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Investment Insights

Market Forces Impacting the Yield Curve

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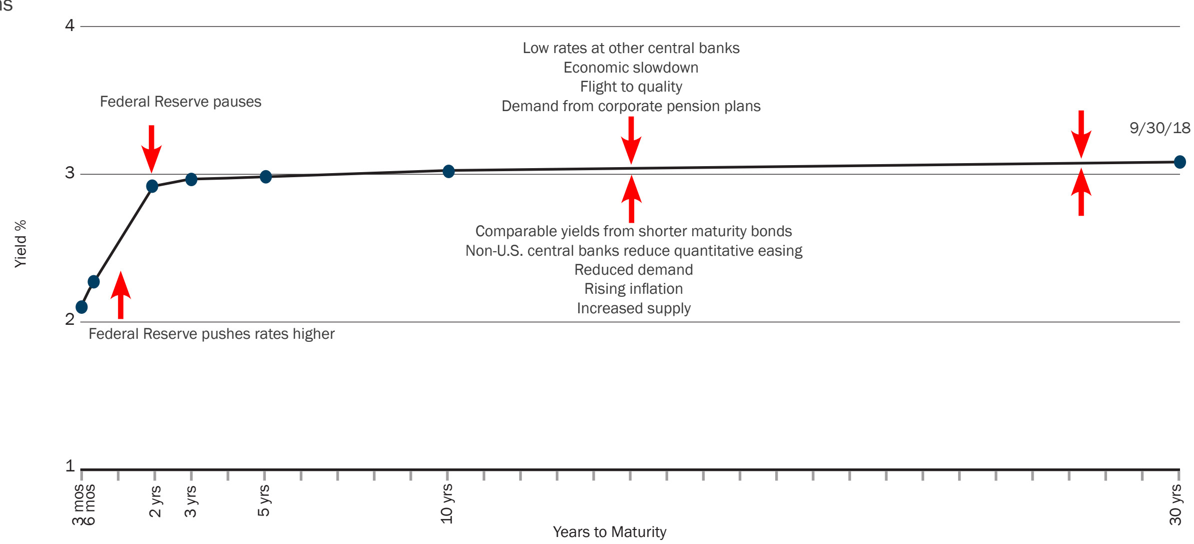
The U.S. Treasury yield curve has attracted a lot of attention this year as interest rates have risen. In this analysis, we outline several factors pushing the yield curve higher, as well as the offsetting forces keeping it from moving more than it already has. While it is difficult to underwrite the magnitude and timing of the factors outlined below, we believe the battle between these offsetting forces will continue over the next year, pushing the yield curve higher than where it stands today.

U.S. Treasury Yield Curve as of September 30, 2018



Source: Bloomberg Finance, L.P.

Forces Pushing Rates Higher

Shorter-term Treasury yields (overnight to roughly two years) are highly driven by the Federal Reserve's monetary policy. As of this writing, the target range for the Fed funds rate is 2.00% to 2.25%[1], with the majority of Fed members projecting another rate increase in December 2018. For 2019, the median projection from Fed members reflects three additional rate increases.

Additional factors that could drive longer-term Treasury yields higher (i.e., bond prices lower) include:

- Rising inflation, driven by a sustained level of solid economic growth, erodes the value of fixed income investments, putting downward pressure on bond prices;
- Increasing supply of Treasury bonds to pay for tax reform and spending policies;

1 Board of Governors of the Federal Reserve System. Open Market Operations. FOMC's target federal funds rate or range, change (basis points) and level. Published September 26, 2018. Retrieved from https://www.federalreserve.gov/monetarypolicy/openmarket.htm on November 1, 2018.

- Reduced demand for Treasuries from the Fed as it tapers its quantitative easing policies by reinvesting only a portion of the income it receives on its approximately $4 trillion balance sheet[2];
- Selling pressure on longer maturity bonds as the yield curve flattens and investors prefer money market funds with competitive yields

Forces Keeping Rates from Rising

Factors that could drive longer-term Treasury yields lower (i.e., bond prices higher) include:

- Continued demand for U.S. bonds from non-U.S. investors as other developed-market central banks maintain their low interest rate policies;
- A deceleration in the Fed's projection for economic growth, reducing the likelihood that the Fed will continue to raise rates;
- Increased demand for bonds driven by a slow-down in economic growth, as investors rotate from stocks to bonds to lock in steady fixed income returns in anticipation of a recession;
- A flight to quality caused by a shock to markets (e.g., military conflict) would increase demand for the safety of Treasuries;
- Continued strong demand for long maturity bonds from corporate pension plans seeking to match long-term liabilities (Liability Driven Investing or LDI).

Summary

While the net effect of these forces is expected to push the yield curve higher, the timing is uncertain. Worth noting, to the extent the strong outlook for the U.S. economy comes into question, demand for longer term Treasuries might increase as investors seek to lock in fixed income rates in anticipation of a recession. This would push prices of longer term bonds higher, and their yields lower, potentially inverting the yield curve. Any variability in U.S. economic statistics is likely to raise this issue and amplify the volatility of interest rates over the next few years.

2 Board of Governors of the Federal Reserve System. Quarterly Report on Federal Reserve Balance Sheet Developments. Published August 2018.

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