Rising real rates: A threat to the equity market?

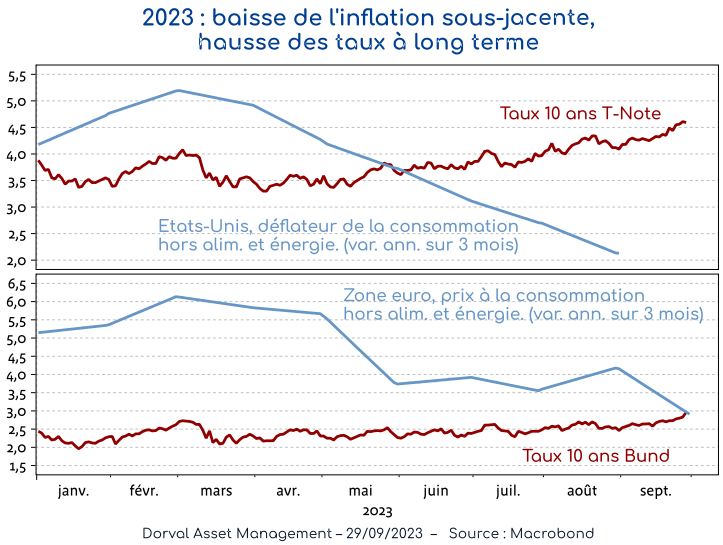
2 October 2023

Dear Clients and Partners,

Despite the decline in inflation, government bond yields have recently reached new highs in this cycle. At this stage, however, the level reached by long-term rates does not pose a threat to equity valuation.

Oil prices have risen since last July, but inflation statistics are following a good trend. The disinflationary process is indeed broad, covering manufactured goods, rents, food and services. Over the last three months, underlying inflation fell to 2% in the US (annualised rate from June to August) and 3% in the eurozone (July to September). However, these solid figures did not prevent long-term rates from continuing to rise (cf. chart 1).

2023: lower underlying inflation, higher long-term rates



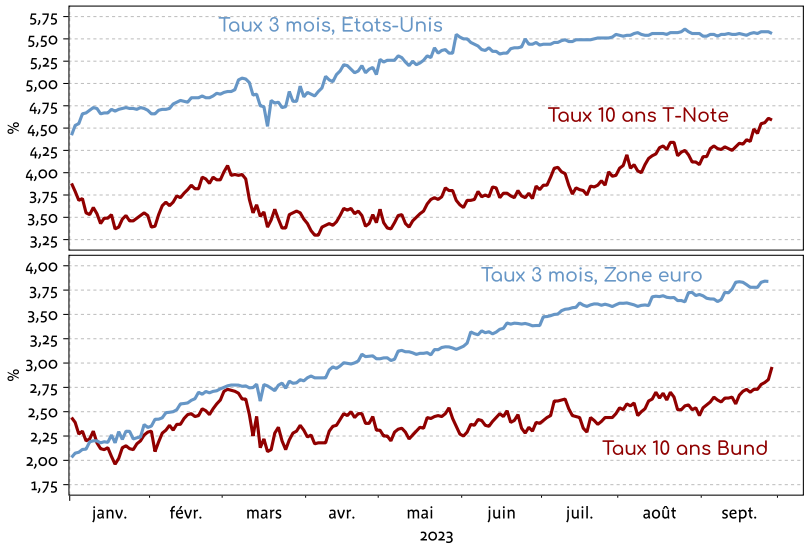
Dorval Asset Management – 29/09/2023 – Source : Macrobond

- *10-year T-Note rate*
  United States, consumption deflator excluding food and energy. (var. over 3 months annualised)
- *10-year Bund rate*
  Eurozone, consumer prices excluding food and energy (var. over 3 months annualised)
- *Jan. Feb. Mar. Apr. May Jun. Jul. Aug. Sept.*

With long-term real rates above 2% in the United States and finally positive in Europe, there seem to be fewer reasons for snubbing the sovereign bond market. However, money market competition remains strong, with short-term rates still around 100 basis points above long-term rates (cf. chart 2). It is certainly justified that the yield curves are inverted since central banks no longer have a reason to raise their rates significantly, and these rates – now well above underlying inflation – are likely to decline at least a little in the coming years. But the probability of such a process unfolding in the coming months remains quite low.

Money market competition weakens the bond market

La concurrence du monétaire fragilise l'obligataire



Dorval Asset Management – 29/09/2023 – Source : Macrobond

- *3-month rate, United States / 10-year T-Note rate*
- *3-month rate, eurozone / 10-year Bund rate*
- *Jan. Feb. Mar. Apr. May Jun. Jul. Aug. Sept.*

In the United States, economic momentum could lessen somewhat under the pressure of a temporary government shutdown and the resumption of student loan repayments. But fundamentally nothing seems to be pushing the American steam train off course. On the contrary, unemployment claims fell once again to levels close to 200,000 per week, reflecting strong momentum in the labour market. In Europe, the economic situation is less reassuring – making interest-rate outlooks a little more uncertain – but the labour market also seems resilient.

If long-term rates do not decline, or if they continue to rise, what impact would this have on the equity market? This question should be approached cautiously, as there is no stable relationship between long-term rate prospects and equity valuation. Too fast a rise in long-term rates leads to volatility in all markets, but rising real rates also shows greater confidence in the resilience of the economy. There is also a risk that high real rates will reduce the equity risk premium to dangerously low levels. Today, according to our calculations on the MSCI World Equal Weighted index, this risk premium remains at a comfortable level globally (cf. chart 3). It remains near 2003–2007 levels and is considerably above the very low levels seen at the turn of the century.

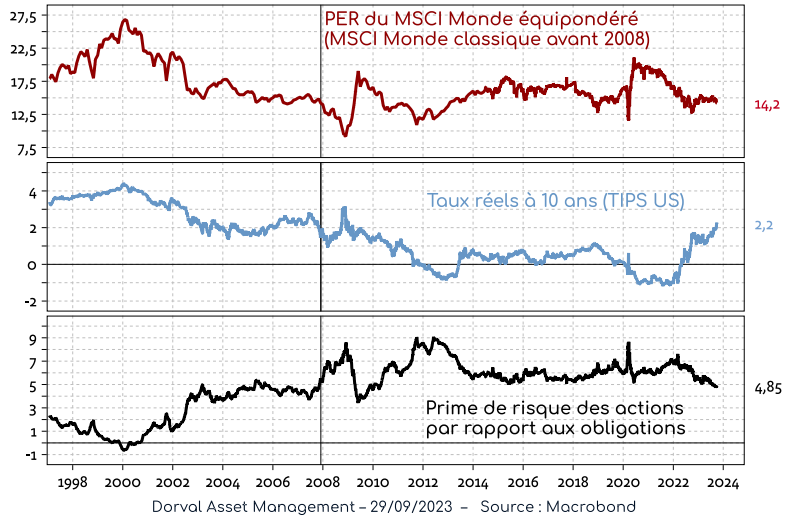
Our global funds retain a neutral allocation in equal-weighted international equities, and a marked underweighting of bonds compared to money market instruments.

Global equity risk premiums remain comfortable

Risk premium = inverse of PER minus real rates on bonds

La prime de risque des actions mondiales reste confortable

Prime de risque = inverse du PER moins taux réels des obligations



Dorval Asset Management – 29/09/2023 – Source : Macrobond

- *PER of MSCI World Equal Weighted (traditional MSCI World before 2008)*
- *10-year real rates (US TIPS)*
- *Equity risk premium (against bonds)*

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 83%.

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