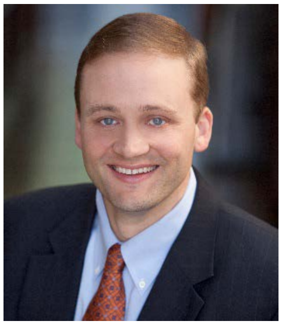

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FIXED INCOME PERSPECTIVE *from the Investment Advisory Group*

Rising Yields Setting Up Opportunity

What Happened

Since early August, intermediate and long US Treasury yields have risen significantly within the context of an extremely low yield environment. Yields for 10-Year US Treasuries have risen from 0.50% to 0.81%, while yields for 30-Year Treasuries have moved from 1.19% to 1.60% over the same span. Both are at their highest levels since June, though remain below their pre-pandemic levels. Meanwhile, the Federal Reserve's (Fed) near-zero interest rate policy continues to anchor short yields close to their lowest point in history. The knock-on effect has been the creation of the steepest 2/10-year yield curve since June and the steepest 5/30-year curve since late 2016. The US Treasury curve's behavior is renewing a common question: does the recent rise in yields signal the beginning of a longer-term trend?

The Steepening of the US Yield Curve

Source: SunTrust IAG, Bloomberg

Our Take

There are several factors behind the recalibration in US yields over the past three months. First, economic activity in the world's two largest economies, US and China, continues to improve from severely depressed levels. As a result, forward-looking growth expectations, while uneven, are improving from historic lows and boosting US yields. Second, markets are pricing in an increased probability of a large fiscal stimulus package and higher government spending in response to polling momentum for Democratic presidential nominee Joe Biden and Democratic congressional candidates. Fresh fiscal stimulus would likely provide a near-term boost in economic activity and sentiment, thus supporting a risk-on trading bias. The prospect of elevated government spending would likely require more US Treasury debt issuance. A more robust supply outlook generally fuels an upward yield bias until demand expands sufficiently to halt the ascent.

However, powerful yield suppressants still loom for US fixed income. The Fed remains in a particularly accommodative posture, ready to support the nascent economic recovery at virtually any cost. Significantly higher intermediate yields could undermine the economy's recent progress, which would likely spur the Fed to step in with stronger forward guidance and an expansion of its purchases of US Treasuries and mortgage-backed securities to keep rates contained. Additionally, global sovereign yields remain at extremely low levels. Roughly one-quarter of the Bloomberg Barclays Global Aggregate Index has negative yields. The positive US yields continue to attract a massive amount of foreign capital seeking better income opportunities. With many global central banks becoming ever-more dovish in support of their own fragile recoveries, foreign demand for US yields should hold strong. Lastly, the pandemic continues to apply significant disinflationary pressures that will make higher US yields difficult to sustain over the next 6-12 months. High unemployment, elevated savings rates, low crude oil prices, and severely disrupted consumer mobility (i.e., the ability to move freely about the economy and spend) each take their own toll on inflation. While inflation expectations have healed significantly since March, they remain well below the Fed's objective.

Bottom Line

In the very near term, there appears to be an upward bias in intermediate and long US yields. The growing odds of a 'blue wave' election outcome—and its perceived implications for larger fiscal relief and higher government spending—may extend this streak. If so, the yield curve should steepen in the coming weeks. However, major headwinds still exist that will make it difficult for US Treasuries to sustain significantly higher yields. Should 10-Year US yields breach the 1.00% threshold, we would view it as an opportunity to seize the highest absolute yields since March and to extend duration for portfolios that have drifted significantly short of their benchmark. In our view, a slightly short-to-neutral duration posture continues to provide the best mix of income and protection from interest rate volatility for most individual investors.

Disclosures

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