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Global Fixed Income Strategy Bulletin

U.S. Treasury yields drop precipitously, test key supports

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Market summary:

Since the June 16th FOMC meeting --the aftermath of which saw yields spike higher only to turn lower by the end of that week--Treasury nominal yields across the curve have continued to fall, with the 5y yield dropping to 0.74%, the 10y to 1.25%, and the 30y to 1.86%. While Treasury yields had already been moving lower into the meeting, this latest move has been extremely sudden and sharp. The amount of yield compression across the curve – generally called a "bull flattening" – is roughly 25-30bps starting at the 7y Treasury "point".

At this level of yields, the Treasury curve is now paying lower yields versus market-pricing for Fed Fund rate hikes out to seven years **(Figure 1)**. Of particular interest is that while TIPS inflation break-evens have fallen, they have not fallen as much as nominal yields, dropping by only about 15bps, indicating that while in part this may be a "slower inflation" story, something else must be driving nominal yields even lower. Real yields have accordingly dropped even further, with the 10y at -1.00%, almost back at its all-time low set last year of -1.12%.

Equity markets are now focusing on the sharp drop in yields on growing concerns that the bond market may be signaling a slower pace of growth than expected once the pandemic stimulus wears off. Should yields continue to follow and maintain a break below their 200 day moving average, it may reinforce this signal **(Figure 2)**.

Figure 1: Market implied Fed funds in two years

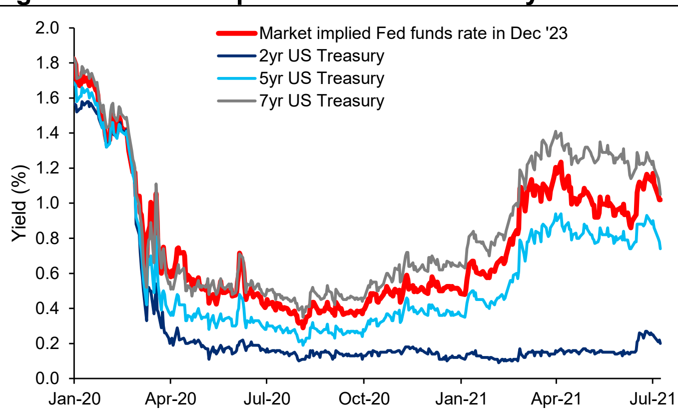
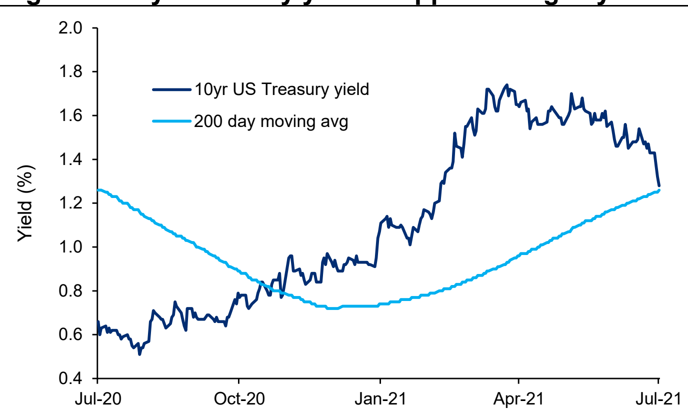


Figure 2: 10yr Treasury yield is approaching key levels



Source: FactSet as of July 8, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

Contributing factors:

There is no single factor that, in our view, satisfactorily explains why Treasury bonds suddenly started moving up in price, but broadly speaking there are probably two "categories" of reasons.

The first category is "fundamental" macroeconomic considerations, specifically that the pace of growth in the economy, inflation indicators, and employment as measured by various data releases appears to be slowing from the initial "reopening phase" of the economy back in early 2021. This is not to say that growth is slowing quickly, it's not, but rather that when the market at its peak in April was pricing the 10y at 1.75%, it was likely expecting continued economic re-acceleration, which subsequently has not proven to be the case. There are many economic data points which bear out this deceleration but the combination of the June unemployment report and June ISM Services report **(Figure 3)** appeared to have triggered fairly heavy trading in the immediate aftermath of their release. A second possible fundamental concern that may be influencing growth expectations is the increase in the "Delta variant" for COVID, with reports circulating that even with two vaccinations, countries such as Israel were experiencing some level of "breakthrough" illness, while in the US there is increasing focus on the variant particularly in states with lower vaccination rates. A third possible contributing fundamental reason may be slowing growth in China, which has held its interest rates higher in an effort to de-leverage speculative pressures within the economy.

Both US economic surveys were released just around July 4th weekend (effectively a 4-day holiday in the US), while widespread reports on vaccine efficacy against the Delta variant in Israel first started circulating at the end of June and really increased in July (at the same time the US Government was increasing communication on the need to get vaccinated). The impact of all of this news flow leading to a possible re-evaluation of growth prospects brings us to the second set of reasons that yields likely dropped so quickly, which might generally be described as "technical".

- **Liquidity**: Most of the "move" in the curve has occurred this month - July - which has only been 3 ½ trading days in the US. Of the 10y yield's 33bps drop from its peak post-FOMC, 19bps was since July 2nd. While markets may be re-pricing growth, the move seems extended given just a few data points on which to base this re-pricing, and even with the backdrop of the delta variant as a potential "fat tail" risk.
- **Short positioning**: While we have discussed this before, it appears that once again that, Commodity Trading Advisors (CTAs) were "stopped out" and flipped from being short Treasuries to long Treasuries at various price levels as bond prices moved higher.
- **Global negative rates**: We have often discussed the differential in global rates as a "draw" for foreign rate investors to buy US Treasuries **(Figure 4)**. With the ECB still focused on providing extraordinary levels of accommodation by buying European government bonds, and the Bank of Japan owning almost 40% of its country's government debt, the only positive interest rate that is broadly accessible to investors remains in the US. Foreign investors can pick up between 50-100bps by buying US Treasuries and swapping them back into their home currencies.
- **Bank demand:** Commercial and Industrial loan balances continue to decline. Over the past month, business loans declined by over $70bn. Banks remain flush with deposits, so they purchased almost $50bn in securities, primarily Treasuries and MBS. This trend is unlikely to reverse as long as the Fed maintains its $120bn/month in bond purchases, as that is creating new deposits which banks must re-invest.
- **Lack of new Treasury supply**: In the midst of these demand factors is a lack of new Treasury supply. The US Treasury only auctioned shorter-term bonds and bills in the latter half of June, and thus far in July has only auctioned bills.

Figure 3: ISM services Purchasing Managers' Index (PMI)

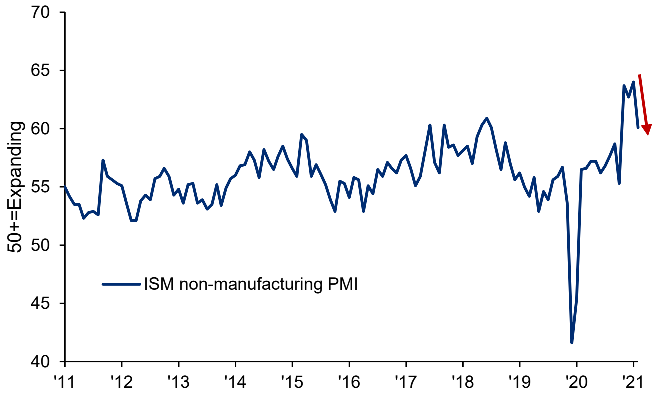
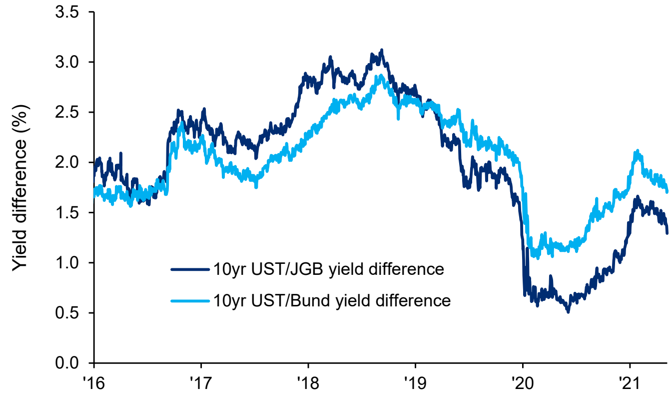


Figure 4: UST yield premium vs Japan & German



Source: Haver Analytics as of July 8, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

What's next?

The current level of rates poses a dilemma of sorts for the Federal Reserve. Although nothing was formally announced at the June FOMC meeting, the shift in higher inflation expectations and move in the "dot plot" conveyed a more "hawkish" Fed, with an official announcement of a reduction in monthly bond purchases ("tapering") expected by the market in late summer/early fall. However the Fed must now determine if the reaction in bonds (and equities, should today's move lower extend) portend a genuine growth scare being increasingly priced by markets, or is "Quantitative Easing" (QE) – the Fed's monthly bond purchases - creating a "technical" of excess liquidity that is in turn pushing down yields and sending an incorrect slow growth signal?

We think the Fed will determine that, while growth is indeed decelerating, the current continued pace of QE should be reduced, even if some view this initially as "hawkish". The reason for the necessity of this reduction is two-fold. First, as discussed above, the economy is no longer absorbing all of the QE that is being provided as deposits are being reinvested back in Treasuries (or in the case of money-market funds, back at the Fed itself via its overnight reverse-repo program. This "technical" may in turn be driving rates lower. Second, lower rates – especially negative real rates – will over time result in continued inflationary price increases. While much of the inflationary impulse in the first quarter appears to have peaked (or at least plateaued), the sustainability of overall higher inflation levels may increase if rates stay negative for an extended period of time. While inflation averaging over 2% is a stated policy goal of the Fed (and as of today, the ECB as well), inflation running much higher than that for long is not. Somewhat paradoxically, as we see today lower rates might also signal to investors that growth is declining, which can create a self-reinforcing psychology leading to lower investment and hiring. In short, given the current pace of QE, it's difficult for the market to get a clear read on just what exactly the lower rates may be pricing.

This is probably why the Fed, and Treasury Secretary Yellen, repeatedly stated this past spring that they were comfortable with higher long-term yields, albeit not extremely high yields. A steeper yield curve and one with an absolute yield level that allows the Fed to raise rates conveys both discipline against future inflation increases above the 2% average, and a growing economy that can absorb higher rates. Accordingly, as monthly inflation numbers remain elevated and the labor market tightens over the summer, we expect that the Fed will announce a taper in the fall. While the Treasury market may shorter-term trade on the technical factors discussed above, we think that additional supply combined with a broadened reopening of the economy will move 10y Treasuries back into the 1.50%-2% range.

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