DORVAL ASSET MANAGEMENT
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A disconnect between equities and bonds in sight

22 January 2024

Dear Clients and Partners,

Whether trending up or down, equity markets have been heavily influenced by changes in long-term interest rates since the summer. This strong correlation is expected to diminish in response to forthcoming monetary easing by central banks.

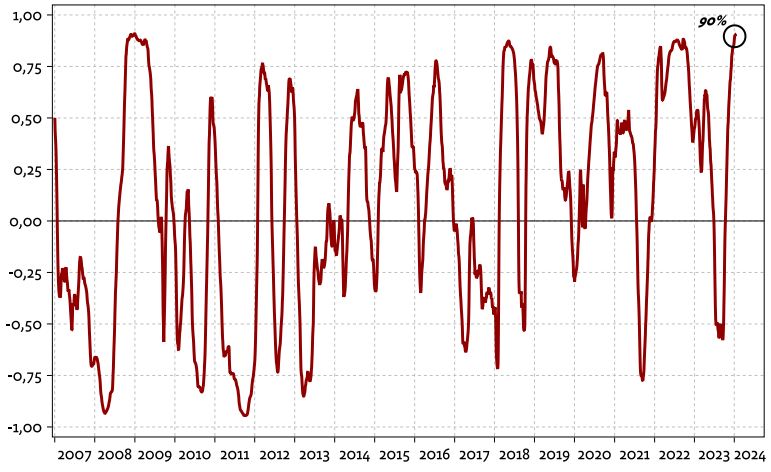
After a brief weak and even negative performance in the first half of 2023 due to the US regional banking crisis, the correlation between equity markets and sovereign bond markets has reached a record level since last summer. The prospective PER for the MSCI World index and US long-term real rates (inverted) had a 90% correlation over six months, a record reached only once since 2007 (cf chart 1). This level is statistically unsustainable; history tells us that the correlation between PER and bond yields is both very unstable and, on average, close to zero. The period we have just seen is therefore quite exceptional.

An abnormally strong correlation between equities and bonds

Corr. over 6 months between the PER for the MSCI World index and inverted US long-term real rates

Une corrélation anormalement élevée entre actions et obligations

Corr. sur 6 mois entre le PER du MSCI Monde et l'inverse des taux longs réels US

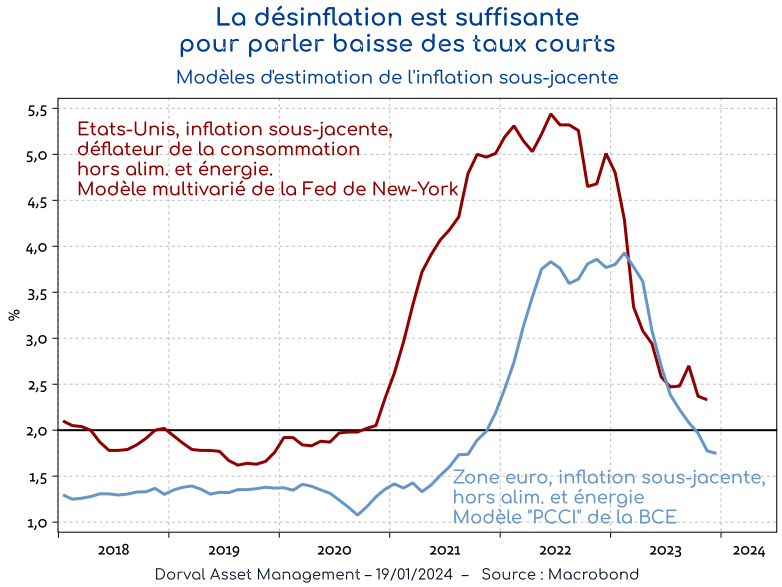


Dorval Asset Management – 19/01/2024 – Source : Macrobond

PER is primarily a measure of perceived visibility by investors. This subjective visibility is affected by a wide range of factors, but it has understandably been closely correlated with long-term rates for the past two years. Inflation, and central banks' responses to it, have largely dominated the conversation around risk. This is still the case today, but with a distinctly positive shift that should eventually reduce the correlation between equity markets and long-term interest rates. With disinflation (cf. chart 2) we have gone from a situation where central banks were prepared to quash growth to curb inflation, to a situation where not only is this no longer necessary, but central banks are beginning to worry – at least preventively – about risks to growth. It's a huge turnaround.

Disinflation is strong enough to talk about falling short-term rates

Models for estimating core inflation



- *US, core inflation, consumption deflator excluding food and energy. New York Fed multivariate model*
- *Eurozone, core inflation, excluding food and energy. ECB PCCI model*

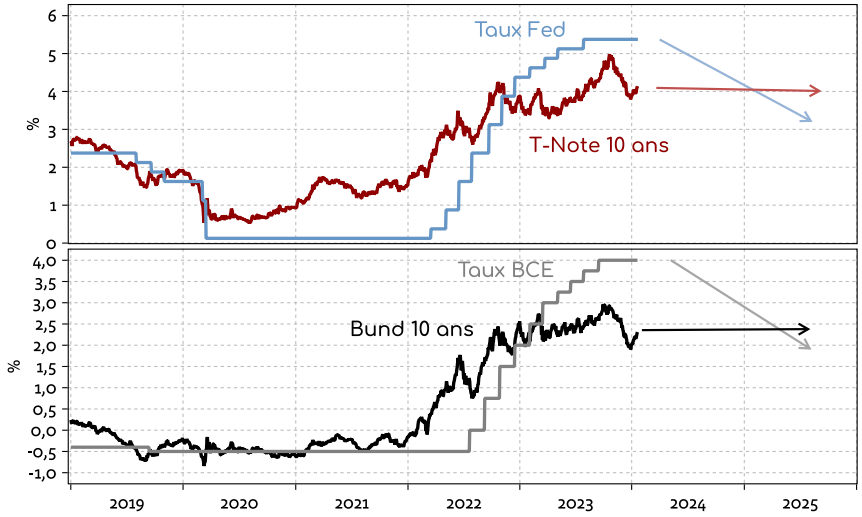
In practice, this change should result in the yield curve gradually normalising from its present strong inversion to a more normal upward curve. In the scenario of a soft landing with well-controlled inflation, we may assume that the Fed and the ECB would lower their rate by around 200 basis points by the end of 2025 to counteract currently restrictive monetary policy. As the yield curve recovers, Fed rates at 3.25% in 2025 are indeed compatible with long-term rates at 4% or more, and ECB rates at just under 2% are also compatible with Bunds rates above 2% (cf chart 3). This soft landing scenario, while seemingly positive for equities, would not necessarily be positive for long-term bonds. It is conceivable that long-term rates may even trend up a little, which is likely to be met with general indifference.

Without a recession, monetary easing will not necessarily lead to lower long-term rates

A potential scenario for rates in 2024/2025

Sans récession, l'assouplissement monétaire ne fera pas forcément baisser les taux longs

Un scénario possible pour les taux en 2024/2025



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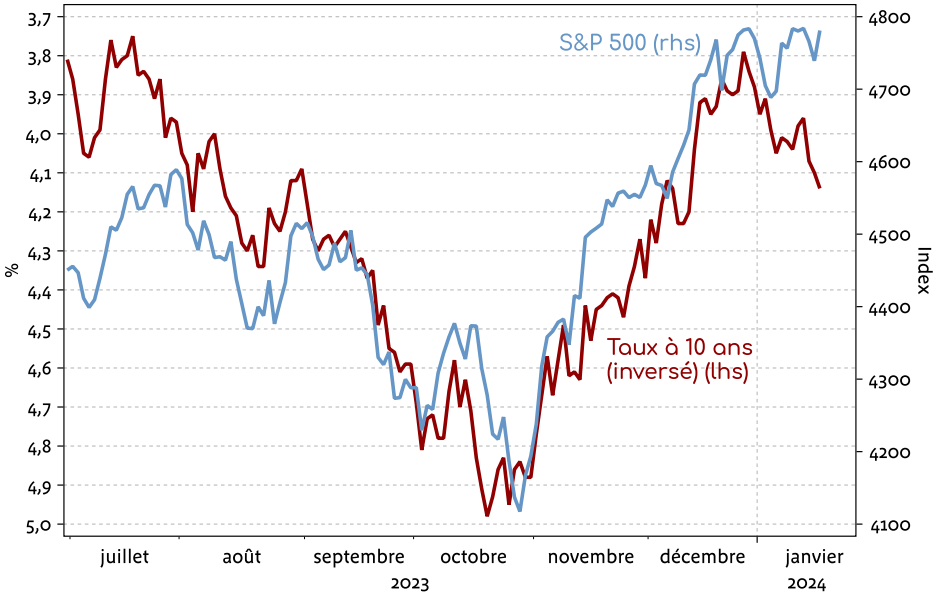
- *Fed rate / 10-year T-Note*
- *ECB rate / 10-year Bund*

How long will it take for the yield curve to start recovering? The ECB seemingly wants to wait a few more months to keep an eye on wage negotiations, and lower short-term rates from June; but if inflation and/or growth figures were to decrease unexpectedly, it could do this a little earlier. As for the Federal Reserve, Jerome Powell's verdict is awaited at the end of January – against the backdrop of a labour market that remains dynamic, making things a little more complicated.

In the meantime, on Wall Street it appears that the equity market's dependence on long-term rate dynamics has lessened somewhat in recent days (cf chart 4). Could investors' focus on long-term interest rates be easing off? Watch this space.

Wall Street appears less stuck on the bond market in recent days; watch this space.

Wall-Street semble moins "collé" au marché obligataire depuis quelques jours. A suivre.



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- *S&P 500 (rhs)*
- *US 10-yr rates (inverted) (lhs)*
- *July August September October November December January*

In our global diversified funds, our positioning remains as follows: overweighting of equities, a moderate bond duration for hedging in the event of an economic slowdown, and returns on money market instruments in euro. In anticipation of an ECB pivot and a gradual recovery in activity, we are maintaining a high exposure to equities in our flexible European funds. In these funds, in addition to a core basket close to Euro Stoxx 50, we are investing in a diversified basket of small and medium-sized stocks, banking stocks and companies benefiting from the themes of productivity and the energy transition.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 70%.

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