The 5% Myth: Why It's Yield Volatility, Not Yield Levels, That Moves Markets

The obsession with specific yield levels—whether **4% or 5%—is misplaced.** It's not *where* yields are, but *how fast* they move that unsettles equity markets. Historical evidence shows that **yield volatility, not the absolute level, is the real culprit** behind market instability. With **U.S. 10-year yield volatility now returning to its long-term average**, we expect greater stability in stock market returns, barring new macro shocks.

Key Trends: Debunking the Yield Level Myth

- **Historical Data Dismantles the 5% Yield Panic**
  The S&P500 has delivered strong returns even in periods of high yields, as long as yields were stable. For instance, **equity markets in the 1990s thrived despite 10-year Treasury yields averaging over 6%.** Conversely, **sharp spikes in yields—regardless of their starting point—have historically coincided with stock market volatility.**

- **Volatility: The True Market Villain**
  Since 2020, the rolling 20-day standard deviation of **U.S. 10-year yields has surged well above historical norms, creating a turbulent backdrop for equities.** However, **recent months have seen a reversion to long-term averages,** a trend that has historically supported market stability.

- **Yield Volatility and Stock Market Volatility Go Hand in Hand**
  The relationship between **bond yield volatility and the VIX is clear: when yields swing wildly, fear and uncertainty dominate equity markets.** Stability in yields reduces this noise, allowing fundamentals to drive stock performance.

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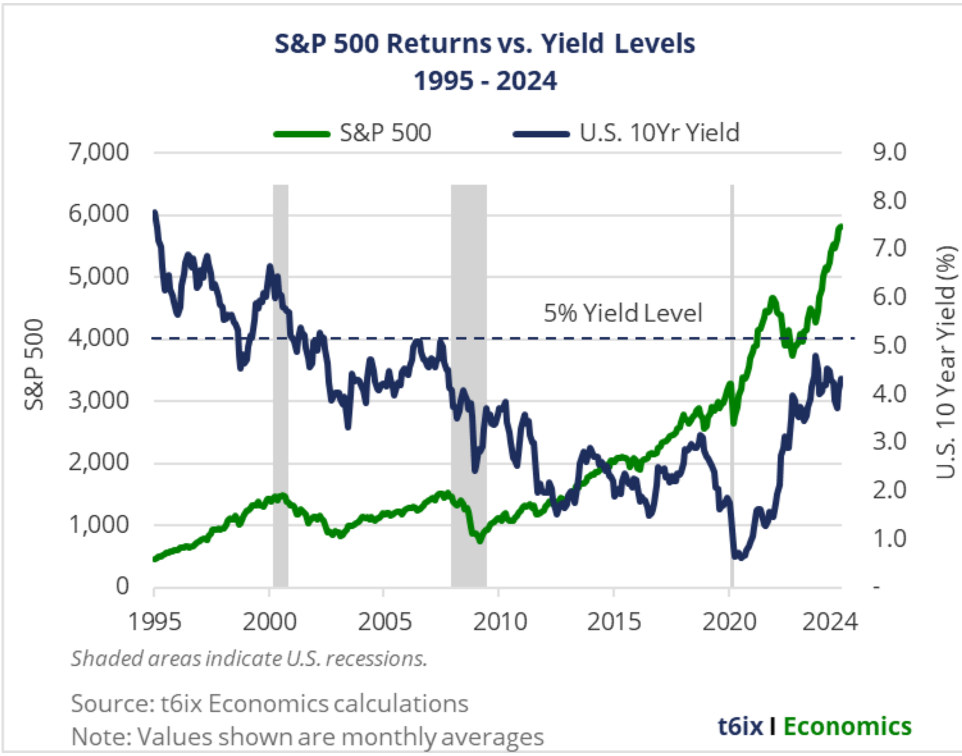
WHAT THE DATA SAYS: YIELDS, VOLATILITY, AND STOCK RETURNS

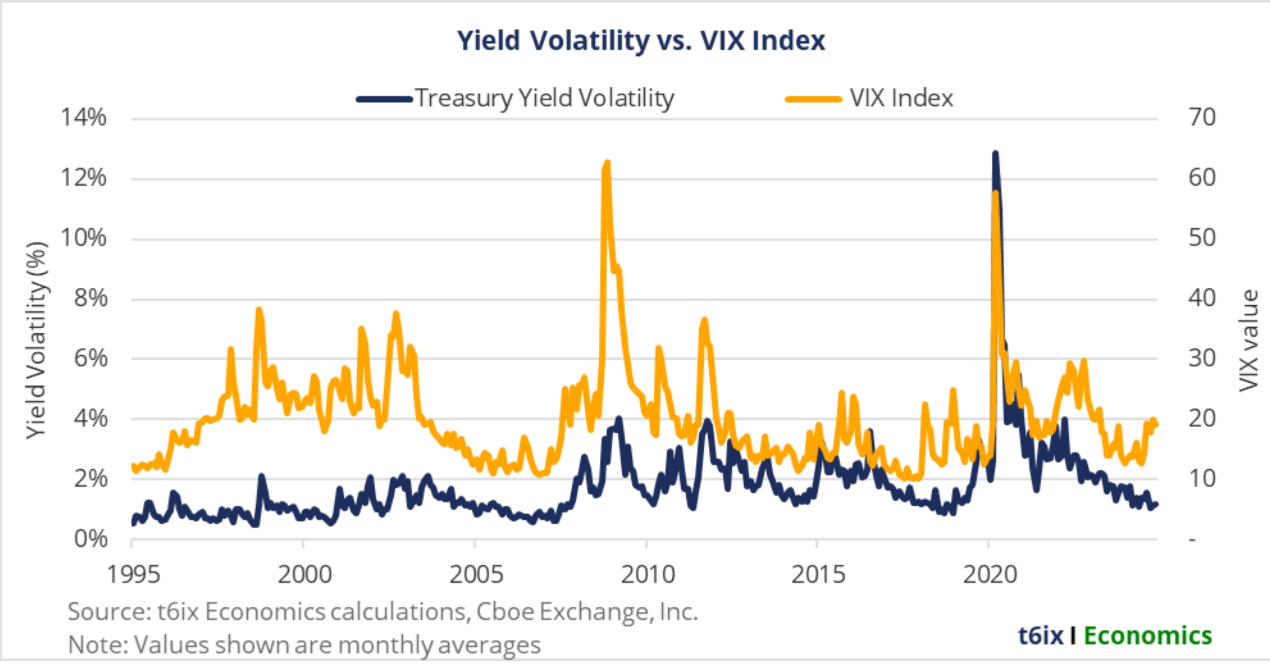
- **It's Not the Yield, It's the Swing**: Historical periods of **high yields have not necessarily coincided with poor equity returns.** The turbulence comes from rapid movements, not the absolute yield level *(Chart 1)*.

Chart 1: High Yields Don't Kill Stocks, Wild Swings Do



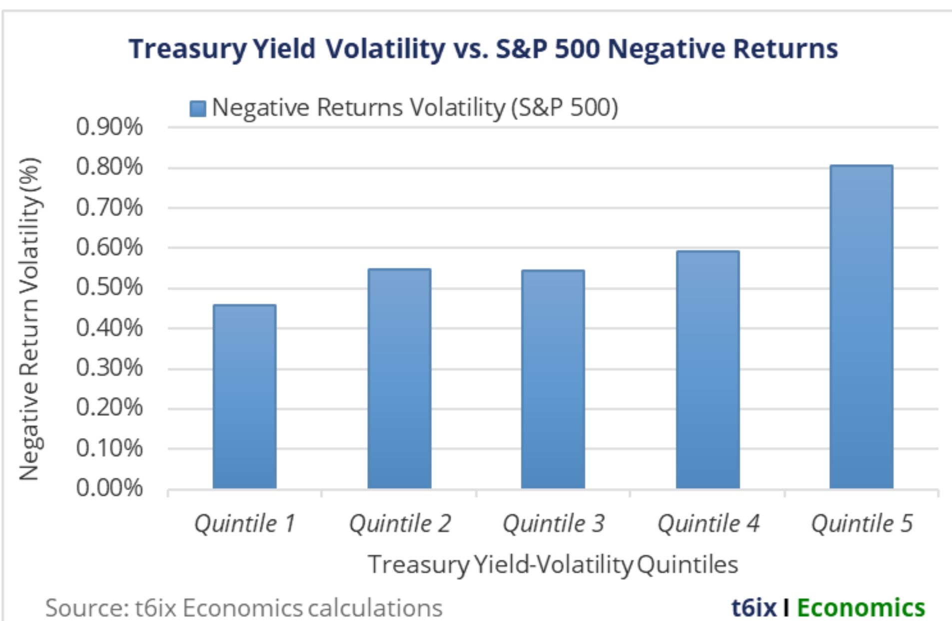
- **Volatility in Yields Drives Fear**: The correlation between yield volatility and the VIX shows that bond market instability feeds directly into equity market sentiment *(Chart 2)*.

Chart 2: Fear in the Bond Market Bleeds into Stocks



- **Normalized Volatility Brings Calm**: As **yield volatility returns to its historical average, stock market stability is improving.** Forward S&P500 returns are less erratic, underscoring this trend *(Chart 3)*.

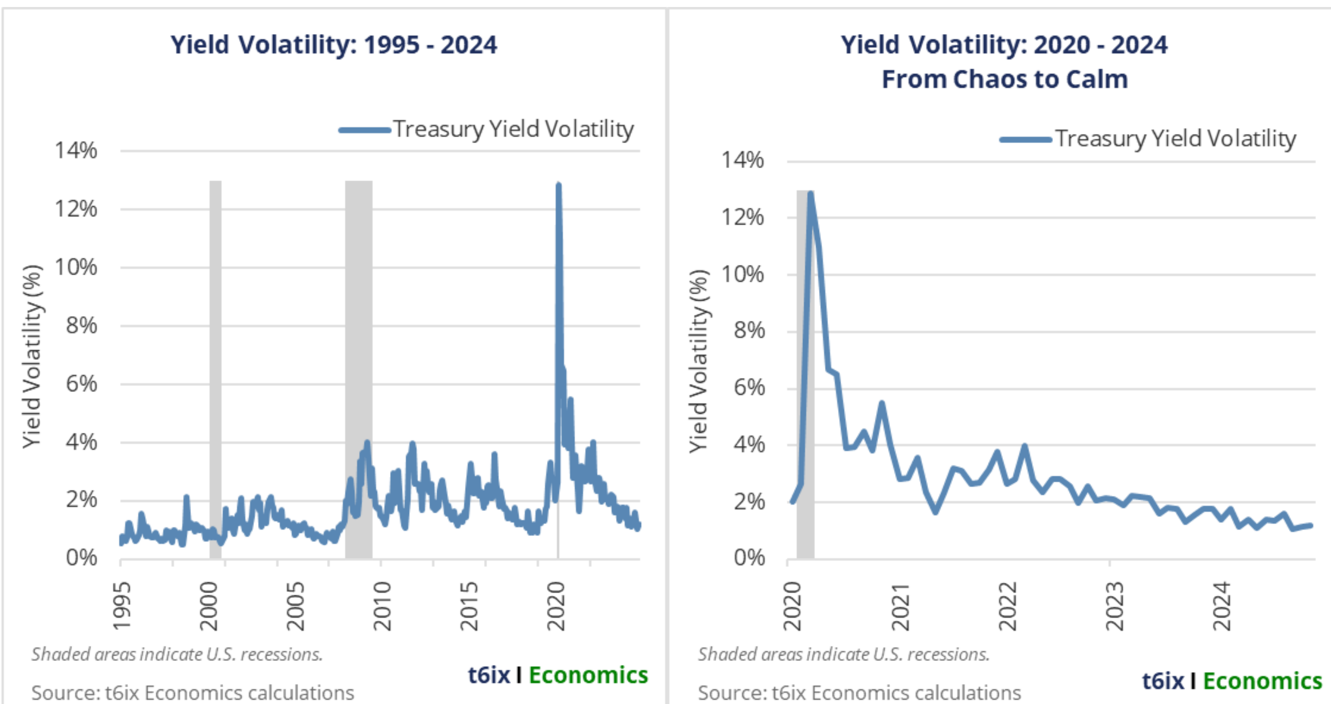
Chart 3: Higher Yield Volatility = Higher Equity Risk



Why This Time Might Be Different

- **The Role of the Fed**: **Market expectations for a "higher-for-longer" rate environment have anchored yields, reducing volatility** *(Chart 4)***.** However, surprises on inflation or labor market data could change this narrative rapidly.
- **Global Macro Shocks**: **Geopolitical instability or shifts in major central bank policies remain wildcard risks** for both yield and equity volatility.

Chart 4: Treasury Yield Volatility Over Time



Risks to Watch

- **The Risk of a Volatility Resurgence**
  Yield volatility may be back to its average *(Chart 4)*, but this stability could be fragile. **Inflation surprises, geopolitical shocks, or hawkish central bank decisions could reignite bond market swings, unsettling equities** *(Charts 2 & 3)***.**
- **Sticky Valuations Under Pressure**
  While stability in yields helps, **absolute yield levels still present challenges for equity valuations.** Growth sectors remain particularly vulnerable to any upward yield adjustments, as **higher discount rates erode future cash flow values.**

- **Earnings Risks in a Slower Economy**
  The market's resilience to high yields depends on robust earnings growth. **If the economic cycle slows, high valuations could face a reckoning.**

OPPORTUNITY: STABILITY FAVORS STRATEGIC POSITIONING

- **Defensive Plays for Consistency**
  Sectors like **consumer staples and utilities, with stable earnings profiles, remain attractive** in a world where market sentiment hinges on macro stability.
- **Energy and Financials Offer Resilience**
  Energy companies benefit from tight global supply-demand dynamics, while financial institutions gain from **favorable margins in a high-rate environment.**
- **Selective Growth Opportunities**
  Stabilized yields provide some breathing room for tech and other growth stocks. **Focus on companies with strong fundamentals and manageable debt loads.**

CONCLUSION: THE MARKET'S QUIET REVOLUTION

The fixation on whether **U.S. 10-year yields cross 4.5% or 5% is misplaced.** History demonstrates that **it's the pace of change—volatility—not the level that matters most to equity markets.** With **yield volatility returning to its long-term average,** the stage is set for greater stability in returns.

Investors should view this environment as an opportunity to rebalance portfolios, focusing on sectors that benefit from stability while hedging against potential shocks. The road ahead will likely be less turbulent—but only if volatility remains in check.

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