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Treasury's Wild Ride

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The bond market has been on a wild ride. In days past we would say to "listen to what the bond market is telling us", as fixed income traders tend to think with a longer term, more even keeled perspective than stock traders. Stocks were the asset class with the big moves, leaving many investors suffering from oscillations between fear and FOMO. That has not been the case during the past couple years, as you can see from the chart below depicting the violent swings for the 10-year Treasury yield.

Chart 1

As you can see, in late 2023 Treasury yields came down dramatically (yellow box), resulting in an 8% surge in the

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Bloomberg Aggregate Index. The move seemed shocking, since the narrative at the time was that inflation was tamed and yields would come tumbling down with Fed rate cuts. Fast forward, the bond euphoria unwound earlier this year with renewed inflation concerns during the summer and through the third quarter. From May to September, 10-year Treasury yields dropped over 100bp (1%) and the index surged 7%. Bond managers, starved for return, chased these assets higher and higher.

Perhaps this is a Pavlovian response after a decade of near zero interest rate policy. But those days are in the past, as going forward growth and inflation expectations are notably higher. Short-term rates should come down if inflation is contained, but longer-term yields are probably in a good spot in the 4% – 4.5% range. Our model for the 10-year Treasury yield target is expected inflation plus expected GDP growth. If we have 2% growth and 2% inflation, then that gets us to 4%, and the bias is to the upside for those estimates, marking 4.5% as the upper band for now.

The problem could come if we see yields continue higher from here. Higher yields could be in response to higher growth expectations (good), higher inflation expectations (bad), or both. From a technical perspective, keep an eye on that green trendline. Much like the white trendline from 2022-2023, a violation to the upside (of about 4.5% as of the time of writing) could bring a bigger move than anticipated. As we have seen over the past several years, the bond market tends to overshoot on moves in both directions.

If we see yields approach the 5% level, then we would expect recession concerns again. Higher borrowing costs could pressure borrowers in the public and private markets and would be very bad for the already struggling commercial real estate sector. The upside risk for yields is something to be monitored closely.

Our tactical bond strategies use systematic risk management programs, allowing us to confidently invest in the credit markets. Higher yields may or may not be a bad thing, depending on the reason, and may or may not even happen. We have been saying for years that the most likely scenario is a soft landing for the economy, but guessing at the future is not our program. Systematically measuring and reacting to what the market is telling us allows us to maximize yield during the good times and seek safe harbors during the bouts of turbulence. For now, it is still time to maximize yield.

IMPORTANT DISCLOSURES:

Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet.

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