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Daiwa's View

Stocks and bonds rise together

- Is a dangerous rise in stocks triggering bond buying?

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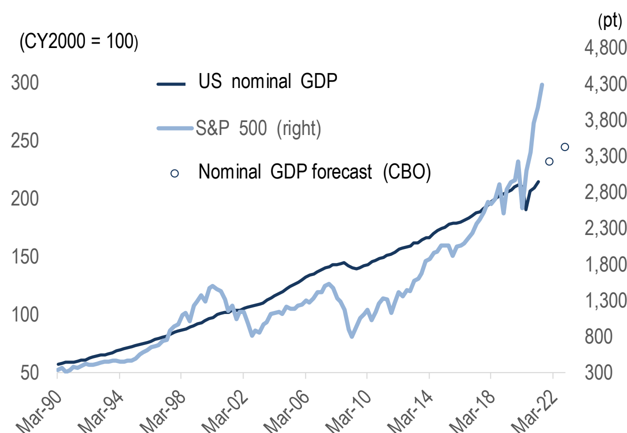
Daiwa Securities Co. Ltd.

Stocks and bonds rise together

Is a dangerous rise in stocks triggering bond buying?

In a previous version of this report we discussed housing prices and nominal GDP. There is also some basis for the view that there is a relationship between share prices and nominal GDP. This is probably why the Buffett indicator is calculated based on the ratio of equity market cap to nominal GDP. In this light, the recent widening of the gap between share prices and nominal GDP is concerning. Share prices do rise in part by pricing in future economic growth, but even after deducting the next two years of growth[1], US stocks appear to be way ahead of themselves (see chart below).

Nominal GDP, S&P 500 Index



Source: BEA, CBO, Bloomberg; compiled by Daiwa Securities.

Buffet Indicator (Stock market cap/Nominal GDP)

Source: Bloomberg; compiled by Daiwa Securities.

Although the economy was hit hard by the pandemic last year, share prices rose sharply on the combination of fiscal stimulus from governments and monetary easing by central banks.

One commonly noted factor that has likely been a major factor behind the rise in share prices since last year is the rise in P/E multiples in financial markets. Could this rise in P/E multiples be explained by the low interest rates brought by the Fed's monetary easing?

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[1] The CBO forecasts nominal GDP growth rates of 10.7% in 2021 and 5.3% in 2022 (4Q-over-4Q).

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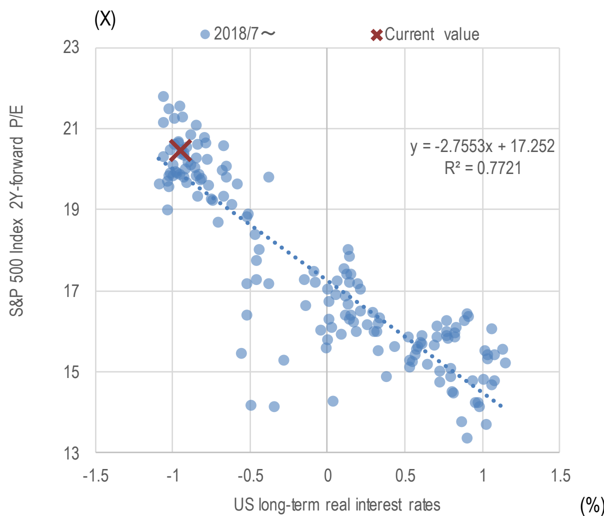
The trend over the past three years in US stock P/E multiples (based on 2-year forward estimates) and real interest rates shows a negative correlation (correlation coefficient of -0.88) between the two: higher multiples are tolerated when real interest rates decline. If that is true, there is nothing unusual about the current levels of real interest rates and P/E multiples, but given that the Fed is moving in the direction of normalization, we would expect rising real interest rates, which are currently at the –1.0% level, to impart a downward bias to P/E multiples.

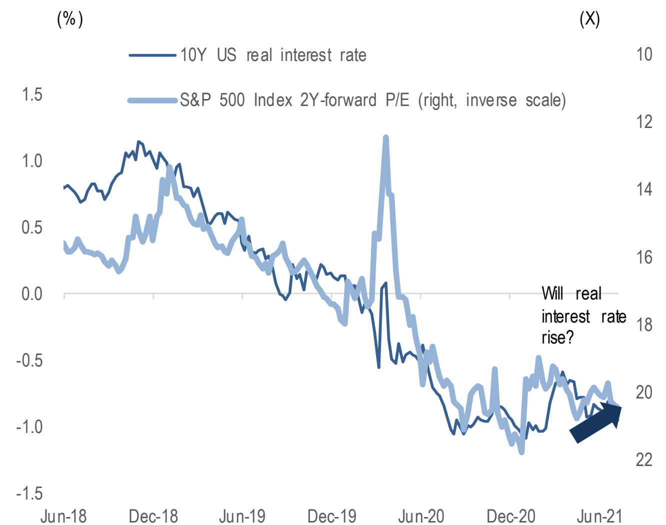
Because corporate earnings have been recovering recently, P/E multiples have declined in step with the rise in EPS but are still high historically, and with the Fed now eying a normalization of monetary policy, are not at comfortable levels.

S&P 500 Index P/E (2Y-forward), **US Long-term Real Interest Rates** (scatter chart)



Source: Bloomberg; compiled by Daiwa Securities.

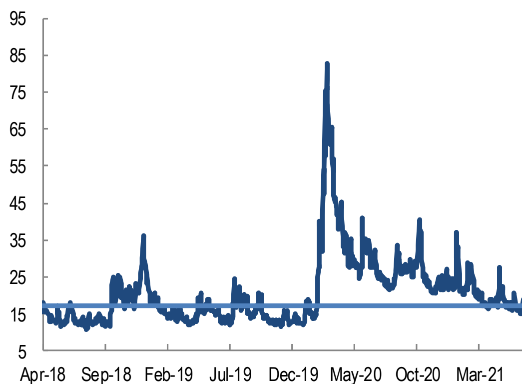
S&P 500 Index P/E (2Y-forward), **US Long-term Real Interest Rates** (trends)



Source: Bloomberg; compiled by Daiwa Securities.

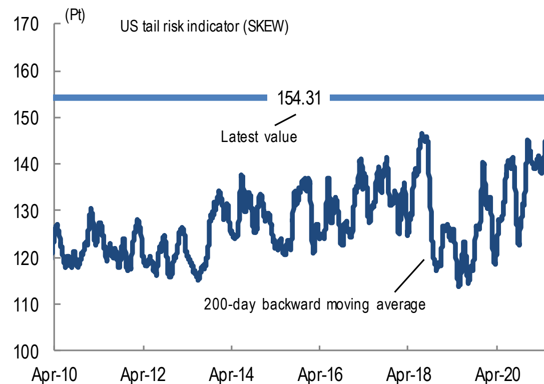
Another reason for high share prices is the decline in stock volatility indices. The VIX has been low and stable at the 17-point level and there are heightening expectations of a summer rally. In contrast, the SKEW index, a closely watched indicator of tail risk, has been rising since April and has been above 150 for the past month, which is high compared with the historical trend. This may reflect the unusually strong trend in the options market of investors insuring against a sharp drop. This indicates concern over the possibility of a sharp enough market correction to necessitate such insurance.

VIX Index



Source: Bloomberg; compiled by Daiwa Securities.

SKEW Index (Black swan index)



Source: Bloomberg; compiled by Daiwa Securities.
**Indexation of slope of curve shape of implied volatility of S&P 500 out-of-the-money options.*

US long-term rates have declined from above 1.7% in April to around 1.3% recently. This decline in interest rates can be attributed largely to a decline in inflation expectations triggered by the Fed changing its stance and by the narrative of the economy having peaked, but we think it may also be possible that investors are buying bonds as an insurance policy against a correction in the seemingly promising stock market.

Stocks have risen to dizzying heights, and the economy, earnings, and real interest rates (the monetary policy outlook) all suggest the possibility that share prices have already risen to dangerously high levels. This danger is probably one factor explaining why stocks and bonds are rising at the same time.

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