A moment in markets – Can equity investors look beyond rising yields?

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Financial markets are complex systems and can, at times, exhibit relationships that seem counterintuitive. For example, conventional finance wisdom tells us that equities should welcome rising levels of inflation because corporate earnings tend to expand as economies grow. But when surging inflation expectations cause yields to rise quickly, equity markets are unnerved. This is because higher yields translate as higher discount rates for future cash flows to equity investors.

Practically, rising inflation expectations raise the prospect of monetary policy tightening. In recent months, the US Federal Reserve (Fed) has reiterated, repeatedly, that rates are unlikely to rise through 2023. It seems investors are taking their time in internalising this reassurance from the Fed. This would explain the jitteriness across the board in global equities in recent weeks in response to rising long term US Treasury yields.

Can investors look beyond the rout triggered by rising yields to identify the potential tailwinds behind equities in the coming months? If they did, they might realise that actual inflation – unlike inflation expectations – remains relatively modest and is ticking up only gradually. The annual inflation rate in the US in February was 1.7% – up from 1.4% in September last year1. And when this is combined with the Fed's new stance of targeting an average level of inflation, apprehensions of policy tightening seem premature.

Vaccine optimism, pent-up demand and the $1.9 trillion US fiscal stimulus may join forces to lift equities in the coming months. Let us not forget, a fiscal injection was pivotal in lifting markets last year. This year, it is supported further by hopes of vaccines bringing an end to the pandemic and pent-up demand from consumers giving economies the buoyancy they need. The macro environment, therefore, is ripe for equities to thrive in the coming months.

But while equity markets were clearly divergent last year, looking across factors and geographies, performance might be a bit more even in the coming months. On the one hand, distressed parts of the market are poised to make a return as the cyclical recovery unfolds. On the other hand, tech related themes promising a long shelf life continue to appeal to investors.

In our equity outlook for the year, we outlined how diversity could bear fruits in 2021. The framework introduced postulated that growth and value can coexist this year amid a favourable market backdrop. The same notion of diversity extends across geographies too. US equities might not be alone in delivering robust gains as Europe, UK and emerging markets may also come to the fore.

The recent dip in equities could, therefore, become a good entry point for both tactical and strategic investors. But can investors look beyond rising yields?

1 US Bureau of Labor Statistics

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