MarketWatch

Why haven't rising bond yields hammered stocks? Here's what analysts say.

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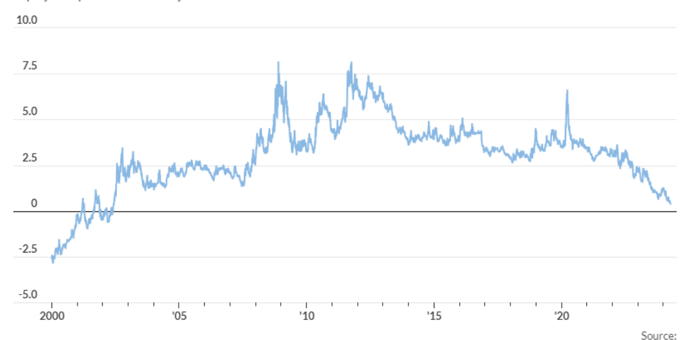
U.S. stocks' gravity-defying performance since October 2022 has left investors with more questions than answers.

The biggest being: How have stocks managed to keep climbing with interest rates at their highest levels in more than 20 years and bond yields near their highest since before the global financial crisis?

Indeed, the latest leg higher in Treasury yields has pushed up the equity risk premium — which measures the excess risk that investors accept for betting on stocks compared with relatively safe Treasury bonds — to its lowest level in nearly 22 years, according to Dow Jones Market Data.

This seems to defy conventional investing wisdom, which dictates that rising bond yields should help rein in equity valuations. Yet stocks are trading at a premium to expected earnings that is higher than the averages from both the past five and past 10 years — periods when interest rates were much lower than they are today.



In a note to clients shared with MarketWatch on Tuesday, Nicholas Colas, co-founder at DataTrek Research, tried to explain the apparent disconnect.

Either investors believe that corporate earnings are much more durable now than they were during the 2010s — meaning earnings will likely be spared the 20% to 30% reversal from highs that typically accompanies recessions — or investors don't believe Treasury yields will linger at or around their current levels for long, according to Colas.

It could also be some combination of both, Colas added. Whatever the reason, valuations for large-cap U.S. stocks show that investors expect profits will grow at a robust pace in the years ahead.

That may turn out to be true, but at least in the near term, Wall Street analysts' expectations for corporate-earnings growth remain a mixed bag. According to a recent analysis from a team of equity strategists at Goldman Sachs, the 10 largest U.S. stocks are expected to see earnings per share grow by 32% in 2024, while the remaining 490 companies in the S&P 500 index SPX are expected to see earnings shrink 4%.

Uneven forecasts for corporate earnings haven't stopped the rally from broadening out in 2024, however. Since the start of the year, the number of S&P 500 sectors outperforming the index has gone from three in 2023 to five through Tuesday's close, according to FactSet data.

One market strategist explained this in relatively straightforward terms: The strength of the U.S. economy has continued to surprise even stock-market bulls, said Phillip Colmar, global strategist with MRB Partners, during a conversation with MarketWatch.

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In response, investors' expectations have shifted away from a "soft landing" for the U.S. economy to a "no-landing" scenario, wherein the economy continues to expand at a robust pace despite the Federal Reserve holding its benchmark interest rate at its highest level in more than 20 years. This, in turn, has benefited more cyclical corners of the market, even though Wall Street's earnings forecasts remain subdued.

"All the economic data has come in stronger than expected," Colmar said. "We're seeing a pickup in manufacturing activity; the services sector is strong; we've even seen a pickup in housing, which is interest-rate sensitive."

As if the economy wasn't already strong enough, the Fed's plans to potentially start cutting interest rates later this year are helping to cement investors' bullish outlook.

While rising Treasury yields have recently spurred some weakness in major indexes like the S&P 500 and the Dow Jones Industrial Average DJIA, stocks have been far more resilient than when the 10-year Treasury yield BX:TMUBMUSD10Y briefly topped 5% in October. Back then, the S&P 500 fell 10% between late July and late October as rapidly rising Treasury yields threatened to finally push the economy off a cliff.

Yet the economy once again defied those fears, which is why equity investors have answered the latest run-up in yields with only a modest pullback. But Colmar warned stocks could turn volatile once again if yields surpass their previous peak and rise into "uncharted territory."

The S&P 500 finished higher on Tuesday, gaining 0.1% to 5,209 points. The index has climbed 45% from its October 2022 closing low, according to FactSet data.

The Dow finished down 9.13 points, or less than 0.1%, at 38,883.67. The Nasdaq Composite COMP gained 52.68 points, or 0.3%, at 16,306.64.

The yield on the 10-year Treasury note fell 5.7 basis points to 4.365% at 3 p.m. Eastern time on Tuesday, from 4.422% on Monday.