NORTHEAST

INVESTORS TRUST

Bonds Loathe Rising Rates, But Do Stocks Hate Them More?

Bruce H. Monrad, Chairman, Northeast Investors Trust

November 2018

In a rising-rate environment, investors worry about the duration of their bonds. Yet the asset class with the highest interest rate risk may actually be equities.

Investors have long been taught that bonds are the asset class they must worry about when interest rates rise. Yet after the yield on 10-year Treasuries jumped above 3% in mid-September, it was the stock market that took the big tumble.

The S&P 500 index of U.S. equities nearly slipped into a correction, losing more than 9% of its value by late October before rebounding after the mid-term elections. At the same time, stock volatility, as measured by the CBOE VIX index, more than doubled from mid-September to the end of October. While the bond market also slumped, it only fell by around 1% during this stretch.

Was this a big surprise? Actually no. Each of the last big stock market downturns—1987's Black Monday crash, the 2000-2002 tech wreck, and the 2007-2009 financial market meltdown—was preceded by a hike in interest rates.

From June 2004 to June 2006, for instance, the Federal Reserve raised short-term rates 16 times leading up to the 2007 bear market in equities. Similarly, yields on the 10-year Treasury jumped from 4.4% in September 1998 to 6.7% in January 2000, just before the dotcom bubble officially burst in March of that year. However, it often takes time for rising rates to begin to grab stock investors' attention—or at least make them notice other structural issues that threaten equity prices.

By contrast, bond investors immediately notice the effects of rising rates because yields and bond prices instantly move in opposite directions. What's more, bond investors are predisposed to think about interest rates because they have a gauge with which to measure their exposure to rate risk—duration. And this statistical yardstick of interest rate sensitivity has been rising lately for the broad bond market, contributing to the anxiety.

But here's the thing: Duration isn't just a measure of fixed income risk; it can be applied to the stock market as well. And by one calculation, the duration for the S&P 500 index may be ten times higher than for bonds, which may help explain why the stock market fell so much more than bonds after rates began rising in September.

> "Duration isn't just a measure of fixed income risk; it can be applied to the stock market as well."

Research also shows that contrary to conventional wisdom, high dividend-paying stocks, which income investors have historically used to supplement or replace fixed income yields at various parts of the market cycle, may have even longer durations than the market as a whole. That means income-oriented investors who are thinking of shifting out of bonds now that rates have risen should be cautious about chasing high dividends.

Understanding Equity Durations

Academics have been debating how to calculate stock duration for more than 30 years, and there's still little consensus. The lack of agreement, though, is no reason to discount equity duration as a valid measure, since there are similar arguments on how to accurately assess the duration for bonds.

Today, the average duration for a broad bond index fund is about 6 years, according to Morningstar. This means you can expect to suffer a 6% loss in the price of your bonds if market rates rise by one percentage point. Since the yield on 10-year Treasury bonds jumped more than 1.5 points since 2016, it's easy to see why fixed income investors are nervous. Yet according to S&P, the duration for stocks has been much higher for years. The S&P 500's duration was around 15 years in the early 2000s, rose above 20 in 2010, and then climbed above 60 by 2016.

There is one big difference. For stocks, a duration of 60 years doesn't imply your shares will fall a full 60% should rates rise by one point. Why not? When you are calculating the duration of a bond, you are assessing how a change in rates may alter the value of a debt contract with fixed terms. With stocks, you are dealing with a far more dynamic set of circumstances. Rates don't directly impact a company's share price so much as the underlying forces pushing rates higher weigh on a company's margins, growth rates, and dividend policy.

Still, rising rates can influence stock prices in at least two visible ways. For starters, rising yields change what investors are willing to pay for earnings.

Historically, there's been a strong link between equity valuations and the yield on the 10-year bond, which becomes clear when you invert the price/earnings ratio to calculate the market's so-called "earnings yield". Today, the P/E for the S&P 500, based on 10 years of normalized earnings, stands at a historically high 30.6, according to Yale economist Robert Shiller. The inverse of this P/E—or 30.6 divided into 1—gets you an earnings yield of around 3.3%, near the 3.1% yield on 10-year Treasuries. In January 1980, when the 10-year yield soared above 11.1%, the market's earnings yield rose to 11.2%, pushing the P/E down to 8.9. In other words, as rates rise, the market's P/E is expected to fall, pressuring stocks.

The so-called "equity risk premium" should also climb. The greater the perceived risk in an asset class, the higher the returns investors will demand, over what they're getting from risk-free Treasury bills. Yet U.S. stocks aren't in a good position to deliver big returns in coming years, due to their high valuations.

Implications for Bond Investors

Investors must weigh the rate sensitivity of all parts of their portfolio—in the proper context. For instance, within the broad stock market, durations are highest among shares that throw off the most income. In fixed income, it's the reverse.

The average duration for investment-grade bonds is 7.2 years, based on the Bloomberg U.S. Aggregate Corporate bond index. And that's been rising; it was around 6 years a decade ago and closer to 5 years in the early 1990s. By contrast, the average duration for high yield bonds is 3.8 years, down from around 4.5 years a decade ago, based on the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index.

And within high yield, the average duration at the short end of the curve is just 2.4 years. That's a third of the duration for high-quality bonds, even though short-term high-yield bonds are paying more than 2 percentages points over investment grade corporates.

What does this mean? Income investors thinking of tweaking their asset allocation on rate fears should think long and hard before shifting out of bonds and into stocks. At the very least, bond investors must understand that they can earn yields comparable to what long-dated bonds are paying without extending the durations of either their bonds or stocks.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (ticker: NTHEX) ,a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers, having run Northeast Investors Trust for more than 29 years. He received his A.B. from Harvard College and his M.B.A. from Harvard Business School.

CONTACT: 1-800-225-6704 (M-F 9:00am - 4:45pm EDT); BMonrad@northeastinvestors.com

NORTHEAST INVESTORS TRUST