Weekly Commentary by Professor Jeremy J. Siegel

Bond Yields Move Higher, but Equities will Continue to Rise

11:10 a.m. EDT, 3/26/2010, Philadelphia PA

The most important news of the past week is the sharp run-up in yields on U.S. treasuries. The ten year Treasury is now at 3.89%, just a few basis points below the high reached last June and nearly 20 bps above the previous week. The principal reason for the drop in bond prices is the strength of the economic recovery, confirmed by the fall in jobless claims and continued strength in other economic indicators. This led to poor Treasury auctions early in the week, signifying that lenders are beginning to worry that an economic recovery will bring a rise in private debt offerings that will overwhelm demand at current interest rates. Yields on TIPS jumped a comparable amount, confirming that the increase in yields is not just a rise in inflationary expectations. However, ten year TIPS are still some 30 bps below their June 2009 peak.

It was this run-up in yields that halted the equity rally yesterday. And if the ten-year crosses 4%, it will continue to put pressure on stocks. Nonetheless, in the middle stages of a bull market, such as we are now in, rising interest rates often serve as only a temporary barrier to rising stock prices.

Another worry for bondholders is the prospect for a very strong job report next Friday. Some believe that the Bloomberg consensus of 190k might actually be too low. If the report is very strong, there is a distinct possibility that Bernanke will raise the discount rate another 25 bps. If Thursday's jobless claims data also come in strong, Bernanke would most certainly act, especially if the long bond breaks 4%.

Yesterday, Bernanke caused a bit of a stir when he stated that "restoring the size and composition of the Fed's balance sheet to a more normal configuration" is a long-term goal of the central Bank. He, of course, was referring to the sale of mortgage backed securities so that Treasuries would once again be the lion's share of the Fed's balance sheet. But this goal will not be pursued any time soon. The first step is a raise in the discount rate, then an increase in the rate paid on reserves in conjugation with an equal increase in the funds target. Finally, the Federal Reserve will raise the funds target above the interest rate on reserves and shrink the monetary base. This last step could be a year or two in the future.
