WHY AREN'T INVESTORS SELLING STOCKS TO BUY BONDS?

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The Economist says by one measure stocks are the most expensive they've been in five decades:

This chart shows the equity risk premium which simply takes the forward earnings yield (the inverse of the price-to-earnings ratio) and subtracts the 10-Year Treasury yield.

PREMIUM BONDS, United States, equity risk premium*
Percentage points

Past performance is not indicative of future results.
Source: The Economist. Data: Bloomberg; Federal Reserve.
*S&P 500's 12-month forward earnings yield minus 10-Year Treasury yield.

I asked last week if valuations still matter anymore for the stock market, but this one makes sense intuitively.

Interest rates went up a lot in the past couple of years. Stocks have had a nice run. On a relative basis, bonds are much more attractive now than they've been in a very long time.

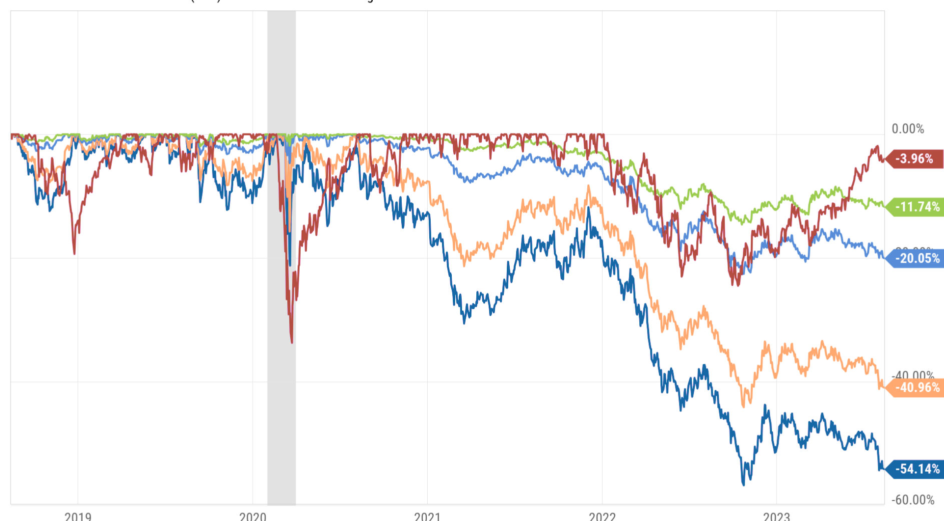
So why is the stock market rising? Why are investors still allocating so much money to equities when the bond market is finally offering decent yields?

The simple answer is stocks are up and bonds are down.

Here's a look at drawdowns for various maturities in the bond market along with the S&P 500® Index:

The S&P 500 has essentially round-tripped from the bear market.

Long-duration bonds are not only still down—they are squarely in market crash territory. Even 7-10 year Treasuries are still in a bear market.



Past performance is not indicative of future results. As of 8/14/23. Source: YCharts.

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Investors are used to bear markets for stocks. We had one last year, in March 2020, in 2008, at the start of this century from the dot-com implosion, not to mention all of the corrections along the way.

Investors have become conditioned to buy or, at least, hold stocks after they have fallen. Not everyone has the ability to pull this off, but history has taught stock market investors that stocks always come back. "Buy when there is blood in the streets" and so on.

But we've never seen anything like this in the bond market. While it's true that higher yields should lead to higher expected returns in fixed income, there is a psychological toll from these losses.

If interest rates keep rising, we could be looking at an unprecedented run of losses in the bond market.

Obviously, 2023 is not over yet but we're looking at the possibility of three years in a row of losses in the benchmark U.S. government bond.

There was a stretch in the 1950s with four losses in five years, but those losses were all less than 3%. The cumulative return from 1955-1959 was -1.8%, hardly a reason for alarm.

Other than that, there hasn't been another instance of back-to-back losses for 10-year Treasuries until the past two years.

10-YEAR TREASURIES ANNUAL RETURNS: 1928-2023

Year	Returns	Year	Returns	Year	Returns
1928	0.84%	1960	11.64%	1992	9.36%
1929	4.20%	1961	2.06%	1993	14.21%
1930	4.54%	1962	5.69%	1994	-8.04%
1931	-2.56%	1963	1.68%	1995	23.48%
1932	8.79%	1964	3.73%	1996	1.43%
1933	1.86%	1965	0.72%	1997	9.94%
1934	7.96%	1966	2.91%	1998	14.92%
1935	4.47%	1967	-1.58%	1999	-8.25%
1936	5.02%	1968	3.27%	2000	16.66%
1937	1.38%	1969	-5.01%	2001	5.57%
1938	4.21%	1970	16.75%	2002	15.12%
1939	4.41%	1971	9.79%	2003	0.38%
1940	5.40%	1972	2.82%	2004	4.49%
1941	-2.02%	1973	3.66%	2005	2.87%
1942	2.29%	1974	1.99%	2006	1.96%
1943	2.49%	1975	3.61%	2007	10.21%
1944	2.58%	1976	15.98%	2008	20.10%
1945	3.80%	1977	1.29%	2009	-11.12%
1946	3.13%	1978	-0.78%	2010	8.46%
1947	0.92%	1979	0.67%	2011	16.04%
1948	1.95%	1980	-2.99%	2012	2.97%
1949	4.66%	1981	8.20%	2013	-9.10%
1950	0.43%	1982	32.81%	2014	10.75%
1951	-0.30%	1983	3.20%	2015	1.28%
1952	2.27%	1984	13.73%	2016	0.69%
1953	4.14%	1985	25.71%	2017	2.80%
1954	3.29%	1986	24.28%	2018	-0.02%
1955	-1.34%	1987	-4.96%	2019	9.64%
1956	-2.26%	1988	8.22%	2020	11.33%
1957	6.80%	1989	17.69%	2021	-4.42%
1958	-2.10%	1990	6.24%	2022	-17.83%
1959	-2.65%	1991	15.00%	2023	-0.40%

Past performance is not indicative of future results. Source: NYU.

Three down years in a row doesn't even happen in the stock market all that often.

The U.S. stock market fell four years in a row from 1929-1932. It was also down three years in a row from 1939-1941. The most recent back-to-back-to-back losses were from 2000-2002.

If rates keep rising, things are going to get worse for the bond market before they get better.

S&P 500® INDEX ANNUAL RETURNS: 1928-2023

Year	Returns	Year	Returns	Year	Returns
1928	43.81%	1960	0.34%	1992	7.49%
1929	-8.30%	1961	26.64%	1993	9.97%
1930	-25.12%	1962	-8.81%	1994	1.33%
1931	-43.84%	1963	22.61%	1995	37.20%
1932	-8.64%	1964	16.42%	1996	22.68%
1933	49.98%	1965	12.40%	1997	33.10%
1934	-1.19%	1966	-9.97%	1998	28.34%
1935	46.74%	1967	23.80%	1999	20.89%
1936	31.94%	1968	10.81%	2000	-9.03%
1937	-35.34%	1969	-8.24%	2001	-11.85%
1938	29.28%	1970	3.56%	2002	-21.97%
1939	-1.10%	1971	14.22%	2003	28.36%
1940	-10.67%	1972	18.76%	2004	10.74%
1941	-12.77%	1973	-14.31%	2005	4.83%
1942	19.17%	1974	-25.90%	2006	15.61%
1943	25.06%	1975	37.00%	2007	5.48%
1944	19.03%	1976	23.83%	2008	-36.55%
1945	35.82%	1977	-6.98%	2009	25.94%
1946	-8.43%	1978	6.51%	2010	14.82%
1947	5.20%	1979	18.52%	2011	2.10%
1948	5.70%	1980	31.74%	2012	15.89%
1949	18.30%	1981	-4.70%	2013	32.15%
1950	30.81%	1982	20.42%	2014	13.52%
1951	23.68%	1983	22.34%	2015	1.38%
1952	18.15%	1984	6.15%	2016	11.77%
1953	-1.21%	1985	31.24%	2017	21.61%
1954	52.56%	1986	18.49%	2018	-4.23%
1955	32.60%	1987	5.81%	2019	31.21%
1956	7.44%	1988	16.54%	2020	18.02%
1957	-10.46%	1989	31.48%	2021	28.47%
1958	43.72%	1990	-3.06%	2022	-18.01%
1959	12.06%	1991	30.23%	2023	18.11%

Past performance is not indicative of future results. Source: NYU.

I don't have the ability to predict where interest rates go from here. There is a good case to be made that rates could keep moving higher if the economic acceleration in growth continues.

The good news for bond investors in that situation is that expected returns keep right on rising with even higher yields. The bad news is you're going to experience more losses in the meantime.

Bond yields across the board are at their highest levels in years.

Past performance is not indicative of future results. As of 8/15/23. Source: YCharts.

This is a good thing for those looking for regular income and higher yields than the stock market.

But, it might be difficult for investors to come around to the idea of moving a substantial piece of their portfolio from stocks to bonds when bond losses continue to pile up and the stock market is moving higher.[1]

In the tug-of-war between fundamentals and the pain of losing, it's the pain that wins out most of the time in the markets.

[1]Maybe if the stock market rolls over yet again investors will change their tune.

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The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and it is not available for direct investment.

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