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Professional Investment Management

BLOG POST
Treasury Yields
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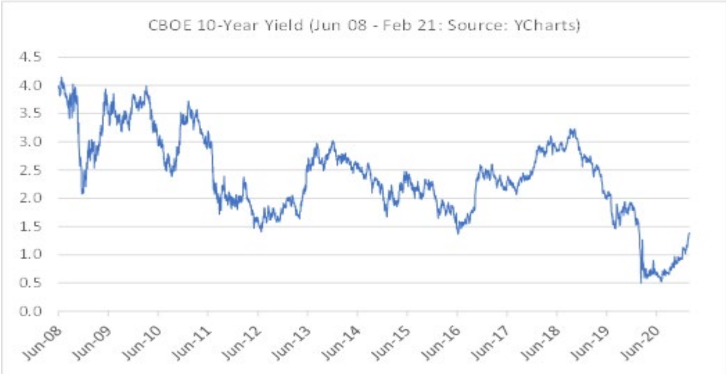
The recent move in U.S. Treasury yields has garnered most of the investment headlines so far this year. After reaching a low of approximately 0.50% in March 2020 amid the depths of the COVID-19 outbreak, yields have begun to climb higher. By the end of February 2021, the benchmark 10-year yield sat at approximately 1.5%, which is roughly equal to the dividend yield on the S&P 500.

The recent uptick in Treasury yields has, so far, been more-or-less steady. Furthermore, the rise in rates has not seemed to have adversely impacted equity forecasts. Still, in a post-financial crisis world, any uptick in yields makes the headlines.

To maintain perspective, it is helpful to evaluate how the benchmark 10-year Treasury has behaved over time, particularly around major market events. The chart below plots the CBOE 10-year spot rate going back to June 2008 (just prior to the financial crisis):

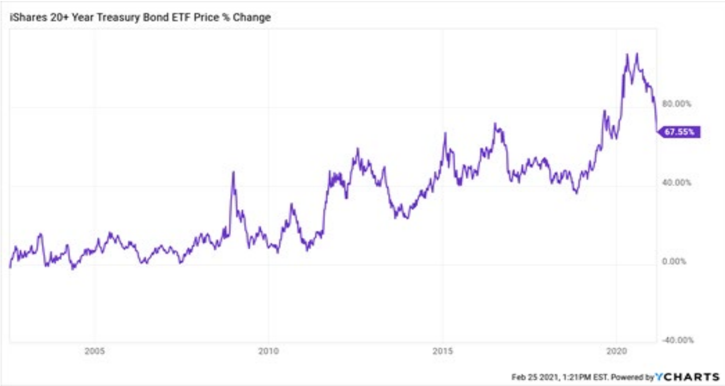


Starting from the left, the first dip in yields – from roughly 4% to 2% – coincided with the financial crisis. Yields then rebounded as stocks rose in 2009. Move forward to the Flash Crash and Greek sovereign debt issues of 2010, and yields fell once again, rebounded, and then subsequently collapsed amid the Euro Crisis of 2011.

Then we move forward to the Taper Tantrum of 2013, when Fed chairman Ben Bernanke hinted that the central bank might not be so accommodative. Yields rose again only to fully reverse heading into the 2016 presidential election. At the time, massive infrastructure spending and tax cuts would prove inflationary. The Fed began to raise interest rates. By the end of 2018, as the S&P 500 fell 20%, the Fed reversed course and began to lower its target rate.

Yields fell throughout 2019, then COVID-19 hit in late February of 2020, and yields collapsed down to 0.50%. We have now since bounced off the COVID-19 lows.

In addition to evaluating the 10-year spot rate from the chart above, it is also useful to examine the historical trading pattern of the long-term U.S. Treasury index, which tracks a total return investment in a constant maturity Treasury bond. The Blackrock iShares 20+ Year Treasury Exchange Traded Fund (Ticker: TLT) tracks an investment in longer dated Treasuries. The chart below shows the percentage change of an investment in TLT going back to its inception in July 2002:



We show the growth in terms of percentage change to illustrate that historically, we have seen trading patterns similar to what we are seeing today. Typically – but not always – a major disruption event to the downside in equities occurs, Treasuries become overbought (i.e., yields decline as bond prices rise) and then eventually reverse course. This tendency played out in 2008, 2011, and more recently in 2020.

Is the reversal we are seeing today simply a repeat of the trading pattern we have experienced in the past? In other words, did bond prices simply overshoot to the upside during the pandemic and are now heading to some equilibrium (perhaps a yield closer to the S&P 500), or is there something more fundamental under the surface that will send interest rates materially higher? Interestingly, it was not that long ago that the dividend yield on the S&P 500 was roughly three times the benchmark 10-year Treasury rate.

If inflation is truly coming due to stimulus and the reopening of the economy from COVID-19, it is likely that the Federal Reserve will be forced into action. It could take the form of a new QE program to help keep longer-term rates under wraps. Increasing the discount rate would likely prove problematic for the equity markets.

From a portfolio construction standpoint, it would be prudent to consider both the volatility of U.S. Treasury returns and the correlation of these returns to the broader equity market. As market conditions change, rebalance your allocation accordingly. As history has shown, U.S. Treasuries can be an effective hedge to equity volatility. However, interest rates can move quickly, so be prepared.