William Blair | Blog
REPRINTED FROM INVESTING INSIGHTS AT WILLIAM BLAIR

Yielding to Pressure: What Do the U.S. Yields Tell Us Today?

August 2, 2021

Today, Olga and Hugo discuss the puzzle that is the recent moves in the yield on U.S. 10-year notes. They delve into the arcane world of central banking statistics and conclude that the Fed has largely affected the move in rates since March.

Hugo Scott-Gall: Let's talk about the number 1.16, the current yield on U.S. 10-year notes from Uncle Sam. I am a bit surprised, and I suspect you are too, not only by this yield, but also its direction of travel since this spring. Given the unfolding Mother of All Recoveries, it is slightly confounding observers that the yield on 10-year U.S. Treasury notes declined consistently since May from a high of nearly 1.7 to today's lows. Perhaps it's a short-term phenomenon but given it's arguably one of the most important price signals in the world, let's discuss.

Olga Bitel: I am as surprised as you are. We and others have long observed that over time, the yield on the U.S. 10-year Treasury notes follows the three- to five-year moving average of the U.S. GDP growth. On current consensus estimates for this year and next, the 10-year yield a year from now by this calculation should be around 2%-2.25%.

Having said that, MOFAR is predicated on successful management of the pandemic. In early spring it looked as though rapidly scaling vaccination campaigns had put the pandemic in the rearview mirror, at least in the U.S. and in Europe. Unfortunately, recent developments provide ammunition for a less optimistic view.

Specifically, the delta variant of the virus is currently working its way through the U.K., where the current run-rate

of infections is 528 per million people and racing higher. That is already well in excess of the 400 infections per million that the U.K. experienced last autumn. What is notably different is that the hospitalization rate is barely one-fifth the level of last October and November. In other words, the virus remains infectious, but much less lethal.

At least for now, the vaccines are working: over 80% of those testing positive in the U.S. are unvaccinated. Compared to fourth quarter 2020, today the yield on the U.S. 10-year Treasury notes is still some 45 basis points higher. Of course, we can debate whether this adequately reflects 90%-plus demonstrated efficacy rate of the vaccines or that over half the adult population is vaccinated in both Europe and the U.S., and that vaccine production has ramped up to reach projected 7 billion doses next year. Or that industrial production growth in the euro area has reached 24% per annum and is comfortably growing at double digit rates across all DMs.

Hugo: I see your point. We have got a tangible, visible recovery. Ok, growth is most likely peaking: there are no major economies in the world today that can sustain double-digit growth rates. Even so, with each passing day and month we get corroborating data points on strong economic recovery. Is the bond market telling us that the "next decade will be like the last decade"?

Olga: I think my approach to this question is slightly less philosophical than what you imply. Yes, the yield on U.S. 10-year Treasury notes is arguably the economy's most central price in so far as it is used as a benchmark rate for all sorts of domestic markets, from corporate credit to mortgage rates to auto loans and credit cards. For us in the public equities space, it very much affects the level of near-term multiples.

To the extent that over time the yield on the U.S. 10-year notes moves in tandem with GDP growth, we have developed a tendency to view it as an indictment across a rather wide spectrum: the future rate of inflation, Fed's conduct of monetary policy, economic projections of all sorts.

So much so, that we forget that at any one point in time, the yield in the secondary market is determined by nothing more than supply and demand for the underlying securities, with each potential buyer assessing his or her options across a range of financial instruments. And the Fed affects its policy priorities by changing the relative attractiveness of financial instruments for private buyers.

And to be sure, the Fed has been quite active in changing the relative supply of U.S. Treasury notes, thereby reducing yield on 10-year notes. This is undeniably too geeky for our walks, but I just had to share with you this chart: in March, the Fed began to withdraw liquidity by selling U.S. Treasury securities in the open markets. The Fed's action coincides exactly with the decline in the yield on U.S. 10-year Treasury notes.

Source: Federal Reserve, as of July 2021.

To go back to your question, the bond market did not change its mind on the current or future state of the U.S. or global economy or its outlook for inflation. Rather, it is responding to the changes in the supply of Treasury notes implemented by the Fed.

Hugo: If I understood you correctly, you are basically saying that before we jump into any far-reaching interpretations of the bond market moves, we should look at what the Fed is doing. If so, our assessment of the 10-year yield being closer to 2% may be quite consistent with fundamentals and the Fed will guide the markets there when it feels appropriate. Ok, stop me from getting overly excited and saying things like “goldilocks,” but it sounds like we are not getting the multiples headwind that we expected with the exceptionally juicy economic growth and

earnings growth. This is great for equities and actually feels pretty good for what we do, quality growth investing. With the markets having had a huge run, is there more to play for?

Olga: Oh, I think so! In many ways, it is really not different this time, just a classic recovery moving into expansion. What's different is the amplitude of this cycle. Exceptionally strong economic growth translates directly into high-double-digit earnings growth that companies will likely enjoy for longer than many currently expect. And we haven't even talked about operational leverage.

In fact, we have already seen some de facto multiples contraction, even in the absence of rising yields. For example, the multiple on the S&P 500 index of stocks has been basically flat since last summer, all the while companies are reporting exceptional double-digit earnings growth. In other words, these stocks are already "growing into their multiples," classic behavior as we move from recovery to expansion.

Now, we know that PMI surveys and especially the orders-inventories component offer the timeliest indication of near-term peaks. As orders roll over, we may face some near-term jitters in the equities markets. But on any multiyear horizon, equities remain one of the best growth assets, and there is little reason to think that it will be different this time. The key question today is what rate of economic growth is likely to be sustained in the post-pandemic economy? What is the cruising altitude for the global economy?

Hugo: Yes, that is the essential question today. If yields cannot tell us much about the next decade in terms of growth and inflation, what can? From our vantage point as growth investors, we see all kinds of attractive opportunities with huge potential profit shifts. I'm keen to discuss nascent inventions and innovations that will power the next decade of growth and returns. What is now scarce and unaffordable that might become cheap and ubiquitous tomorrow? How do we relate economic growth to specific investment opportunities or investability more broadly?

Olga: These are the kinds of topics I am really excited about. Already very much looking forward to our next walk.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.

Copyright © 2020 William Blair & Company, L.L.C. "William Blair" is a registered trademark of William Blair & Company, L.L.C. No part of this material may be reproduced in any form, or referred to in any other publication, without express written consent.