Making Sense of Rising US Treasury Yields

August 2023
By Brian Luster

The 10-year U.S. Treasury yield, which hit its lowest point in early April at 3.28% following a period of regional banking stress, has since rebounded to 4.23% on August 15th, reaching its highest level in over 15 years.

This trajectory has become a subject of considerable interest of fixed income investors, driven by a confluence of factors, both fundamental and technical:

- **Divergence between Economic Data and Leading Indicators**: Despite encouraging incoming economic data, the market remains wary as leading indicators, such as The Conference Board's Leading Economic Indicators Index, have displayed a 15-month decline—the longest streak since the 2007-08 financial crisis. In contrast, the coincident index has shown modest growth this year, surprising investors, and implying that the economy is continuing to expand. This divergence has caused market expectations to be tempered and is putting upward pressure on rates as the data suggest the economy remains strong.
- **Delaying Rate Cuts, Not Anticipating Rate Hikes:** The Federal Reserve's discussion of rate cuts in 2024 in the context of gradually decreasing (although still above target) inflation, has not translated into an expectation that the Fed will become more tolerant of higher inflation. In fact, inflation breakeven rates have not significantly increased. Instead, the market is pricing in the likelihood of the Fed maintaining higher rates for an extended period, as reflected in the repricing of the 1-year forward policy rate - a projection of future interest rates.
- **Increased U.S. Treasury Supply:** The U.S. Treasury has revised its borrowing estimates upwards for the third and fourth quarters of 2023, injecting additional Treasury supply into the market. At the same time, the Treasury seeks to maintain a higher cash balance in the Treasury General Account (TGA) by year-end (which is partially funded from the sale of Treasury bonds). This influx of supply coincides with the Federal Reserve's balance sheet reduction of its Treasury holdings, thus necessitating more public purchases. This combination of increased supply and falling demand for US Treasuries is putting downward pressure on prices, and upward pressure on yields.
- **Fitch's U.S. Debt Downgrade:** Although Fitch's downgrade of U.S. Treasury debt initially impacted the market, its effects were short-lived. The 10-year Treasury yield briefly rose but did not see a significant widening of credit default swap (CDS) spreads, suggesting a more contained reaction. Still, a lower debt rating puts marginal upward pressure on longer term interest rates.
- **Unexpected Policy Shift by the Bank of Japan (BOJ):** The BOJ's decision to loosen its yield curve control (YCC) policy has the potential to reduce foreign demand for U.S. Treasuries. As Japanese interest rates increase and their yield curve steepens relative to U.S. Treasuries, Japanese

investors may find Japanese government bonds (JGBs) more attractive, putting downward pressure on foreign demand for US Treasuries.

- **Reversion to Mean Valuations:** Fundamental models indicate that the 10-year U.S. Treasury had been trading at a premium, implying that the recent yield increase might be a reversion to fair value.

In summary, improved economic growth prospects and the Federal Reserve's commitment to keeping rates steady have jointly contributed to the upward movement in Treasury yields. Additional factors like increased Treasury supply, potential reduced foreign demand, and valuations reverting to historical norms have further influenced these yields.

For investors, the decision of whether to extend the duration of their investments amid rising yields is a complex one. However, we believe that the risks lean towards lower yields in the future. This anticipation is rooted in the likelihood of yield stabilization at current levels, followed by a period of moderating inflation and growth, which should exert downward pressure on yields. Given the present interest rate landscape and bond income potential, investors may benefit from a “one-two-punch” of income and potential price appreciation with longer-term bonds.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

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