Despite the recent corrective move in U.S. equities, the dominant theme in the markets this summer, post Brexit, was that stock valuations were generally flat. In fact, if you'd unplugged in mid-July and didn't check your screen again until early September, you could be forgiven for thinking time had stood still. The question now is what will follow this period of market indecisiveness?

For pessimists, the record-low bond yields are a warning sign not to be ignored. In July, yields on ten-year U.S. Treasury bond fell to 1.36%, the lowest level ever. Keep in mind that U.S. Treasuries are a global asset, so their performance sheds light on the global economy.

Why are bond yields so low?

A number of formidable fundamental factors are contributing to the ultra-low yields. The fundamental factors include:

- ☑ slow global growth
- ☑ low inflation
- ☑ high consumer debt and aging demographics.

In addition, quantitate easing by the United States, United Kingdom, European Union and Japan have siphoned up a massive volume of bonds, while developed markets have been issuing fewer bonds in debt issuance thanks to lower fiscal deficits.

Another headwind could come from the Federal Reserve's increased warnings about potential upcoming rate hikes. In the past, U.S. interest rate increases have hindered growth in developing countries and caused sell-offs of emerging market assets.

The implication of the low bond yields is that the current global environment will continue for some time. That would mean more anemic growth, ongoing low inflation and further monetary policy easing (outside of the U.S., which has halted its easing program). In the pessimist's view, the most likely next phase of the global cycle is a recession, followed by long-term secular stagnation.

The U.S. economy continues to expand

Optimists counter that the continued expansion of the U.S. economy could – as it has so many times in the past – breath life into the international marketplace. A rise in deficit spending by the major players would also help in this regard. China, of course, has already loosened its purse strings, Japan recently announced it will increase deficit spending, and the likelihood is increasing that U.K. and the U.S. will follow suit.

If the U.S. stays on its present growth track, modest though it is, and China continues to steady itself, the optimist's scenario starts to gain credibility. This view is supported by recent economic data, such as accelerating U.S. wage pressure, the rebound in oil prices off their Q1 lows and the positive indicators in global manufacturing and trade.

Stock prices get helping hand

With Treasury yields plumbing to new depths, investors are going elsewhere in search of higher yield. One of the sectors to profit from this development is that of bond-proxy, or high-dividend yielding, equities. Examples include stocks in utilities, REITs and consumer staples. The increased demand has elevated the stock valuations of these equities to historically high levels relative both to their past and the broader equity market.

At the same time, low bond yields have helped drive increased valuations across the equity market generally. This is occurring because the low bond yields provide lower interest rates to discount the present value of future corporate earnings.

Global outlook

Prior to Brexit, market data across a variety of metrics indicated that the global economy was displaying tentative signs of acceleration. For instance, more than 75% of countries' manufacturing sectors were in expansionary territory during June. And though Brexit delivered an economic shock felt around the world, the previous hesitant trend towards a more stable global environment seems intact.

Certainly, there's no case to be made at present for a lively rebound in global economic activity. However, the on-going bull market in U.S. stocks offers a compelling counter-argument to the doom-and-gloom scenario suggested by the low bond yields.

In a weak economy, investors tend to stand on the sidelines waiting for clear signs of recovery. In this environment, it may make more sense to focus simply on signs of life. If the economy begins to outperform the market's timid expectations, that modest surprise could spark further activity and begin to generate a more offensive-minded investor outlook.

Getting Advice

Are you looking for additional perspective on the financial markets and how it might affect your portfolio?

We encourage you to talk to us.
Speak to your Financial Advisor or contact investor services at 1 800 608 7707.