U.S. 10 YEAR TREASURY YIELDS: "GROUNDHOG DAY: THE SEQUEL"

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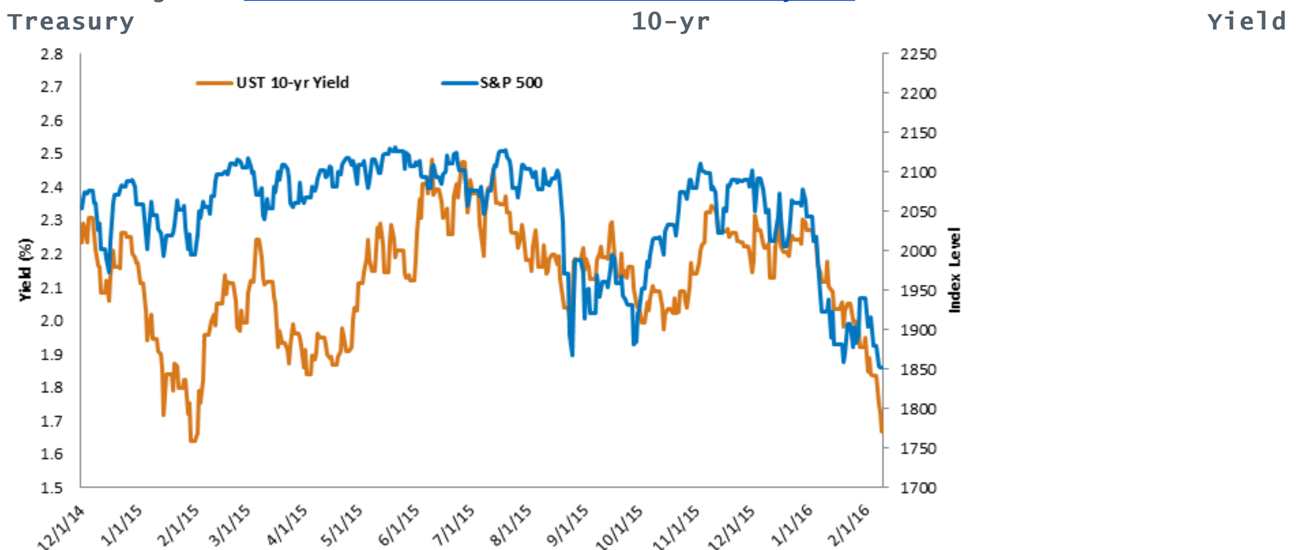
When looking at the price action for the U.S. Treasury (UST) 10-Year note thus far in 2016, it's hard not to think we are stuck in a sequel for the movie "Groundhog Day." Typically, a sequel includes some type of twist from the original movie, and that's what has transpired here early in the new year. After examining how the UST 10-Year yield began the current calendar year and comparable period in 2015, one discovers very similar traits. To provide perspective, prior to New Year's Day 2015, the 10-Year yield reached a high point of 2.26%, and then plunged to a low of 1.64% in a little more than one month's time. The current scenario witnessed the 10-Year yield pop up to 2.31% on Dec. 29, 2015, only to recently plummet to less than 1.60%, the lowest reading since 2012. In each instance, these declines prompted the headline "Treasuries Off to Best Start Since 1988." The natural question that comes to mind is whether the catalysts were of a similar nature as well. Indeed, concerns about slowing growth, favorable global interest rate differentials and overseas developments were all part of the mix, but this year's experience added a new twist: safe-haven demand. Since the financial crisis hit, a key supporting influence for Treasuries has been the "risk-off," or flight-to-quality, trade. When trying to ascertain such a phenomenon, it is rather useful to look at developments in the U.S. equity arena as compared to yield movement for the UST 10-Year note. The graph below underscores the pattern that has been established over the last month or so and how tight the correlation has been between the drop in the S&P 500 and the decline in the 10-Year yield. We believe the current safe-haven demand for Treasuries, and any potential reversal, will more than likely play a key role in determining the future direction of the UST 10-Year yield.

S&P 500 Index vs. U.S. Treasury 10-yr Yield



Source: Bloomberg, as of 2/10/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Certainly one potential market-moving event, Federal Reserve (Fed) Chairman Janet Yellen's semiannual monetary policy testimony before Congress, apparently did not alter investor sentiment

as yet. Given the volatile nature of the global financial markets in recent weeks, that was probably her intention. Yellen seemed to walk the fine line between acknowledging recent events and not igniting any further anxieties. The relatively balanced testimony highlighted the risks of foreign economic developments to U.S. growth and less supportive financial conditions, such as equity declines, wider credit spreads and a stronger U.S. dollar, but also mentioned how job gains and improved wages should provide a lift to income, consumer spending and the domestic economy in general. There is no doubt the Fed will be “monitoring global economic and financial developments” very closely, and at this point, unless there is a sea change in the aforementioned headwinds, the FOMC looks to be on hold. As we have seen in a variety of financial instruments, the UST 10-Year also seems to have discounted a lot of negative news. Based on recent behavior over the last month, further declines in equities will most likely continue to put downward pressure on Treasury yields. However, barring a crisis situation, we believe fixed income investors may want to avoid chasing the current rally, and if the equity arena were to stabilize, Treasuries would lose a key supporting influence. Even in a range-bound landscape, the UST 10-Year yield can reverse course quickly. Looking at last year as an example, after posting the aforementioned low, the 10-Year yield hit a high of 2.48% not five months later.

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DEFINITIONS

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.