline in bonds.

We have explained how the chart works and shown that equities have been outperforming bonds, so here are six reasons to manage our intuition.

First, the original question assumed causality runs from equities to bonds. However, valuations of both require use of a discount rate, and it is more common to take the risk free rate from bonds. After a significant period of rate increases bonds have arguably started to lead policymakers and economic data.

Second, the chart shows that initial conditions matter. The gap between cumulative returns today of 1.2 (3.5 minus 2.3) is wide by historical standards and even greater than at the time of the 'dot com' bubble. On 10 March 2000, when the NASDAQ peaked, the gap between our two series was 0.9 (2.0 minus 1.1).

Third, continuing on this theme, there have been periods when equities underperformed. We squeezed a few vertical narrative lines onto the chart to identify significant events through time. We started the series before the 1987 stock market crash, which we note hardly makes an impression on the chart. Equities regularly underperformed bonds from the dot com bubble in 2000 to the Lehman bankruptcy (15 September 2008). They even had a significant down period between 2000 and 2003.

Fourth, we chose the index for long bond returns because we wanted to make a fair comparison with high duration equities. But bond investors will know that this also presents a conservative view of the yield available to them. Adding investment grade credit can be worth another 150-200bp of spread. High yield and emerging markets can add a lot more on top of this.

Fifth, investors are anyway not confined to bonds and equities. Modern portfolios incorporate alternatives including real estate, commodities, private equity and hedge funds. Given the rapid rise in policy rates, cash – and cash surrogates like short bonds – can be an attractive alternative, permitting investors to sit and wait.

Finally, what about adjusting the returns for risk? Volatility is low for equities today at a time when for bonds it has returned towards the highs of the global financial crisis (GFC, 2008). Whatever the reason for this divergence, the denominator-effect skews backward looking measures of risk-adjusted returns against bonds. This could change when rates volatility subsides once the outlook becomes more clear.

So the more considered answer to the bonds versus equities question is that: there is a lot more to it. At a minimum we need to consider the direction of causality, the selection of time horizon, adjustment for risk, and valuations of alternatives. The intuitive response that bond yields should be higher if equity valuations remain unchanged is already being challenged by the clawback that began last October.

We have learnt to challenge our intuition and, whilst there is no definitive answer to the original question, we will mind the gap.

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