# THE BOND MARKET RALLY THAT HAS YET TO BE VALIDATED

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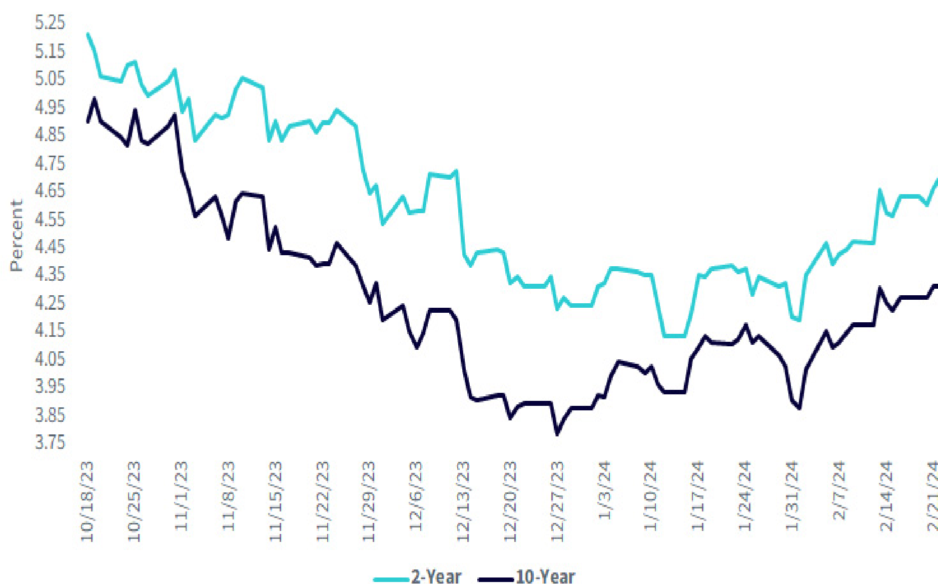
02/28/2024

The optimism that gripped the bond market heading into 2024 has evaporated of late. Indeed, the U.S. Treasury (UST) arena produced a rally for the ages to end last year. But as we get ready to enter the final month of the first quarter, a far less favorable tone is now hanging over the market. During the Q4 rally, I noted on numerous occasions that in order for UST yields to remain at, or below, the levels that were being registered, validation needed to occur. What we're discovering now is that the bond market rally has yet to be validated.

For those who may not be as familiar with the inner workings of the UST arena, oftentimes price action is based on what is being anticipated for the months ahead. This discounting mechanism can be a powerful force, as we witnessed firsthand from about mid-October through to the beginning of this year. The key underpinnings were the expectation that disinflation would continue to work its magic and the economy, specifically the labor market, would finally begin to buckle from the historic Fed rate hikes. These two forces would combine in not only a pivot to monetary policy, but ultimately end up with Powell & Co. cutting rates sooner rather than later and by a sizeable amount.

**U.S. Treasury Yields**




Source: Bloomberg, as of 2/22/24.

Let's provide some perspective on just how optimistic the UST arena had become. By around mid-October, the entire Treasury yield curve was trading somewhere around 5%, with the closely followed 2- and 10-Year notes topping out at 5.22% and 4.99%, respectively. It was from these more than 15-year high-water marks that the

aforementioned rally ensued. Ultimately, the decline in yield amounted to roughly 110 basis points (bps) for the 2-Year and 120 bps for the 10-Year, pushing their respective yield levels down to 4.14% and 3.79%.

So, what has happened here over the last month or so? Well, first off, the labor market data is not only not showing any signs of buckling, job growth has actually been coming in much better than expected. This point was underscored again last week with another drop in the leading economic indicator, weekly jobless claims. In addition, the disinflation trend that was witnessed throughout 2023 showed potential signs that the last mile to the Fed's 2% target could be a more challenging task than the improvement that occurred from the 2022 peak in price pressures.

Needless to say, the Fed rate cut outlook has changed in a rather noticeable fashion as the policy makers have seen the same data and have collectively pushed back on the UST market's very optimistic outlook for rate cuts. As a result, the UST 2- and 10-Year yields are now at 4.71% and 4.32%, respectively, retracing about half of that "rally for the ages," as of this writing.

**Conclusion**

Against the economic and monetary policy backdrop that has been on display thus far in 2024, the key question is, what Treasury yield level represents fair value for the benchmark UST 10-Year note? Sometimes, it just comes down to the math, whereby one takes the 10-Year TIP, or real, yield and adds it to inflation. In my opinion, a real yield in the area of 2% seems reasonable, and when combined with a year/year inflation target of roughly 2.50%, that would put the UST 10-Year yield at 4.50%, or a little above where it currently resides.

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## DEFINITIONS

**Treasury** : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Treasury yield** : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Rate Hike** : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**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.

**Curve** : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

**2-Year Treasury** : a debt obligation of the U.S. government with an original maturity of two years.

**10- Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.

**Basis point** : 1/100th of 1 percent.

**Disinflation** : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

**Rate Cut** : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

**TIPS** : Treasury Inflation Protected Securities.

**Inflation** : Characterized by rising price levels.