Perhaps the single most important driver of global asset prices over the near term is the direction of the nominal U.S. 10-year yield – a harbinger of prevailing discount rates and financial conditions. Meanwhile, there is mounting uncertainty surrounding the benchmark interest rate. Based on current economists' forecasts, the expected range at year end 2021 is anywhere from 1.0% - 2.0%. A 100 basis point discrepancy over a 4-month period.

The primary macro factors reflected in the 10-year Treasury are inflation and GDP growth. A higher, long-term inflationary environment translates to investor demands for higher nominal yields in order to compensate for inflation expectations and associated risk premiums. A strong economic backdrop generally coincides with a higher yield curve as the Fed moves to curtail excessive borrowing and risk appetites swell. Of course, the story gets more complex as we dive into the dynamics impacting the current 5.4% CPI and 6.5% GDP prints.

There is a prescriptive manual for managing higher sustained inflation and economic growth. Theory would suggest the current environment warrants a materially higher interest rate policy than what is observed today. For example, the Taylor Rule implies a Fed funds rate of nearly 6%, while the U.S. central bank remains at the zero lower bound and has yet to announce its taper plan. We acknowledge that adhering to one "rule" amid such a distinct time is likely too simplistic precisely because of what is driving GDP and consumer prices. The prescriptive manual has been tucked away on a shelf for a later day.

Mapping the Debate

Inflation

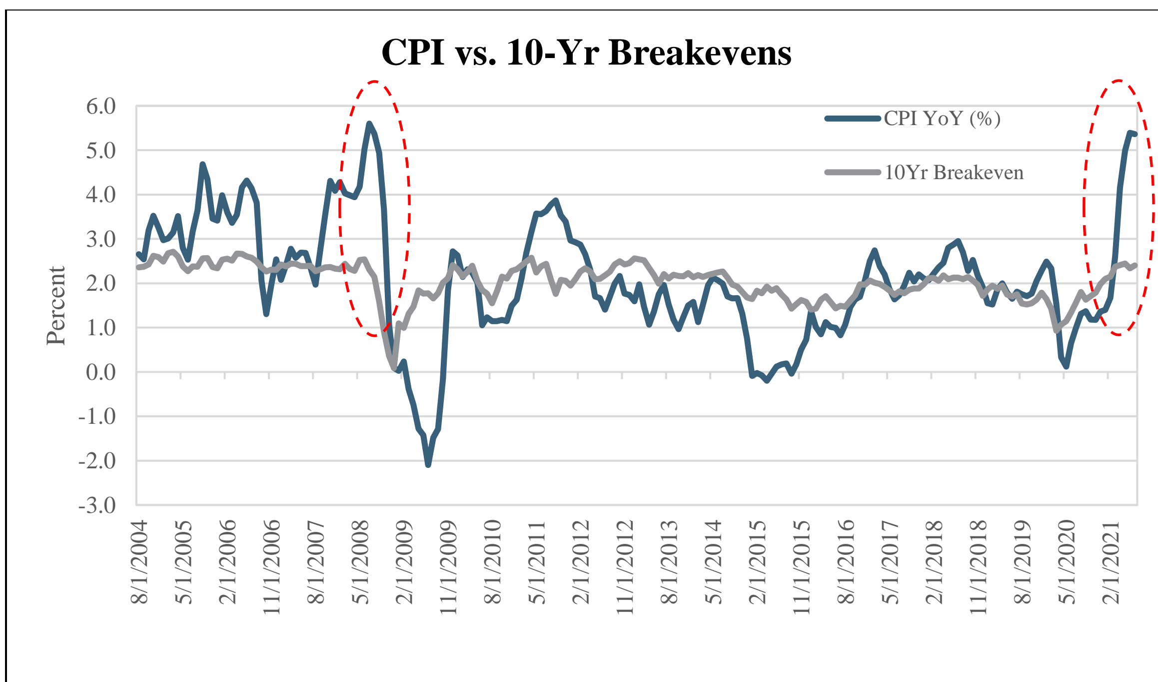
Is inflation a demand story (long-term concern) fueled by increasing wages or a supply story (short-term dislocation) caused by backlogs and sudden reopening? Average hourly earnings are growing at 4.2% annualized growth over the past 6 months while companies continue to announce higher pay to attract workers. It is also well-known that supply chains are tight, with everything from semiconductor chips to shampoo ingredients difficult to source. Are wage pressures resulting from enhanced unemployment benefits? Virus fears? When will supply chains ease given recent data showing inventories remain low and shipping costs high?

Economic Growth

Can the growth in 2021 be attributed to massive fiscal and monetary stimulus measures or is the consumer in better fundamental shape? Will higher wages and fiscal support from the government continue to support buying power or will record spiking prices curb consumer demand? Can the current rate of consumer spending, the main driver of Q2 GDP, pass the baton to fixed investment for enduring future growth?

Market Positioning and Response

Grasping the underlying dynamics of the inputs to expected inflation and future growth, which in turn affect Treasury yields, have never been more difficult as government policies and the pandemic cast a shadow on market forces. Market participants are at odds regarding the above questions as represented in current rate dynamics. The first Fed Funds rate hike is priced in by the end of 2022 indicating the central bank will need to move moderately faster than it has communicated. This should temper long-term inflation expectations out the curve and lend credence to lower nominal 10-year yields. Currently, that is playing out as inflation expectations remain muted: the chart below depicts how CPI has diverged the most from long-term market expectations of inflation to the highest extent since the financial crisis. Investors have piled into TIPS funds at record pace recently, yet the 10-year nominal yield has remained subdued throughout August.



The outlook for rates in the near term is blurry at best. The answers to the questions we have presented will only be revealed with more economic data as monetary policymakers so frustratingly remind us. We believe there is ample room for a policy misstep, investor overreaction, or both as economic fundamentals come to light. The Bloomberg Barclay's Aggregate Bond Index has a duration of 6.7 years, the highest in over three decades, and equity markets remain at all-time highs. If inflation proves a more lasting fixture, expect yields to move up aggressively and long duration assets (whether bonds or low cash flow stocks) to sell off.

In a more typical economic construct, where the forces of market supply and demand are known to be at work, forecasting leans a bit (a bit) more toward science than art. We aren't in a typical economic construct. We are in a world where the Fed owns 25% of U.S. government debt (still growing) and there are more job openings than unemployed individuals, yet recent data releases have surprised decidedly to the downside; according to the Citi Economic Surprise Index. The ambiguity about the 6-12 month outlook in rates resides to a greater extent in the short vs. long-lasting nature of the factors behind the macro factors of inflation and GDP growth. The going rate on the 10-year Treasury is anybody's guess.

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Disclosures:

Indexes are unmanaged and one cannot invest directly in an index.

Investing involves risk, including the possible loss of principal.

Diversification may not protect against market loss.