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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

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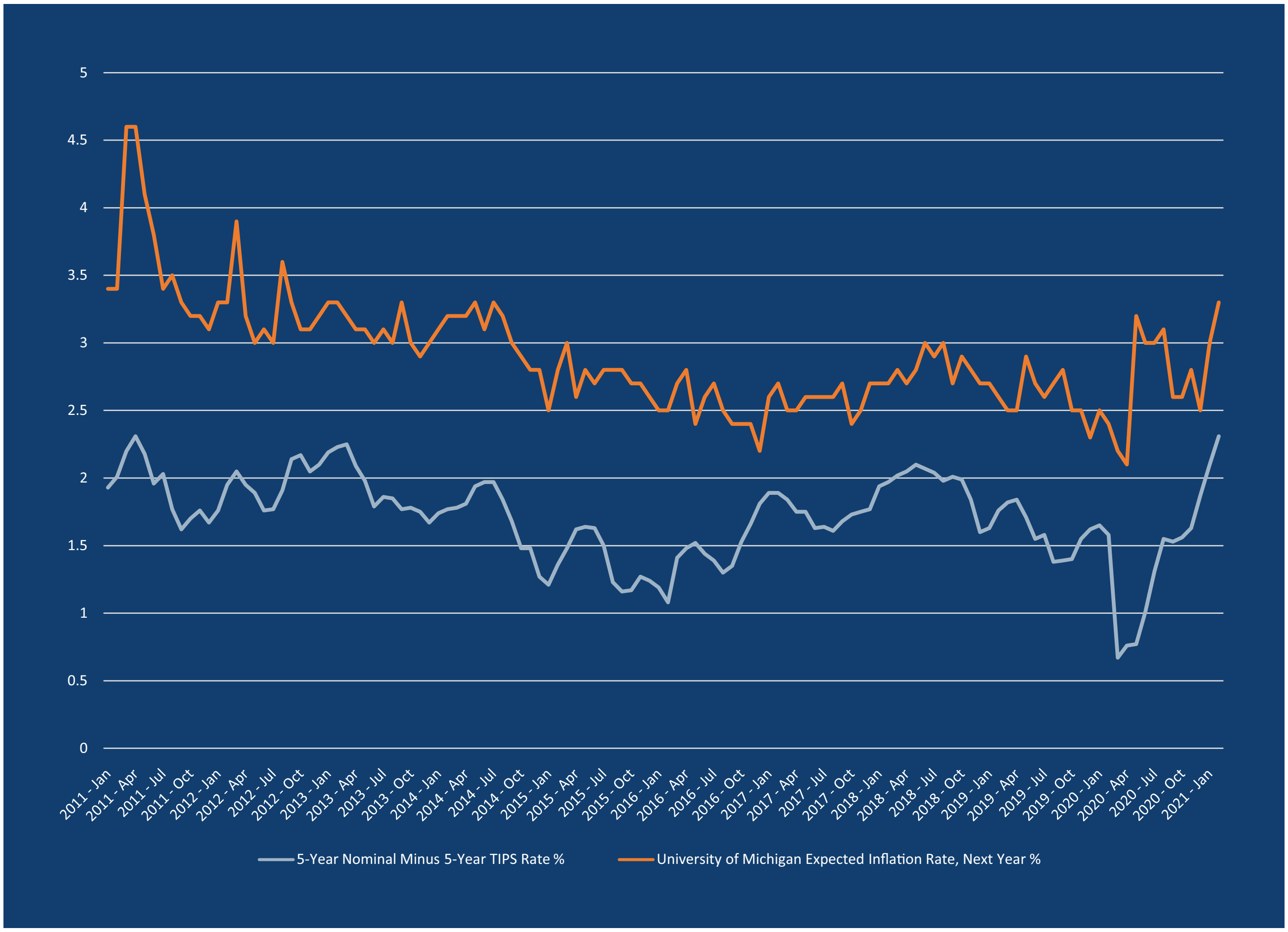
The Bond Market Yields to Inflation Talk

After plummeting last year to record low levels, intermediate- and long-term benchmark Treasury yields have been steadily increasing since late last summer. The 10-year Treasury traded at a record low yield of 51 basis points (0.51%) in August and recently has been trading around the 1.50% level, back where it was in January 2020 pre-Covid.

In our view, the increase in bond yields is happening on a combination of factors, most of them "good" news. The overall theme is one of the Fed potentially moving away from its policy stance of "lower for longer," as there has been an influx of better news on the vaccine front and decreasing Covid cases, and the impacts of these developments on the economy. While we don't believe the Fed will begin raising rates in 2021, futures markets have started to reprice the timing of the first quarter-point rate increase into late 2022 or early 2023.

The brightening outlook for the U.S. economy, coupled with extremely accommodative monetary policy and additional fiscal stimulus, has resulted in both market-based and survey-based inflation expectations increasing (see exhibit 1). Inflation and inflation expectations historically have been an important driver of bond yields, and these recent increases in expectations are another contributing factor to the rise in yields. The better economic outlook and increasing inflation expectations are also captured in the steepening of the Treasury yield curve. Short-term yields remain anchored by the Fed's policy and rhetoric while intermediate and longer maturity yields have been rising on the aforementioned factors.

Chart 1. 5-Year Nominal Minus 5-Year TIPS Rate
University of Michigan: Expected Inflation Rate, Next Year %



Sources: Federal Reserve Board/Haver Analytics, University of Michigan

It is important to put this recent move in yields in perspective. First, at a yield of 1.50%, the 10-year Treasury remains below where it has traded for most of the last decade. In other words, yields moved from "very low" back towards "low" with this recent move. Quantitative easing (QE), ZIRP (zero percent interest rate policy), low inflation and, most recently, the Covid recession have all combined to keep the bond market becalmed at low yield levels. While some of those factors are changing, enough of them should persist to bias bond yields towards the same ranges we have experienced in recent years.

Globally, benchmark sovereign yields are also trending higher. Of the 19 global bond markets we review on a frequent basis, 16 have seen yields increase over the past six months. Most have not moved as much as the U.S. and most also have yield below the U.S. (particularly in developed Europe). It would be more troubling if U.S. yields were increasing by themselves, indicative of unwillingness globally to invest in U.S. assets. Instead, bond markets around the world are responding to the more positive news on the vaccine and Covid fronts.

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Monetary policy remains a powerful influence on benchmark Treasury yields. The target Fed funds rate remains at 0%, and the Fed continues to purchase at least $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities per month. These are things that will bias yields lower and will remain in place until the Fed decides otherwise. It is also worth noting that the Fed could revive Operation Twist, targeting the yield curve by selling shorter bonds and buying longer maturity bonds. The Fed also has other policy tools (and rhetoric) it can use to target various parts of the bond market if it feels it is necessary.

It is also important to understand that the current low yields result in larger price swings when rates do change. A hypothetical 50 basis point increase in the benchmark Treasury yield has a larger impact on price at 1% market yields than 4% market yields because of the amount and timing of the cash flows (in bond lexicon the term is "duration," which is defined as weighted average of the time until a bond's fixed cash flows are received). These potential price swings are less important for investors who hold bonds until maturity. We would also point out that not all types of bonds (i.e. municipals, high yield and investment grade credit) move to the same degree or at the same time as Treasuries.

How high can yields go? That is a question that investors might not have worried about at various times in recent history, when the concern was that U.S. yields would follow other countries into negative territory. However, with inflation concerns, deficits, more stimulus and the prospects of the economy more fully reopening this year, it is a question that is top of mind.

Prior to the Global Financial Crisis (GFC), bonds (as measured by the 10-year Treasury) had traded with a positive real yield that averaged 2.6%-2.7%. In other words, add that premium to inflation and that is what yields averaged through time. Another good proxy was to think about the benchmark in terms of growth plus inflation as a rough estimate of "fair value" for yields. Those metrics have been rendered obsolete by ZIRP and quantitative easing, known more formally as financial repression (policies that result in savers earning returns below the rate of inflation). The bond market has been more heavily influenced by these factors which are still in place today. As noted previously, through quantitative easing, the Fed is purchasing almost $1 trillion of Treasuries per year and has anchored the short part of the yield curve with Fed funds at 0% and a promise to keep them there for an "extended" period.

Forecasting interest rates has been a frustrating endeavor in this environment. However, the following chart (exhibit 2) provides very good perspective and can help frame an answer to the question. It shows a 15-year history of the benchmark 10-year Treasury that roughly corresponds to the advent of extraordinary monetary policy. The 10-year note has averaged 2.7% over that time frame and at the lows last year was trading almost exactly two standard deviations below the mean. Currently, it is very close to one standard deviation below the mean. While inflation is expected to increase, the longer-term forecast (survey and market based) is for it to remain below 3%. And with the Fed committed to ZIRP and QE, we would suggest that the recent ranges provide a good trading range, between the 15-year mean and one standard deviation below it, which roughly corresponds to 1.60% to 2.7%. We started this by suggesting that bond yields were moving from "very low" as a result of the pandemic back to "low," and we feel this range is consistent with that view. To move more fully into this range, we believe we will need to see higher inflation or a change in Fed policy or rhetoric.

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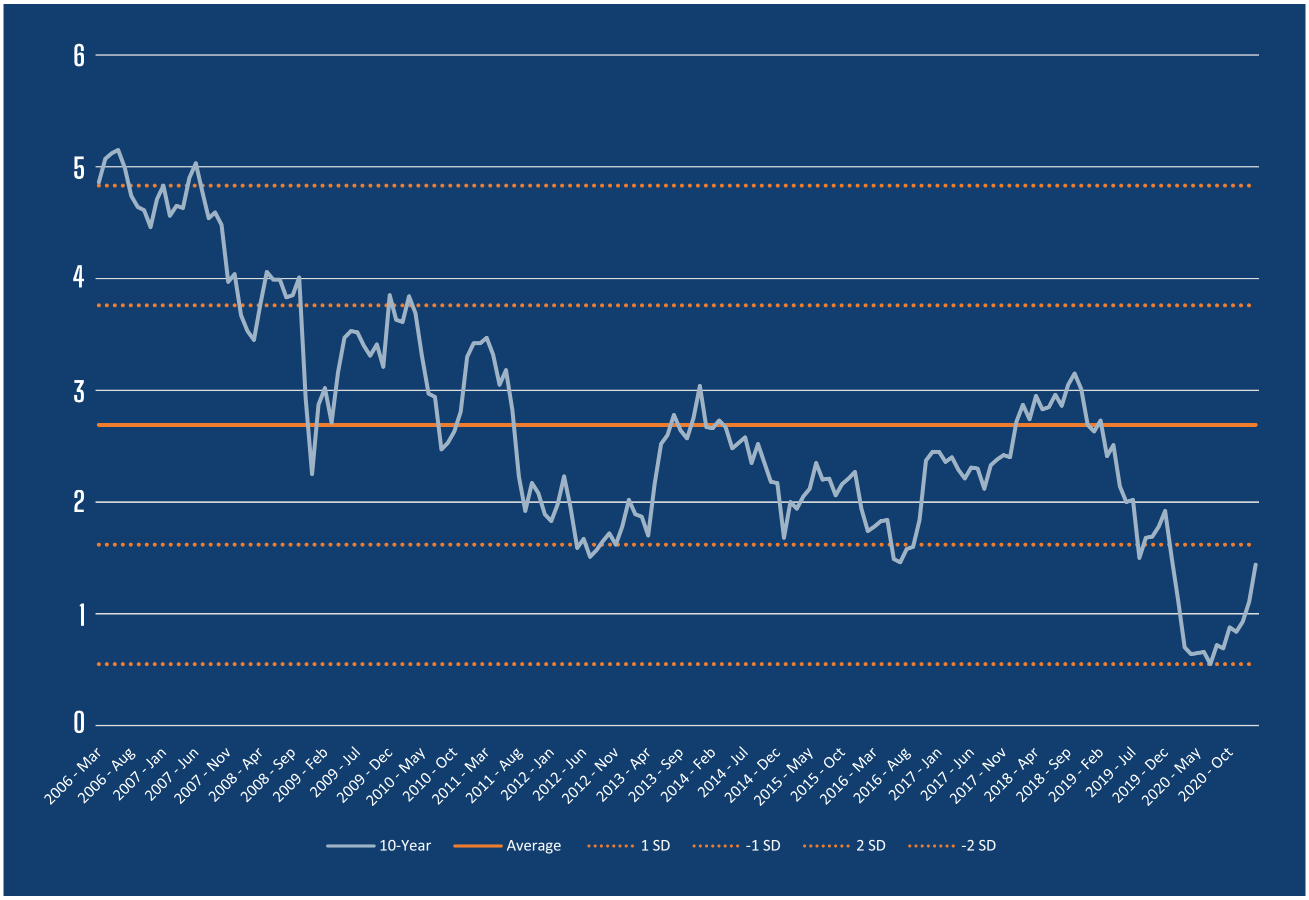
Chart 2. 10-Year Treasury Note Yield at Constant Maturity
EPO, % p.a.



Sources: Federal Reserve Board/Haver Analytics

In this environment, our advice as it relates to bonds is unchanged. First, investors must have a realistic view of what bonds provide a portfolio: liquidity, cash flow, stability, but little in the way of real returns. Despite the return challenges, there is still a role for core fixed income in multi-asset portfolios. It isn't an asset class we would suggest overweighting, but we wouldn't abandon it because of its defensive properties. We would continue to use a laddered approach, focusing in the intermediate part of the yield curve, and we would be wary of taking on too much concentrated credit risk.

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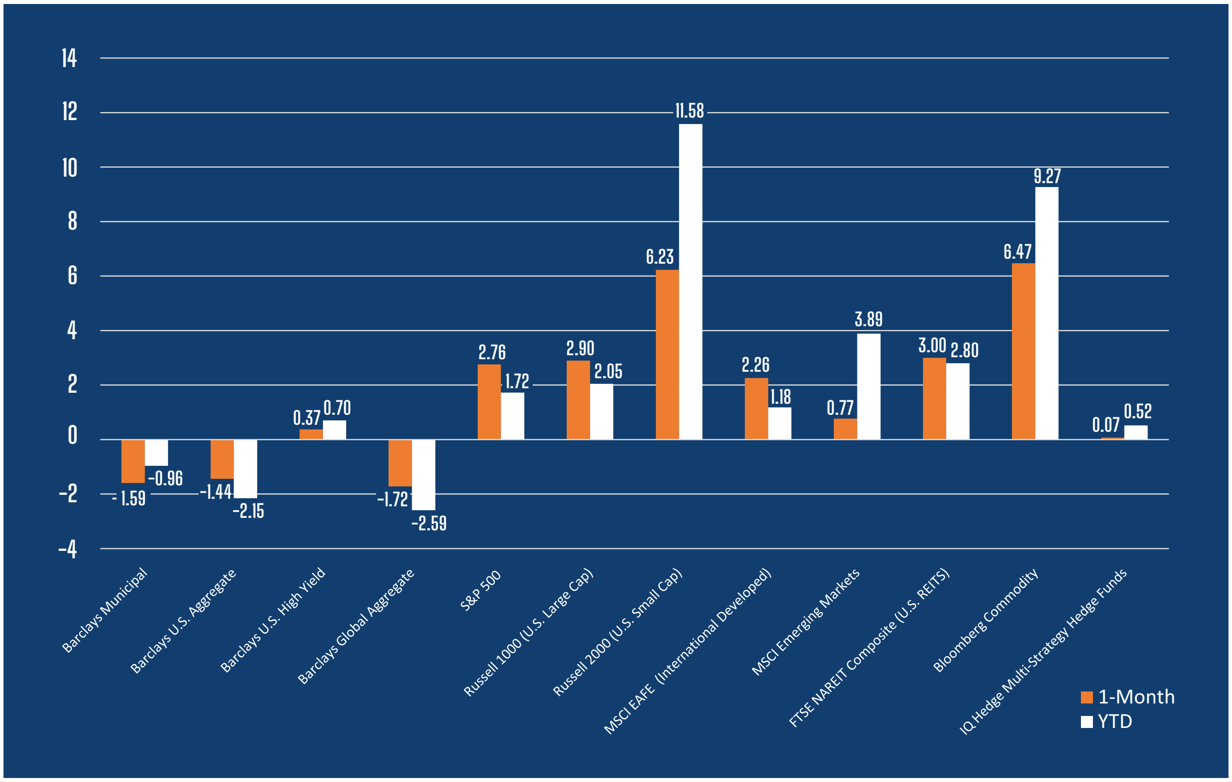
Asset Class Returns

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Intermediate- and long-maturity benchmark Treasuries remained under pressure. Yields increased 30-35 basis points for maturities greater than five years.
- The yield curve continued to steepen with the two-year vs. 10-year spread widening approximately 30 bps for the month.
- Buoyed by stronger equity prices, riskier credit (high yield and bank loans) outperformed benchmark Treasuries.

Equities

- Domestic equities were strong at the beginning of the month, before higher Treasury yields spooked investors, resulting in some selling pressure.
- All sizes and styles were higher except for the Russell 1000 Growth index. Large cap growth and technology stocks have been particularly weak in recent months.
- Value continued to outperform growth, with small cap value the best performing sector.
- Earnings were generally better than expected.

Real Assets

- Oil reached a 12-month high in late February as good news on the vaccine front increased optimism for the global economy.
- Real estate posted positive returns and is now positive for the year to date.

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February 26, 2021	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.01%	0.01%	0.01%	0.29%	1.46%	1.13%	0.59%
Barclays Municipal	-1.59%	-0.96%	-0.96%	1.06%	4.83%	3.43%	4.44%
Barclays U.S. Aggregate	-1.44%	-2.15%	-2.15%	1.38%	5.32%	3.55%	3.58%
Barclays U.S. High Yield	0.37%	0.70%	0.70%	9.38%	6.57%	8.97%	6.50%
S&P/LSTA Leveraged Loan	0.59%	1.78%	1.78%	5.78%	4.23%	5.86%	4.25%
Barclays Global Aggregate	-1.72%	-2.59%	-2.59%	4.33%	3.84%	3.61%	2.48%
JPM GBI EM Global Diversified	-2.68%	-3.72%	-3.72%	3.70%	0.59%	5.54%	1.11%
U.S. Equity Indices							
DJ Industrial Average	3.43%	1.41%	1.41%	24.41%	9.80%	16.08%	12.46%
S&P 500	2.76%	1.72%	1.72%	31.29%	14.14%	16.82%	13.43%
NASDAQ Composite (Price)	0.93%	2.36%	2.36%	53.98%	21.96%	23.68%	16.84%
Russell 1000	2.90%	2.05%	2.05%	34.28%	14.98%	17.37%	13.58%
Russell 1000 Growth	-0.02%	-0.76%	-0.76%	44.26%	20.97%	22.22%	16.45%
Russell 1000 Value	6.04%	5.07%	5.07%	22.22%	8.23%	12.02%	10.40%
Russell Mid Cap	5.57%	5.29%	5.29%	36.11%	13.74%	15.87%	12.34%
Russell 2500	6.52%	9.13%	9.13%	45.90%	15.08%	17.42%	12.27%
Russell 2000	6.23%	11.58%	11.58%	51.00%	14.87%	17.92%	11.86%
Russell 2000 Growth	3.30%	8.28%	8.28%	58.88%	18.95%	21.15%	13.80%
Russell 2000 Value	9.39%	15.15%	15.15%	41.06%	10.14%	14.22%	9.65%
Non-U.S. Equity Indices							
MSCI World	2.60%	1.60%	1.60%	29.98%	11.37%	14.73%	10.02%
MSCI ACWI	2.35%	1.91%	1.91%	30.87%	10.87%	14.84%	9.43%
MSCI ACWI Ex-U.S.	1.99%	2.23%	2.23%	26.73%	5.94%	11.73%	5.25%
MSCI EAFE	2.26%	1.18%	1.18%	22.98%	5.10%	10.26%	5.53%
MSCI EAFE Growth	-0.34%	-1.69%	-1.69%	28.41%	9.39%	12.39%	7.35%
MSCI EAFE Value	4.79%	3.99%	3.99%	16.62%	0.52%	7.86%	3.56%
MSCI Europe	2.46%	0.99%	0.99%	20.91%	4.79%	9.49%	5.29%
MSCI Japan	1.52%	0.51%	0.51%	28.86%	5.58%	11.66%	6.37%
MSCI AC Asia	1.35%	3.62%	3.62%	37.35%	8.14%	14.88%	7.32%
MSCI EAFE Small Cap	2.66%	2.29%	2.29%	31.66%	5.56%	12.15%	8.14%
MSCI ACWI Ex-U.S. Small Cap	3.63%	3.46%	3.46%	34.83%	5.91%	12.23%	6.60%
MSCI Emerging Markets	0.77%	3.89%	3.89%	36.51%	6.74%	15.66%	4.78%
MSCI EM Asia	0.94%	5.34%	5.34%	46.20%	10.43%	18.09%	8.06%
MSCI China	-1.03%	6.25%	6.25%	43.33%	9.55%	20.48%	8.75%
MSCI EM Eastern Europe	1.47%	-0.58%	-0.58%	6.98%	2.18%	13.76%	-0.06%
MSCI EM Latin America	-2.98%	-9.49%	-9.49%	-5.75%	-7.45%	7.35%	-3.86%
MSCI EM Small Cap	5.97%	6.06%	6.06%	42.27%	4.59%	11.73%	3.97%
MSCI Frontier Markets	0.14%	0.52%	0.52%	8.62%	-0.92%	7.48%	4.39%
Hedge Fund Indices							
IQ Hedge Long/Short	-0.55%	-0.67%	-0.67%	17.04%	5.67%	0.07	--
IQ Hedge Multi-Strategy	0.07%	0.59%	0.59%	8.94%	4.05%	4.54%	3.71%
Real Assets Indices							
FTSE NAREIT Composite	3.00%	2.80%	2.80%	2.62%	9.77%	8.16%	8.40%
Alerian MLP	7.77%	14.07%	14.07%	0.26%	-7.37%	-1.04%	-1.65%
Bloomberg Commodity	6.47%	9.27%	9.27%	20.32%	0.32%	3.52%	-5.88%
S&P Global Infrastructure	0.77%	-1.35%	-1.35%	1.12%	4.22%	7.57%	5.68%
Other							
Oil Price Brent Crude	18.34%	27.66%	27.66%	30.90%	0.18%	12.95%	-5.16%
Crypto/Bitcoin	31.90%	48.70%	48.70%	--	--	--	--
CBOE Market Volitility (VIX)	-15.53%	22.86%	22.86%	-30.32%	12.08%	6.34%	4.30%

Source: Morningstar

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