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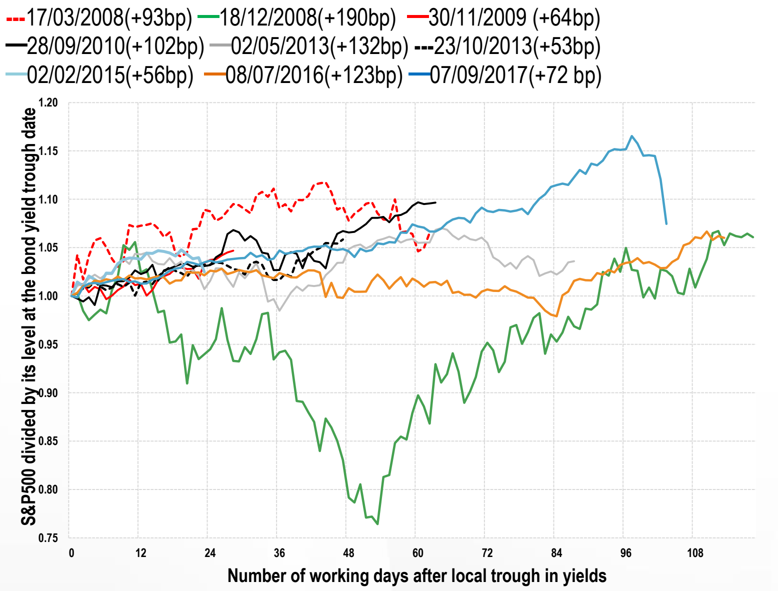
US: Somnolent risk wakes up

■ During the current business cycle, rising bond yields have been accompanied by rising equity prices ■ From a historical perspective, the rise in equities in recent months has been abnormally strong, probably helped by the prospect of corporate tax cuts ■ Market developments this week show a high sensitivity to economic surprises which may end up fuelling economic uncertainty

Search engines generate a huge number of articles published this week referring to "healthy correction". Whether the big drop of Wall Street last Tuesday was healthy very much depends on one's positioning. Opinions of somebody looking for a good moment to enter the market versus those invested in a short VIX strategy will differ. From an economic perspective, the recent events are quite instructive. Firstly, the knock-on effets of the stock market decline was as expected: a big jump in implied volatility (VIX), international spillover effects and a decline in US treasury yields on the back of safe haven buying. Secondly, the sequencing of movements was interesting. A rising trend in long term interest rates eventually impacted share prices following the surprising jump in hourly wages last Friday. The equity market decline in turn pushed down bond yields. This would indicate that in a scenario of a late cycle pick-up in inflation, the cumulative rise in bond yields could be capped by the nervous reaction of equities in response to higher rates. Such a development could still weigh on the economic outlook but more because of increased uncertainty, rather than significantly higher bond yields. In this respect, the chart shows the evolution of the S&P500 during periods of significant cumulative increases in bond yields. The analysis starts in 2008 and for each period it shows the date of the local trough in bond yields and, between brackets, the cumulative rise in yields. The increase in yields starting at the very end of 2008 occurred while the economy was still in recession so unsurprisingly equities initially declined. This was an exception to the general observation in this business cycle that rising bond yields are accompanied by flat to rising equity markets: the negative impact of higher rates on equity prices tends to be more than compensated by an improved economic outlook and/or a decline in the required risk premium (which reflects greater *confidence* in the outlook). What makes the cycle since September 2017 so special is the abnormally strong equity rally, quite probably fuelled by the prospect of corporate tax cuts. There is a price though: greater sensitivity to unwelcome surprises. The events this week are a useful reminder of this. It could also end up fuelling economic uncertainty.

S&P 500 IN A RISING 10-YEAR US TREASURY YIELD ENVIRONMENT



Sources: FRED (Federal Reserve of St. Louis), BNP Paribas

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