Rate Repricing: More To Come?

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INTEREST RATES HAVE BEEN RISING SINCE AUGUST 2020, WITH THE YIELD ON THE 10-YEAR US TREASURY BOND HAVING DRIFTED 100 BASIS POINTS (BPS)[1] HIGHER OVER THE PAST SIX MONTHS OR SO. But recent rate action has really caught the market's attention, particularly the 10-year's swift 30-basis point yield increase and the spillover into global equity markets.

Is this latest bout of "rate repricing" due to higher inflation expectations? Stronger economic growth? Treasury supply concerns? Investors "fighting the Federal Reserve (Fed)"? Or is it those pesky convexity[2] hedgers? Let's take a stab at making sense of it all.

Yields have risen for the right reasons – Rates have been adjusting to prospects for better growth and higher inflation for months now, reflecting an improving pandemic outlook and ample policy support. Rising inflation expectations are baked into wider spreads[3] between Treasury yields and real (inflation-adjusted) yields, using 10-year Treasury Inflation-Protected Securities (TIPs)[4] as a proxy. Orderly rate moves have historically been absorbed by risk markets, with equities climbing higher and credit spreads narrowing.

The recent rise in rates was different – With the latest spike in yields, real yields are rising not on expectations of increasing inflation but rather on the expectation that the Fed could hike its policy rate sooner than previously thought. **FIGURE 1** shows an unusual inversion of the "breakeven" inflation curve, reflecting higher near-term inflation expectations relative to longer-term expectations that formed in February 2021. This is a concern because higher real yields could snuff out the economic recovery, whereas higher inflation expectations *lower* real yields.

The Fed's playbook hasn't changed – Even though the market has been "fighting the Fed" (i.e., challenging it to meet growing expectations of a sooner-than-anticipated rate hike), Chairman Jerome Powell and other Fed officials reiterated that: 1) rate hikes will not be considered until there has been "substantial further improvement" in the economy; and 2) structural issues such as automation, globalization, and demographics have likely suppressed long-term inflation.

Key Concepts

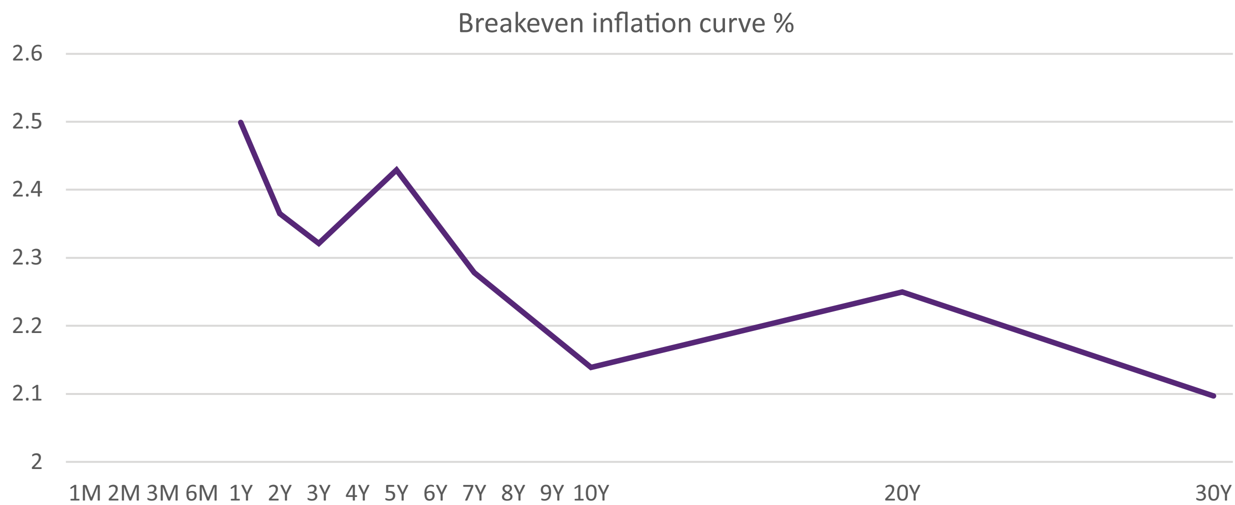
- Despite the recent rate volatility, rates have been adjusting to prospects for better growth and higher inflation for months now, reflecting an improving pandemic outlook and ample policy support.
- Even though the market has been "fighting the Fed," Chairman Powell and other Fed officials reiterated their unchanged policy position.
- There is potential for markets to remain on "inflation watch," which may induce greater rate volatility and higher 10-year yields.

Brace for more "Fed fights" – There could be further yield increases going forward. With economies reopening, higher commodity prices, depressed inventories, supply-chain disruptions, and pockets of skilled-labor shortages, inflation scares could periodically roil the markets. Given that so many risk assets[5] have fed off of the prevailing low-rate/high-liquidity regime, I think there are bound to be some drawdowns that cannot withstand higher rates.

10-year yields could go higher – I believe markets could continue to remain on "inflation watch," which may induce greater rate volatility and higher 10-year yields. If real GDP is 3% and inflation is 2%, and the Fed's asset purchases are worth -100 to -200 bps, a 10-year yield of 2% to 3% is imaginable over the next six to 12 months. However, I think the Fed knows this and views it as a healthy mechanism for resetting growth and inflation expectations to more normal levels, while also wringing out some of the excess in asset prices. The Fed will probably continue to telegraph its rate-hike plans and could even extend its asset-purchase programs to help manage long-end rates lower.

FIGURE 1

Near-Term Inflation Expectations Have Moved Higher



Source: US Treasury, as of 2/25/21.

Investment Implications

For total return, favor short duration.[6] For total-return-seeking bond investors, I suggest limiting duration exposure, as 10-year yields could rise further still in the months ahead.

Higher rates could impact equities. With US large-cap growth looking more vulnerable to rising rates, I continue to favor value-oriented, non-US equities; cyclical sectors (e.g., financials, industrials); and smaller caps.

"Bad" inflation headlines could spook markets again. The market could continue to react to recurring inflation headlines by pushing yields higher, which could be temporarily disruptive to risk assets.

Higher yields may come with an improving economy. Higher yields can bring about a healthy asset-repricing process. While the path may be bumpy at times, I believe today's environment could remain conducive to owning risk assets.

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[1] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[2] Convexity is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[4] Treasury Inflation-Protected Securities (TIPS) are Treasury bonds whose prices are adjusted to eliminate the effects of inflation on interest and principal payments, as measured by the Consumer Price Index (CPI).

[5] Risk assets (such as equities, commodities, high-yield bonds, real estate, and currencies) have a significant degree of price volatility.

[6] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

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