Can equities withstand higher bond yields?

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Is economic growth strong enough to support higher rates?

Earnings growth continues to support equity markets

Can equities withstand higher bond yields?

by Christian Gattiker and Mathieu Racheter

Investors entered the week digesting a more hawkish message from the Federal Reserve and a renewed rise in government bond yields. The response across asset markets was swift. Gold retreated, the Treasury yield curve flattened and sectors sensitive to interest rates came under pressure.

Is economic growth strong enough to support higher rates?

Recent policy signals have reinforced the view that inflation remains the Federal Reserve's primary concern. That leaves investors focused on incoming economic data, including business surveys and labour market indicators, for clues about the next move in interest rates.

If growth continues to prove resilient, policymakers are likely to feel comfortable maintaining a restrictive stance. If activity begins to slow more sharply, expectations for further tightening could diminish.

For now, the balance of evidence suggests the economy remains on relatively firm footing. That is an important distinction because rising bond yields driven by resilient growth tend to have different market consequences from those caused by financial stress or inflation fears alone.

Bond yields have become a central focus for equity investors once again. Many regard a 5% yield on the 10-year US Treasury as an important psychological threshold. However, the level of yields tells only part of the story. Investors should also consider the pace and cause of the move.

Historically, equity markets have shown an ability to absorb gradually rising yields, particularly when corporate earnings are growing. Markets generally become more vulnerable when yields rise sharply over a short period, creating a sudden adjustment in valuations. So far, the recent increase appears orderly rather than disruptive. While policy uncertainty has contributed to higher term premia, yields remain broadly consistent with economic fundamentals.

Earnings growth continues to support equity markets

The outlook for equities ultimately depends on whether companies can continue to grow profits fast enough to compensate for higher financing costs and valuation pressures. On that front, the picture remains encouraging. The median company in the S&P 500 is generating earnings growth of around 12%, while European companies are experiencing their broadest earnings upgrade cycle in several years.

Those trends provide an important cushion for investors. Stronger earnings can help justify higher valuations even as discount rates move higher. The principal risk remains a sudden acceleration in yields, particularly if driven by policy concerns rather than economic strength. Such a scenario would present a much greater challenge for equity markets.

Rather than ending the equity rally, rising yields may simply alter market leadership. Market participation remains healthy, with a large majority of US and European stocks trading above their long-term trend levels. That suggests investor confidence extends beyond a narrow group of technology companies.

In this environment, higher yields often favour sectors traditionally associated with value investing. Financials and banks, in particular, tend to benefit from a higher-rate backdrop. At the same time, investors need not abandon long-term structural growth themes such as artificial intelligence. Instead, the market may be entering a phase in which leadership broadens. Growth stocks can continue to perform, but other sectors may begin contributing more meaningfully to returns.

The next test for markets will come from economic data rather than central-bank rhetoric. Business activity surveys, inflation readings and employment figures will help determine whether the economy remains resilient enough to support current market expectations. Strong data could reinforce the case for higher-for-longer interest rates, while weaker numbers might revive hopes of policy easing. For investors, the challenge is to distinguish between volatility and a genuine change in trend.

Rising bond yields are often viewed as a threat to equities. This time, the picture appears more nuanced. The increase in yields has been gradual, corporate earnings remain healthy and economic growth has yet to show signs of a significant deterioration. While higher rates may create winners and losers across the market, they do not necessarily signal the end of the broader rally.

For now, the evidence points towards rotation rather than retreat, with investors increasingly rewarded for diversification rather than concentration. The weeks ahead will reveal whether the economy can continue to support that view.

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