Rapid Rise in Rates

Sharp Moves in the Bond Markets

March 2021

Key Observations

- The yield on a 10-Year treasury bond has spiked ~60 basis points (or 65%) in 2021, year-to-date.
- This rapid increase in rates is signaling economic growth, a faster than expected reopening of the economy and continued fiscal and monetary support.
- The Federal Reserve (represented by J. Powell) suggested their policy stance would remain as-is and that they may allow inflation to run higher than normal prior to hiking interest rates.

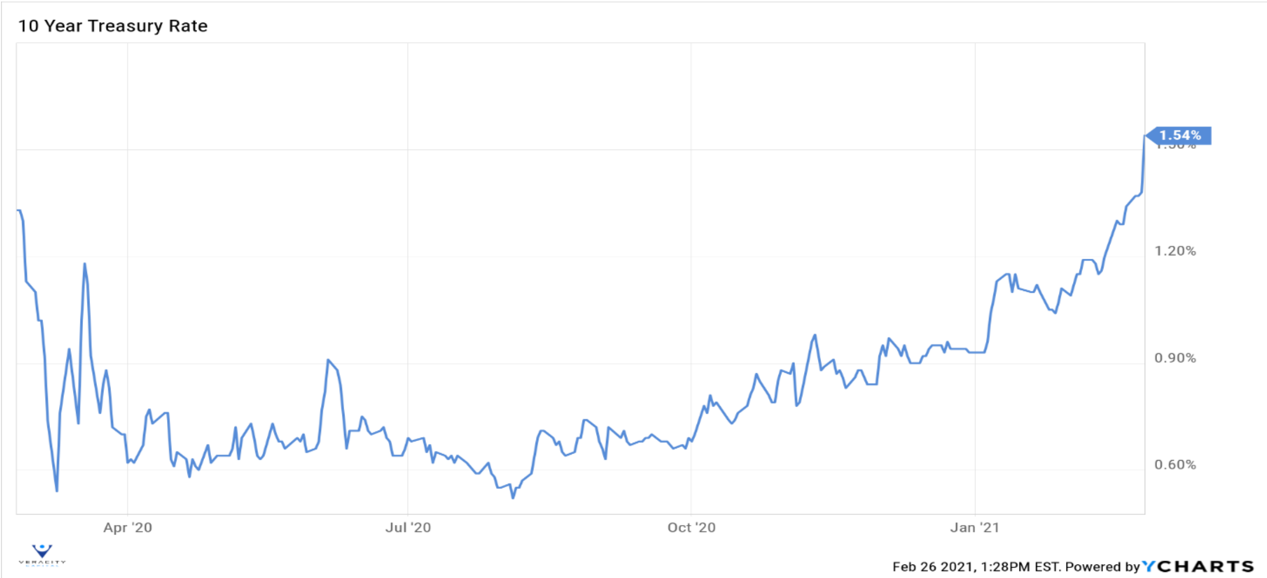
Market Commentary – Increasing Interest Rates:

Interest rates can be used as a gauge for economic growth so what may create short-term volatility, as we have seen in the last week of February, will possibly be a positive longer-term signal. While we believe the macro backdrop of accommodating fiscal and monetary policy, coupled with an improving US economy warrants higher interest rates, we think there were "technical" market factors that led to the sharp move.

We received commentary from traders in the fixed income markets that suggested there was limited economic data released on February 25th (when rates jumped), therefore much of the selling and the rise in rates, was due to technical factors. Selling begets selling and as pressure began moving interest rates higher, more selling occurred in an attempt for larger institutional traders to hedge and trim risk.

Point being, there is a macro backdrop that could support higher rates, but the speed of the recent move was driven by technicals, not simply an improving economy. To put the rate changes into context, please review the below charts and articles.

Here is a look at how the 10-year treasury yield has changed over the past 12-months.



Here is a longer-term look at the 10-Year Treasury, over the past 30 years. (Recessions in gray)

Why stock investors are starting to really worry about rising bond yields

By: Bob Pisani
February 25, 2021
[Link to Article]

Fear of inflation is causing investors to speculate the Federal Reserve may have to shift policy sooner than expected, by either reducing bond purchases or even raising rates at some point.

Hans Mikkelsen, credit strategist at Bank of America…on economic growth…..thinks it will be much stronger than anticipated and that will push inflation up: “Since the summer of 2020 economists have consistently underestimated economic growth to an extent never seen before. There appears a real risk the Fed is not going to be able to sound dovish much longer and that transition could see wider credit spreads.”

Because stock prices are so high there is no room for error. Small shifts in yields could cause tech investors in particular to take profits, under the assumption that this is as good as it gets.

Veteran stock commentator Michael Farr from Farr, Miller & Washington has already told clients that even this relatively modest rise in rates is a signal: “The days of simply piling into the market leaders regardless of valuation may be drawing to a close. Investors must now recognize that there are alternative opportunities out there, including both heretofore underperforming stocks as well as incrementally more attractive bonds. A powerful economic rebound combined with rising interest rates and higher inflation, if that indeed transpires, will change the investment backdrop in a meaningful way.”

What the Bond Market Is Telling Us About the Biden Economy

By: Neil Irwin
Feb. 23, 2021
[Link to Article]

What is happening is known as a "steepening of the yield curve," with long-term rates rising as short-term rates hold still. It tends to presage faster economic growth; it is the opposite of a "yield curve inversion," which is known as a harbinger of recessions.

But the flip side is that the moment appears to have passed when bond markets were giving the government an all-clear signal to do whatever was necessary to boost the economy, essentially making endless funding available at extraordinarily low cost. That could have implications for how the Biden administration approaches the rest of its economic agenda.

Put it all together, and the surge in rates so far is basically an optimistic sign that the post-pandemic economy will mark the end of a long period of sluggish growth. But the speed of the adjustment is a reminder that the line between too hot and just right is a narrow one.

Bond Selloff Prompts Stock Investors to Confront Rising Rates

By: Sam Goldfarb
Updated Feb. 21, 2021
[Link to Article]

The lift in yields largely reflects investor expectations of a strong economic recovery. However, the collateral damage could include higher borrowing costs for businesses, more options for investors who had seen few alternatives to stocks and less favorable valuation models for some hot technology shares, investors and analysts said.

"The market has principally been saying hooray, the pandemic is coming under control and the economy is starting to grow again. But now we're actually starting to see the consequences of that in the form of higher rates, and I think the market's processing that," said Brad McMillan, chief investment officer at Commonwealth Financial Network.

Rising yields, which result from falling bond prices, often reflect investor expectations of faster growth and an accompanying rise in inflation, which makes the interest payments of bonds less valuable. A pickup in inflation could also eventually lead the Federal Reserve to raise short-term interest rates, though most investors don't expect that to happen in the near term. More government borrowing could boost yields as well just by increasing the supply of bonds.

The impact on stocks depends a lot on how high and how quickly yields can rise, analysts said. A range of analysts forecast that the 10-year Treasury yield will reach anywhere from 1.5% to 2% by the end of the year, as investors start preparing for future rate increases from the Fed.

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