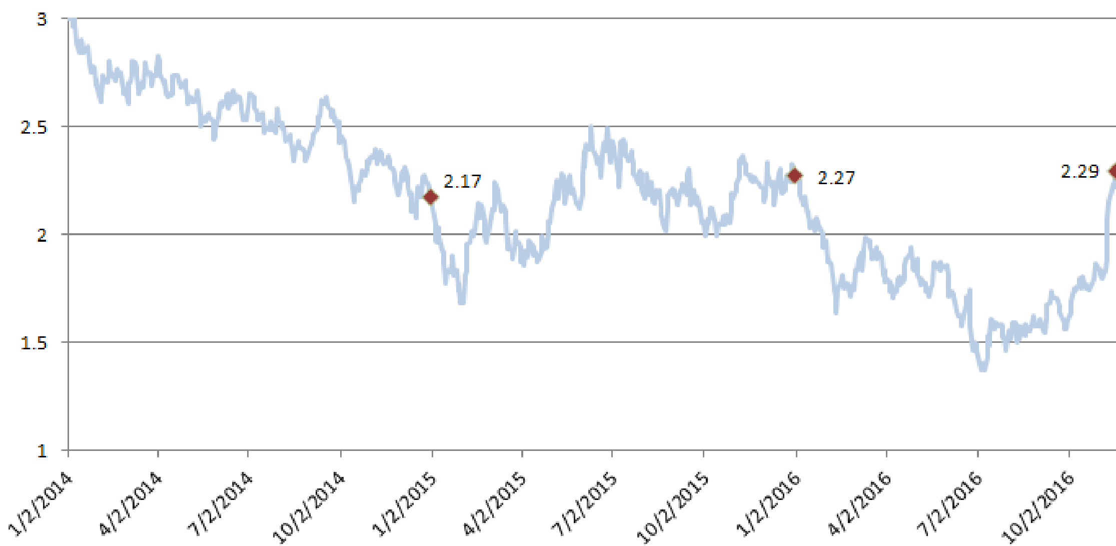
Will 2017 Be the Year of Rising Rates?

Following the presidential election, bond markets have seen a major selloff. Bond yields, which move inversely to bond prices, have risen, reaching 2016 highs. Case in point, the U. S. 10-year Treasury yield rose from 1.88% on Election Day to 2.34% on November 18. The graph below provides some prospective on this sharp move. Since hitting a historic low and falling under 1.4% in early July, the 10-year Treasury yield, generally considered a benchmark, has moved nearly one percent higher in just six months. Looking back over the last couple of years, 2016 is not all that different from 2015. Yields in both years started around the same level, experienced some volatility, and then ended close to where they began. The red dots in the graph below highlight where the 10-year U.S. Treasury yield ended each year. The last red dot represents the most recent data as of 11/17/16.



Source: U.S. Department of the Treasury

This year may be different than 2015, though. Drivers of the volatility in 2015 include volatility in oil prices and anticipation of the Fed raising interest rates. This year's movement seems to be driven more by inflation speculation. Beyond the inflationary pressure of the potential infrastructure spending that both candidates supported on the campaign trail, Trump has supported deregulation which could be expected to spur more growth and thus even more inflation.

Contrary to some of the negative campaign rhetoric on both sides, the economy is actually improving. Recent economic data shows housing starts jumped 25.5% in October, the fastest pace since August 2007, and weekly jobless claims fell to the lowest level since 1973. The U.S. economy may be near full employment, with an unemployment rate below 5%. This is starting to put pressure on employers to increase wages, which could be a key driver of inflation. As of September, wages rose 2.8% on a year over year basis, the largest increase in seven and a half years. Voters in four states (Arizona, Colorado, Maine and Washington) voted to increase the minimum wage. These increases will take effect in 2020 and will likely add inflation pressures.

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In addition to domestic factors, there are also international factors pushing Treasury yields higher. It is expected that the Bank of Japan and European Central Bank will reduce their expansionary monetary policies, which may lead their bond yields to rise as they buy fewer bonds. Also, the yield advantage for foreign buyers who had been buying U.S. Treasurys and hedging the currency risk in a search for yield has dissipated, as it is increasing expensive to hedge this currency risk. Lastly, central banks in emerging markets have been selling Treasuries to support their currencies.

There are many factors pushing up inflation expectations in 2016 and leading investors to sell Treasurys and drive yields higher. The U.S. economy is expected to benefit from increased fiscal spending, decreases in tax rates and deregulation. This potential for growth, which could lead to tighter monetary policy, has raised inflation fears. It remains to be seen where yields go from here, but there does seem to be merit to these fears. We may very well be in a new paradigm. Bond yields have fallen for over 30 years, and, for the reasons outlined above, this may be set to reverse.

We continue to recommend a shorter-than-benchmark duration, although still keeping some duration in portfolios to buffer equity volatility. Being overweight credit may benefit a portfolio as the additional yield can offset some of the principal losses from falling bond prices. We are comfortable with this credit overweight because improving growth prospects which push up yields would also likely cause default rates to remain subdued. Diversification within fixed income is also important, such as not having too much exposure to one risk factor such as duration, credit or sector.

This report is created by Tower Square Investment Management LLC

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