# Mixed Signals: What Are the Bond and Stock Markets Telling Us?

Jun 5, 2014 / **By Bill DeShurko, CFP**

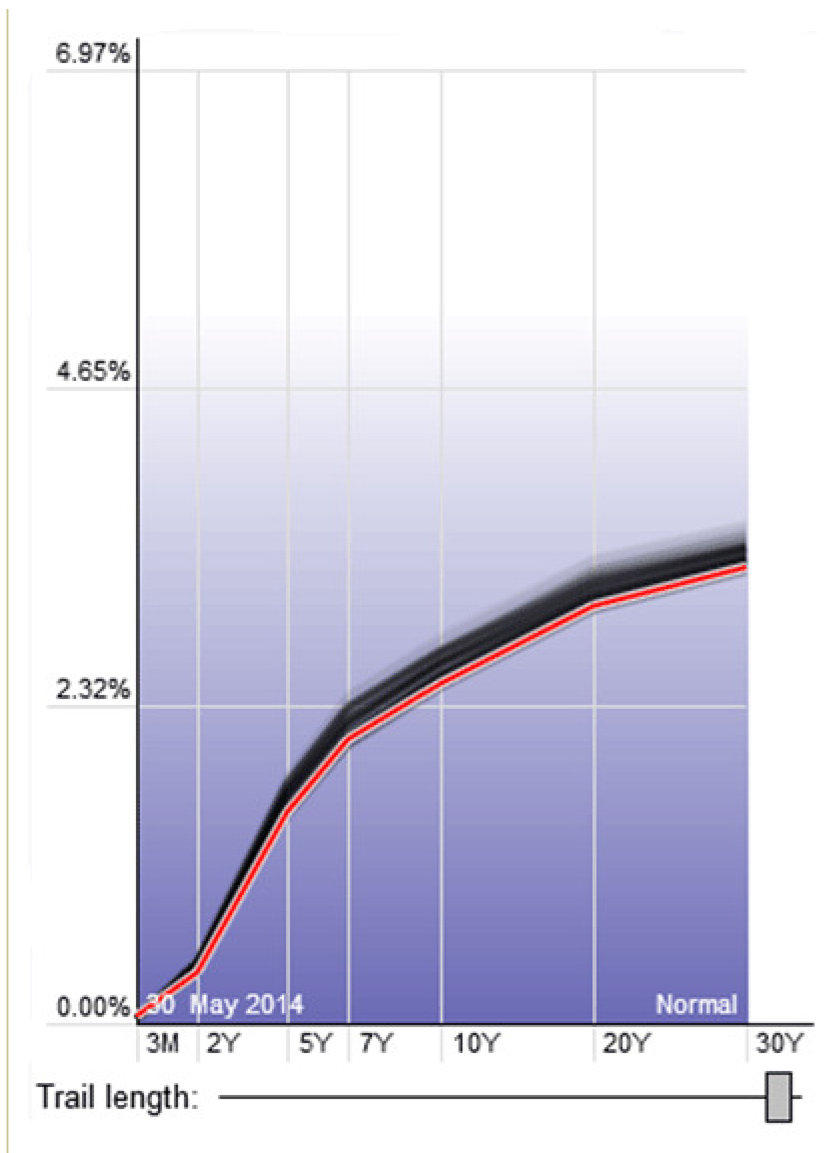
**While stocks keep hitting new highs, the recent fall in Treasury yields coupled with decidedly mixed economic data may mean the bond market is trying to tell us something that the equity market is missing.**

The recent dive in Treasury yields has created a bit of a stir in the financial markets. As we all know, the Fed has been cutting back on its bond buying, and theoretically this would cause long-term rates to rise.

Instead we've enjoyed a pretty solid bond rally this year, as seen in Figure 1, below. The dynamic yield curve shows the current yield

curve (red line) and a black "tail" showing where rates have come from. Such a sharp flattening can be a sign of an anticipated slowing of the economy.

Figure 1: Dynamic Yield Curve




*Source: StockCharts.com*

Looking at the overall stock market (see Figure 2), notice we're having a nice little year-to-date rally. Since the April 11 low that brought the S&P 500 into negative territory on the year, SPY, the SPDR S&P 500 Index ETF,

is up 6.2%, albeit on declining volume. This coincides with a recent bond rally.

Figure 2: SPY Year to Date

*Source: Yahoo*

While we have become quite familiar with stock market rallies on bad news, it's still a worthwhile exercise to look at the overall environment and see if, in this case, the bond market is just smarter than the stock market.

(Are we likely to see economic softness ahead?)

Figure 3 shows a table of economic data that came out in May. I focused on the reports that had a consensus estimate that was released prior to the actual release. I color-coded the actual release based on whether the actual data beat (green) or missed (red) the estimate.

Figure 3: May Economic Releases

| Name | Period | Consensus | Actual |
|---|---|---|---|
| US - Motor Vehicle Sales (Apr, 2014) | Apr 2014 | 16.2 M | 16.0 M |
| US - Personal Income and Outlays (Mar, 2014) | Mar 2014 | 0.40% | 0.5 % |
| US - Jobless Claims (wk4/26, 2014) | wk4/26 2014 | 320 K | 344 K |
| US - PMI Manufacturing Index (Apr, 2014) | Apr 2014 | 55.8 | 55.4 |
| US - ISM Mfg Index (Apr, 2014) | Apr 2014 | 54.3 | 54.9 |
| US - Construction Spending (Mar, 2014) | Mar 2014 | 0.60% | 0.2 % |
| US - Employment Situation (Apr, 2014) | Apr 2014 | 215,000 | 288,000 |
| US - Factory Orders (Mar, 2014) | Mar 2014 | 1.40% | 1.1 % |
| US - ISM Non-Mfg Index (Apr, 2014) | Apr 2014 | 54.2 | 55.2 |
| US - ICSC-Goldman Store Sales (wk5/3, 2014) | wk5/3 2014 | | -2.0 % |
| US - Jobless Claims (wk5/3, 2014) | wk5/3 2014 | 330 K | 319 K |
| US - NFIB Small Business Optimism Index (Apr, 2014) | Apr 2014 | 94.5 | 95.2 |
| US - ICSC-Goldman Store Sales (wk5/10, 2014) | wk5/10 2014 | | -0.1 % |
| US - Retail Sales (Apr, 2014) | Apr 2014 | 0.40% | 0.1 % |
| US - Consumer Price Index (Apr, 2014) | Apr 2014 | 0.30% | 0.3 % |
| US - Empire State Mfg Survey (May, 2014) | May 2014 | 5 | 19.01 |
| US - Jobless Claims (wk5/10, 2014) | wk5/10 2014 | 317 K | 297 K |
| US - Industrial Production (Apr, 2014) | Apr 2014 | 0.00% | -0.6 % |
| US - Philadelphia Fed Survey (May, 2014) | May 2014 | 14.3 | 15.4 |
| US - Housing Market Index (May, 2014) | May 2014 | 49 | 45 |
| US - Housing Starts (Apr, 2014) | Apr 2014 | 0.980 M | 1.072 M |
| US - Consumer Sentiment (May, 2014) | May 2014 | 84.5 | 81.8 |
| US - Jobless Claims (wk5/17, 2014) | wk5/17 2014 | 310 K | 326 K |
| US - PMI Manufacturing Index Flash (May, 2014) | May 2014 | 55.9 | 56.2 |
| US - Leading Indicators (Apr, 2014) | Apr 2014 | 0.40% | 0.4 % |
| US - Existing Home Sales (Apr, 2014) | Apr 2014 | 4.69 M | 4.65 M |
| US - New Home Sales (Apr, 2014) | Apr 2014 | 420 K | 433 K |
| US - Durable Goods Orders (Apr, 2014) | Apr 2014 | -0.80% | 0.8 % |
| US - FHFA House Price Index (Mar, 2014) | Mar 2014 | 0.50% | 0.7 % |
| US - S&P Case-Shiller HPI (Mar, 2014) | Mar 2014 | 0.70% | 1.2 % |
| US - PMI Services Flash (May, 2014) | May 2014 | 55.4 | 58.4 |
| US - Richmond Fed Manufacturing Index (May, 2014) | May 2014 | 9 | 7 |
| US - Consumer Confidence (May, 2014) | May 2014 | 83 | 83.0 |

*Source: Bill DeShurko*

It would be easy to pull out specific data and present either a bull or bear case. However, placing no weighting on any individual data release provides a decidedly mixed picture. One take is that since the severe weather was responsible for weak data early in the year, May data should see a rebound from pent-up demand. That result is questionable.

## The importance of the yield curve

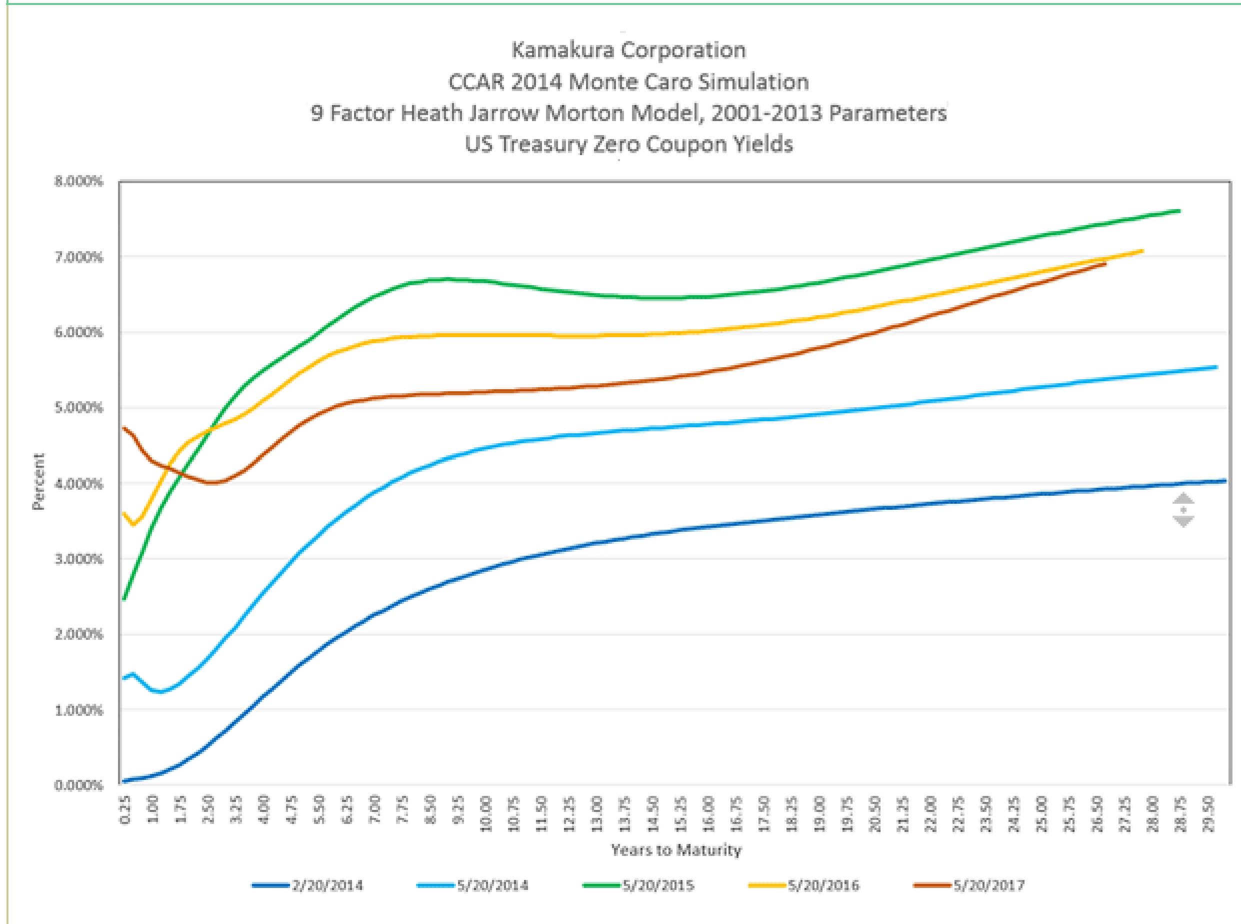
The yield curve has historically proven to be a reliable indicator of future recessions. So much so that the Federal Reserve has a formula that predicts the likelihood of recession from current interest rates.

In April, the Fed calculated less than a 3% probability of recession within the next 12 months. However, this does not account for the manipulated shape of the yield curve caused by the Fed's zero-interest-rate policy (ZIRP). As intermediate and longer-term rates come down (see Figure 1), the steepness of the current curve comes from the short maturity being anchored at zero up to about the seven-year maturity bond. What happens when (if) ZIRP ends?

Figures 4 and 5 show possible scenarios resulting from the Fed raising short-term rates. The assumption up to now has been that if short-term rates rise, then rates along the entire yield curve would rise simultaneously,

keeping the yield curve looking normal. In Figure 4, Kamakura Corporation illustrates how the yield curve could change as short rates are allowed to rise.

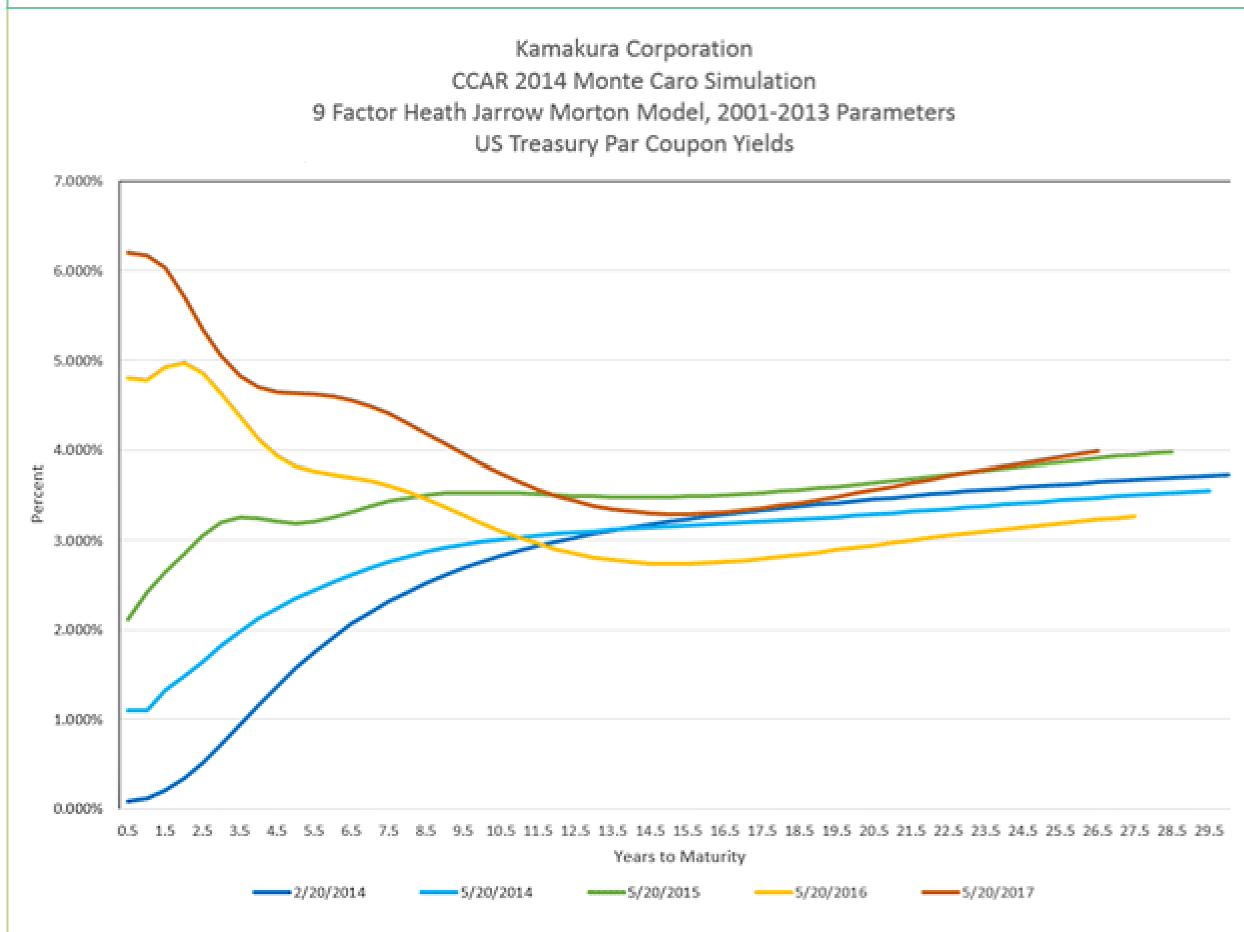
**Figure 4: Possible Yield Curve Flattening From Rising Short-Term Interest Rates**




*Source: Seeking Alpha*

Figure 5 illustrates a more extreme case where the yield curve actually inverts by 2016 due to rising short-term rates.

Figure 5: Possible Yield Curve Inverting From Rising Short-Term Interest Rates




*Source: Seeking Alpha*

There are thousands of potential outcomes as rates rise. The above are

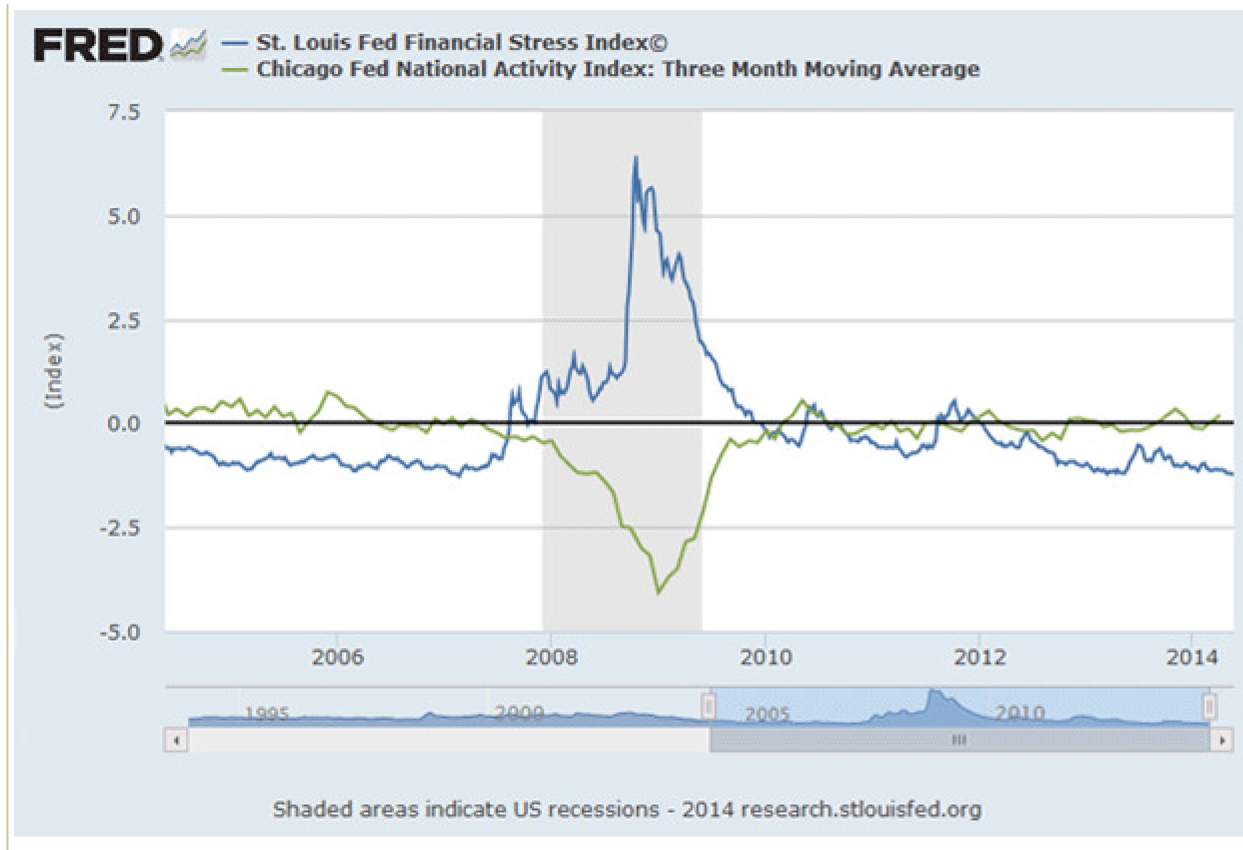
simply examples from a Monte Carlo simulation that illustrates a scenario where the yield curve is signaling a recession.

## Financial Stress Index

One last graph to look at is the St. Louis Federal Reserve's Financial Stress Index (SLFSI) plotted with the Chicago Federal Reserve's Business Activity Index—three-month moving average. I use this because the crossover of the two indexes has proven to be a reliable recession indicator.

The current indexes give a different view. The LFSI is at its lowest level in 10 years. Meaning that financial conditions are extremely favorable for the business climate. But at the same time, the CFNAI continues to revolve around the zero level as it has for most of this recovery. In fact, the recent reading (not shown) has dipped into negative territory.

Figure 6: St. Louis Fed Financial Stress Index




*Source: St. Louis Federal Reserve*

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