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Investment Institute

Weekly perspective on current market sentiment July 28, 2021

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Last week's S&P 500 Index: +2.0%

Going low, for now

Key takeaways

- Low U.S. Treasury security yields are the result of both technical and fundamental factors.
- Our expectations call for higher yields as we move toward year-end 2022 and the bond market responds to a higher-growth environment.

To begin, we do believe interest rates are going to move higher. The question is "when and by how much?" As inflation readings have been on the rise, the yield on the 10-year Treasury note has actually fallen from just a touch below 1.75% in mid-May to the recent 1.25% low earlier this month. Recall that the year-over-year change in the Consumer Price Index (CPI) was +5% in May and +5.4% in June, which was highest reading for this indicator since December of 1990. And we may have several more months of high CPI readings ahead of us though we believe this indicator is in the process of peaking.

So higher inflation has resulted in lower bond yields. How is this possible you might ask? Shouldn't bond yields be going up in a rising inflationary environment? While that would typically occur in a "normal" recovery period within an economic cycle, that has not been the case so far in this particular one.

There are a couple of forces at work here in our opinion. First, let's look at it from a more technical angle. The Federal Reserve (Fed) is in the market buying $80 billion of Treasury securities each and every month and looks likely to extend this level of purchases at least into fall of this year. And that magnitude of purchasing has been meaningful. And in the second quarter, Fed purchases absorbed the entire net issuance of Treasury bonds, notes, and bills. This occurred as the Treasury General Account balance fell and reduced the need to issue debt securities and at the same time boosted demand by increasing bank reserves.

Another consideration is simple market demand. A resurgence of the COVID virus through the spread of the Delta variant here at home and abroad also likely brought safety-seeking investors into the market. Investors have been buying U.S. dollars, and Treasury securities. We expect the economy to maintain a strong growth rate, but some investors have concerns that global economic growth is slowing more quickly. In addition, the search for yield on a global basis has brought buyers into the U.S. Treasury market. While the nominal (not inflation-adjusted) yield on the 10-year Treasury note is a low 1.26% at the time of this writing, for example, the German 10-year Bund nominal yield is -0.43% (that's right, investors are paying the German government to hold their money).

As we look down the road through year-end 2022, we expect the global economic recovery to continue and the bond market to reflect improved conditions. Our projections call for 7% US. Growth this year and 5.3% in 2022, well above the historical average. We think the "perceived flight to safety" into U.S. Treasuries will ease and interest will rates to rise toward and likely somewhat above 2% by year-end 2022.

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Technical analysis is based on the study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the future.

Definitions

An index is unmanaged and not available for direct investment.

The **Consumer Price Index (CPI)** produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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