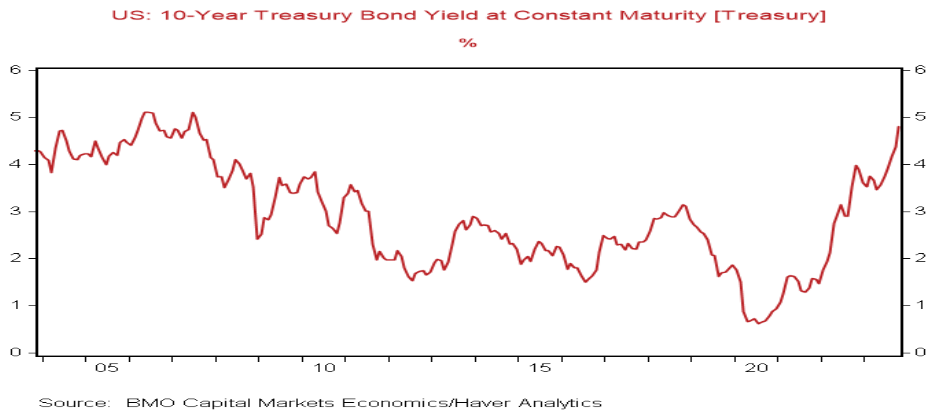
The 10-Year Tale

The 10-year Treasury yield is unanimously known as the S&P 500's adversary for the most watched benchmark in the financial markets. Over the past few months, the US 10 year has garnered even more attention through its stark fluctuations. Considered the "meteorologist" of the lending market, when there are shifts in government security yields, this is an indicator of fluctuating "weather patterns" throughout the borrowing landscape [1]. **Investors and corporates alike pay close attention to the movement in the 10-year treasury yield because it serves as a compass for bond and equity markets.** It is also a benchmark for mortgage rates, student debt, and auto loans, which if strained, can have direct impacts on the broader global financial health.

Changes in the 10-year yield can indicate a multitude of outcomes that generally pave a path for the economic backdrop and sentiment of the global markets. Economists, financial analysts and professionals that manage wealth at any capacity closely follow movements in the 10-year to establish predictions on all asset classes. In my experience, no asset class is insulated from interest rate moves over a defined period. During a period of rising yields, general economic theory suggests that there are higher expectations for sustained economic growth (and thus, inflation). When analyzed from the other end of the spectrum, declining yields signal flight to quality and restlessness in the capital markets leading to an influx of capital into US Government backed "safe-haven" investments. For example, after the referendum in which the UK voted to part ways with the European Union there was calamity in the financial markets, causing the Treasury yield to fall to 1.37% (record low at the time)[2]. A few months later when Donald Trump was elected president in November 2016, the 10-year gained some measurable traction reaching 2.60% by mid December. More recently, the COVID pandemic caused panic amongst investors and in the same month equity markets bottomed out, the Treasury yield hit an all time low of .54% on March 9, 2020. **Signals of economic growth and weakness can test yields.**



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As of recent, the US 10-year yield has been hovering around 4.1-4.2% as the process of consolidation continues through the release of retreating headline and core inflation numbers. This would be considered "relief" after the terse run-up to a 16 year high crossing the 5% mark. Natural growth in the 10-year is welcomed, but not at an unrelenting pace. Sustained advances in labor markets over the 2010's as well as 4-decade high inflation (and ensuing rate hikes by the Federal Reserve) were leading factors to breaching the 5% mark in October. Additionally, there has also been a steady pace of quantitative tightening, meaning the Federal Reserve is reducing the debt load on its balance sheet which further reduces liquidity in the markets and raises rates. The perfect cocktail of events to surpass the 10-year outside of accommodative territory is not an innocuous outcome. This barometer for economic health steers a lot of fiscal and monetary deliberations and order is necessary for all stakeholders in the financial markets.

What is the 10-year/What does the 10 year mean

As a refresher, the US 10-year bond is a debt obligation that is issued by the United States Government with a maturity of 10 years. The notes are sold to banks and other financial institutions through auctions directed by the US Treasury. These institutions then resell these notes on the secondary market [4]. Buyers of these securities are lending their capital to the US Government and are compensated by receiving interest on a semi-annual basis, as well as the face value upon maturity. In short, these securities are a loan to the US government which is deemed a safe haven investment as anything government backed is generally recognized as "riskless" (albeit, not as reassuring with the most recent debt dynamic). The 10-year yield affiliated to these securities is the annualized rate investors would earn if held to maturity.

The Yield Curve

Investors are particularly interested in the shape of the yield curve across different maturities. Typically, under "normal" circumstances and/or during expansionary environments, the curve is upward sloping. This is largely because debts of similar credit structure with longer maturities routinely compensate with higher interest rates. Investors are rewarded for holding bonds over longer periods because interest rate, inflation and default risks are all increased as the maturity lengthens. When the economy is in a state of growth, treasury yields are not typically attractive compared to equity market returns. This posit is more theoretical in nature as we have experienced an atypically long period of low yields. Conversely, when there is a flight to quality into the worlds most well-known reserve currency, investors of all stature will seek debt instruments at varying maturities which lowers the interest rates available. As demand increases through an influx into this asset class, the debtor can naturally offer lower rates.

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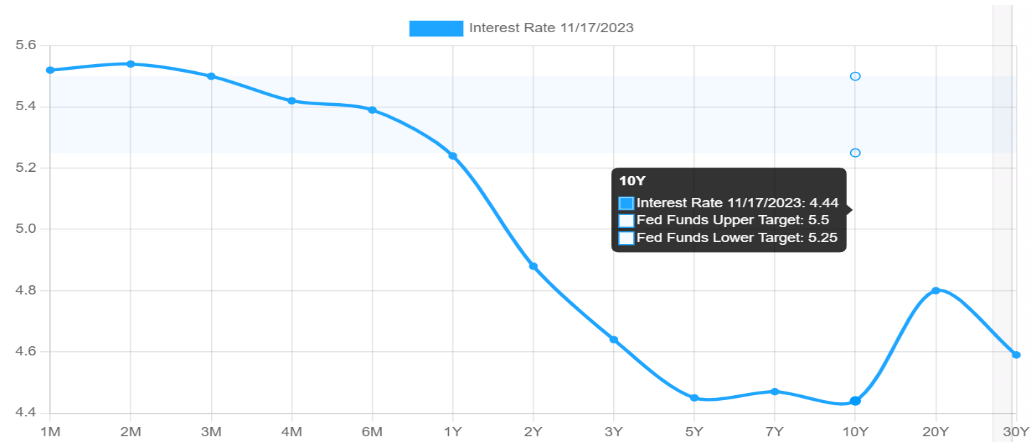

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As per the illustration above, during the central banks orchestrated regime to regain economic stability, investors lost confidence in risk assets which concurrently lead to an inversion. The short-end of the curve has been generated through consistent rate hikes to rein in inflation. Nonetheless, when there is an inversion of rates, this suggests the market has an acute sense of a forthcoming contraction. Cracks in the system from rate hikes have been seen in production numbers, easing labor markets and inflation data domestically and across the pond. However, the United States is remaining resilient on the GDP front which has challenged general macroeconomic theory.

November 2023 presented a much different story. A heightened view of deviation between Canada and the United States, our largest trading partners, continued to defy the imminent warning signs of a recession and grew at a 5.2% annualized pace in the most recent quarter [6]. Higher wages and excess savings continue to keep US consumer spending buoyed to the notion of demand leading to the fastest growth pace in nearly two years. US Equity markets saw a banner month; the S&P 500 rose 8% and the Nasdaq was up 10%, its best month since July 2022. The Dow also hurdled over its 3 month losing streak, rising 8.8% and recording its strongest month since October 2022 [7]. Strength normally correlates with higher yields. However, it appears that investors are pricing in the US economy to succumb to some economic woes alongside its developed counterparts. This all coincides with an inflation report that shows core and headline numbers reprieving and trending back to target levels of a well functioning economy. Even after the 4th straight month of lowering consumer sentiment within varying socioeconomic groups, data shows more tolerance and thus a rally in both bond and equity asset classes. This has satiated investors bringing a meaningful drop in bond yields and subsequent upside in equity markets.

As Treasuries are trending downward due to less strain from inflation numbers, it poses the question of directionally where the real economy is heading. This creates conflicting responses in equity markets and the necessary course of monetary policymakers in 2024. Yields falling across the curve because of inflation retreating is a signal of good news. Alternatively, yields falling because there is a demand for duration as investors anticipate a less than “soft” landing- not as positive of a storyline.

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What does this mean from an investor lens?

Still, when the 10-year is mentioned amongst investors alike, it is more of a high level talking point massaged into too high indicating "restrictive" and too low indicating "overly accommodative". There is a sweet science to its behaviour and underlying implications within a portfolio of investable assets:

1) The 10-year is used as a reference rate when valuing publicly traded securities. This point of reference can be utilized for discounted cash flow calculations, meaning an estimate on an investments value based on company projections for future income. The discount rate correlated with the 10-year can cause gyrations in valuations, especially when valuing a growth stock with forward looking sentiment.
2) Higher yields will draw investors away from riskier stocks, which can ultimately draw capital away from the greater market [8]. This principle has not necessarily been uniformly appreciated, or at least unambiguous in 2023 as the tech sector has continued to make strides.
3) From a capital structure perspective, during low interest rate environments in previous decades, companies had capacity to take on higher levels of debt to grow, invest in research and development, or simply stay afloat in leaner years. Now the burden of interest payments has many large corporations revisiting the viability of debt at its current borrowing costs. This can have a spillover impact on earnings and bottom-line profits, which is magnified through equity share prices.
4) The 10 year is closely tied as a proxy for mortgage rates. This rudimentary math indicates that as rates fall, the housing market strengthens which advances the economy. The US is more insulated from rate moves due to their ability to stretch out locked in rates over a 30-year period.

While the function of the 10-year suggests where capital is being deployed and the current macroeconomic environment, it should be emphasized that this is a moving target. The 5% October 10-year was slightly unsettling from a valuation perspective, but the frame of thinking should be to structure one's investments for the long-term. This means utilizing investment vehicles that steers one's capital into companies that are intuitive, supported empirically, and have competitive advantages that will maintain market share at a reasonable price point. There will be reversion in rates throughout the yield curve which will provide fertile grounds for both equities and fixed income. Patience is a virtue as investors endured a painful 2022, a year of adjustment in 2023 and a hopeful transition to broad based upside in the years to come. In the words of the late Charlie Munger, "the big money is not in the buying and selling, but in waiting".

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1) The 10-year Treasury yield: What it is and why it matters (usatoday.com)
2) Publications | BMO Economics
3) What Is The 10-Year Treasury Yield? Why Is It So Important? – Forbes Advisor
4) What Is The 10-Year Treasury Yield? Why Is It So Important? – Forbes Advisor
5) US Treasury Yield Curve
6) U.S. GDP grew at a 5.2% rate in the third quarter, even stronger than first indicated (cnbc.com)
7) Dow gains 520 points as US stocks notch their best month this year | CNN Business
8) 10-year Treasury yield: What it is and why it matters (sfgate.com)

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