Divergence Between US Equities and US Treasuries

The divergence between the US treasury market and US equities can be accounted for.

1. US treasury yields are held down because.
    a. Floating rate note issuance is expected to be circa 180 billion USD. This will substitute away some of the fixed coupon issuance. This means less supply of fixed coupons.
    b. Tax receipts are up which will also slow the issuance of treasuries.
    c. Major trading partners such as China and Japan are seeing a reduction of trade surpluses or an increase in trade deficits implying slowing supply of USD offshore and thus weaker demand for treasuries.

1. US equity markets:
    a. Economic growth remains robust. There was a speed bump due to the harsh winter but this has passed.
    b. Trend growth is not 3% but 2%. Given this, any 'fail' of the 3% mark is not a risk of reception but a cyclical slowdown within a global rising trend. Since 2010 GDP YOY has oscillated around 2%, which I regard as the new trend growth rate. Why is trend growth lower today than before? This is not an easy question and there are no definitive answers. One possibility is that credit creation has become impaired. Despite efforts to inflate the monetary base, bank regulation and scarcity of bank capital are constraining credit creation. The 3% average growth rate from 1980 – 2006 was probably boosted by a full 1% due to the early 80's boom in junk bond issuance, the securitization of debt in the late 1980's and the surge in securitized and tranched mortgage bonds in the last 15 years. Absent this credit innovation, trend growth would have been 2% as it is now.
    c. Given the above view of a secular recovery, US equities are in a secular bull market. That said, we could be at a cyclical peak given

that price levels have run ahead of earnings.

d. The continuation of the current cyclical bull requires a recovery in corporate investment which has not yet happened. The growth of the past 5 years has been driven by consumption and housing. Corporate profitability is now at a cyclical high and household savings rates have fallen from mid 5's to low 4's. While US equities remain fundamentally sound, a continuation of earnings growth now stands on a single pillar, corporate investment. I believe this will happen given the average age of the capital stock…

1. Conclusion:
    a. I expect the US treasury market to be more resilient than consensus for reasons of demand and supply.
    b. I expect the US equity market to be in the early stages of a secular bull market.
    c. However, I do feel that the US equity market is currently vulnerable as fundamentals have yet to catch up to valuations.