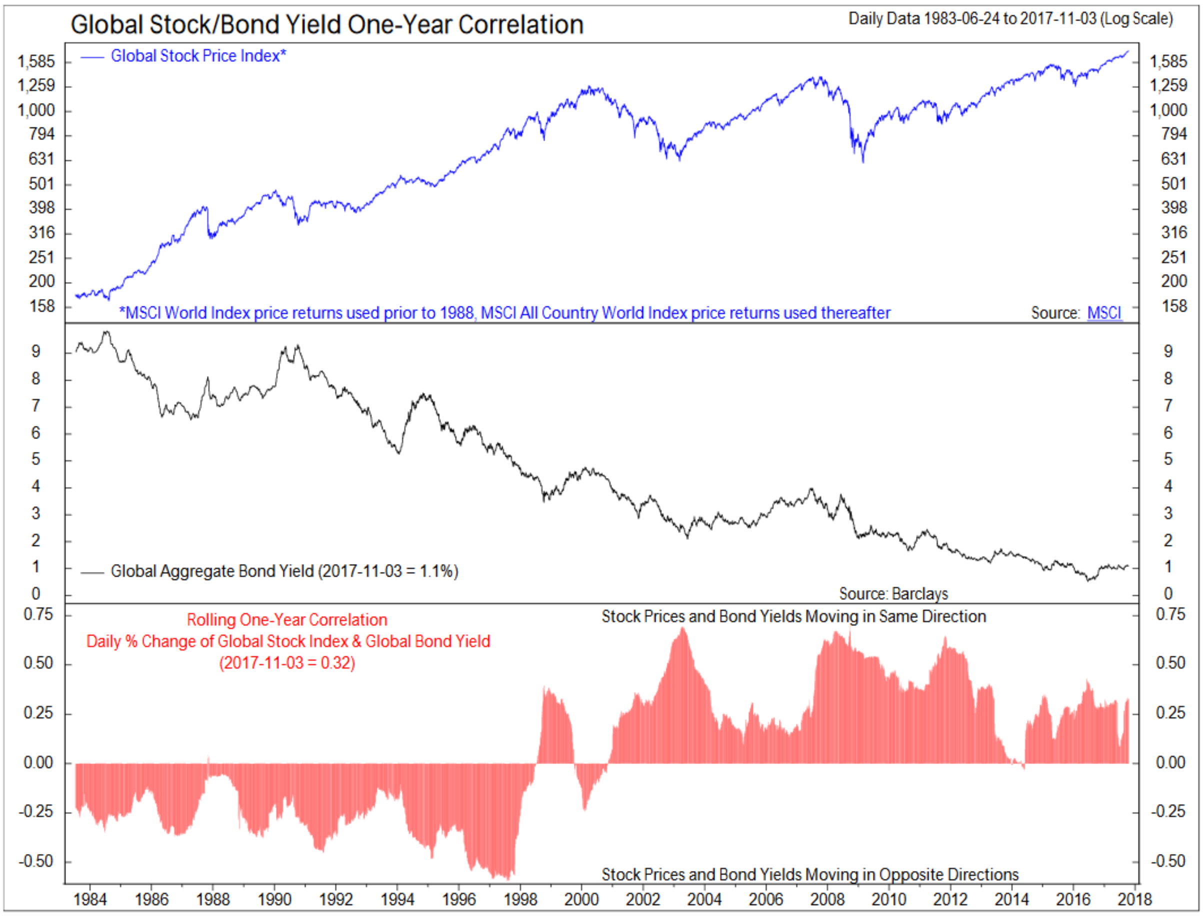
When Will Rising Interest Rates Threaten Equities?

Guessing the level where rising 10-year yields will threaten the cyclical bull in stocks is a popular game right now. But it would be best to let the markets answer the question.

When correlations between market indices and bond yields shift from positive to negative, inflection points will have been reached.

Correlations currently say that for most of the world's market cap, bond yields can be expected to rise in tandem with climbing stock prices. But as bond yields inch higher, it will be pertinent to see if the contingent of positive correlations declines while the ranks of inverse correlations increases, and the ACWI correlation, (shown in the chart) also turns negative.



For some markets, rising bond yields are already a market threat. In the universe of MSCI market indices, one-year correlations with 10-year yields show:

- Eight markets have inverse correlations of at least -0.19, and six of them have yields of at least 4.5%.
- Seven markets have positive correlations of at least 0.20, and none of them have yields exceeding 2.7%.
- A positive correlation between a country's market and bond yield is more likely to be associated with relatively low yields while an inverse correlation is more likely accompanied by a relatively high yield.

Also Watch Tech Sector Correlations

An early warning that rising interest rates are moving from market friend to foe could come from the Tech sector (which has the second highest weight in the ACWI behind Financials), where the correlation has dropped to around zero.

The correlation of each ACWI sector and its relative strength line to the Global Aggregate Bond Yield is shown in the table below.

ACWI SECTOR INDEX CORRELATIONS TO GLOBAL AGGREGATE BOND YIELD

Sector	Current Correlation 11/1/17	Correlation 11/1/16	One-Year Change
Financials	0.59	0.42	0.17
Industrials	0.42	0.27	0.16
Materials	0.29	0.23	0.06
Consumer Discretionary	0.26	0.28	-0.02
Energy	0.22	0.28	-0.07
Health Care	0.17	0.16	0.01
Information Technology	0.05	0.26	-0.21
Telecommunication Services	-0.04	0.14	-0.18
Consumer Staples	-0.17	0.06	-0.23
Utilities	-0.38	-0.08	-0.30

Report Notes:
Data sources: MSCI & Bloomberg Barclays Indices.

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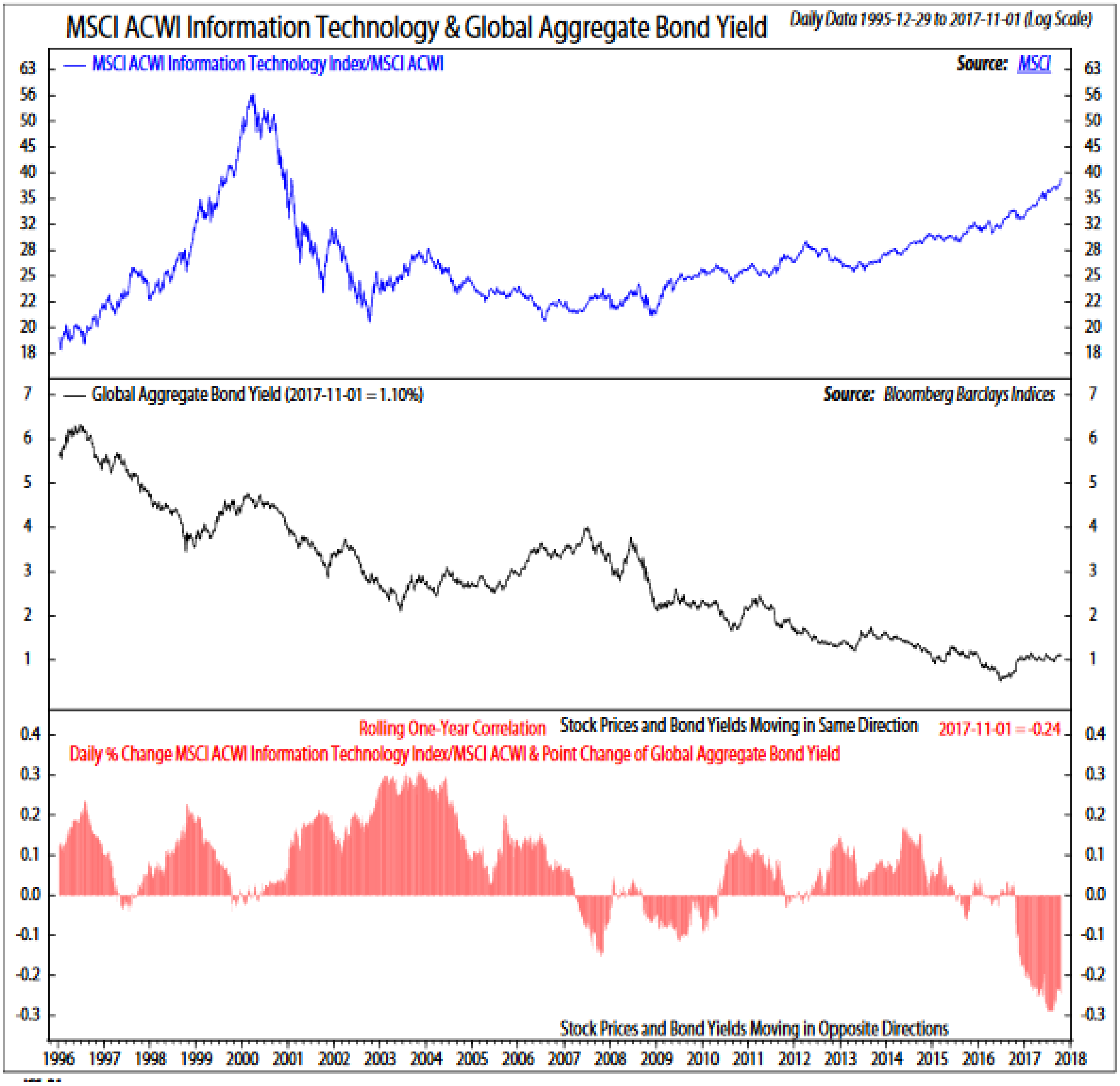
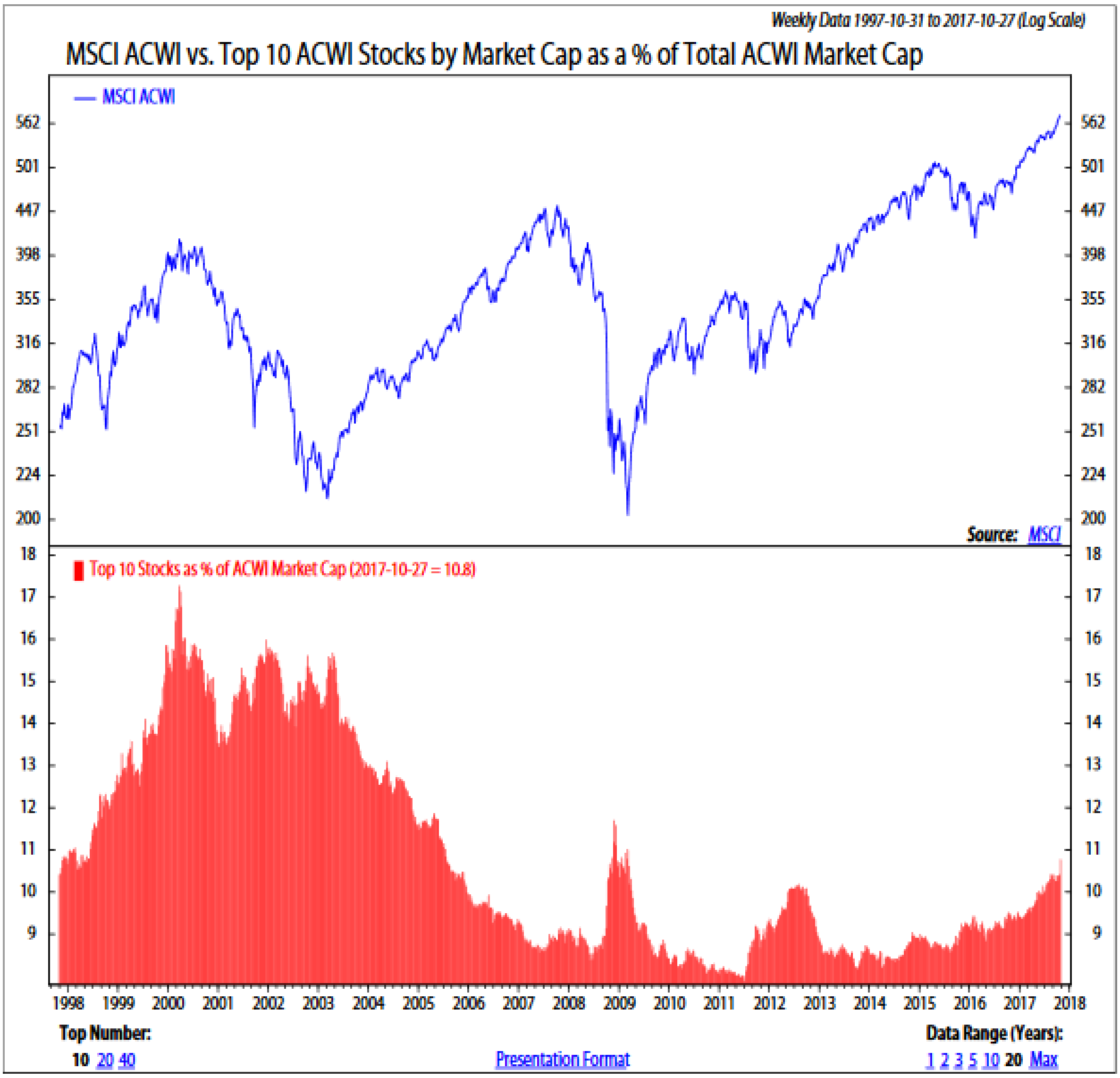
Tech's relative strength is the second most correlated with the ACWI and still rising, whilst over the past year, the decline in the Tech sector's correlation has been the third greatest, behind Utilities and Consumer Staples (far right column of table). Tech's relative strength correlation has already turned negative (chart below), declining more than the correlations of any other sector over the one-year period.



Hence it would be a worry if the Tech sector's correlation with the bond yield fell to negative, on a relative or absolute basis, and yields moved into a decisive uptrend.

An inversion in the Tech sector's bond yield correlation would be especially threatening to the market advance if Tech megacaps were to continue gaining dominance in the ACWI (chart below). The ACWI's top 10 stocks, most of which are Tech stocks, now account for nearly 11% of the ACWI. Global breadth charts indicate the sector is leading the rest of the world higher, maintaining the strongest uptrend based on the 100-day momentum of its 200-day moving average.

Concerns would escalate if Tech dominance started to look more like it did in 1999 and 2000, when Tech was even more dominant with a much higher correlation. Tech was not just a leader in 1999, it was the only game in town. Even without gaining that magnitude of influence, the combination of an increasingly inverted correlation and bond yield breakouts would be worrying, it would make it more likely that a dropping Tech sector would drive the rest of the market lower.



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