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Monday Morning Outlook

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The Bond Bubble Bursts

Fundamental forecasters who have faith in the idea of efficient markets (like our group here at First Trust Advisors) view market psychology with skepticism. While we have enough experience to know that psychology can push a market above or below fair value, we also know that this cannot last forever.

The trouble comes in trying to explain fundamental value in a world that seems dominated by psychology. For example, we have argued for more than a year that US interest rates were headed higher. Our models suggested the entire Treasury yield curve was artificially low, particularly long term rates, and the inverted curve was a fluke.

One reason for this was that the "real" after-tax yield of a 10-year Treasury bond was extremely low – just 30 basis points (calculated using a 4.7% bond yield, 35% tax rate and 2.75% inflation) – a tiny reward for the risk. Another reason was that 10-year yields were significantly below the growth rate of nominal GDP – a good gauge of value. If there was a "bubble" we felt it was in bonds.

But this did not sit well with the conventional wisdom. Market psychology has been extremely pessimistic, and bubbles are thought to exist in stocks, private equity, housing, and consumer demand, but not in oil or bonds.

The negative psychology has been so pervasive it feeds on itself. The story goes like this: Oil prices are up because demand exceeds supply, but housing is weak because supply exceeds demand. Together, these problems will force the Fed to cut rates as the consumer crashes, and since the all-wise bond market saw all this coming, rates stayed low.

Like many world views that become so ingrained, contrary indicators were routinely ignored. The fact that equity prices have soared in recent months was passed off as a result of private equity deals, or mergers and acquisitions. Moreover, now that bond yields are up, the pessimists are arguing that stocks can't possibly keep rising.

The idea that a bull market in stocks could be due to strong fundamentals didn't fit the story. But the stock market is up almost 25% from last year, while 10-year yields are about the same. Almost all of the increase in stock prices is due to earnings growth, not a shift up in the P-E ratio. Our capitalized profits model (which has consistently used as its discount rate, a 6% 10-year Treasury yield) says the broad US equity market is still 20% undervalued.

Yes, the economy did slow in the past year, but this appears to be similar to the slowdown of 1995 – when rapid Fed rate hikes during 1994 rippled through the economy causing a lull in growth. The same has happened in the past year, but just like 1996 the economy is bouncing back. One of our favorite indicators is initial claims for unemployment insurance. They moved up slightly earlier this year, but have fallen back to boom-time levels.

Right now, our forecast for second quarter real GDP growth is 4.0%, with nominal growth likely to push over 7%. No wonder the leveraged-bond-trade, based on pessimistic forecasts, is unraveling fast. A 6%, 10-year Treasury bond yield is still our forecast. The good news – it doesn't change our bullish call on stocks.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-19 / 7:30 am	Housing Starts – May	1.480 Mil	**1.513 Mil**		1.528 Mil
6-21 / 7:30 am	Initial Claims - Jun 16	310K	**311K**		311K
9:00 am	Leading Indicators – May	+0.2%	**+0.2%**		-0.5%
6-25 / 9:00 am	Existing Home Sales - May	6.000 Mil	**5.972 Mil**		5.990 Mil
6-26 / 9:00 am	New Home Sales – May	0.944 Mil	**0.922 Mil**		0.981 Mil
6-27 / 7:30 am	Durable Goods – May	+0.0%	**-4.0%**		+0.8%
7:30 am	Durable Goods (Ex-Trans) - May	-0.5%	**-1.1%**		+1.9%
6-28 / 7:30 am	Q1 GDP Final	+0.7%	**0.7%**		0.6%
7:30 am	Q1 GDP Chain Price Index	+4.0%	**4.0%**		4.0%
6-29 / 7:30 am	Personal Income – May	+0.6%	**+0.6%**		-0.1%
7:30 am	Personal Spending – May	+0.6%	**+0.7%**		+0.5%
9:00 am	Chicago PMI – Jun	57.3	**59.3**		61.7