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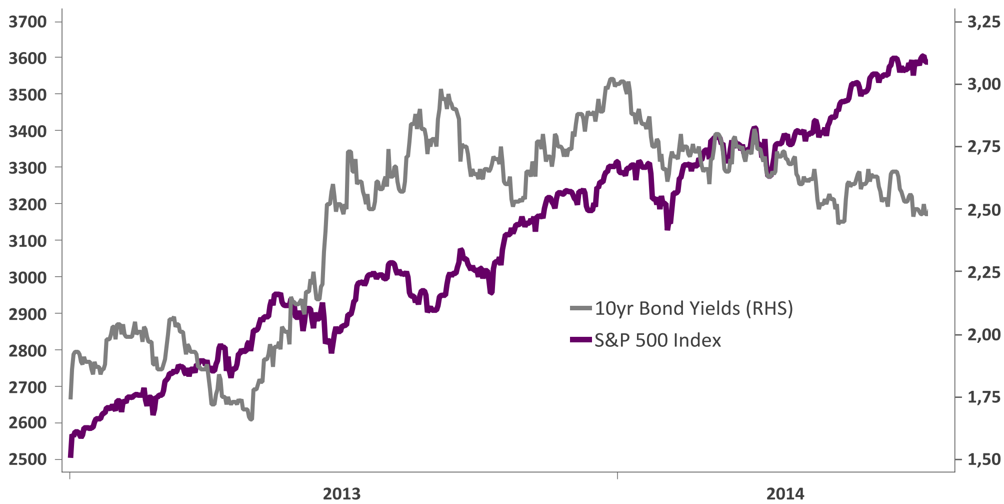
GLOBAL MACRO

T-Bonds or S&P, which of these markets has got it wrong?

Improving economic indicators, ongoing accommodative monetary policy from the Fed and the bountiful reporting season have propelled U.S. equity indices to new highs in recent days: the S&P has added gains of 6% in the last three months making for a YTD gain of 18% and has even flirted with the 2,000 point level. The confidence backing up these trends is, however, a far cry from the signals the bond markets are sending us. Since the end of April, the yield on 10-year T-bonds has fallen to below 2.50%, i.e. 25 basis points less than mid-April levels and 50bps off from where it started the year. Such distortions between equity and bond markets are tough to reconcile over the duration and will end up being corrected. It is merely a question of when and to what extent. The response will come from economic changes in the coming months. So what should the market being taking a very hard look at?

US S&P vs 10 yr Bond Yields



Sources : RichesFlores Research, Macrobond

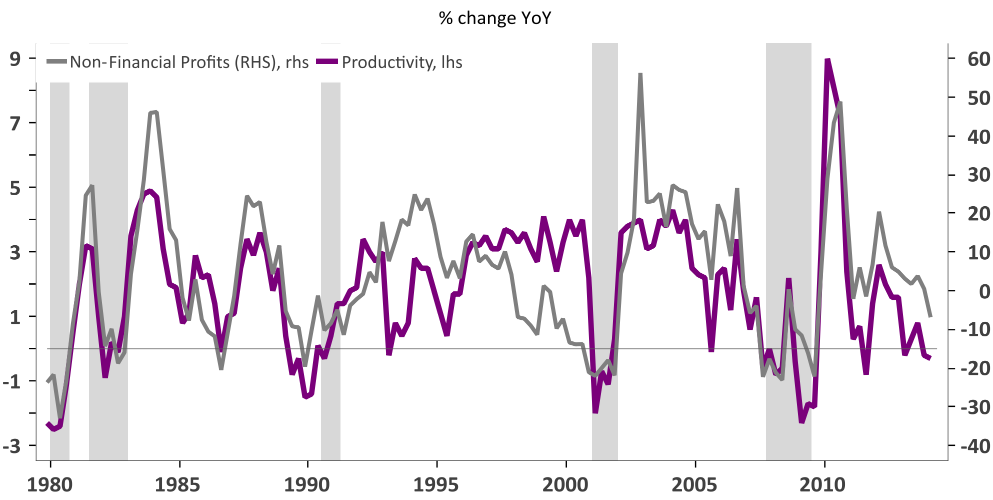
U.S. prospects: two conflicting visions

The analysis of the U.S. situation varies considerably from one economist to the next. In one camp are those saying the American economy has emerged from its hard times in the belief that 1) it has made enough progress on its banking problems and 2) high corporate profits. They believe these two positives are enough to fuel the investment boom that must occur if the job market is to consolidate its gains and the economic cycle is to continue. U.S. growth, although well shy of initial forecasts this year, will thus rebound to the 3% range on average next year and has several bright years ahead of it. Under such a scenario, the Fed will be able to normalize, with ease, its interest rates so that 1) the yield on the 10Y, pricing in these developments, will rise sharply in the coming quarters (the consensus has forecast rates of 3.50% by mid-2015) 2) the yield curve will steepen, returning to a configuration seen in the early or mid-point of the cycle, which would be more reassuring in terms of both a healthy economy and credit growth.

While most equity investors are buying into this scenario en masse, there is also an alternative vision for the U.S. economy, which puts much more emphasis to the persistent dysfunctions in the current cycle, including the following three troublesome areas:

1- **Dysfunction on the productivity front**. The lack of productivity growth that has marked the current cycle, for two years now, goes a long way in explaining the stagnation in CAPEX. Productivity gains need to start to come to fruition, which would require GDP growth to outstrip job growth for a period of several quarters, in order to stimulate corporate profits and the investment that results from them. In recent months, the business sentiment of SMEs has made an initial step towards a possible improvement in the outlook. That said, the other ingredients are still missing in action.

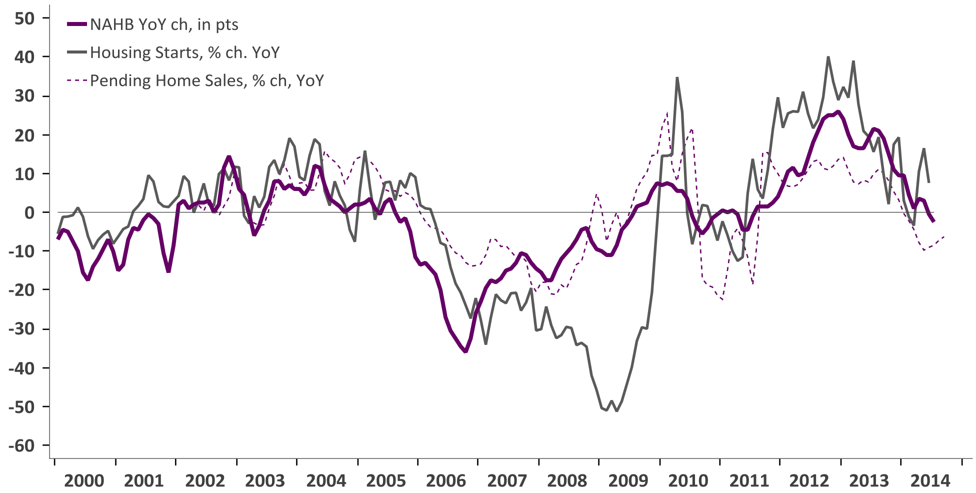
U.S. Hourly Productivity versus After Tax Real Profit Growth



Sources: RichesFlores Research, Macrobond

2- **Dysfunction in the property market**. The distortions that have been created in this market in recent quarters are disquieting (for more on this subject see "U.S. real estate, does it still matter?"), the abnormal increase of new home prices is holding back the sector recovery and consumption prospects. The existing-home segment will determine whether or not the conditions for an improvement, capable of providing fluidity to the real estate market, are created. Unfortunately, despite recent upticks lately, the numbers remain less than convincing at this point.

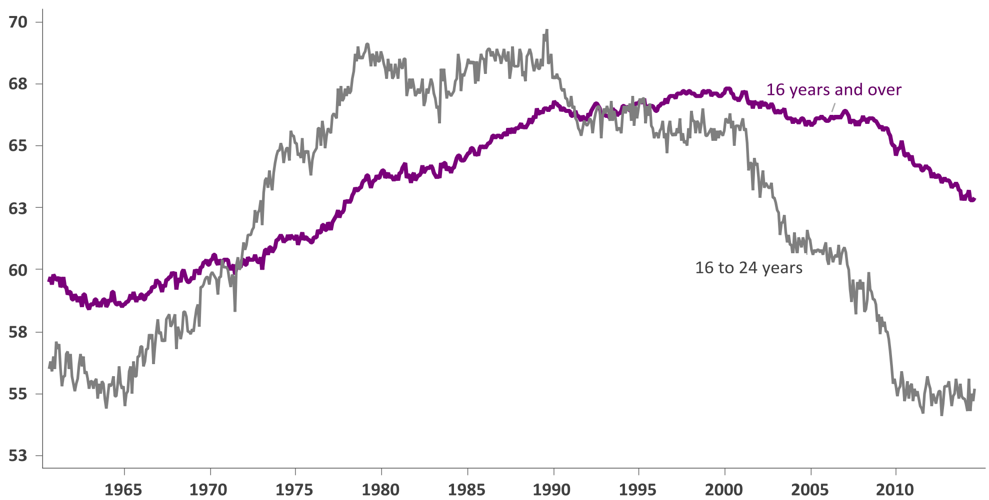
U.S. Real Estate Activity



Sources: RichesFlores Research, Macrobond

3- **Dysfunction in the job market**. The deterioration in the labor market that has coincided with the drop in the participation rate of the working-age population in recent years has become a reality liable to have two impacts, including: creating an unusual sluggishness in the U.S. economy and increasing demand's sensitivity to changes in consumer prices.

Participation Ratio of The U.S. Working-Age Population



Sources: RichesFlores Research, Macrobond

The drop in the participation rate among young people to levels that haven't been seen since the 1960s has deprived the economy of an important component that could drive demand for housing. In turn, the potential normalization of this market hinges on resurgent demand. Despite its importance, the acceleration in job creation in recent months has yet to reverse the trend in the participation rate of young people and will undoubtedly have to wait until the recovery spills over into SMEs before materializing.

Let's not get ahead of ourselves…

Despite the recent improvement of economic indicators, these weak points limit the capacity of the U.S. economy to cope with the normalization of interest rates and justify, to some extent, the soft bond markets and the Fed's relatively circumspect view of investor ebullience. Yet, it is probable that anticipations will not move much so long as these uncertainties are not resolved, which implies looking carefully at economic indicators, particularly:

- confidence levels of SMEs
- the participation rate of young people
- transactions in existing-home sales

Most likely, these trends will have to improve markedly before interest rates, and therefore bond markets, can be re-evaluated and before our scenario will be adjusted to the upside. **At this point, the dearth of positives compels us to leave our analysis as is: we are selling, by all accounts, the equity story and are heavily overweight T-Bonds.**

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