Interpreting the 10-Year Treasury Yield Spike

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On Wednesday (10/3), the 10-Year Treasury yield rose by nearly 12 basis points, the largest one-day rise over the past year. The 10-Year yield closed the day at 3.18%, the highest level in more than seven years and well above the May 17th high of 3.11%, a level that some market observers did not expect to be breached. At first equity markets took the rise in stride, but on Thursday 10-year yields continued to rise and equity markets sold off.

So what does this mean and where do we stand?

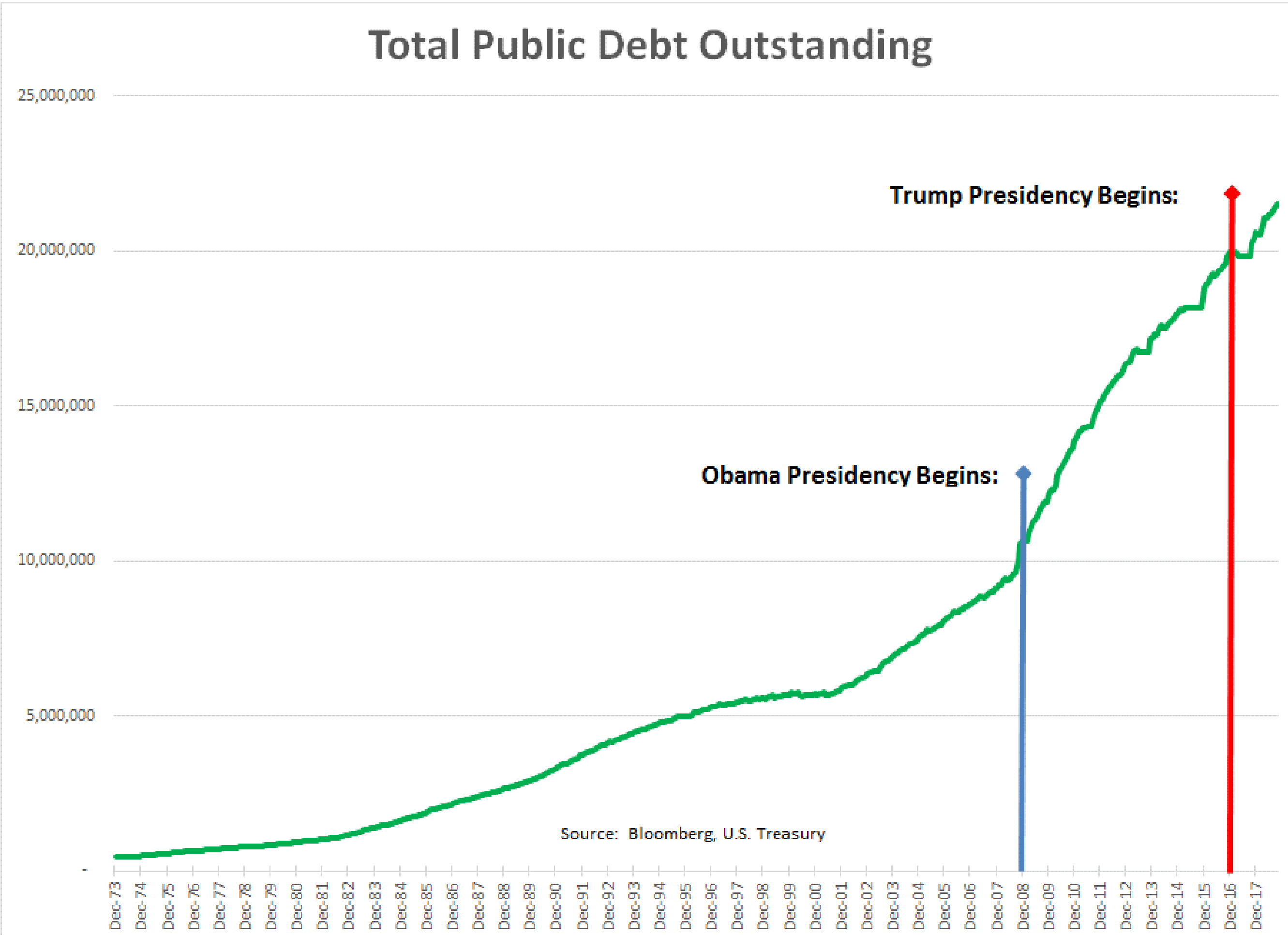
1. What people probably don't want to hear is that in real terms yields are still low which means **there is more room and pressure for yields to rise along the curve so long as growth remains strong.**

2. The yield curve has steepened, reducing the risk of an inverted yield curve induced recession. The 10-year spread over 2-Year Notes has risen to 33 basis points from a low of about 19**. Versus Fed Funds, the 10-year yield is almost 100 basis points higher, giving the Fed ample room to continue to tighten.** The more 10-year yields rise, the more room the Fed has to raise rates without inverting the yield curve.

3. **The debate is whether the 10-Year yield rise reflects higher expected long run growth by the bond market or higher expected inflation.** A consensus seems to be forming that inflation will remain contained and higher expected long-run growth is driving the rise. This is based on the rise of real yields in Treasury Inflation Protected Securities (TIPS). However the expected inflation rate tied to TIPS also modestly rose, so the rise was probably driven by a combination of higher long-run growth expectations and higher inflation expectations

4. **The growth vs inflation expectations debate is pivotal to equity markets.** If growth dominates, equities can continue to perform, but if inflation dominates higher rates with low growth would be detrimental to equities.

The challenge with respect to growth expectations is how one views the impact of the President Trump's tax and deregulation policies. Clearly, less regulation and lower tax rates support an increase in productivity and therefore long-run growth rates. Also true is that deficit spending is a source of immediate but temporary economic stimulus. The chart on the next page shows the total public debt outstanding, which reflects cumulative deficit spending. As you can see, total public debt almost doubled under President Obama and has accelerated with the President Trump's tax cut, which has been driving recent growth. A common view is that the impulse from the deficit spending will diminish in 2019 at the same time that Fed tightening will peak. This would be a drag on the economy and stocks in 2019, but also a potential source of declining rates. For now, growth remains strong and supportive of equities, and while higher interest rates work against growth, they are not yet high enough to stall growth.



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