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MACROCOSM

The 10-year at 3% – Bring It On!

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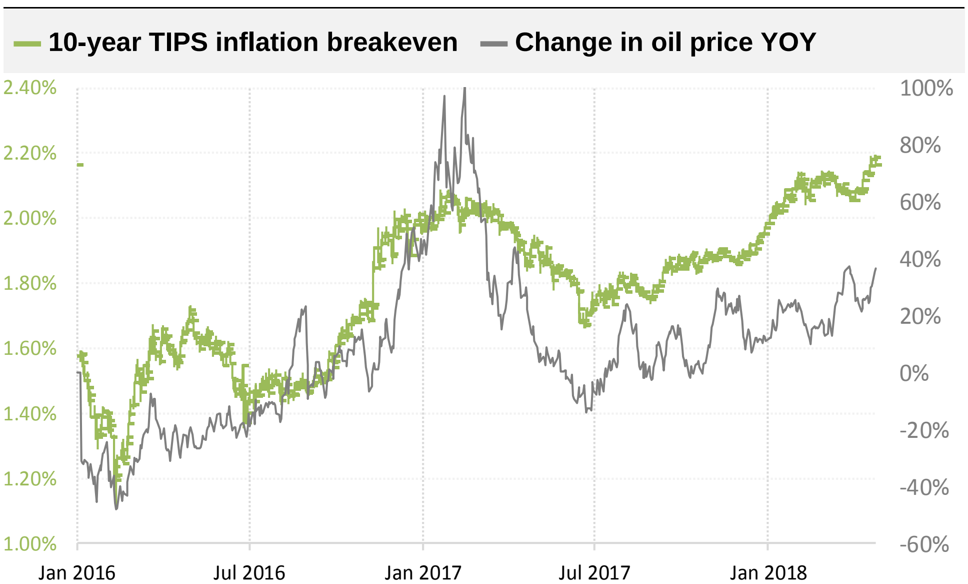
The risk isn't that the 10-year yield moves above 3%. The risk is that it doesn't last.

As we predicted (see "On the March FOMC" March 21, 2018), yesterday the 10-year Treasury yield breached the psychologically significant 3% level – albeit very briefly – and is trading above it today, as of this writing. *It's not at all clear to us that yesterday's sell-off in equities should have been triggered by the move above 3% -- if anything, it should have been triggered by the fact that the move was not able to be sustained.* *We say that because we see this back-up in yields as purely good news, and very much expected. Equities shouldn't go "risk-off," because 3% means bonds are going "risk-on"* (see "Risk-Back-On in a Week of Tape-Bombs" April 16, 2018). *3% is a sign that growth and inflation expectations are intact, that safe haven demand is receding, and that the widely anticipated Fed rate hike in June will not be contractionary or deflationary. We hope this time it sticks.*

- *The yield at 3.01% as of this writing – comprised of a real yield of 0.84% and inflation compensation of 2.17% – represents a significant recovery from recent dysfunctionally low levels that were not "stimulative," but rather were indicators of pathological risk aversion.*
- The inflation compensation component – the TIPS breakeven



Source: Bloomberg, TrendMacro calculations

Update to strategic view

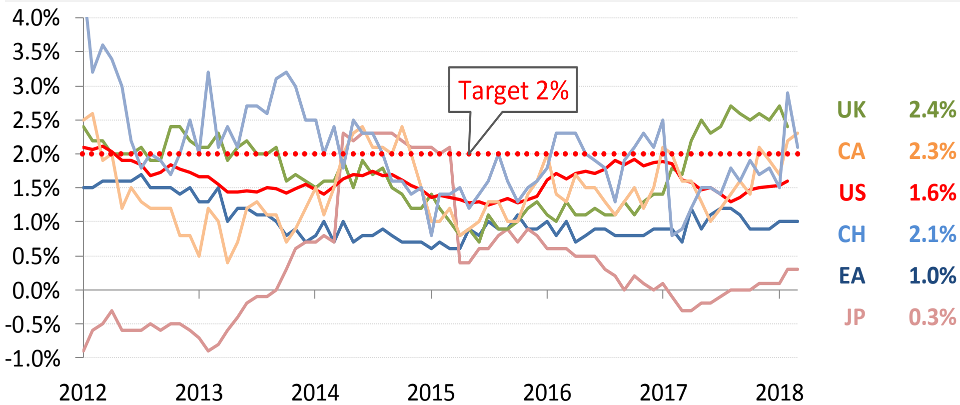
US BONDS, US STOCKS, US MACRO, US FED, OIL: The 10-year at 3% has spooked equity markets. But it is an indicator of endogenous improvements in inflation and growth expectations, and equities should hope that long-term yields rise further – as we think they will – and be concerned if they don't. The salutary rise in inflation expectations is connected to recent high oil prices, and should continue as oil stays in this new high range. Improving growth expectations should continue based on forward earnings growth, tight credit spreads, bank lending growth and housing transaction growth. Higher yields indicate that Fed policy normalization is working – if the Fed were too tight, yields would be falling. History indicates that increased Treasury issuance is unlikely to make a difference in yields one way or the other, and that higher yields are consistent with positive and above-average equity returns.

[Strategy dashboard]

spread – was as low as 1.11% in February 2016, exactly when oil was making its bear market lows at $26 and nearly throwing the global economy into recession (see "The Recession Caused by Low Oil Prices" January 8, 2016). As oil prices have recovered, so has the TIPS breakeven, a consistent relationship on the upside *and* the downside that has been rigorously documented (please see the chart on the first page, the New York Fed's study, "On the June FOMC" June 14, 2017.

- *The strengthening of inflation expectations should be welcomed, and we expect it will continue as oil trades in a somewhat higher trading range* (see "Oil's Bullish Bottlenecks" April 24, 2018). Remember, the starting position here is that inflation is *too low*, and we want it to be *higher*. Indeed, ever since the Great Recession, every major central bank in the world has struggled to move inflation back to their 2% target rate – but the central banks of the United States, the euro area, and Japan have conspicuously failed to do it (please see the chart below).

Core inflation in major world economies Year-over-year



Source: Bloomberg, TrendMacro calculations

- *The present 2.17% TIPS breakeven is not absolute assurance that the Fed will succeed – and certainly no indicator that inflation is accelerating dangerously, or leaving the Fed behind the curve.* TIPS are calculated based on the Consumer Price Index, which typically runs 50 bp to 75 bp higher than the measure the Fed uses for its target – the Personal Consumption Expenditures deflator. So now it is merely echoing the present 1.6% year-over-year reading of core PCE.
- *At the same time, today's real yield of 0.84%, a recovery from negative 0.11% in July 2016 in the aftermath of the Brexit panic, demonstrates a welcome resurgence of growth expectations and risk tolerance.* The negative real yield in 2016 indicated a spasm of risk aversion, and in combination with a still-low inflation breakeven spread, drove the nominal 10-year yield to as low as 1.138%, the lowest in the entire history of the United States. Again, that was not "stimulative" and was not to be welcomed – it was a fearsome sign of extreme pessimism.
- Today's 0.84% real yield is an improvement, to be sure, but it is

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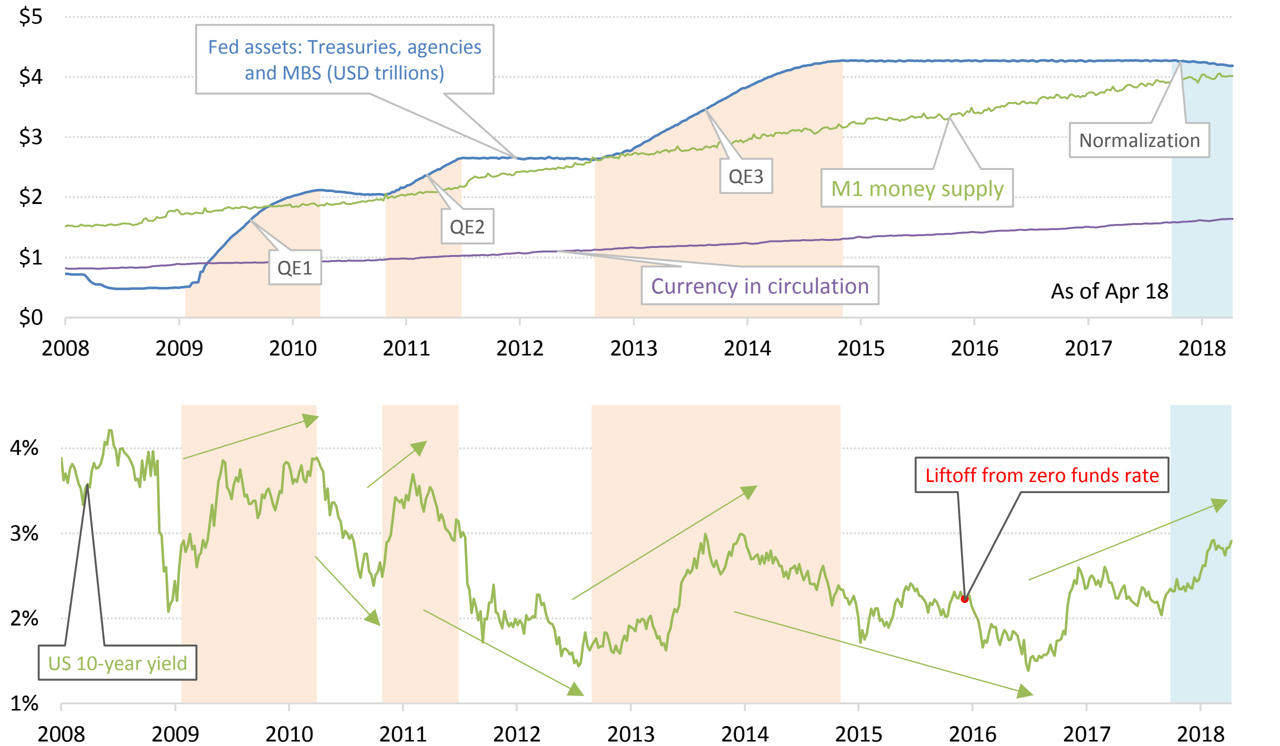
only a down-payment. It remains below much higher levels associated historically with robust growth expectations and risk tolerance.

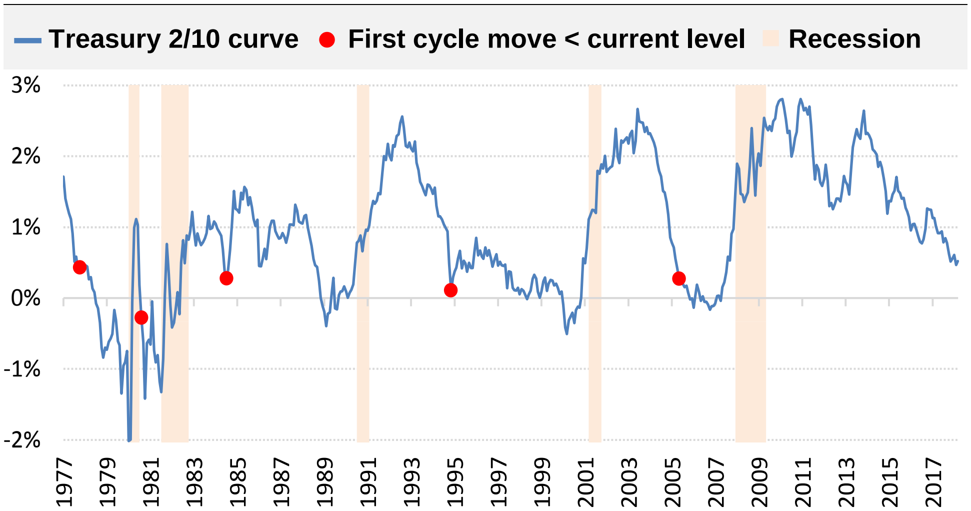
- <u>*The 10-year above 3% indicates that the Fed's gradual normalization of rates and its balance sheet is working.*</u> In prior attempts to normalize – the too-early ends to QE1, QE2 and QE3, and the ill-timed liftoff from the zero funds rate when the economy was weakening in late 2015 – all had the consequence of driving the 10-year yield *lower*, because those errors lowered growth and inflation expectations (please see the chart below). <u>*Yes, those expectations could be even better today, and the Fed could potentially contribute to making them so by slowing the pace of normalization – but the rising 10-year yield shows that the Fed is not directionally wrong.*</u>

Federal Reserve policy and the 10-year Treasury yield



Source: FRB, Bloomberg, TrendMacro calculations

- <u>*A number of clients are focused on the apparent flatness of the yield curve*</u> as counter-evidence suggesting that the Fed is too tight, and should normalize no further. We are generally sympathetic to these concerns, but <u>*we are not worried that the curve is flashing a danger-signal of any immediate significance.*</u>
- At 52 basis points as of this writing, the 2-10 curve is at a level that, over history, is first attained in a business cycle expansion when there are still about five years to go until recession (please see the chart on the following page). Even an outright inversion of the 2-10



Source: Bloomberg, TrendMacro calculations

curve leaves one to two years until recession – a lag so long and variable as to be nearly useless as a forecasting tool.

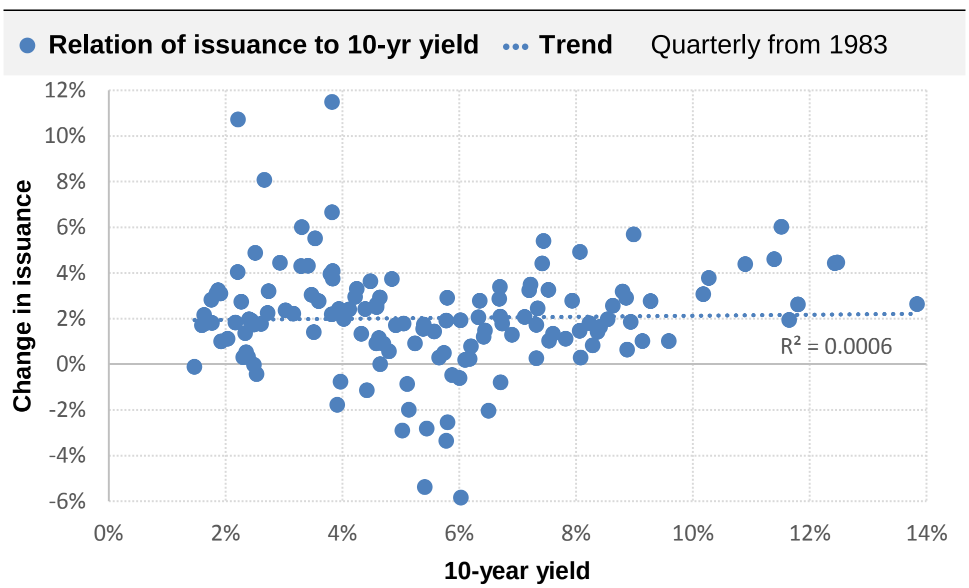
- *A number of clients are also worried that the higher 10-year yield will be toxic to equity valuations*, by narrowing the equity risk premium and making equities less relatively attractive.

History of back-ups in 30-year Treasury yield — Month-end data except for most recent

Episodes		Change in 30-yr T-bond yield	S&P 500 total return, annual rate
Apr 1946	Jun 1953	+1.05%	+10.3%
Jul 1954	Oct 1957	+1.26%	+13.7%
Apr 1958	Feb 1960	+1.10%	+19.1%
Jun 1965	Aug 1970	+2.61%	+2.8%
Nov 1971	Oct 1974	+2.66%	-4.8%
Dec 1976	Mar 1980	+5.11%	+3.7%
Jun 1980	Sep 1981	+5.20%	+6.5%
Apr 1983	May 1984	+3.46%	-3.1%
Aug 1986	Sep 1987	+2.58%	+28.8%
Jul 1989	Apr 1990	+1.08%	-2.7%
Oct 1993	Dec 1994	+1.93%	+1.4%
Dec 1995	Aug 1996	+1.17%	+11.5%
Sep 1998	Feb 2000	+1.17%	+24.8%
Oct 2001	Mar 2002	+1.07%	+22.7%
May 2003	Jul 2003	+1.01%	+19.8%
Jun 2005	May 2006	+1.02%	+9.3%
Dec 2008	Mar 2010	+2.03%	+25.8%
Aug 2010	Jan 2011	+1.06%	+66.0%
Jul 2012	Dec 2013	+1.42%	+25.7%
Jan 2015	Jun 2015	+.90%	+10.8%
7/6/2016	4/24/2018	+1.04%	+15.5%

Source: Bloomberg, TrendMacro calculations

- *History shows exactly the opposite. Since 1946, in the 21 episodes of significant back-ups in long-term Treasury yields, equities had positive returns in all but three cases, and more often than not those returns were above-average* (please see the chart on the previous page).
- In a dividend discount model framework, at first blush one might think that higher yields raise the discount rate on future payouts and therefore lower the present value of equities. But to the extent that higher yields reflect improving expectations for inflation and nominal growth, then the model's growth-variable would have to be upgraded in lock-step, preserving the present value.
- *Finally, some clients are worried about a factor we haven't touched on at all here so far – that the rise in the 10-year yield reflects a surge in Treasury issuance.* If that were the case, then higher yields would *not* be the happy product of endogenous growth and inflation expectations, but rather an exogenous shock to the economy in which increased government borrowing could potentially crowd out other issuers, and slow growth by artificially raising borrowing costs for everyone.
- It's a multifactor world, and one can never know which factors are the drivers So we can't rule this out. *But history indicates that there is either no relationship between yields and changes in issuance, or if there is one, that it must be swamped by other coincident – and, apparently, systematically offsetting – factors* (please see the chart below).



Source: US Treasury, Bloomberg, TrendMacro calculations

So again, we hope 3% – and more – sticks. We don't see it as an exogenous threat to growth, nor as an indicator that the Fed or the Treasury is such a threat. We see it as the outward expression of endogenous growth factors.

We think it will stick. We expect it to be supported by improving inflation expectations, if for no other reason than we expect oil prices to remain in their present high price range (again, see "Oil's Bullish Bottlenecks"). And we expect it to be supported by improving growth expectations, based on our most salient forward-looking indicators – including strong forward earnings growth, tight credit spreads, strong bank lending growth and strong housing transaction growth.

Bottom line

The 10-year at 3% has spooked equity markets. But it is an indicator of endogenous improvements in inflation and growth expectations, and equities should hope that long-term yields rise further – as we think they will – and be concerned if they don't. The salutary rise in inflation expectations is connected to recent high oil prices, and should continue as oil stays in this new high range. Improving growth expectations should continue based on forward earnings growth, tight credit spreads, bank lending growth and housing transaction growth. Higher yields indicate that Fed policy normalization is working – if the Fed were too tight, yields would be falling. History indicates that increased Treasury issuance is unlikely to make a difference in yields one way or the other, and that higher yields are consistent with positive and above-average equity returns.