The Runway Toward Higher Treasury Yields Looks Free and Clear

February 23, 2021

by Liz Capo McCormick, Daniela Sirtori-Cortina

The obstacles to higher yields in the world's biggest debt market are slowly melting away.

Bond bears appear to be having more than just a moment here at the start of 2021, with Treasury yields finally busting out of long-held ranges to levels last seen in the early days of the pandemic. Most Wall Street analysts see yields gliding even higher, given the vaccine rollout, and the prospect of business reopenings and additional fiscal stimulus.

The threat of higher borrowing costs is already looming over risky assets, from U.S. shares to emerging-market securities. So far, the pace of increase doesn't appear to be alarming Federal Reserve officials, but traders will be monitoring Chair Jerome Powell's testimony to Congress next week for any sign that he's troubled by steeper long-term borrowing costs. Barring any such hint, the market is left to ponder the extent to which the reflation trade will drive up yields.

"Before the pandemic, the 10-year yield was trading at about 1.6%, and if we are going to get back to what the economic situation was -- give or take -- back then, then there's no reason why yields should be lower than that," said Stephen Stanley, chief economist at Amherst Pierpont Securities.

He forecasts the 10-year yield will end the year at 2% -- a level last seen in August 2019 -- up from the almost one-year high of 1.36% reached this week.

Surging inflation expectations have been a key driver for 10-year yields, a trend that the Fed has helped fuel with its promise to keep policy rates ultra-low until consumer prices accelerate sustainably. Ten-year breakeven rates, a proxy for where investors see the annual inflation rate for the next decade, touched 2.26% this month, the highest since 2014.

Real Headache

The pace of the jump in nominal yields has been startling. But markets are also watching real yields, which strip out inflation and are seen as a purer read on the growth outlook. Real rates have reached an important milestone, with those on long bonds rising above zero for the first time since June. This is potentially an issue for risky assets as real rates are viewed as a gauge of companies' capital costs.

The median forecast in a Bloomberg survey is for 10-year Treasury yields to reach 1.45% in the fourth quarter. Zachary Griffiths of Wells Fargo sees the rate between 1.3% and 1.5% by mid-year, with the low end possible if vaccine distribution falters or additional Covid-19 challenges surface.

To be sure, there are some big bond bulls out there. Robert Tipp, chief investment strategist at PGIM Fixed Income, which manages about $968 billion, warns the 10-year yield could sink back to around 1% by year-end.

Inflation expectations have risen too far, and markets may also be ignoring that the economic boost from government stimulus will eventually fade, he says.

See here for more on an options bet that yields may not rise much more.

Countering Forces

There are other forces to be wary of. International investors may step in to buy at some point, especially given currency-hedged returns have jumped. And with any unruly leap in long-term borrowing costs that tightens financial conditions or sparks illiquidity, the Fed could decide to boost asset purchases.

So far, there's little hint of concern. New York Fed President John Williams on Friday said rising yields show optimism toward the recovery.

“The reflation trade is going to stay,” said Chris McReynolds, head of U.S. inflation trading at Barclays Plc. “We’ll of course continue to see volatility around inflation expectations and actual inflation prints themselves. But you have to take the Fed completely at their word, that they are going to be behind the curve” in tightening policy even as the economy and inflation pick up.

There’s a strong market signal backing that view -- the sharp rise in the ratio between the prices of copper and gold, which has a solid track record predicting yields. The relationship typically works because copper is a cyclical commodity, and gold is a haven that’s sensitive to inflation and rates.

The ratio has been surging, suggesting the rise in yields may just be getting started.

What to Watch

- The economic calendar:
  - Feb. 22: Chicago Fed national activity index; leading index; Dallas Fed manufacturing activity
  - Feb. 23: FHFA house price data; S&P CoreLogic housing data; Conference Board consumer confidence; Richmond Fed manufacturing index
  - Feb. 24: MBA mortgage applications; new home sales
  - Feb. 25: Durable/capital goods orders; jobless claims; GDP; Bloomberg consumer comfort; pending home sales; Kansas City Fed manufacturing activity
  - Feb. 26: Advance goods trade balance; wholesale/retail inventories; personal income/spending; PCE deflator; MNI Chicago PMI; University of Michigan sentiment
- The Fed calendar:
  - Feb. 22: Governor Michelle Bowman
  - Feb. 23: Chair Jerome Powell to deliver semi-annual monetary policy report to Senate Banking Committee
  - Feb 24: Powell appears in virtual hearing before the House Financial Services Committee; Governor Lael Brainard; Vice Chair Richard Clarida in two appearances
  - Feb. 25: Atlanta Fed’s Raphael Bostic; St. Louis Fed’s James Bullard; Vice Chair for Supervision Randal Quarles; New York Fed’s John Williams
- The auction calendar:
  - Feb. 22: 13-, 26-week bills
  - Feb. 23: 52-week bills; 42-day cash-management bills; 2-year notes
  - Feb. 24: 2-year floating-rate notes; 5-year notes
  - Feb. 25: 4-, 8-week bills; 7-year notes

--With assistance from Eddie van der Walt.