T. ROWE PRICE INSIGHTS
A VIEW FROM GLOBAL FIXED INCOME

The Four U.S. Treasury Yield Phases of a Fed Tightening Cycle

Portfolio managers collaborate to help shape duration positioning.

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One of the biggest questions facing fixed income portfolio managers in late July is when to take a strategic long position in U.S. duration.[1] This positioning in the U.S. could bring powerful performance benefits if rates reverse some of their extended, steep increase as the Federal Reserve has raised interest rates since March 2022.

However, the negative carry[2] imposed by the inverted U.S. Treasury yield curve makes being early to add U.S. duration punishing. With the 10-year U.S. Treasury yielding about 100 basis points[3] less than the two-year note in late July, a long position in the 10-year segment involves a very meaningful yield sacrifice if longer-term U.S. Treasuries don't rally to offset the negative carry. In fact, simply holding cash equivalents, such as the three-month U.S. Treasury bill, would yield much more than longer-maturity U.S. Treasury notes.

Our analysis of the 10-year U.S. Treasury yield in past Fed tightening cycles since the early 1980s, led by Portfolio Manager Saurabh Sud, shows that there were typically three distinct phases of yield movements followed by a fourth phase of decreasing yield. These phases varied to some degree based on the Fed's actions and other aspects of the market environment, but they were identifiable across all of the tightening cycles.

Phases of U.S. Treasury yields in historical tightening cycles:

1. Strong upward trend in yield as the Fed tightens
2. Long sideways consolidation in yield as the market tries to determine the level of the terminal rate for that cycle
3. Final "blow off" move sharply higher in yield around the time of the final Fed hike
4. Powerful decrease in yields

Did the 10-year U.S. Treasury's move to a yield well over 4% in early July followed by a quick decrease represent phase three? Only time will tell if the yield will test its recent high of 4.25% in October 2022, but some portfolio managers could have interpreted it as a signal to go long duration in anticipation of the transition to phase four.

Across T. Rowe Price Associates' fixed income platform, portfolio managers and analysts collaborate extensively, seeking better investment decisions as they consider the opinions of colleagues and incorporate them into their own views. However, T. Rowe Price does not have a "house view," and portfolio managers have the freedom to position their strategies in accordance with their mandates and outlooks.

[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] Carry is an investment's yield above or below the risk-free interest rate, such as on a short-term Treasury bill.
[3] A basis point is 0.01 percentage points.

Some of our managers have taken divergent strategic positions on U.S. duration.

The Bull Case

U.S. Fixed Income Portfolio Manager Steve Bartolini, while cautious on near-term U.S. Treasury positioning, interprets the yield increase in early July as a potential phase three, which could lead to a major breakout toward lower rates in phase four. He is accordingly positive on U.S. duration in the medium to longer term. He sees the combination of slowing U.S. growth, lower inflation, and tight Fed monetary policy leading to lower yields and a steeper curve by the end of 2023.

The Bear Case

On the other hand, Global Fixed Income Portfolio Manager Ken Orchard views the early July spike in the 10-year U.S. Treasury yield as part of a prolonged phase three of yield moves, not a quick high that leads to phase four. He doesn't see a catalyst for a U.S. recession, such as an energy price spike, on the medium-term horizon. As a result, his outlook is for higher U.S. Treasury yields, and his portfolios have a shorter-than-benchmark position in U.S. duration.

Our other fixed income portfolio managers may have different combinations of strategic and tactical views on U.S. duration. They also may choose to use tools other than outright duration, such as currency positions or exposure to the sovereign bonds of other countries, to express those outlooks in their strategies.

We believe that the sharing of views across the fixed income platform can lead to better-informed investment decisions, which are ultimately up to the individual portfolio manager. This represents a core strength of active fixed income portfolio management—the ability for a portfolio manager to collaborate with other experts to adapt to changing market environments and position their strategies accordingly.

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