



# Weekly Market Commentary



February 07, 2011

## Do Rising Bond Yields Pose A Problem For Stocks?

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

#### Highlights

As the 10-year Treasury yield approaches 4%, investors are beginning to wonder when rising interest rates may start to negatively affect stock prices.

While rising interest rates may eventually pose a problem for stocks as the mountain of debt and rising commodity prices build, the tipping point of 5% is still a significant distance away.

In the meantime, rising yields are good news for stocks.

After being stuck in a tight range around 3.5% since mid-December, the yield on the 10-year Treasury note jumped higher to 3.65% last week. This rise was in response to the generally stronger economic data and the inflation signal coming from higher commodity prices. The yield on the 10-year Treasury note has risen by about 1.25 percentage points to 3.65% from 2.39% four months ago.

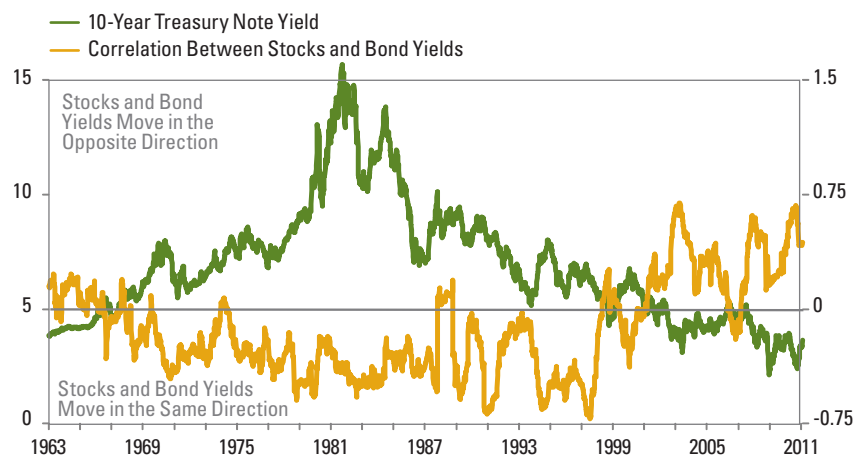
With yields now climbing towards 4%, investors are beginning to wonder when rising interest rates may start to negatively affect stock prices. Higher yields can slow borrowing and spending, weighing on economic and profit growth. If this pace of rising yields were to continue over the next four months, they could reach nearly 5% by this summer, a level not seen since July of 2007. While higher rates are bad news for bond investors, the good news is that rising yields may mean rising stock prices at least for some time yet. It is at 5% where yields begin to become a negative for stocks.

Historically, whenever the yield on the 10-year Treasury note was below 5% stock prices and bond yields moved in the same direction, as measured by a 52-week rolling correlation above zero. When the yield was below 5%, bond yields and stock prices rose together [Chart 1].

#### 1 The 5% Line

10-Year Treasury Note Yield (left scale)

52-Week Rolling Correlation Between Stock Prices and Bond Yields (right scale)



Source: LPL Financial, Bloomberg data 2/4/11

Correlation is a classical statistical method for measuring how closely related two series of data are. A correlation of 1.00 means they move perfectly together, while -1.00 means they are perfect opposites of each other.



The opposite was true when yields were above 5%. Yields were above 5% during the period from the late 1960s through the end of the 1990s. Then, the correlation between stock prices and bond yields was below zero. In general, during that period as yields rose stock prices fell.

The reason for the different relationship above and below 5%, and why rising yields are good news for stocks right now, has to do with economic growth and inflation.

- When yields were rising from a low level they reflected improving growth and low inflation which was a favorable environment for stocks.
- When yields were rising above 5%, economic growth was accompanied by higher inflation which threatened future growth, eroded the present value of future earnings, and acted as a drag on stocks.

While rising interest rates may eventually pose a problem for stocks as the mountain of debt and rising commodity prices build, the tipping point of 5% is still a significant distance away. As economic data continues to reflect solid growth in the coming months, bonds yields and stock prices are likely to continue their climb.

---

#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing may involve risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit