DOW JONES, A NEWS CORP COMPANY

Stoxx 600 **374.22** -0.58% ▼ Nikkei **23783.72** -0.80% ▼ U.S. 10 Yr **-11/32 Yield** 3.230% ▼ Crude Oil **73.60** -1.00% ▼ Euro **1.1486** -0.31% ▼

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CREDIT MARKETS

Surging Yields Raise Threat of Tipping Point for Stocks

Investors may start to pull back from riskier assets since they are being better compensated for holding risk-free ones

A strong economy is generally good for stocks. But if yields continue to march higher, investors may start to pull back from riskier assets since they are being better compensated for holding risk-free ones. PHOTO: SETH WENIG/ASSOCIATED PRESS

By Michael Wursthorn and Sam Goldfarb

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Yields on long-term U.S. government debt moved abruptly higher last week, calling into question the durability of the more than nine-year-old bull market for stocks.

A booming U.S. economy and investors' desire to put their money in riskier assets, such as stocks and corporate bonds, have sent bond prices tumbling. That in turn has pushed the yield on the benchmark 10-year U.S. Treasury note, the backbone of borrowing costs for consumers, corporations and governments, to 3.23%.

> A strong economy is generally good for stocks. But if yields continue to march higher, investors may start to pull back from riskier assets since they are being better compensated for holding risk-free ones. Higher borrowing costs could also cool the pace of the economic expansion.

The dilemma for stock investors is in gauging at what point higher yields will cause a significant reversal.

Last week's jump in the yield on the 10-year U.S. Treasury dashed a five-day run of gains for the Dow Jones Industrial Average, its longest streak since mid-July. Tech stocks that have propelled markets higher this year were particularly hard hit.

Even so, major U.S. stock indexes still sport solid year-to-date gains; the Dow industrials are up 7%, while the tech-heavy Nasdaq Composite Index has risen 13%.

And stock indexes have defied rising yields for some time. In little more than two years, the yield on the 10-year Treasury has more than doubled, climbing to today's level from a trough of 1.36% in summer 2016. During that same time, the Dow industrials gained more than 8,000 points.

"The market has been able to withstand yields in the low 3% range because the economy has been solid and earnings have been strong," said Leo Grohowski, chief investment officer at BNY Mellon Wealth Management.

Other reasons stocks have fared well: a sweeping corporate tax cut that sent profits soaring this year, higher consumer spending that bolstered confidence among investors and business owners, and record-low unemployment.

Just last week, investors put $1.2 billion into U.S. stocks and pulled $1.6 billion from bonds, the biggest week of outflows all year, according to data from EPFR Global. Investors have been selling bonds at a torrid pace the past two weeks, with total outflows reaching $2.7 billion.

During previous cycles of interest-rate increases, a 5% yield on the 10-year was usually the inflection point for stocks, according to Credit Suisse data analyzing stock-market returns over the past 54 years. But after a decade of near-zero interest rates and other easy-money policies, this rate cycle has been unlike any other, forcing investors to reset their expectations.

The closer the yield moves toward 3.5%, the bigger the risk to "investors' ability to call this stock market reasonably valued," said BNY's Mr. Grohowski.

Many analysts and money managers agree that 3.5% this round would mark a turning point. Credit Suisse's analysis showed that stock valuations start running into trouble once yields breach 3%, with pressure mounting at 3.5%.

Analysts have mixed views on when the yield on the 10-year will reach 3.5%. Goldman Sachs Group Inc. recently predicted the Fed will increase short-term interest rates five more times by the end of 2019, along with a 3.4% yield on the 10-year.

At the same time, the explosive profit growth that has factored heavily into the stock market's run-up this year is expected to cool. Companies in the S&P 500 are projected to post 10% earnings growth in 2019, about half the growth rate projected for this year, according to FactSet.

The combination of higher interest rates and slowing profit growth is factoring heavily into investors' portfolio makeup. Some are opting to pare back risk in stocks and take advantage of safe, higher-yielding debt.

BNY-Mellon Wealth Management, for example, decided at its monthly investor meeting last week to pare back stock exposure and increase its allocation to fixed income "ever so slightly," said Mr. Grohowski. "Fixed income remains underweight, but for the first time in quite some time, we've added more money as yields move above 3%," he added.

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So far, rising yields have had a muted impact on the corporate debt market. Since the 10-year yield rose above 3% in mid-September, strong investor demand has supported the ninth-largest ever sale of speculative-grade debt. That was a $13.5 billion bond-and-loan package funding the leveraged buyout of the financial data provider Refinitiv. The fourth-largest investment-grade bond issuance, a $27 billion deal backing Comcast Corp.'s purchase of Sky PLC, also took place.

"Generally people can handle rising rates," said Andrew Karp, co-head of global debt capital markets at Bank of America Corp. At this point, investors haven't been affected too much by falling corporate bond prices and have benefited from the ability to reinvest money at higher yields.

Still, that could change, Mr. Karp said. If the 10-year yield rises quickly to around 3.5%, he said, investors could soon feel enough pain that their appetite for bonds could diminish, thus making it harder for companies to borrow.

Rising yields are of particular concern to investors who have a broader array of anxieties. While the economy is strong, companies are generally holding a large amount of debt relative to their earnings, and many face increased competitive threats from the likes of Amazon Inc., said Michael Collins, a senior portfolio manager at PGIM Fixed Income.

When rising yields are added to the picture, it begins to feel that a long run of easy credit conditions is "moving at an accelerating rate toward the end," he said.

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