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THE BAFFLING BOND MARKET

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KEY TAKEAWAYS

The 10-year Treasury yield has declined at a rapid pace.

Economic fundamentals still look sound, even as yields send cautious signals.

Investors around the world have rushed into Treasuries for income, safety, and liquidity.

The bond market has been baffling recently. While U.S. stocks surged earlier this year, the 10-year Treasury yield quietly crept lower, puzzling market participants as the typical relationship between stocks and bonds (higher stock prices, higher yields) broke down at a rapid pace.

Then, the alligator jaws snapped shut. The S&P 500 Index has dropped about 6% since reaching a record high on April 30, and the decline of long-term government bond yields across the globe picked up speed [Figure 1]. Last week, the 10-year yield posted its biggest weekly drop in over four years to close at a 20-month low of 2.12%, and parts of the yield curve have flipped back into inverted territory (long-term rates falling below short-term rates).

The bond market's excessive pessimism has commanded Wall Street's attention, and we've seen several interpretations of Treasuries' cautious undertones. We'll sort through a few of them below.

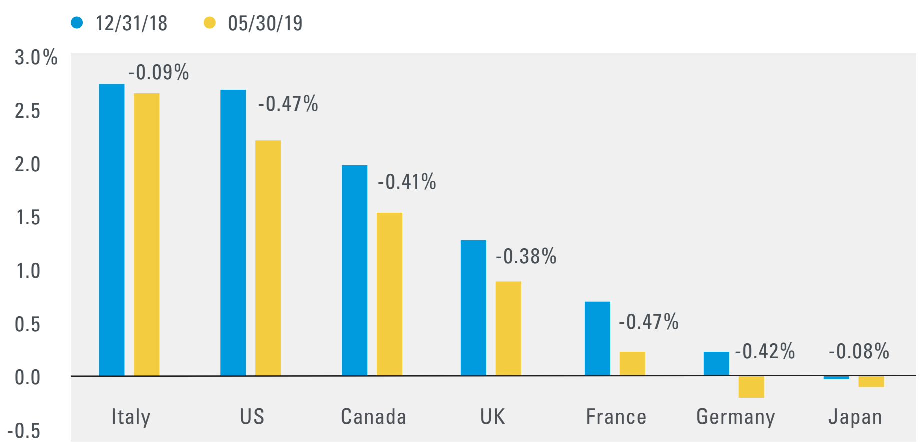
ECONOMIC PROSPECTS

The bond market has a reputation as one of the best predictors of economic prospects, so the recent drop in long-term yields has fueled recession fears.

To be fair, there is evidence of weakness in economic data. Recent durable goods orders, industrial production, and manufacturing data have shown that

1 U.S. LEADS 2019 GLOBAL YIELD ROUT

10-Year Government Bond Yields of G7 Countries



Source: LPL Research, Bloomberg 05/30/19 global demand continues to soften. Some of the 10-year yield's biggest drops this month occurred on days these reports were released.

The bulk of economic fundamentals don't support a 10-year yield nearing 2%, though. The economy has been growing at a 3% rate, according to last quarter's gross domestic product (GDP) growth; wage growth is healthy; and the U.S. labor market is close to full employment.

We also haven't seen signs of stress in other fixed income indicators. The spread between the 2-year and 10-year yields increased last week and remains squarely in positive territory, and corporate debt spreads have been relatively contained. We'd expect to see more deterioration across credit markets if a recession were imminent.

SAFE HAVEN TRADING

U.S. economic fundamentals look sound, but the rest of the world has struggled with signs of slowing this year. Trade and political headwinds have weighed on the global economy, and the most recent escalation in trade discord has been overwhelming for sovereign debt rates. The 10-year German bund yield is hovering around a record low, and the amount of negative-yielding global debt has climbed above $11 trillion [Figure 2].

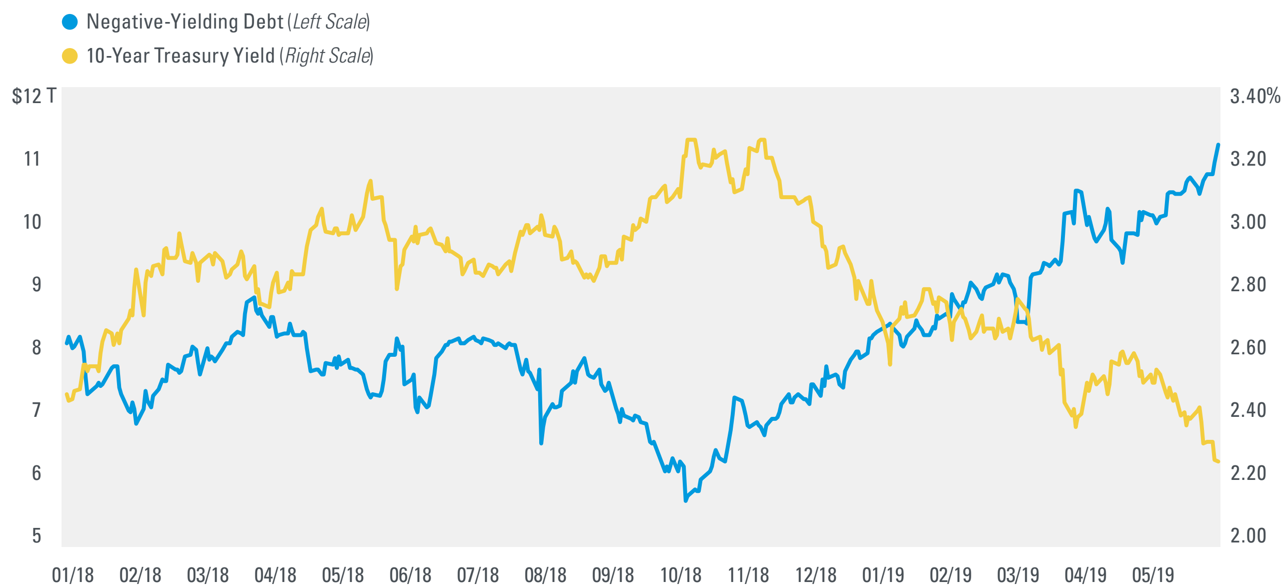
Because of this, global investors have piled into Treasuries at an increasing rate as they search for income, safety, and liquidity. Global stocks' recent slide has also sparked a safe-haven rush into Treasuries as investors look to hedge stock losses.

Fixed income investors' insatiable appetite for Treasuries could be a product of global uncertainty, and we expect it to continue as trade tensions between the United States and China remain elevated. We see a high chance of some negotiation on the horizon—maybe not a trade deal, but at least a trade truce that allows discussions to get back on track. If this happens, we'd expect stabilizing global growth to help support yields worldwide.

RATE CUT POSITIONING

Trade and political headwinds have understandably spooked investors, and they've increasingly positioned for Federal Reserve (Fed) rate cuts.

2 RATES SLIDE AS NEGATIVE-YIELDING DEBT CLIMBS



Source: LPL Research, Bloomberg 05/30/19

Negative-yielding debt is measured by the Bloomberg Barclays Global Agg Negative Yielding Debt Market Value USD Index.

The 2-year yield has dropped more than 50 basis points (0.50%) below the upper-bound fed funds rate, and fed fund futures are now pricing in a near-certain chance of a lower policy rate by year-end. Even though short-term yields are more reflective of monetary policy, the growing consensus for loosening policy has weighed on the entire Treasury curve.

We don't see the argument for a lower policy rate should trade tensions improve, which remains our base case. However, a protracted trade dispute could further weigh on growth and justify a cut. The Fed has already communicated a pause in policy adjustments until there is greater clarity on global conditions, which we think could come from U.S.-China trade progress. Clarity on trade should lead to a resurgence in business and consumer demand, which would eventually necessitate tighter policy—perhaps not in 2019, but later in this economic cycle.

The Fed has repeatedly said policy decisions are data-dependent. While policymakers consider financial markets in their deliberations, they ultimately operate under a dual mandate of stable inflation and maximum employment (with an unofficial third mandate of global stability). It's tough to make a case for lower rates with over 3% GDP growth, healthy wage growth, and a labor market close to full employment. The Fed also understands that any cut now would reduce its ability to adjust policy when a recession does materialize.

If the United States and China come back to the table, we would expect stabilizing growth expectations to fuel a reversal in rate cut positioning and a rebound in yields.

CONCLUSION

One of our biggest challenges this year has been explaining a bond market that's become increasingly pessimistic on the economic outlook. In any case, we encourage investors not to get too caught up in Treasuries' cautious signaling. We see plenty of evidence that solid U.S. fundamentals are intact, and we don't think yields' recent decline is simply an indictment of future economic growth. We think the most plausible explanation here is that intensifying trade and political risks have ignited a wave of panic buying in U.S. debt, a trend we expect to reverse as trade risk subsides. ■