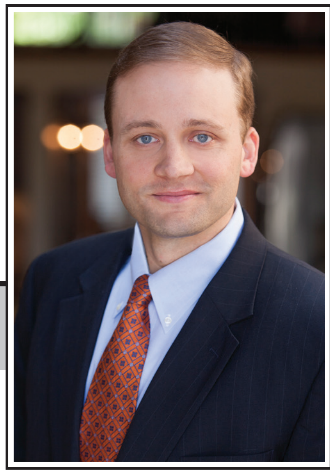
Sterling Advisors

THE MARKET MATTERS



September 2018

Chip Hughey, CFA®
Head of Retail Fixed Income Strategy and Services
BB&T Scott & Stringfellow

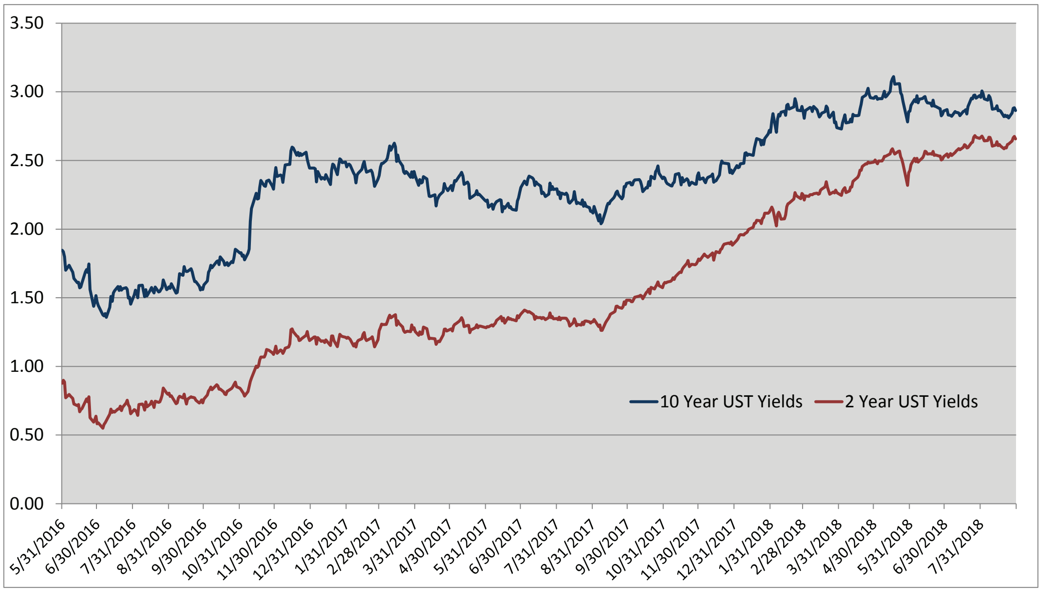
Silence is Deafening

The yield offered by a 10-Year U.S. Treasury note (UST 10) is one of the most carefully monitored benchmarks in global finance. Its effect on economic activity is virtually unparalleled. For example, its level directly affects the appetite for residential and business financing, two critical engines that power domestic growth. Secondly, its relationships to other economic indicators can be illuminating. The yield offered by the UST 10 relative to the yield offered by U.S. debt with shorter maturities and to the dividend yield offered by the S&P 500 has a convincing track record for predicting future economic health and stock market performance. In short, the UST 10's significance is wide and deep.

However, the yield on a 10-Year U.S. Treasury note currently stands just 1 basis point (0.01%) from where it sat on June 1. Over that period, UST 10 yields have bounced in a channel only 20 basis points wide, from a low of 2.81% to a 3.01% high (Bloomberg) despite an average daily trading volume north of $540 billion in 2018 (SIFMA). The U.S. Treasury market is currently in its least volatile quarter since 1965 (Bloomberg). But just because the UST 10 isn't ranting and raving doesn't mean it has nothing to say. Below we discuss the recent quiet period and what we may glean from it.

Inflation: Inflation and inflation expectations are major factors in determining the current yield offered by the UST 10. Since mid-2016, UST 10 yields have risen roughly 1.50%. A portion of that move is attributable to inflationary pressures emerging in the U.S. By virtually every measure, inflation has climbed steadily over that span. Housing and energy prices have been consistent contributors to the increase but those boosts have weakened in recent months. In housing's case, it appears higher mortgage rates since 2016 – which are closely tied to UST 10 yields – are finally beginning to slow housing demand after its meteoric rise post-financial crisis. Higher mortgage rates reduce home affordability and demand. At the end of last month, S&P CoreLogic Case-Shiller data showed home prices posted their smallest gain in more than two years (Bloomberg). What once provided an inflationary tailwind is beginning to drag. The story is similar in oil prices, which have exhibited a strong correlation to inflation and, by extension, UST 10 behavior. Brent crude oil prices grew 56% between mid-2016 and the end of May 2018 (Bloomberg). Since then, prices have flat-lined, removing yet another major source of inflationary pressure. Overall, many prices are slowly rising, particularly in prescription drug costs and in the food service industry (Bureau of Economic Analysis). Therefore, inflation is still edging higher. But two big, reliable sources of upward price pressure have receded, contributing to the UST 10's sideways chop for the past three months. One big source of uncertainty remains on the trade front. U.S.-imposed tariffs would raise the prices of U.S. imports from China and any other affected trading partners. That could effectively raise prices on U.S. soil and push prices – and UST 10 yields – higher. It appears the U.S. and China remain open to negotiations, but the outcome is far from certain. That leaves fixed income markets hunkered down and tightly constrained.

Spread to the UST 2: By now, it's likely you have read here or elsewhere about "yield curve inversions." This occurs when the yield in the front end of the curve surpasses those of longer-dated U.S. debt (i.e., a downward sloping curve). The most common measurement compares yields of the UST 10 with the 2-Year U.S. Treasury bill (UST 2). Right now, 20 basis points (0.20%) separate the yields of the UST 2 and UST 10 (Graph 1). That is the slimmest margin in roughly 11 years. Over the past six decades, yield curve inversions have proven themselves powerful predictors of economic slowdown. The Fed knows this and is beginning to sweat. The central bank's primary tool for monetary policy is setting short-dated interest rates, which directly impacts yields in the front of the curve. Since the end of 2015, the Federal Open Market Committee (FOMC) raised short rates seven times in 25 basis point (0.25%) increments. Today, a growing number of Fed policymakers are concerned with hiking the Fed Funds rate to a point that the curve inverts and signals an upcoming recession. Still, Fed voters are expected to hike an eighth time later this month. This is a time for Fed caution, which sounds odd with U.S. equity indices sitting at all-time highs. An inverted curve essentially says monetary policy has become overly aggressive relative to growth expectations. That is toxic to investor confidence and equity rallies. No one wants to see the curve flip over. These concerns are contributing to the UST 10's narrow trading range and preventing its yield from falling dramatically.



Graph 1. 2- and 10-Year U.S. Treasury Yields since May 31, 2016 Source: Bloomberg

Equity Performance: The subdued nature of the U.S. bond market since May is a major support of the strong U.S. equity performance we are seeing. Back in January, U.S. equity indices revolted against a UST 10 that moved towards and ultimately through the 3.00% threshold. At that time, the UST 10 out-yielded the S&P 500, creating a risk-reward imbalance that sparked a powerful rotation out of equities and into fixed income. The S&P 500 fell -10.16% in just nine trading sessions (Bloomberg), bringing the valuation relationship between equity and fixed income more in sync – but the equity rout was jarring indeed. Today, the steady UST 10 (holding below 3.00%) has freed up U.S. equities to continue their march higher in response to solid corporate earnings and encouraging GDP data. Higher U.S. yields risk reinstating the risk-reward imbalance we saw seven months ago. Additionally, investors don't like seeing higher UST 10 yields because it means higher borrowing costs for U.S. companies. A significant move up for U.S. yields would probably reinflame these concerns. This steady period in intermediate U.S. yields is creating a near-term goldilocks scenario for risk investors. Today's equilibrium between the UST 10 and S&P 500 valuations is encouraging the UST 10 to stand pat. However, the CBOE/CBOT 10-year U.S. Treasury Note Volatility Index (TYVIX) is near its lowest point of the year (Bloomberg). Should the UST 10 creep towards 3.00% while U.S. equities are setting all-time highs, conditions would appear ripe for another abrupt rotation. It is in these periods of equity exuberance that diversification is crucial to protecting long-term investment objectives.

Foreign Demand: International demand for U.S. yield remains a suppressive force on the yield curve. Our yields are uniquely high on the global stage – and for mostly the right reasons. In short, it's mainly because we are one of the best growth stories in the world. Ballooning U.S. debt issuance and a hawkish Fed are playing their part; but solid growth numbers and rising inflation are the primary culprit of rising intermediate and long yields. Meanwhile, our sovereign peers' interest rates remain lower – far lower in some cases. That is fueling foreign demand for U.S. debt investment, thereby driving bond prices up/yields down. As U.S. yields edge higher, we see surges of inflows from overseas.

Summary: We have benign inflation and the fear of a yield curve inversion preventing yields from falling. Simultaneously, we have the relationship between equity and fixed income yields and global demand for U.S. debt preventing a yield breakout to the upside. However, this period of ultra-low U.S. Treasury volatility suggests we must fight complacency and stay diligent.

There is always plenty to listen to – even in the quiet times.