Yield Curve Steepening Likely to Continue

With Fed on hold, short rates should stay anchored near zero.

KEY INSIGHTS

- We think that long-term U.S. Treasury rates will drive changes in the yield curve because short-term yields are anchored by the near-zero federal funds rate.
- With data poised to improve going into the summer as the economy reopens, we anticipate that long-term Treasury yields could continue to increase modestly.
- While we expect the economic recovery to be choppy, we have positioned the New Income Fund to potentially benefit from a steeper yield curve.

With short-term U.S. Treasury yields anchored by the near-zero federal funds rate and the Federal Reserve’s Treasury purchases limiting volatility in intermediate maturities, we think that fluctuations in long-term rates will drive changes in the Treasury yield curve. We expect U.S. economic data to improve going into the summer as growth begins to recover from what could be the worst quarterly contraction ever in the second quarter. As a result, we anticipate that 30-year yields will increase, so we have positioned the fund for modestly higher long-term rates and a longer-run continuation of the yield curve steepening that began in May.

Fed QE Dampens Volatility

After the huge Treasury rally in early March as investors scrambled for safe-haven securities, the Fed’s massive quantitative easing program has eliminated much of the volatility from the Treasury market. The 10-year Treasury yield stayed between about 0.50% and 0.75% from late March through May before climbing over 0.90% in early June. The Fed has gradually tapered its daily purchases of Treasuries from USD 75 billion in March to USD 4.5 billion in early June, but the presence of a large, price-insensitive buyer of Treasuries has removed most of the volatility from short- and intermediate-maturity yields.

In addition, we see little chance that the Fed will raise the fed funds rate from its current 0%–0.25% range in the foreseeable future as the central bank holds the rate at the “zero lower bound” to foster growth. We also think that a move to a negative policy rate is unlikely, primarily because of its detrimental effects on money markets, a crucial funding source for U.S. corporations.

With the Fed on hold for an extended period, yields on Treasuries with maturities up to at least two years are...
likely to stay near the fed funds rate. The two-year Treasury yield has hovered in a range of about 0.15%–0.25% since mid-April and is unlikely to break out of that band. The effects of the zero lower bound may extend out as far as the five-year Treasury, potentially helping to limit yield increases in that maturity as well.

**Economic Data Stop Getting Worse**

We believe that trends in growth and inflation expectations are the main drivers of Treasury rates. As of early June, economic data appeared to have at least stopped getting worse, if not improving slightly. Obviously, data beginning in March have been terrible. But more current indicators of economic activity, such as regional Fed indexes, have recently not been as poor as they were in March and April. Measures of economic data surprises, which increase for positive surprises and fall for negative surprises, have turned upward. One of the more prominent surprises was the May nonfarm payrolls report, which showed that the U.S. added 2.5 million jobs and the unemployment rate declined against consensus expectations for millions of jobs lost and an unemployment rate approaching 20%.

With data poised to improve going into the summer as the economy reopens, we anticipate that long-term Treasury yields could continue to increase modestly, with short- and intermediate-term yields staying relatively steady. Since early April, more positive risk sentiment has led to increases in long-term yields and a steeper curve, while negative risk sentiment has led to decreases and a flatter curve. With this dynamic likely to remain in place, we see potential for the Treasury curve to steepen further into the back half of 2020 as the growth outlook improves, possibly with pauses as the market consolidates after the steepening experienced in early June.

**Positioned for Steeper Curve**

While we expect the economic recovery to be choppy, we have positioned the fund to potentially benefit from a steeper yield curve, primarily by being underweight the longer-term segment of the curve. Although we are optimistic that we are through the worst of the downturn, we are keeping the fund’s overall duration1 posture close to neutral versus the benchmark in light of our outlook for steady short- and intermediate-maturity yields.

The risk to this positioning is that a second wave of the pandemic reverses efforts at reopening the economy, driving longer-term yields lower amid renewed demand for safe havens. However, with rates at very low levels and the worst of the downturn likely behind us, we believe there is limited room for further yield compression, tilting the risk/reward trade-off in favor of positioning for a steeper yield curve.

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1 Duration measures a bond’s sensitivity to changes in interest rates.
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