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The big news from last week was the drop in the yield on the 10-year US Treasury. This was not expected given that the Consumer Price Index (CPI) print came in above expectations, giving new fuel to the ongoing conversation about whether inflation will be transitory or more persistent. The questions I got most last week: What is happening? Will it continue? Let's start with the first question.

What drove the yield drop in the 10-year Treasury?

Headline CPI rose 5% year over year for May 2021.¹ Month over month, it rose 0.6% versus consensus expectations of 0.5%.¹ Core CPI, which excludes food and energy prices, rose 0.7% month over month versus consensus expectations of 0.5%.¹ There are a few possible reasons why investors seemed to shrug off these higher-than-expected inflation figures and pushed Treasury yields lower:

- **Rationalization of CPI print.** May 2020 was ugly for the US economy, which was deep into lockdown. And so any comparison between May 2020, the “base month,” and May 2021 is going to show very significant price inflation because the economy has improved substantially. The base effect is a legitimate reason for a higher CPI print for May.

Then there were the components of CPI that showed the highest price increases. Used cars and trucks were a significant portion of the problem, with prices up a whopping 7.3% month over month.¹ Apparel was another category that contributed to the rise in consumer prices, increasing 1.3% month over month; airline fares also rose significantly.¹

Let's look into those figures: I think surging demand for airlines and apparel is definitely transitory. After being cloistered for more than a year, Americans want to start traveling again. However, there are only so many trips they can take, as many people are working or may be starting new jobs in the next few months given the hot job market and high level of openings — and they will not have unlimited vacation days. And they certainly need new clothes to travel with and go to work in, given most people have been wearing just a few sweat pant ensembles for the past year (I am guilty as charged), but once they have replenished their wardrobe, I expect spending on clothing to normalize. As for car prices, I'm assuming the surge in used car purchases is because people are preparing to go back to work but have decided public transportation is not their preferred way to commute. So one could make a compelling argument that the rise in consumer prices is a combination of base effects and short-term price increases. After all, it seems that the surge in demand for lumber has already subsided, with prices down well more than 30% from their peak.²

- **Relief that the CPI print wasn't worse.** Another theory is that markets were bracing for much worse, as whispers suggested the CPI increase would be higher, so a CPI rise of 5% was actually a relief. In other words, we dodged a bigger bullet so we should be happy about the print.

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- **Pandemic resurgence fears.** Another theory is that the bond market was reacting to concern that some countries are having difficulty controlling COVID-19, especially with the more concerning Delta variant spreading rapidly, and that this might dampen economic growth. The Delta variant is considered more dangerous and more serious than the original COVID-19 virus. Approximately 12% of patients with the Delta variant become critically or severely ill within three to four days of exhibiting symptoms, which is far more than the 2% to 3% that come down with severe to critical illness with the original COVID-19 virus.³ Additionally, the Delta variant is reported to be 60% more transmissible than the original COVID-19 virus.⁴ The Delta variant comprises 90% of new cases in the UK and is likely to become the dominant strain in the United States.⁵
 - **Markets finally believe the Federal Reserve.** It seems that in recent weeks, markets have started to believe that the Fed's new inflation targeting policy means it will remain "behind the curve" and tolerate higher inflation, especially since it is predisposed to the view that inflation is transitory. This is illustrated in the difference between market-based measures of inflation expectations and survey-based measures of inflation expectations. It seems investors have grudgingly come to realize that what the Fed believes is more important than what consumers are experiencing — at least for now. And so, even if markets worry that inflation is more persistent, the Fed doesn't seem inclined to think that. And it's the Fed that is calling the shots.
 - **Foreign demand for Treasuries.** Investors outside the US are still attracted to Treasuries, especially given the very low rates in the eurozone. One catalyst last week was the weaker dollar, which spurred an increase in foreign buying of US government bonds.

Will this market behavior continue?

The bond market has historically been viewed as more rational than the stock market, and yet that is being called into question again because of its behavior last week. However, I suspect the bond market is being relatively rational, and that the yield drop in the 10-year Treasury last week reflects a combination of the reasons I listed above. Keep in mind that yields moved up substantially earlier in the year in anticipation of rising inflation, so consolidation was likely.

But that could all change this week if the Fed is not sufficiently dovish. The Fed begins a two-day policy meeting June 15, and it could easily move longer yields higher. A revised dot plot could be one way to do that if it shows the anticipation of earlier or more aggressive rate hikes. And Fed Chair Jay Powell could easily push rates up if he shares that the Fed has started discussing tapering or suggests tapering could start in the next several months. Don't get me wrong — I expect discussions about tapering to begin at this meeting, and that tapering will likely be announced at Jackson Hole in later

summer, planned to begin in the fall. But markets may not be ready to hear that yet. Regardless of what happens this week, I do expect yields to go up in the back half of this year and finish well higher than where they are today.

Source

¹Source: US Bureau of Labor Statistics, June 10, 2021

²Source: Bloomberg, L.P.

³Source: The New York Times, "In China's latest outbreak, doctors say the infected get sicker, faster," June 12, 2021

⁴Source: Media reports quoting UK epidemiologist Neil Ferguson

⁵Source: Media reports quoting former FDA Commissioner Dr. Scott Gottlieb

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions. All investing involves risk, including the risk of loss.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

The opinions referenced above are those of the author as of June 14, 2021. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.