Federated®

Why are long-term rates stuck?

Inflation shows little sign of breaking out. Until it does, it's difficult to see long rates breaking up in any significant manner.

Published 03-05-2019

R.J. Gallo, CFA
Senior Vice President
Senior Portfolio Manager
Head of Municipal Bond Investment Group
Head of Duration Committee

In a word, inflation—or more appropriately, the muted level of inflation. Virtually every key gauge of prices that factor into the Federal Reserve's thinking has fallen off its highs of last summer—and those highs were modest by historical standards and only somewhat above the Fed's general 2% inflation target. This downshift coincided with softer economic data in the U.S. and around the world—which along with trade war worries, Fed tightening and a government shutdown—spawned a steep sell-off in risk assets and rally in long Treasuries in the closing months of 2018. But even as risk-on has come roaring back so far this year, with both equities and the credit sectors of the fixed-income market up strongly, longer Treasuries haven't moved all that much: in the past two months, the 10-year has traded within a 15 basis-point range between 2.63% and 2.78%.

Barring a surprise, (e.g., a total breakdown in U.S.-China trade talks or a Mueller report finding incontrovertible evidence of collusion or obstruction), it's difficult to see longer Treasuries breaking much above this range as long as inflation remains restrained and the Fed is in pause mode. Fed leadership, in fact, is sending signals that its researching a change in measuring its inflation target that would result in more

dovish policy in the near-term to support a rise in inflation expectations. Policymakers have not changed their framework yet, but such trial balloons send a message that could mean the Fed is done tightening or, at most, may stop at just one more quarter-point hike later in 2019. We should get a better read on near-term policy intentions at the Fed meeting in two weeks. We expect the policy dots to be lowered, reflecting this shift in thinking, but wouldn't be surprised if the long-run median dot holds at 2.75%, about where the 10-year Treasury is currently.

That said, Federated's fixed-income duration committee, which attempts to position bond portfolios to benefit from changes in the level of market rates, met today and agreed that we think the bias will be modestly up in the month ahead. Chief among our reasons: the improving tone of U.S./China trade negotiations, which indicate a meaningful deal (i.e., most or all U.S. tariffs are removed and China relents on some easing of non-tariff barriers) seems more likely than not. Other supporting factors include the sharp improvement in financial conditions since the Fed went on pause so publicly after its December hike; continued U.S. economic growth, albeit at slower rates than in 2018; diminishing risks of a hard Brexit in the U.K; possible bottoming of growth conditions in Europe; and most importantly, emerging "green shoots" in China, where authorities continue to apply large doses of various stimuli. Given all of this, and modest increases of late in German and Japanese sovereign yields, the argument for slightly higher won the day today. Just not that much higher.

TAGS

FIXED INCOME

INTEREST RATES

DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Federated Investment Management Company

2729408611

Federated®

Copyright © 2019 Federated Investors, Inc.