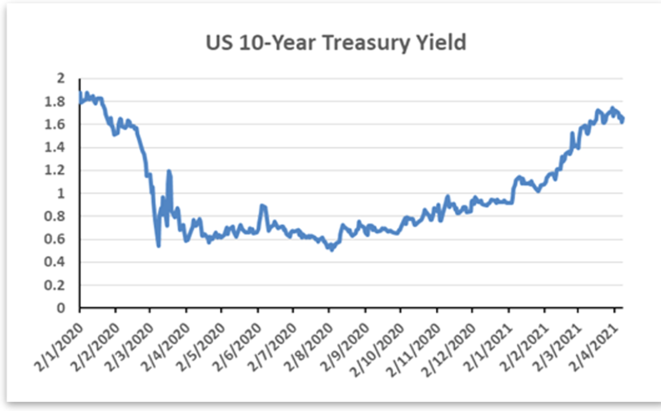
Fund Managers Ltd.
A member of the JN Group
Insight!

# Rising Yields and the Bond Market

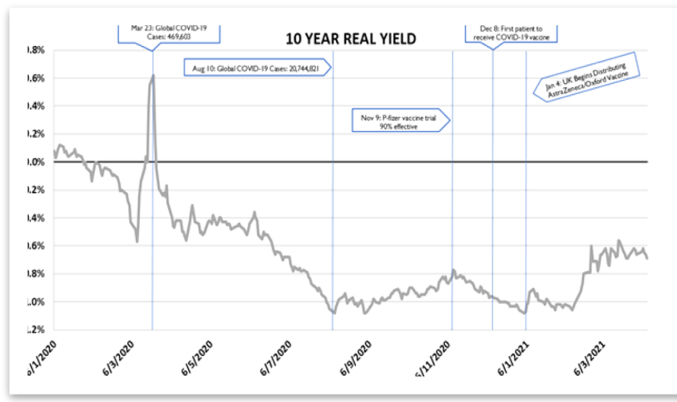



The yield on the US 10-Year Treasury climbed to 1.63 per cent as at the time of writing this article, more than doubling since the end of December 2020 and surpassing the level seen at the start of the pandemic in February 2020. Financial market practitioners pay keen attention to yields as it is a strong indicator of the real-time appetite for risk in the financial markets. Furthermore, 'the yield' which has two components, expected inflation, plus a real yield, provides the market with valuable information about the bond market's demand and supply conditions.

Although inflation expectation, cannot be determined by the nominal yield (such as the yield quoted by Bloomberg), it can be calculated by assessing the breakeven rate[1]. The breakeven rate can be determined by subtracting the Treasury Inflation-Protected Security (TIPS ) yield from the nominal bond yield. If you are not interested in that 'experiment' you could visit https://fred.stlouisfed.org/series/T10YIE, or take my word that the 10-Year Breakeven Inflation Rate was 2.33 per cent as of April 8, 2021. Another important element is that the principal on TIPS increases with inflation and decreases with deflation. As such, the TIPS yield is the real yield component of the bond yield.

Given that the 10-Year Treasury yield is at 1.63 per cent, and the breakeven rate is at 2.33 per cent, the implied real yield is approximately -0.70 per cent. When we compare where we are today, to where we were a year earlier[2], when governments across the world were implementing strict lockdown measures to curb the spread of the virus, we can see that real yields are lower now than they were then. What is 'the yield' telling us about the bond market's demand and supply conditions today? The central point is that there is still a lot of excess demand for bonds, and that investors are willing to accept negative real yields as a result.

The phenomenon of 'flight to safety', which occurs when there is severe economic uncertainty, such as that caused by the COVID-19 pandemic, may explain investors' acceptance of negative real yields. Investors are willing to accept negative returns in these cases to protect their investment. This is evident in the chart below, mapping the movement in real yields, which demonstrates how real yields grew increasingly negative as the pandemic accelerated in 2020, but have since become less negative as vaccines became available and distribution began, signalling renewed optimism that things would return to normal soon.




[1] https://fred.stlouisfed.org/series/T10YIE

[2] Real Yield April 8 2020 was 0.42% - Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=realyieldYear&year=2020

It is fair to expect nominal yields to increase further as normalcy returns. As economies continue to reopen aggregate demand is expected to increase further, leading to higher inflation. In the short-term, however, inflation is unlikely to climb to dangerous levels because unemployment remains relatively high globally. If inflation gets to dangerously high levels, the Federal Reserve has almost all the monetary tools needed to correct the issue. The Federal Reserve chair, Jerome Powell, himself has reiterated this on several occasions.

Although the negative yields are signalling that there is excess demand for bonds, the path of the curve is indicating that investors demand for the asset is declining. The decline in demand for bonds is partly due to the expectation that normality is likely to return soon. Since normality is likely to lead to higher bond yields, higher inflation and a higher breakeven rate, the demand for bonds would reasonably be expected to decline given that rising inflation will make the fixed cash flow nature of bonds less attractive.

**Disclaimer:** All information contained herein is obtained by JN Fund Managers Limited's Global Investment Research Unit from sources believed to be accurate and reliable. All opinions expressed are based on the Research Analyst's judgment as of the date of the report. As such, no warranty is made, expressed or implied by JN Fund Managers Limited in any form whatsoever as to the accuracy, timeliness or completeness of information contained in this report. JN Fund Managers Limited is therefore not liable for any actions taken in reliance on information contained herein.

JN Fund Managers Limited's Global Investment Research Unit does not provide investment advice that considers the circumstances and objectives of the parties who receive this report. It is therefore recommended that before making any investment decision, investors seek the advice of a JN Fund Managers Limited Investment Advisor.

This report does not represent an offer to buy or sell, or solicitation of an offer to buy or sell the securities mentioned. Past performance is not necessarily an indication of future performance. Estimates of future performance are based on assumptions that may not be realized. Additional information not available in this research report may be available upon request.

JN Fund Managers Limited is a multifaceted organization with, investment banking, investment management, fund administration and brokerage business lines. JN Fund Managers Limited may therefore conduct investment banking or other business activities with some of the companies and countries covered by the Company's Global Investment Research Unit.

JN Fund Managers Limited may invest in and trade the securities covered in this report for its own proprietary account and/or on behalf of its clients. JN Fund Managers Limited's trading activity in these securities may be contrary to the recommendation(s) indicated in this report .