Sterling Advisors

THE MARKET MATTERS

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The Mythical 3.00%

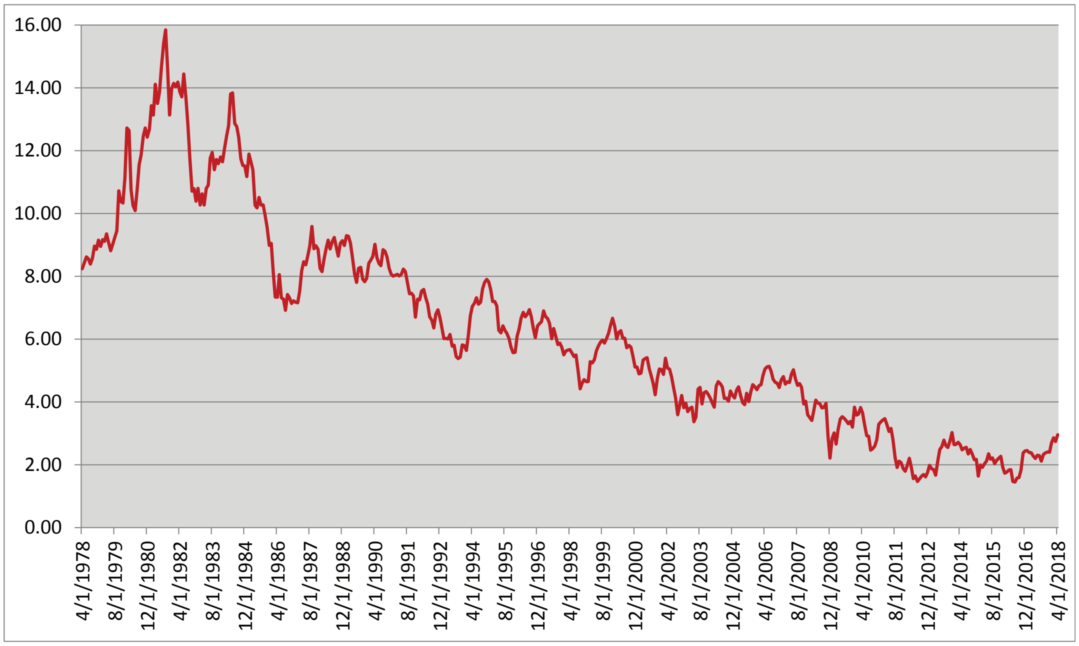
On April 25, the 10-Year U.S. Treasury note (UST 10) closed with yields above 3.00% for the first time since December 31, 2013. Media outlets were quick to point out the milestone and ruminate on its implications. Over the past year, some of the fixed income market's most visible pundits have claimed exceeding the 3.00% yield mark on the UST 10 would mark the official end to the 37-year bull market for bonds. However, the 3-handle on the UST 10 survived exactly one day before yields retreated (i.e., U.S. debt prices rose) back to 2-handle territory (Bloomberg). Was the hubbub for naught or has the UST 10's trip to 3.00% altered the fate of fixed income markets?

Any hyperbolic claim that 3.00% (or any other specific yield level, for that matter) marks some point of no return is misguided. A 3.00% UST 10 has been an oasis on the horizon for years. The UST 10's approach to 3.00% naturally came with a great deal of anticipation. In mid-February, 10-Year yields marched towards 3.00% after a surprise jump in Average Hourly Earnings (AHE) suggested inflationary pressures were potentially awakening from their long winter. The AHE data lifted inflation expectations and drove long yields higher. The abrupt move jolted the U.S. equity market and sparked a -10% rout that was further propelled by U.S.-China trade war concerns.

This equity correction highlighted several points. For one, 3.00% was (and is) a significant level for traders – both psychologically and technically. Even though the UST 10 had already spent the better part of two month's within 20 basis points (0.20%) of the 3.00% mark, actually surpassing 3.00% carried significant weight in investors' mindsets. 3.00% just 'feels' different, and not in a good way as far as many stock investors are concerned. Why? Because rising yields mean increasingly penal borrowing costs for U.S. companies, which directly impacts their bottom lines. This threat to corporate profitability emerged while equities flirted with all-time highs. This mixture created a volatile cocktail. We were long overdue for an equity correction of that magnitude following virtually no volatility in 2017. Investors finally had a tangible reason to doubt near-term equity performance.

This brings us to another issue traders took with 3.00% on the UST 10. At the time of the correction, the risk-reward balance associated with U.S. equities appeared out of whack next to a government-backed debt security yielding 3.00%. The S&P 500's dividend yield was less than 2.00%, and its prospects for future price appreciation were under attack by trade concerns. The opportunity was ripe to rotate out of equities and into fixed income, decrease exposure to risk, and lock in the loftiest high-grade fixed income yields in a half-decade. This rotation had (and has) a lot of force behind it. Since the financial crisis, many investors have moved money into high dividend stocks to meet their income targets in response to all-time low yields in traditional fixed income (i.e., investment grade Corporate bonds, Municipal bonds, U.S. Treasuries, U.S. Agencies). That has created imbalances in how portfolios are positioned. As of mid-April, State Street Global Markets estimated investors are overweight 'riskier' assets such as equities by one of the largest margins in the past 15 years. These same investors are aging and need income stability with more conservative portfolios. The recent increase in U.S. yields is encouraging this belated rebalancing to finally happen.

That is a lot of background stories from February. But these phenomena remain just as relevant today. The UST 10 chopped sideways for the next two months but recent appearances from Federal Reserve officials have revealed the Fed remains intent on raising interest rates despite a historically flat yield curve (i.e., there is a very slim yield difference between 10-Year and 2-Year U.S. Treasury debt) and below-target inflation data. The Fed believes inflation data will continue to slowly improve and a few more hikes this year will help the Fed stay ahead of the curve, literally and figuratively. Their hawkish guidance is one of the most influential factors driving yields higher. The Fed's rate hikes push short rates higher while their rosy economic outlooks support better growth expectations. This, in turn, drives long yields up. But the proof will be in the data – and early May is chock-full of critical jobs, inflation, and growth data releases. These numbers will ultimately decide if the Fed's expectations align with reality or if they are being too aggressive and optimistic. If the numbers – particularly inflation – fall short, we would expect U.S. yields to fall away from the 3.00% threshold. On the flip side, a good showing from Core PCE (the Fed's favorite inflation gauge) and AHE would provide some validation for the UST 10 to move above 3.00% and hold.



Graph 1. 10 Year U.S. Treasury yields (past 40 years) Source: Bloomberg

But that good news could come at a cost. For one, the 'rotation' discussed above is not complete. A sustained move above 3.00% could fuel more rotation out of U.S. equities and into bonds. Not only could investors look to recalibrate portfolios, but equity investors are still not enthusiastic about higher borrowing costs for U.S. companies. Additionally, higher UST 10 yields mean home mortgages, car loans and small business loans grow that much more expensive for consumers. Demand for these loans could fall and negatively impact U.S. growth outlooks. That would be a bearish development for the economy and U.S. equity performance. That scenario supports demand for safe-haven assets like investment-grade fixed income securities. Lastly, U.S. yields remain stratospheric relative to our sovereign peers. Their respective recoveries remain uneven and foreign central banks are maintaining ultra-accommodative monetary policy (i.e., low rates and/or quantitative easing programs). As a result, each time U.S. yields have moved abruptly higher, foreign buying has spiked and put the brakes on their ascent. The demand for U.S. yields based overseas remains intact. We believe this all means a move significantly beyond the 3.00% mark in the near-term is unlikely. In fact, the recent 'double-top' exhibited by UST 10 yields in February and late-April suggests a move back toward 2.85% is a more likely outcome.

To us, the most important aspect of 10-Year U.S. Treasury yields is not the yield level itself but its relation to the 2-Year. Right now just 46 basis points of yield separate those two maturities. The past nine times the yield curve inverted (i.e., the UST 2 offered more yield than the UST 10), the U.S. entered a recession within the subsequent 24 months. Right now, the Fed is publicly debating between 2 or 3 more hikes in 2018. As it stands today, two more Fed hikes would likely invert the curve. History suggests that would signal an impending end to this economic expansion. There is a high-stakes game of chicken underway between the Fed's hawkish intentions and sluggish U.S. inflation. If inflation fails to flinch in the coming months, we certainly hope the Fed will. We continue to maintain our position that the Fed's guidance is overly aggressive given our current economic landscape.

So what is 3.00%? It's one basis point more than 2.99%. But the U.S. yield curve remains the best economic barometer we have – and its pressure readings are ticking higher by the day.