Why is everyone talking about the 10-year Treasury?

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- The new headline this week centered on the 10-year U.S. Treasury yield, which rose slightly above 3% intraday for the first time since January 2014. The 10-year U.S. Treasury is a yardstick used to gauge long-term growth and inflation expectations and thus serves as a key indicator of where the U.S. economy is heading.
- The markets, which have been lethargic, sold off as they digested the news on concerns that higher interest rates could start eating into corporate profits and potentially signal more inflation.
- There is little debate that the economic expansion is classified as "late-cycle," but that does not mean it must come to an early end. With the passage of the Tax Cuts and Jobs Act late last year, growth could accelerate throughout 2018, suggesting the end is not upon us just yet.

Why is the 10-year U.S Treasury dominating the headlines?

The 10-year Treasury is considered a risk-free benchmark, which makes it the one asset class to which all others – stocks, bonds, mortagages, etc. – are pegged. Because stocks are riskier than Treasuries, investors expect a higher return, with capital gains and income from dividends. Treasury bonds are risk-free because they are backed by the U.S. government, which has the ability to raise funds through taxation as well as print money. Therefore, Treasuries are considered free of default risk, whereas stocks and corporate bonds can fail. In short, the 10-year Treasury is a key bechmark that sets the baseline expectations for all other asset class returns.

What does the move in the 10-year U.S. Treasury signal?

To fully understand the significance of the move in the 10-year Treasury, we need to look briefly at the concept of yield. In its simplest definition, yield is the current income return you receive when you own an investment. For example, if a bond purchased for $1,000 pays $30 per year, that's a 3% annual yield. The concern behind the move in the 10-year Treasury note is that once it crosses over 3%, investors will find stocks less attractive and thus sell their stocks in order to buy Treasuries, which would essentially put an end to the bull market. In other words, think of the yield on the 10-year U.S. Treasury as competition for stocks.

Normally, interest rates are higher for longer-term maturities and lower for shorter-term maturities. The plot of interest rates to maturity is referred to as the yield curve. In recent months, another potential warning sign that has the markets nervous is that short-term interest rates could move higher to match the long-term rates. This phenomenon is known as the flattening of the yield curve. Recently, as the Federal Reserve has been raising rates, the gap between the 2-year yield and the 10-year yield has shrunk to about half of a percentage point. It's important to note that a flattening yield curve tends to signal future economic weakness. However, it's more important for investors to keep a close eye on the potential for an inverted yield curve, which occurs when longer-dated yields fall below those with shorter maturities. Historically, this scenario has proven to be more of a reliable indicator of future recession. Currently, the risk of an inverted yield curve remains low.

Is there a significance to 3%?

The 3% yield is viewed as a key threshold for many reasons, two of which could have a meaningful impact on the economy. First, auto loans, home mortgages, and other loans are tied to the benchmark 10-year yield. Mortgage rates in particular are closely tied to the level of the 10-year yield: as the 10-year yield rises, mortgage costs will move higher. As mortgage costs rise, U.S. economic growth, which is primarily fueled by credit, could slow down. Second, investors fear that higher interest rates could start to eat into corporate profits and signal that more inflation is coming. If corporate profits slow, that could result in layoffs, stagnant growth, a potential recession, and lower stock prices.

In many ways, the move up in yield is a positive sign indicating a normalization of markets as we enter a late-stage economic growth cycle. Nevertheless, investors have become accustomed to extremely low rates and are likely to panic when they see psychological thresholds breached. According to FactSet, corporate earnings have been strong so far for the first quarter, with 17% of the companies in the S&P 500 reporting actual results, of which 80% of those companies reported positive earnings per share (EPS) and 72% reported positive sales. Unfortunately, investors seem to be shrugging off the strong corporate earnings news over a single data point. Relatively speaking, a 3% long-term yield is not very high, and is an indication that central banks are stepping back because markets are healthy, and can cope without central bank help.

Bottom Line

As we move further into the 10th year of the current economic cycle, it is understandable that investors are nervous, especially as monetary policy and financial conditions shift from lowering interest rates to raising interest rates. There is little debate that the economic expansion is classified as "late-cycle," but that does not mean it must come to an early end. With the passage of the Tax Cuts and Jobs Act, growth could accelerate throughout 2018, suggesting the end is not upon us just yet. Moreover, investors should consider that consumers did not begin feeling the effects of tax cuts until the middle of February, when companies adjusted wages to reflect the new tax rates, suggesting that consumption could pick up for the remainder of the year. In addition, a very strong first-quarter earnings season suggests companies could increase investment spending in the quarters ahead. Taken together, these effects should sustain both economic and earnings growth in 2018, providing support for equity markets. So far, the 3% shock does not appear to be enough to alter the upward economic momentum that began last year with the tax reform. For the moment, at least, the beat goes on. La de da de de, la de da de da.

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