Private Bank

Fixed Income Strategy Bulletin

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US Treasury yields re-price higher on improving economy

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- As discussed in our recent communications (CIO Strategy Bulletin: Beware the Cash Thief and Fixed Income Strategy Bulletin: Bond Investors Confront Inflation Risk With Valuations Still High), US Treasury (UST) rates were expected to continue weakening throughout 2021 as the likelihood of a fiscal mega-stimulus being deployed increases and the economy re-opens. Yesterday however, US Treasuries yields violently re-priced higher across the curve into our expected 2021 range, with the closely watched 10y Treasury jumping almost ~25bps intra-day to a high of 1.55% before settling back to around 1.50%. Bond volatility also spiked to the highest levels since last March **(see Figure 1),** as rates are catching up to this strong growth reality.

- The more extreme move in Treasury yields however occurred at the shorter end of the curve around the 5y point, which experienced a ~20bps move higher. **(Figure 2)**. This move was in part likely a response to the futures markets moving the start date of the Fed rate hikes forward, combined with a very poor 7yr UST bond auction result **(Figure 3).**

Figure 1: US Treasury bond volatility

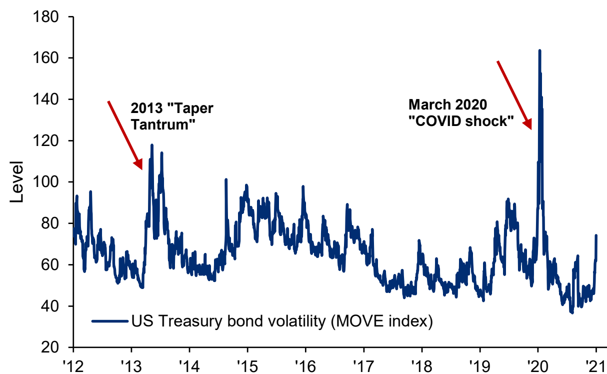
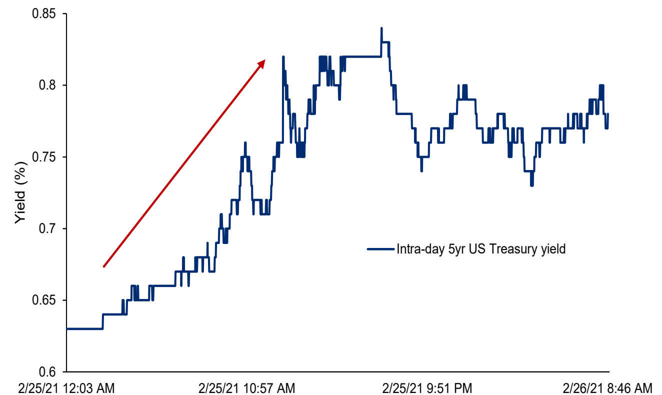


Figure 2: US Treasury 5-year yield over the last two days



Source: Haver Analytics as of February 26, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 3: Weak 7-year UST auction came at vulnerable time

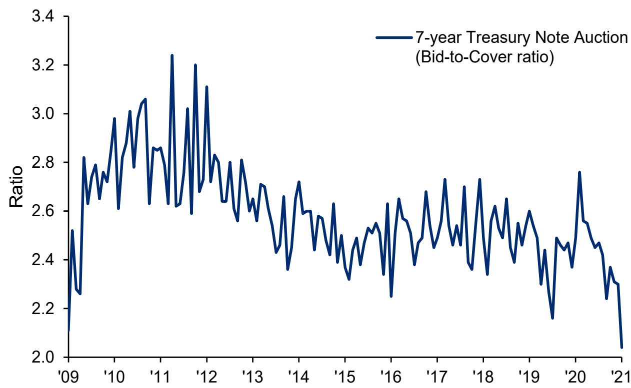
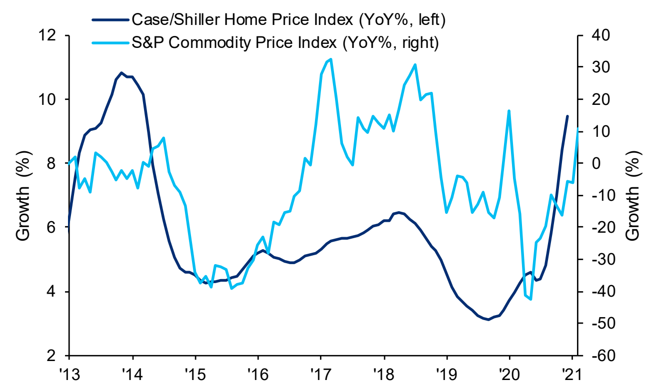


Figure 4: Rising commodity prices



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- There are numerous contributory explanations for the speed of the overall move. Globally, bond market yields have been moving higher, particularly in "commodity-producer" countries such as Australia and Canada, creating the conditions for UST yields to potentially move higher - and become more volatile in doing so- as commodity prices continued to increase **(Figure 4)**.

- A second possible factor was Federal Reserve communications, with Chairman Powell stating earlier this week that he did not see inflation sustaining levels over 2% for quite some time: "It may take more than three years". He also expressed his acceptance with higher long-term rates, saying: "In a way, it's statement on confidence on the part of markets that we will have a robust and ultimately complete recovery". The continuation of this "lower for longer" communication has led the market to price the Fed playing "catch up" to expected higher inflation **(Figure 5)** when the central bank ultimately does start to raise rates, while the absence of push-back on higher long-term rates gave the appearance of the Federal Reserve perhaps even desiring a somewhat higher level of yields.

- A third factor in yields moving higher was likely technical positioning in the market. As rates moved toward certain yield levels, mortgage books were forced to engage in "convexity hedging" (selling Treasuries as mortgage portfolio duration increases), as benchmark mortgage rates suffered one of their largest one-day moves on record **(Figure 6)**. Similarly, risk-parity funds, which may have been selling over the past few months as Treasuries moved lower, may have accelerated their sales.

Figure 5: Market now pricing in hikes in 2023

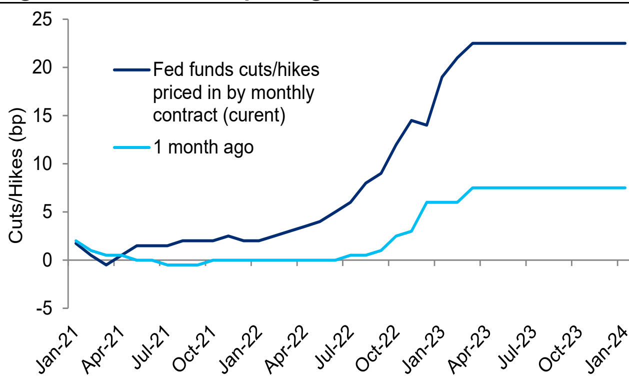
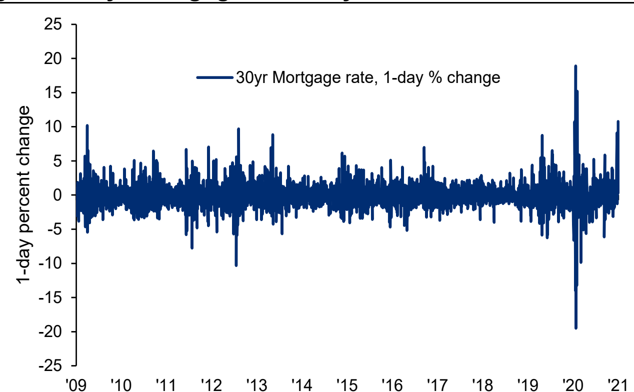


Figure 6: 30yr Mortgage rate daily moves



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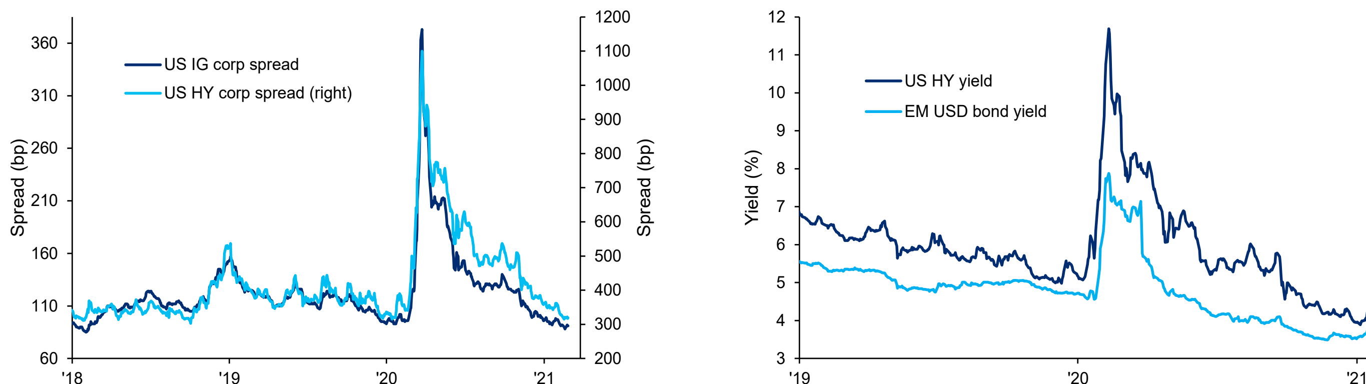
- It's important to note that while risk assets overall did sell off in sympathy with higher yields, particularly in certain equity sectors such as tech, IG and HY credit did not react negatively to higher rates **(Figure 7)**. The economy reopening, which will result in meaningfully higher revenue for issuers, is a much larger positive for most companies than a slightly higher interest rate dampening some demand on the margin, or slightly higher interest

expense. With the 10yr at 1.50%, rates are still historically low, and it will take a meaningful move higher most likely before even the more levered balance sheets are impacted.

- The good news for fixed income investors is that with this re-pricing, corporate bond yields are becoming more attractive on both a nominal basis and a real basis. Investment grade (IG) corporate bond yields are now on average closer to inflation break-evens (2.16% vs 2.10%), while high yield (HY) bond yields, emerging market (EM) bonds, and preferred bonds are all also higher by about 25bps, providing a higher absolute and real yield to cushion against expected inflation **(Figure 8)**. In addition, the potential protection to rising rates embedded in variable-rate bank loans also continues to make them attractive alternatives for adding risk.

- Despite the recent rise in Treasury yields, and possible move higher still as the year progresses, we continue to believe that investors will benefit by holding a diversified set of fixed income alternatives within their core portfolio.

Figure 7: US IG & HY spreads remain firm near record tights **Figure 8: While credit was firm, "rate shock" drove yields**



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