Harry's Take

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Corporate Bond and T-Bill Yields Competing With Stock Earnings Yields

Investors can get income from investments in various ways, including through interest on bonds and T-bills and through dividends on stocks, which are derived from earnings. The dividends are paid directly; the remainder of earnings are accrued into the value of the stock. They call that retained earnings.

Stocks typically deliver greater longer-term appreciation when companies are growing in sales and earnings, and bonds deliver more-predictable fixed income from scheduled interest payments. The value of a bond on the markets will go up if general interest rates are falling, as that makes its rate look more attractive than the interest rate investors can get in the future. Conversely, the value will go down if rates are rising.

We have now seen a longer and a bit stronger rally in stocks than I would have expected, given 14 months of rate hikes through May designed to slow the economy. A slowing economy should mean appreciation in risk-free bonds like Treasuries, as competing rates will fall. But that typically means a fall in stock values, as future earnings are expected to decline.

Stocks Looking Less Attractive as Bond Yields Rise, While Yields Similar

Source: https://lmtr.com/time-to-add-to-hedges/

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This chart shows another trend that should limit the rise of stocks at present, in addition to an expected slowing of the economy from tightening interest-rate policies.

Now, investors can get a 5.37% yield on a three-month T-bill and 5.40% on a six-month bill. That is similar to an average 5.5% yield on a 20-year investment-grade corporate bond and around a (now) 5.5% earnings yield on stocks, which has been somewhat consistent and has averaged close to 6% since 2013.

So, why take the risk of owning stocks, when bond yields are similar to earnings and the economy could slow, maybe by a lot?

And I see it slowing a lot, given 14 years of stimulus, which has prevented the restructuring of bad debts and zombie companies for longer than ever, something that is necessary to the long-term health of the economy and that recessions do best. Hence, there is little or no chance of a soft landing here, despite the hopes of Wall Street, as usual.

This is another way that tightening policies hit the economy and stock markets… and another reason you should be selling stocks now and waiting to buy again until well into 2024, by my best estimates.

Harry

Got a question or comment? You can contact us at info@hsdent.com.