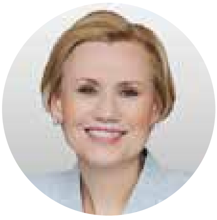
Rising US Treasury yields do some of the Fed’s heavy lifting

Weekly Market Compass | October 23, 2023



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I love it when I can figure out a way to work more efficiently or, even better, get someone to do my work for me. The less I have to do, the better. I think the US Federal Reserve (Fed) agrees. After all, when it comes to tightening financial conditions and therefore slowing the economy, the Fed is getting the 10-year US Treasury yield to do its work for it. In just the past few days, we have seen the 10-year US Treasury yield move from 4.59% on Oct. 13 to 5% on Oct. 23.[1]

When someone is happy to do your work for you, I think that’s a good thing. I’ve mentioned before how my oldest son used to prefer cleaning with his grandmother to playing with toys when he was a toddler. My husband was uncomfortable with this, but I immediately recognized the benefits. What’s the harm in having him clean the sliding glass door (at least the lower part of it that he could reach) and straightening up the playroom?

It seems the Fed has found a “helper” of sorts as well in the rising 10-year yield (and one that’s a bit more effective than a three-year-old armed with Windex and paper towels). Different Fed members have said as much in recent days, and even Fed Chair Jay Powell admitted last week that “financial conditions have tightened significantly in recent months, and longer-term bond yields have been an important driving factor in this tightening.”[2]

Why have yields risen?

The release of the September “dot plot” started the recent rally in the 10-year US Treasury yield. There’s also an imbalance in supply and demand for Treasury bonds.

Impact on mortgage rates

Most US mortgages are long-term fixed rate mortgages at relatively low rates, so I don’t expect rising rates to impact consumers the way they did in the Global Financial Crisis.

Demand for “safe havens”

The conflict in the Middle East is a countervailing force that has driven down yields at least somewhat on certain days, as investors seek “safe haven” asset classes, though there is a clear preference for gold.

Why are long-term bond yields going up?

There are a variety of reasons for this increase. The 10-year US Treasury yield is composed of two drivers: 1) it’s influenced by short-term rates (which is fairly straightforward) and 2) it factors in a “term premium” that investors demand for holding onto a bond for that long. That term premium reflects everything else that could occur over the life of the bond, including growth expectations and inflation expectations. Recently, inflation expectations have remained relatively stable, and so we need to look to other factors to explain the rise in long yields:

- **Fed expectations.** First and foremost, markets believe the Fed will keep rates higher for longer. The catalyst that began the most recent rally to nose-bleed level yields (relatively speaking) was the release of the September “dot plot,” which implied that we could see 50 basis points in rate cuts for 2024 (a significant change from the 100 basis points of cuts implied in the June dot plot).[3] That kicked off greater sensitivity to positive economic data. Positive surprises, such as the US retail sales data released last week, have helped to push the 10-year US Treasury yield higher.
- **Supply and demand.** But there’s more to the story than just that. As with any asset, supply and demand determine price, and there has been a growing imbalance. On the supply side, more Treasury bonds were issued following the lifting of the debt ceiling early last summer. On the demand side, there is some reduced demand from foreign investors as a result of fraying relationships with the US. There are also serious concerns about the US’ growing debt level and greater

reliance on deficit spending. (Several decades ago, when I was in middle school, veteran strategist Ed Yardeni coined the term "bond vigilantes" to describe those who would eschew purchasing US bonds as punishment for profligate spending.) That can be an important part of the rather nebulous term premium calculation as well.

Demand for "safe haven" assets also impacts Treasury yields

Of course, there is a countervailing force that can push down yields, and has done so on at least a few days since the conflict in the Middle East began: a preference for "safe haven" asset classes. There have been concerns that this crisis could be contagious and expand to involve other countries, which has fueled a move to Treasuries on several days since the conflict began. Although there has been far more of a preference for gold as a safe haven asset class, preferences can change —especially since the opportunity cost of owning gold is higher as yields rise.[4]

Is a high 10-year yield good or bad?

The rising 10-year yield is arguably a positive development in that it means the Fed doesn't have to hike rates anymore and therefore hastens the end of the tightening cycle, in my opinion. In other words, it's ripping the band-aid off. However, it's also exerting downward pressure on stocks. And when I talk to clients outside the US, they worry about the impact that higher mortgage rates, driven up by the 10-year US Treasury yield, will have on American consumers.

But while the national average 30-year US fixed mortgage rate just hit 8%,[5] a level that has not been seen in many years, I don't think it will have a very significant impact on US households. That's because more than 90% of existing mortgages in the US are long-term fixed rate mortgages — with an average rate below 4% — so rising rates will not impact US households the way they have impacted households in other countries that do not have the exorbitant privilege of long-term fixed rate mortgages.[6] Or the way they impacted US households in advance of the Global Financial Crisis, when nearly 40% of existing mortgages were adjustable rate.[6] In fact, past due residential real estate loans have declined since mid-2020.

The biggest result of high mortgage rates may be a low inventory of houses for sale, since many homeowners are unwilling to put their houses on the market with rates so high. The environment has created "golden handcuffs" for them.

Where do we go from here? That depends on the Fed.

Policy uncertainty is likely to create an environment in which the 10-year yield will continue to move in a wide range in the near term. But I believe once we get clarity from the Fed that the rate hike cycle has ended, then I think we will see yields begin to ease. (In other words, I think sky-high long-term yields are likely to be very temporary.)

I think we are likely to get policy clarity in the next few months. After all, I thought it was meaningful that Fed Chair Jay Powell admitted last week that "indicators of wage growth show a gradual decline toward levels that would be consistent with 2 percent inflation over time."[7] Wage growth is typically the stickiest part of inflation, so that suggests the Fed is content with progress made in the labor market – all the more reason they shouldn't need to hike rates again.

And while the Fed may continue to talk tough in the short term (and we got a lot of tough talk in Powell's speech last week), I think it will be quick to recognize signs of the lagged effects of monetary policy on the economy, as I believe a very real slowdown (a bumpy landing) is coming. The very data-dependent Fed should soon realize there is no need for more rate hikes – and that there will likely be a need for at least one rate cut before the end of the first half of 2024. I believe higher oil prices will also weigh down on the US consumer and do some of the Fed's work for it.

What does this mean for stocks?

US stocks are likely to come under pressure in the near term as the 10-year yield remains high and perhaps moves slightly higher. Last week, the S&P 500 Index fell more than 2%, down to 4,224 — which marks its lowest level since June 1.[8] But I have to put this all in perspective: it is well below its peak of 4796 on Jan. 3, 2022, but is well above its closing low of 3,577 on Oct. 12, 2022.[8] I think it is telling us that the recession that was priced in last year with an approximately 25% drop in the S&P 500[8] is being replaced with a slowdown, being forecasted by a milder drop in the S&P 500 this year.

At the expense of sounding like a broken record, I see this as an environment that reminds us of the importance of broad diversification across and within not just equities and fixed income, but alternatives.

Dates to watch

After a flurry of data releases last week, I'm primarily waiting to see what the Federal Open Market Committee decides to do in its meeting on Nov. 1. You can join me on X, formerly known as Twitter, as I share my real time views of the Fed's decision and key takeaways from Powell's press conference as it happens.

But there are some important data points and events between now and then:

Date	Report	What it tells us
Oct. 24	Japan Purchasing Managers' Index (preliminary)	Indicates the economic health of the manufacturing and services sectors.
Oct. 24	Eurozone Purchasing Managers' Index (preliminary)	Indicates the economic health of the manufacturing and services sectors.
Oct. 24	UK Purchasing Managers' Index (preliminary)	Indicates the economic health of the manufacturing and services sectors.
Oct. 24	US Purchasing Managers' Index (preliminary)	Indicates the economic health of the manufacturing and services sectors.
Oct. 25	Bank of Canada decision	Reveals the latest decision on the path of interest rates.
Oct. 26	European Central Bank decision	Reveals the latest decision on the path of interest rates.
Oct. 26	US durable goods orders	Is seen as an indicator of economic strength.
Oct. 26	US gross domestic product	Measures a region's economic activity.
Oct. 27	US Personal Consumption Expenditures Index	Tracks the path of inflation.
Oct. 27	Michigan Inflation Expectations	Tracks consumer sentiment regarding inflation.

Date	Report	What it tells us
Nov. 01	Federal Open Market Committee meeting	Reveals the latest decision by the US Federal Reserve on the path of interest rates.

Notes

[1]Source: Bloomberg, as of Oct. 23, 2023

[2]Source: US Federal Reserve, transcript of Jay Powell speech, Oct. 19, 2023

[3]Source: Federal Reserve Board of Governors Summary of Economic Projections, Sept. 20, 2023, and Summary of Economic Projections, June 14, 2023

[4]Source: JP Morgan, Refinitiv Datastream, and Invesco Global Market Strategy Office, as of Oct. 20, 2023

[5]Source: Bankrate, as of Oct. 23, 2023

[6]Source: Invesco, Macrobond, and Federal Home Loan Mortgage Corporation (Freddie Mac), as of Sept. 31, 2023

[7]Source: US Federal Reserve, transcript of Jay Powell speech, Oct. 19, 2023

[8]Source: Bloomberg, as of Oct. 20, 2023

Important information

Past performance is not a guarantee of future results.

An investment cannot be made into an index.

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.

Diversification does not guarantee a profit or eliminate the risk of loss.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

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

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

A basis point is one hundredth of a percentage point.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

Inflation is the rate at which the general price level for goods and services is increasing.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

GDP (Gross domestic product) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

Tightening monetary policy includes actions by a central bank to curb inflation.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The opinions referenced above are those of the author as of October 23, 2023. 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.t