RBA Richard Bernstein Advisors

RBA Fixed Income Insights

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From cornering the market to backed in a corner

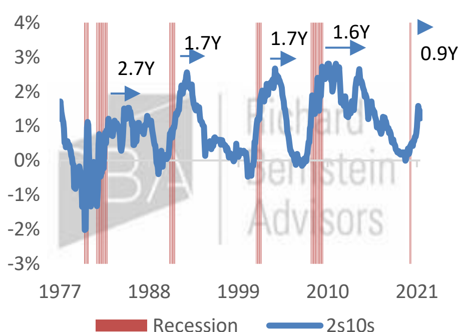
The Federal Reserve entered 2021 with an explicit message to investors: By keeping rates low and monetary policy loose, they would encourage a hot economy and would not fear inflation. With this mandate, the rates market priced an epic steepening of the 2s10s yield curve (10-year interest rates going up more than 2-year rates), going from 0.80% to 1.60% in a matter of 3 months — a 2 standard deviation event on par with the "taper tantrum," the Great Financial Crisis, and 9/11. But since the peak of the reflation exuberance, we have seen something entirely different: a skittish Treasury market reflecting fears of secular stagnation at best, recession at worst. With 10-year yields now down to 1.16% and the 2s10s yield curve at 1.0%, we are left asking, has a new Treasury bull market begun?

Our analysis suggests that this is one of the rare times where the rates market is pricing in a situation that is unlikely to occur. If current bond pricing is correct, this would be the shortest post-recession steepening cycle by 9 months (Chart 1); something that we see as improbable given strong corporate profits, corporate deleveraging, falling default rates, significant fiscal and monetary stimulus, and technical pressures.

There are 4 main drivers of Treasury yields: economic growth (we measure using the Leading Economic Indicators*, LEI), inflation (we measure based on the Consumer Price Index, CPI), the size of the Fed's Balance Sheet and the Fed Funds rate. All but the Fed Funds rate point to higher rates. For example, the rate of change of the CPI is the highest in decades, LEIs continue to remain strong as the economy re-opens, and just last week Chair Powell reiterated the committee's intention to reduce its purchases of Treasuries in coming quarters, which alone should cause yields to rise. Further, the Fed's cornering of 10-20-year government bonds (Chart 2) and the subsequent reduction in free float has likely exacerbated yield moves both to the upside and downside; and the unwind of such market manipulation should result in not only higher rates but more volatility.

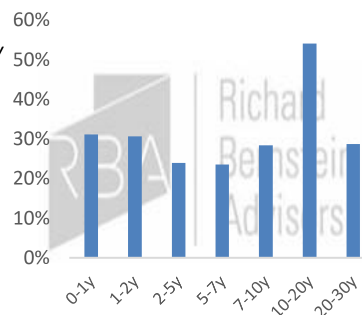
On the other hand, the Fed couldn't be more explicit about their desire to keep the Fed Funds rate low to generate strong inflation and growth: Members forecast just 2 hikes over the next 2 years (Chart 3). Such a slow path of normalization shouldn't slow the economy, and in fact, when coupled with reducing asset purchases, should steepen the yield curve. For these technical and fundamental reasons, we believe investors should remain in low duration assets and be wary of a market trading on a narrative rather than on fundamentals.

Chart1: 2s10S Curve steepening is not finished



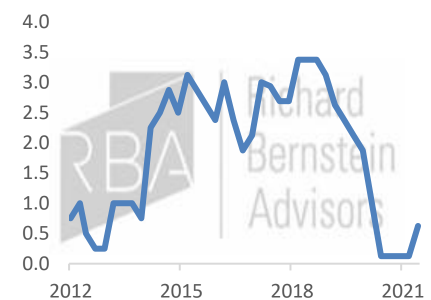
Source: Bloomberg

Chart 2: The Fed has cornered the Treasury market



Source: NY Federal Reserve Bank

Chart 3: The Fed's rate hike expectations are neither imminent nor aggressive



Source: Bloomberg, Federal Reserve

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* The Conference Board's Leading Economic Indicators include 10 economic components including Average Weekly Hours, Building Permits, Consumer Expectations, Initial Jobless Claims, among others. For a full definition see https://conference-board.org/data/bcicountry.cfm?cid=1

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