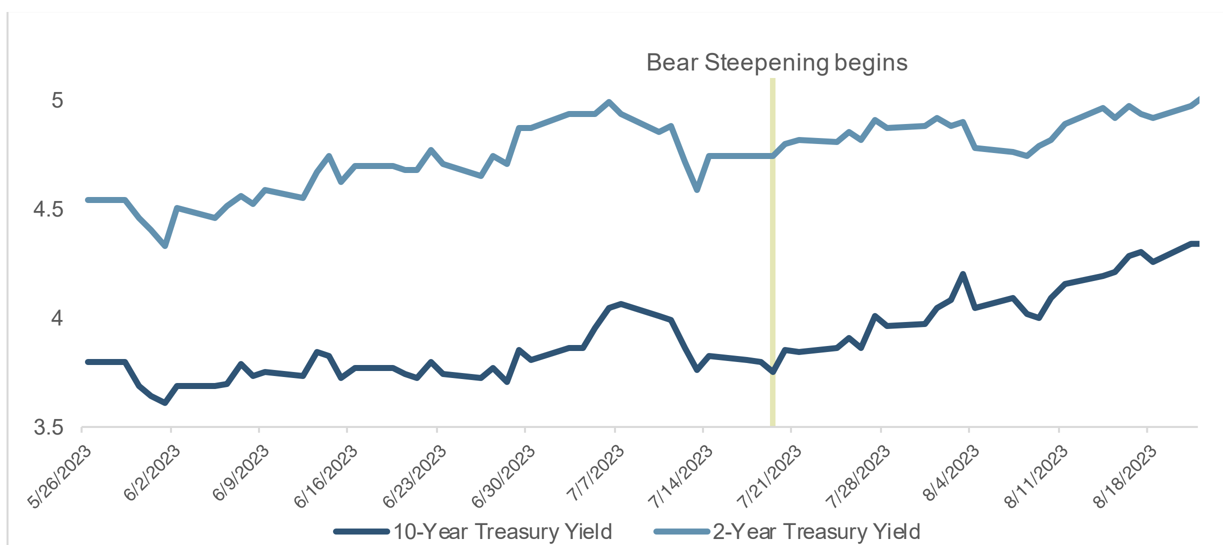
# MARKET UPDATE

August 29, 2023

## BEAR STEEPENING IN THE U.S.

Yields on 10-year U.S. Treasuries spiked in August, rising as much as 40 basis points from where they began the month. The result has been a rare bear steepening, where long-term yields rise faster than short-term yields. Historically, bond markets have found themselves in the midst of a bear steepening only 10% of the time and rarely this far into a tightening cycle. The increase in yields has been primarily driven by expectations for higher economic growth and tighter monetary policy. Additionally, several technical factors such as supply/demand imbalances in the Treasury market, spillover effects from recent tweaks in Japan's yield curve control program, and Fitch's recent downgrade of the U.S. credit rating could be contributing to the increase in yields. Given the critical and numerous roles the 10-year Treasury plays throughout markets, deciphering the future path for yields will have wide-reaching investment implications.




Long-term nominal bond yields can be decomposed into four key components: real yields, inflation breakeven rates, real risk premium, and inflation risk premium. Changes in these components are primarily driven by changes in the prevailing macroeconomic environment. The real yield, also known as the real interest rate, reflects the compensation you receive for lending money adjusted for expected inflation. Real yields are essentially a proxy for future economic growth so as growth expectations increase, so do real yields. Next, inflation breakevens give investors an idea of the market's anticipation of future inflation rates. This is calculated by comparing the yields of Treasury Inflation-Protected Securities (TIPS) and nominal Treasury bonds of the same maturity. Higher inflation breakevens suggest that investors expect inflation to increase, influencing the overall yield.

Moving on, the real risk premium compensates investors for the risks associated with holding onto an investment as time goes on. It captures factors like economic uncertainties and market volatility. During uncertain times, market participants will demand a higher real risk premium, which in turn affects the nominal yield. Lastly, the inflation risk premium accounts for the uncertainty linked to future inflation rates. If investors predict higher inflation than initially thought, they'll want a higher premium to counter the potential decrease in purchasing power. As a result, an increase in the inflation risk premium contributes to higher nominal yields.

With that in mind, we can more clearly observe what is putting upward pressure on yields. Incoming economic data continues to defy weaker leading indicators, pushing real yields higher. Payrolls expanded another 187,000 in July and the unemployment rate ticked down to 3.5%. Retail sales continue to come in stronger than expected as consumers show no signs of pulling back on spending. Finally, housing starts surged in July as a shortage of previously owned homes persists. As a result, the most recent estimate for 3rd quarter GDP from the Atlanta Fed is 5.9%. Additionally, the Fed continues to signal that rate cuts won't materialize until 2024 as inflation continues to decline. Accordingly, yields moved higher as market participants have pushed out their expectations for rate cuts in response to the growing likelihood that the Fed will keep rates higher for longer.

At the same time, some technical factors have likely played a role in moving yields higher over recent weeks. The U.S. Treasury lifted its estimate for federal borrowing in 3Q23 and 4Q23 to $1 trillion and $852 billion, respectively. Additionally, they had to issue more debt in the wake of the debt ceiling standoff to refill the Treasury General Account (TGA). This additional supply comes at a time when the Fed is shrinking its holdings of Treasuries, so the combined effect will be a large increase in Treasury supply that the market will have to absorb. Additionally, the Bank of Japan announced they will allow interest rates to rise more freely in a surprise tweak to their yield curve control policy. The loosening of yield curve control could weaken foreign demand for U.S. Treasuries as Japanese government bonds will look more attractive if Japanese rates rise enough. Finally, the Fitch downgrade of U.S. debt could translate to higher yields as investors may perceive higher credit risk with U.S. government debt. However, given how short-lived the market reaction was to the downgrade, this is likely not playing a material role.

Higher long-term rates would persist if growth continued to defy expectations or if inflation proves stickier than expected. At this point, we think it's prudent for investors to extend duration and lock in higher yields. Rate volatility should be lower moving forward as the Fed is nearing the end of its tightening cycle. Also, as inflation continues to decline, and the growth outlook is repriced higher forward rate volatility should be driven lower in response to lower macro uncertainty. While allocating more to fixed income at this point makes sense, that shouldn't be construed as a recommendation to reduce overall portfolio risk. While equities can struggle with higher yields, especially when valuations are stretched, that isn't always the case. The S&P 500 returned an average of 9.5% in the 12 months following past episodes of bear steepening. This makes sense considering the message from the bond market is that growth is stronger than expected and monetary policy isn't too tight at this point. We may be moving to an environment of structurally higher medium/long-term yields, but the sharp moves of the last few weeks are unlikely to sustain especially if both inflation and growth start cooling simultaneously.

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