Investment Update

BNY MELLON
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Mixed Signals

When I moved to the San Francisco Bay Area in 1997, I quickly learned an important rule about navigating the city. To ensure you get to your destination, you take Bush Street when traveling east into downtown. The reason is simple: the lights are synchronized. As long as you travel about 35 mph, the lights will change to green as you approach each intersection. The same is true for Pine Street when traveling west.

As a strategist, I prefer those times when the markets are traveling in sync, like Bush and Pine Streets, because this helps provide an important, consistent signal about the economy's direction. For example, when stocks are rising and bond prices are falling (with yields rising), market theory says the economy is strengthening. When the opposite is happening—stocks falling and bond prices rising (with yields falling)—the economy is weakening.

Today, however, both stocks and bonds are on the rise, leaving many to wonder the meaning for the economy. What happens when both sides of the market are rising? Do we believe the upward path of stocks, which signals a growing economy? Or do we believe the upward path of bonds, which often signals the opposite? I have found that when you have a market with mixed signals, it is critical to look deeper to distinguish economic factors from the "noise."

Understanding the Economy's Signals

The five-year bull market continues to reach new highs almost on a daily basis, with the S&P 500 up 7.24% year to date as of June 20. Meanwhile, the bond market also has shown its strength. Bond prices have been rising steadily in 2014, with the Barclays Aggregate Bond Index up 3.38% year to date as of the same date. Treasury yields, which move in the opposite direction of bond prices, have fallen from 3.04% at the start of the year to a recent low of 2.61%.

Certainly, history has shown that both markets have very good records for predicting general economic direction. If the equity market has a flaw, it is that it is too optimistic. If the bond market has a flaw, it is that it is too pessimistic.

In the current landscape, both markets continue to wrestle with mixed economic data. On the positive side, payroll employment figures for the past few months have provided a backdrop for jobs growth, although at a pace slower than past recoveries. Strong numbers from the Institute of Supply Management (ISM), in both manufacturing and non-manufacturing, have also been reported recently. Add healthy auto sales, very good small business survey data and a rebound in housing to the mix and you begin to see a consistent support for the notion that economic growth continues to improve.

On the negative side, the global economy faces some headwinds. The European Central Bank (ECB) recently cut interest rates to fend off deflationary pressures that are spreading across the region. In addition, in an unprecedented move, the ECB pushed rates negative on any deposits held at its facility. China continues to wrestle with slowing growth and a slowing housing market. Adding to the uncertainty is the geopolitical unrest in Russia, Ukraine, and now, in Iraq.

Bond Returns Influenced by Many Non-Economic Factors

The bond market has probably been more accurate in its predictive power, or at least that is the view generally accepted on Wall Street. However, yields may fall for many non-economic reasons, thus weakening the case that a slower economy lies ahead.

For example, U.S. short-term interest rates now are predicted to stay lower for longer. As this "new normal" is becoming accepted by the overall market, it is putting a near-term lid on rates.

Another non-economic reason is that nearly every bond manager and economist believed that rates were going to head higher as we ended 2013. As such, many had already positioned themselves to profit from this view. This "crowded" trade soon unraveled because there was no one left to sell bonds, but there were others who were willing to buy, including the Federal Reserve through its quantitative easing program. This lopsided trading caused yields to fall, putting pressure on those who had sold bonds short or had positioned their portfolios to be less interest rate sensitive than their benchmark.

In addition, pension plans are rebalancing after a very strong prior year in global markets, and this has had its influence on the bond market. These institutional players have to meet pension obligations over long periods of time, and, as such, are very disciplined about selling winners and allocating the proceeds to the underperforming asset class. Hence the trade entering 2014 was to sell equities and buy bonds, bringing them back to their target allocations.

Lastly, the U.S. bond market has been impacted by falling yields in Europe, especially in Germany. As low current inflation and also low inflation expectations remain prevalent in the eurozone, yields have fallen. Because we live in a global bond market, U.S. Treasury yields followed European yields lower. At one point, yields in Europe had declined such that Spanish debt was lower yielding than U.S. Treasury debt.

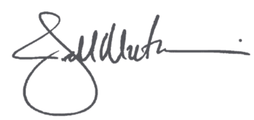
Conclusion

When the equity and bond markets are delivering mixed signals, it is our job to wade through the noise and determine the right direction. For now, we think the equity market has it more "right." Our view is that we are at an inflection point to faster growth globally. As long as this growth is measured, we believe that yields will increase slowly over the coming years. This should bode generally well for the U.S. equity market, which we expect to move higher as earnings continue to grow and multiples continue to expand modestly.

Our overweight to equities relative to bonds remains intact, in spite of the market's rise to near all-time highs. We continue to think valuations are reasonable, which is positive for the stock market. We also believe that yields will rise again once global growth is seen to be the dominant theme, and the other non-economic reasons for lower yields will dissipate.

The market seems to be coming around to our point of view, at least in the near term. For instance, Treasury yields have risen 20 basis points from the lows of 2.44% on May 28, while equities remain at or near their highs. Time will tell. For now, however, we believe that, in the coming quarters and years ahead, our views will continue to play out in the both the equity and bond markets.

If you're traveling in San Francisco, and want to make good time, I expect to see you east on Bush or west on Pine. We can only hope that the stock and bond markets eventually get back in sync as well. Until then, don't let the mixed signals throw you off course.



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