Stocks sank last week, but the focus for investors has been on developments in the bond market.

The yield on the benchmark 10-year Treasury had been trading at around the 2.0% level for a period of several months before moving sharply higher in recent weeks. The yield rose to above 2.35% last week before settling at around 2.25% by the end of the week (bond prices move inversely to yields). The selloff in bonds has caused some to wonder whether we are at the forefront of a bond bear market. Additionally, it raises questions about what yield movements mean for the stock market.

First, as we indicated last week, we would not be surprised to see additional upward moves in yields, at least in the short term. Economic news has been relatively good over the past few months and as long as that trend continues, yields should retain an upward bias. This is not to say, however, that a bond bear market is upon us. Typically, bond bear markets happen during periods of interest rate policy tightening. While the Federal Reserve has indicated that economic trends have been improving, there is almost no evidence to suggest that the United States is entering into an inflationary environment, and the central bank has maintained its forward guidance that short-term interest rates are set to remain low for some time.

Additionally, we do not believe that higher bond yields by themselves will act as an impediment to the stock market. While it is true that any sharp and sudden moves in yields have the potential to unnerve investors, such effects are likely to be temporary. Over the longer term, we do not believe that modestly higher yields should be a source of concern for stocks, especially since we believe that the rise in yields is coming as a result of improved economic conditions.

So what are some of the improved economic conditions that have been pushing yields higher? We have devoted quite a bit of space in recent weeks to discussing the improvements in the labor market, and while jobs growth is certainly among the most important economic indicators, there are other factors that have been showing signs of improvement as well.

Debt deleveraging remains a source of concern, but we have been seeing progress on that front. Individuals have been paying down their debt over the past few years and household debt levels have been falling noticeably.

Similarly, the housing market has long been a significant source of weakness, but that sector of the economy does appear to be in the midst of a long-term bottoming process and may be entering into some sort of recovery.

An additional issue on the minds of many investors is the US fiscal situation. The end of this year marks several important deadlines, including the scheduled expiration of the Bush-era tax cuts and temporary incentive measures as well as the beginning of scheduled spending cuts. Forecasting exactly what will happen on the fiscal front is complicated due to this November's elections, but our guess is that there is probably a 50% chance (maybe marginally higher) that some sort of tax compromise is enacted either later this year or early next year. The likelihood of a bipartisan compromise on entitlement reform would be less likely.

There are a number of angles that could be taken if one wanted to emphasize potential downside market risks. In addition to concerns over rising yields, we could point to economic and debt problems in Europe, concerns over growth in China, relatively modest levels of global economic growth, weakening trends in corporate profits and escalating geopolitical tension in the Middle East.

While all of these concerns are real, we would argue that the current strong run for equities has mostly been a result of macro risks receding. We argued at the beginning of the year that as long as fundamentals were at least decent, that should be good enough for risk assets. We never believed that solid market performance would require a significant turnaround in global economic growth conditions and a continued environment of modestly positive fundamentals should remain a market-friendly one.

In our view, stocks still remain attractively valued and the market is still discounting a more negative environment than what we expect. Corporations remain flush with cash and are poised to engage in a number of shareholder-friendly activities. From an individual investor perspective, a large number of people are still underweight stocks and we have yet to see significant moves into equity mutual funds. As such, we believe we have not yet seen the end of the market's upward moves.

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