Will US yields break out of their range?

by Mona Mahajan | 09/10/2018

Summary

After staying stuck in a narrow band for much of 2018, 10-year Treasury yields have only recently stayed above the 3.05% barrier for a prolonged time. This could be the beginning of a sell-off in Treasuries that pushes yields higher, though other factors are putting downward pressure on yields as well.

Key takeaways

- Investors are watching the 10-year Treasury to see if it can remain above 3.05% for an extended time
- Inflationary pressure, tariffs, shrinking liquidity and rising debt levels may support a breakout, but increased demand for income and shifts in consumption and globalisation may keep yields down
- The market may be underestimating how many times the Fed will raise rates in 2019 and 2020
- As shorter-term rates have moved up and longer-term rates appear range-bound, the yield curve has flattened

10-year yields have been range-bound so far

As we move deeper into the fourth quarter, investors are watching to see if the 10-year US Treasury yield will break out for a prolonged time above the 2.75%-3.05% range it has held for much of this year.

We began the year with the 10-year at 2.45%, and we quickly moved upwards towards 2.90% levels, creating nervousness in risk assets and sparking a sell-off in equities in February. However, since that time, yields have remained somewhat range-bound, testing 3.05% once in May, but not holding this level for more than one week until early October.

We are now above 3.1% in the 10-year, and once again, investors are wondering: could this be the beginning of a rates sell-off, pushing yields higher?

Figure 1. US Treasury 10-year yields, 2018 (%)

Source: Bloomberg. Data as at October 2018.

Forces that work for and against rising yields

There are a range of forces that may support rising yields, including inflation, tariffs, liquidity and debt.

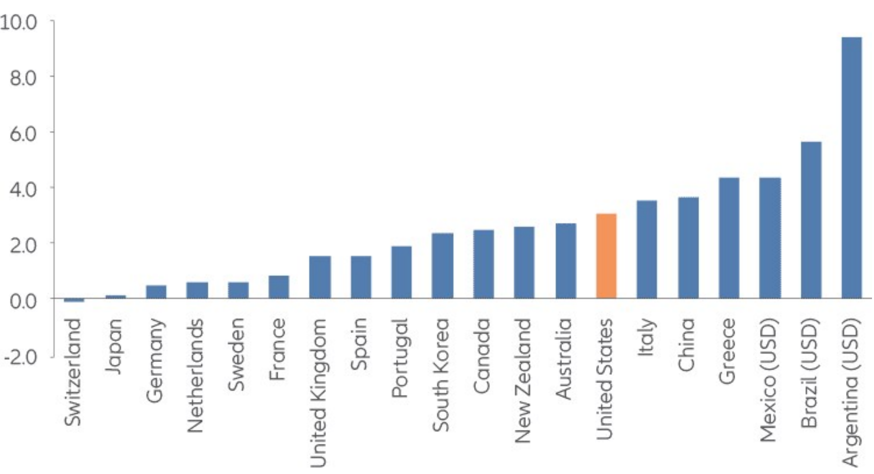
- **Inflationary pressure is building:** As growth rates in the US have remained robust, we have also seen both core PCE (personal consumer expenditures) and core CPI (the consumer price index) move above 2.0% this year. With US unemployment near 18-year lows, wage growth (average hourly earnings) has been trending higher, recently reaching a post-crisis high at 2.9% (although still below the 3.0%-3.5% range we observed pre-crisis). Commodity prices, such as the price of oil, have also had substantial moves upward this year, adding to inflation expectations.
- **Tariffs are also incrementally inflationary:** The ongoing tariff rhetoric and escalation can be inflationary on the margin. So far, the US has implemented tariffs on washing machines and solar panels, steel and aluminium – and notably, tariffs on USD 250 billion of Chinese goods (which could increase by an additional USD 267 billion). If and when corporations pass on parts of these tariff increases to end consumers, we may see upward pressure on inflation. This would then place upward pressure on long-term rates.
- **The Fed is removing liquidity:** The Federal Reserve remains committed to its normalisation path, including both rate hikes and balance-sheet reduction (see below for more on Fed rate hikes). These actions remove liquidity from the system and also create a greater supply of US Treasury securities, potentially pushing prices lower and yields higher.
- **Federal debt levels are rising:** Longer term, we are watching the US deficit, with the CBO projecting that the federal debt-to-GDP ratio will rise from 78% to 96% over the next decade. These rising debt levels can put upward pressure on rates, especially if investors seek a higher premium to absorb this additional debt.

However, until very recently, yields have remained generally contained in the 2.75%-3.05% range, as noted above, far below the 4.5% average 10-year yield in the 10 years before the financial crisis. Why is this?

- **The global hunt for yield remains in place:** As we look globally at 10-year yields, we see that the US offers a fairly attractive risk-reward with a 10-year Treasury yield at around 3.0%. For example, in order to obtain comparable yield, investors could consider Greek or Italian bonds, but the risk profiles in those economies are much different. Or investors could look to "safer" economies like Germany and Japan, where yields are approximately 40 basis points and 10 basis points, respectively (see Exhibit 2). As a result, as US yields climb past 3.0%, we see increased demand for US Treasuries, both from investors globally as well as those domestic investors (eg, pension funds) looking for longer-dated yield, which in turn puts downward pressure on yields. (However, it is important to note that as the cost of currency hedging rises, this global demand for US yield falls. This is a phenomenon that markets have recently observed, especially for Japanese and European investors.)
- **Secular shifts in automation and globalisation:** Recent trends in automation could potentially create lower-cost substitutes for labour. And globalisation allows for not only an international pool of workers but also enables consumers to efficiently compare prices online for goods sourced from around the world.
- **Treasuries tend to be a flight-to-safety asset:** In risk-off environments, investors globally generally gravitate towards Treasuries and other US government-backed assets. This can weigh on yields during these time periods as well.

Overall, we continue to watch the technical level of 3.05% in the 10-year yield. If this is breached for a significant amount of time (beyond three to four weeks), we believe 3.25% would be the next higher leg.

Figure 2. Global 10-year yields (%)



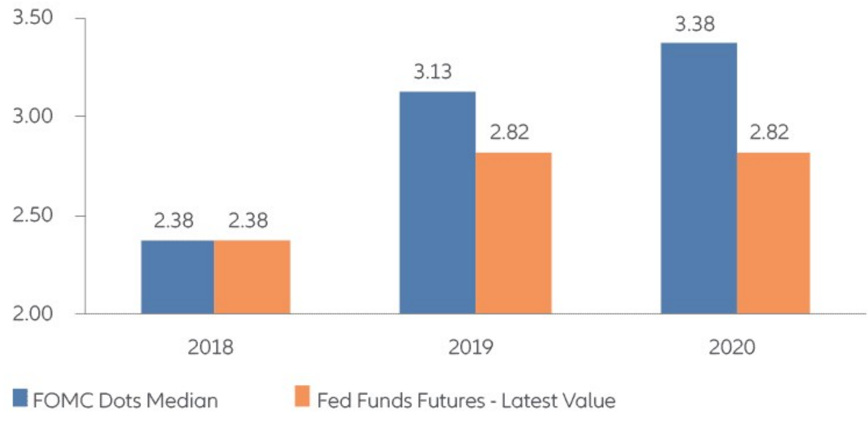
Source: Bloomberg. Data as at October 2018.

Short-term rates will likely rise: the Fed is in play

Meanwhile, the other part of the rates story remains the rise in short-term US rates, driven in large part by the Federal Reserve. At the September Federal Open Markets Committee (FOMC) meeting, Fed Chair Jerome Powell reiterated that it is a "good moment for the US economy", thanks to US GDP growth that is above potential, low levels of unemployment and inflation that is in line with the Fed's target. The Fed's economic projections now show US GDP growth rising by 3.1% in 2018 compared to a 2.8% growth forecast in June.

As a result, the Fed remains committed to its normalisation path. The most recent "dot plot" – a chart released by the Fed that averages the rate-path estimates of FOMC members – continues to indicate one additional rate hike in December, three in 2019 and one in 2020. Meanwhile, the market continues to price in just two rate hikes beyond this year, creating a spread between the Fed and the market that may narrow over time, especially as we get into 2019.

Figure 3. Federal Reserve "dot plot" versus market expectations of fed fund rates (%)



Source: Bloomberg. Data as at October 2018.

One of the more direct impacts of Fed rate hikes can be observed in the short end of the US Treasury yield curve, which has moved up substantially this year. The 2-year yield, for example, rose over 90 basis points this year, to above 2.80%.

Figure 4. US Treasury 2-year yields, 2018 (%)

Source: Bloomberg. Data as at October 2018.

As shorter-term rates move upward and longer-term rates remain range bound, the yield curve (the 10-year yield minus the 2-year yield) has flattened. We have seen this yield curve flattening for much of the last five years, in fact, with the differential between the 10-year and 2-year now close to 25 basis points. While flattening and even inverted yield curves are not uncommon towards the end of a Fed rate hike cycle, we do observe that inverted yield curves can be recession indicators. Analysis shows, however, that recessions do not typically occur until six to 18 months after yield curve inversion.

Three to watch in this environment

1. **Short duration:** In a potentially rising-rate environment, shorter-duration fixed income can provide some insulation from rate-sensitive assets. In addition, the yields of short-duration assets remain relatively attractive. Given the flattening yield curve, investors are now not getting paid as much to take on additional risk by investing in longer-duration assets.

2. **US high yield:** We continue to see value in select areas of US high yield, particularly as we do not see a recession on the horizon in the US; this makes a near-term default cycle seem unlikely. High-yield investors are realising a pick-up in yield, as well as exposure to companies that tend to be more domestically oriented, so they are somewhat insulated from ongoing trade tensions and global uncertainty. As we move later into the US cycle, we believe it is critical to invest with active high-yield managers focused on strong fundamental discipline.

3. **Convertibles:** Finally, we believe the convertibles area of fixed income is attractive in this environment. Convertibles tend to perform better in rising-rate environments and can offer diversification from traditional fixed income. In addition, convertibles offer potential upside from equities and volatility as well, which may become more valuable in a late-cycle environment.

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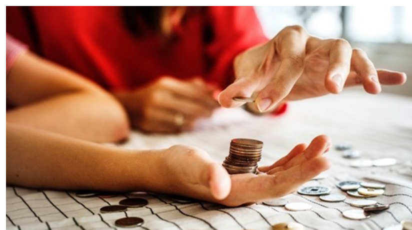

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About the author

Mona Mahajan

US Investment Strategist

Mona is the US investment strategist and a director with Allianz Global Investors, which she joined in 2017. As a member of the Global Economics and Strategy team, she is responsible for providing US retail and institutional clients with differentiated investment thought leadership.

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Summary

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Key takeaways

- New global political agreements mean more infrastructure projects are coming online, and institutional investors are increasingly supplying capital in place of governments and banks