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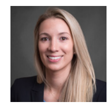
Asset Allocation Insights

A Surprising Rise in U.S. Treasury Yields

September 2023

KEY INSIGHTS

- A sharp rise in U.S. Treasury yields—pressured by a resilient U.S. economy and supply and demand imbalances—has caught many investors by surprise.
- We believe that interest rate volatility is likely to persist as the U.S. Federal Reserve pursues a 2% inflation target and restricts monetary policy for longer than expected.



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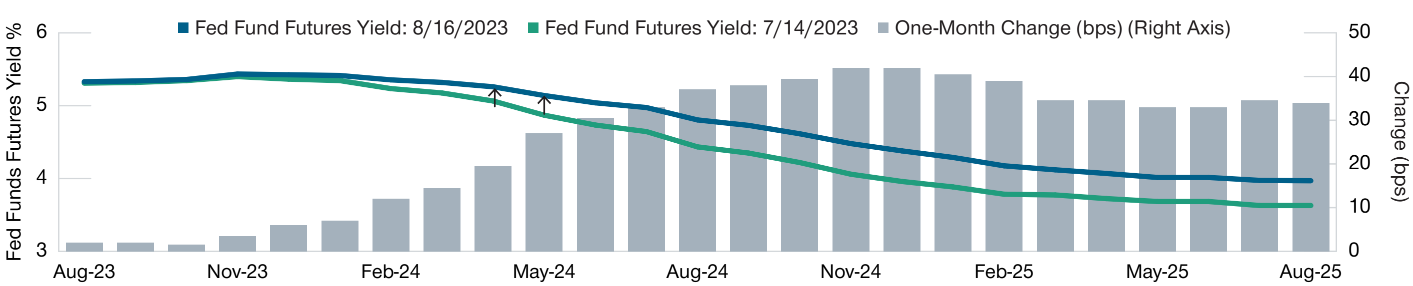
Despite evidence of easing inflation and peaking policy rates in the U.S., 10-year U.S. Treasury yields surged in July and early August to levels not seen since late 2007, catching many defensively positioned investors by surprise. Several factors have pushed yields higher, including the strong U.S. economy and supply and demand imbalances in the U.S. Treasury market.

U.S. economic data have continued to surprise on the upside, led by labor market strength, solid consumer spending, and above-trend growth. This has pushed out expectations of a sharp slowdown in growth or a recession. Meanwhile, the economic impacts of the Fed's aggressive rate hikes have been delayed, and inflation has proven stickier than expected, especially in labor and housing markets. As a result, investors now expect rates to remain higher for longer, a shift reflected in the federal funds futures market (Figure 1).

The Federal Reserve Is Expected to Remain Hawkish for Longer

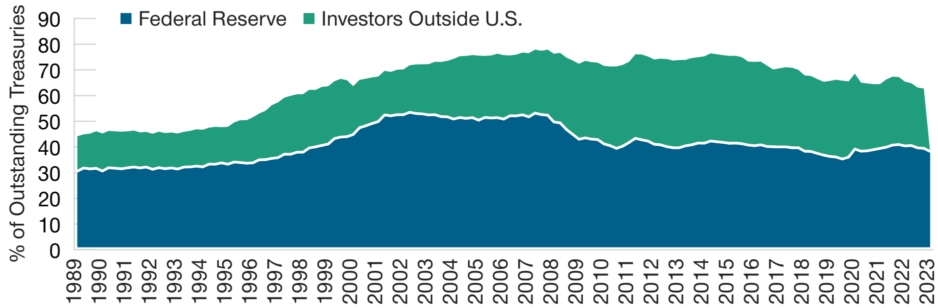
(Fig. 1) Fed funds futures curve



July 2023 through August 2025. The one-month change is between the data as of July 14, 2023, and August 16, 2023.
Actual outcomes may differ materially from estimates. A basis point (bps) is 0.01 percentage point.
Source: Bloomberg Finance L.P.

Demand for U.S. Treasuries Is Fading

(Fig. 2) Ownership shares of outstanding U.S. Treasuries



March 31, 1989, through March 31, 2023.
Source: U.S. Treasury/Haver Analytics.

Supply and demand dynamics in the U.S. Treasury market have also pressured yields higher. On the supply side, the U.S. Treasury surprised markets at the end of July when it announced the need to issue more debt in order to fund the government's growing budget deficit. This additional supply comes at a time when demand has been falling (Figure 2). The largest Treasury owners—the Federal Reserve and foreign investors—have been buying less U.S. debt amid quantitative tightening and more attractive yields on global bonds relative to Treasuries.

Rate volatility is likely to persist, in our view. As the Fed pursues a 2% inflation target, U.S. monetary policy also may remain restrictive for longer than many previously expected. While it is hard to predict if we have seen the top in rates, we believe a much higher neutral rate[1] is likely given the resilient U.S. economy.

With this backdrop, our Asset Allocation Committee has remained balanced across fixed income sectors, maintaining an overweight to cash and cash equivalents while opportunistically adding to longer-term Treasuries amid the recent move up in rates.

[1] The neutral rate is considered to be the interest rate at which monetary policy is neither stimulating nor restricting economic growth.

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