Why Stock Market Investors Shouldn’t Fear the Bond Meltdown

Description

Experts warned that stock markets would crash and bond prices would soar if Donald Trump won the U.S. presidential election.

The experts were wrong again; instead, stock markets soared and bond prices crashed, the latter suffering a ferocious and mind-boggling $1.29 trillion sell-off.

The same experts are now warning that the 30-year bond market bubble is finally about to burst, so is it time to run for cover?

Bond is the word

Most private investors pay little attention to the bond market, yet it is far bigger than the stock market.

It has more than tripled in size in the past 15 years and exceeds $100 trillion. By contrast, global stock markets are worth a relatively lowly $64 trillion, according to S&P Dow Jones Indices.

So when the market blows up, that is big news.

Yields rise

The other reason investors ignore bonds is that they can seem hard to understand.

The key thing to remember is that when bond prices rise, the interest they pay, known as the yield, falls.

It sounds counter-intuitive, but it makes sense. Say you have a $100 bond paying $1.50 a year. If the bond’s price falls to $90, that $1.50 is equivalent to a more generous yield of 1.67%.

Bond prices have fallen sharply as investors rushed to offload, driving up yields.

The other Trump dump

The reason for the sell-off is that president-elect Trump has pledged tax cuts, infrastructure stimulus, and military spending worth a whopping 5% of U.S. GDP, and this is expected to drive up inflation, which in turn is likely to drive up global interest rates.

Bonds pay a fixed rate of interest, which makes them less attractive when interest rates are rising. Hence the rush to dump them.

Crunch time

The big worry is that a rise in borrowing costs will put further strain on the indebted global economy, particularly on emerging markets, which have borrowed heavily in dollars.

As the dollar strengthens in anticipation that the U.S. Federal Reserve will hike rates in December, the value of those debts is spiraling.

While Trump's reflation plan is good news for the global economy, the benefits could be wiped out by a dollar spike and debt crunch.

Bull fight

The experts have called the death of the bond bull market before and been wrong every time.

With many government bonds trading on negative yields, some kind of correction must be a good thing.

U.K. 10-year gilts have yielded between 0.5% and 3% in recent years. After the shock of last week, they now yield 1.43%. That hardly qualifies as a meltdown. Bonds are still expensive.

We still live in a deflationary world, thanks to excess Chinese capacity and ageing Western populations.

The Fed may tighten in December and again next year, but nobody is expecting a rush of rate hikes.

Fears that a bond market meltdown could blow up the global economy have been overdone.

Shares beat bonds

Stocks and shares typically do well in times of rising inflation, the unbeatable combination of capital growth from rising share prices and income from dividends helps protect the value of your money in real terms.

Further bond market weakness will only shift the balance even further in favour of investing in shares.

CATEGORY

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