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If Inflation Is Rising, Why Aren’t Bond Yields Rising Too?

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While US inflation has surprised to the upside, bond yields have remained quiescent.

In the first quarter of this year, as the domestic economy began to recover from the Covid-19 pandemic, US Treasuries witnessed a strong selloff, one that sent the 10-year benchmark note yield to a year-to-date high of 1.74%. In fact, the move to higher yields led to Treasuries having the worst quarter in more than 40 years. Since then, however, the bond market has been subdued. Yields have fallen back below 1.5% even as inflation expectations have remained elevated. These expectations are supported by the combination of reopening businesses, ramped-up consumer demand, and higher government spending. As rates have fallen, bond investors have had to unwind positions that were first established based upon the view that interest rates would be moving higher. This has resulted in more bond buying, causing rates to fall even lower.

The US Federal Reserve (Fed) has maintained its message that the current rise in inflation is a transitory event. The 10-year note yield’s range-bound stance over the past two months could be a product of the Fed’s average-inflation targeting framework, in which the Fed has vowed to allow inflation to run above its 2% target for a period of time. Furthermore, the Fed has remained focused on its mandate of full employment, with several Fed officials telegraphing greater concern about the state of the labor market rather than what they view as temporary inflation. The last two jobs reports have been below consensus expectations.

Interestingly enough, it was the May jobs report — not the disappointing April jobs report — that brought the biggest downward daily move in the 10-year note’s yield since March. Investors may have viewed the Fed’s consistent messaging on transient inflation combined with weaker-than-expected employment as evidence that the Fed will remain accommodative for now, keeping downward pressure on rates. In fact, in a year when inflation fears have dominated market sentiment to a degree not seen in years, a 60% stock/40% bond portfolio closed at a new year-to-date peak last week. This portfolio of financial assets should be vulnerable to rising inflation, given that both stock and bond components have long duration exposure. However, investors seem to be taking comfort in the Fed’s rhetoric about the transitory nature of price increases.

There could be other reasons besides Fed speak that are keeping bond yields in a holding pattern. Monetary policy is global, and the bond yields available on US debt are much higher than those found in Europe and Japan. From the relative perspective of foreign investors, US Treasuries are the cheapest they have been since 2015. With the US dollar weaker over the past two months, swapping from euros into dollars, for example, has become more affordable. This demand for US Treasuries perhaps explains some of the bond market’s resilience in the face of the ongoing inflation narrative. To wit: A 5-year debt sale on May 26 received the most bids from international investors since August. Too, the latest data from the US Treasury Department showed that major foreign investors increased their holdings of longer-maturity US Treasuries in March.

Another factor causing bond yields to remain stubbornly contained could be the liquidity requirements imposed on the money center banks following the Global Financial Crisis (GFC).

These are requirements that fall under the umbrella of high-quality liquid assets (HQLA) and mandate that banks keep significant portfolios of safe and liquid assets that can be used to protect against outflows.

Banks typically use US Treasuries, reserves, and mortgage-backed securities to satisfy these liquidity requirements. In fact, money center banks have provided a technical source of demand by purchasing $350 billion of bonds to satisfy their HQLA portfolios over the past year.

So, what could cause bond yields to move higher and be more representative of inflation expectations? For starters, the Fed would have to move away from its highly accommodative stance. Fed messaging is dependent on data that supports the economic reopening and expansion.

Economic data would have to continue to support rising inflation expectations, and jobs data would have to consistently show numbers on par with the March jobs report (approximately one million new jobs).

Additionally, If the Fed signals a reduction in its asset purchase program, yields could move higher, a situation that would be analogous to the episode known as the "taper tantrum" in 2013.

However, the difference this time is that the Fed's signaling of any reduction in asset purchases is likely to be telegraphed well before the implementation of the taper program. Therefore, any rise in yields could be gradual. However, if global yields rise, foreign demand for US Treasuries may subside. In the meantime, however, the Fed is maintaining its stance that while the economy is on the right trajectory, it is still a long way from making substantial progress. If the Fed pushes off talks about tapering, the discount on 10-year Treasuries may narrow even more.

All said, the recent spike in inflation would customarily trigger a jump in long-term interest rates, too. The fact that this hasn't happened is confounding, but based on certain factors stated above, it is understandable, and such a backing up in yields could still materialize. Given the ongoing uncertainty, we continue to maintain our disciplined approach to risk management and emphasize high-quality issuers who stand well positioned to outperform over the long run, irrespective of fluctuations in interest rates in the short run.

For more information, please contact your Key Private Bank Advisor.

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