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The Day Ahead: Pain and Belief Radiating Across The Rate Spectrum

More often than not, when I use the word "believe" (or belief), it's in some vague and positive context. For instance, something like "bond buyers are starting to believe again." That **won't be the case** today--at least not as far as the positive context is concerned. Today I want to talk about the beliefs that have radiated up from the short end of the yield curve over the past few years. They're like an infection that started in the toe but spread to more vital organs surprisingly quickly.

The "yield curve" is just a fancy way of referring to the **spectrum of time** associated with various loans. The loans in this case are those taken out by the US government (via the Treasury Department) to finance all of its various spending. For instance, there are Treasury bills lasting mere weeks, notes ranging from 2-10 years, and bonds lasting a full 30 years. These different loan lengths are technically known as "maturities" because they refer to the length of time in which the underlying bill/note/bond "matures."

As you might expect, if investors are going to be tying their money up (by lending it to the government) for different amounts of time, they expect **different rates of return**. There's a quintessential "rule" and "exception" here. The rule is the logical part: the longer my money is tied up, the higher the rate of return I expect. For example, a 30yr bond should have a much higher interest rate than a 2yr note.

But there is definitely an exception to that rule. **Counterintuitive** as it may be, there are multiple past examples of short-term rates rising ABOVE longer term rates. The jargon phrase for that phenomenon is "yield curve inversion," and it's pretty close to happening for the first time since 2007.

Inversion is a hot topic because it's thought to **foreshadow recessions**. Beyond that, it's a hot topic because inversions typically mean that short-term rates have had occasion to be rising aggressively for a number of months or years. While long-term rates may not have been rising as much during that time, they nonetheless feel the pressure.

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 5.0	99.37	+0.02
MBS GNMA 5.0	99.93	+0.02
10 YR Treasury	3.9068	+0.0029
30 YR Treasury	4.1960	+0.0028

Pricing as of: 9/1 7:34PM EST

Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	6.43%	+0.02	0.00
15 Yr. Fixed	5.95%	0.00	0.00
30 Yr. FHA	5.82%	+0.02	0.00
30 Yr. Jumbo	6.62%	0.00	0.00
5/1 ARM	6.28%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.35%	-0.51	0.00
15 Yr. Fixed	5.51%	-0.65	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	6.44%	-0.06	0.54
15 Yr. Fixed	5.88%	-0.16	0.68
30 Yr. FHA	6.36%	-0.06	0.85

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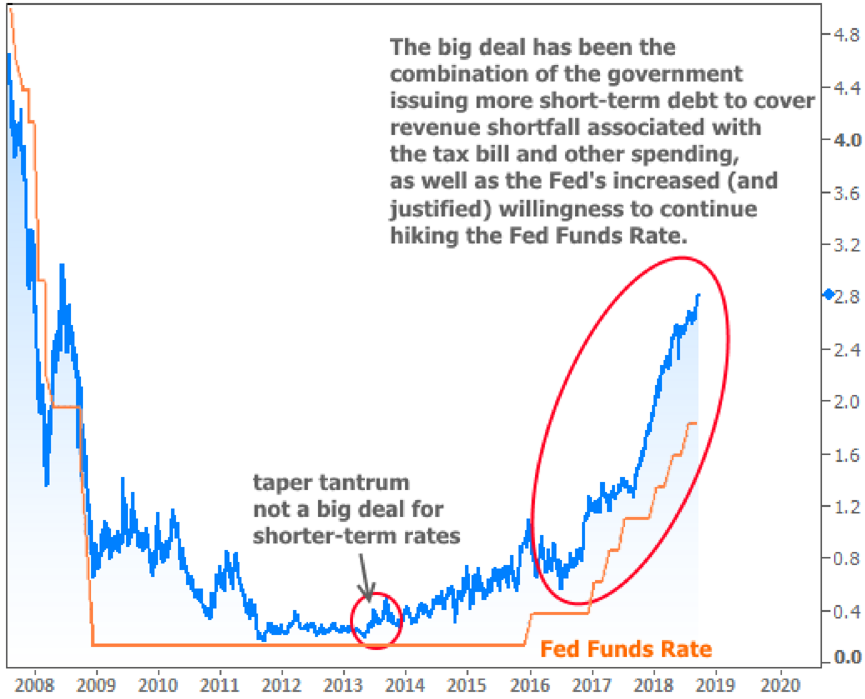
	Rate	Change	Points
30 Yr. Jumbo	6.75%	+0.07	0.39
5/1 ARM	5.98%	-0.27	0.65

Rates as of: 8/30



The previous chart shows how short-term Treasuries are closely linked to the Fed Funds Rate, but that's a bit of a 'chicken or the egg' phenomenon. One could argue the Fed is raising its policy rate due to certain factors in the economy. Therefore, 2yr yields are **actually** rising due to those factors, even if the final question Treasury traders are asking themselves is whether or not those factors make it more likely for the Fed to hike rates.

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Here's where things get a bit more tricky. The Fed Funds Rate (and/or 2yr Treasury yields, if you like) radiate up the yield curve to some extent. In other words, "stuff" that makes short term rates move higher also has a chance to impact longer term rates. The simplest way to think about it would be from the mindset of a bond market investor who sees a strong underlying reason for 2yr yields to move higher and asks "will that underlying reason still be having an impact on rates in 5, 10, 30 years?" In fact, an **even better** way to phrase that question would be something like "how does this underlying reason change the average rates of return I should expect over the next 5, 10, 30 years."

I know this can be a bit esoteric, so here's the simplest way to think about it. Investors have to take what they know about the forces impacting rates today and essentially guess at how those forces will impact rates in the future in order to get an idea of their desired rates of return. In the chart above, notice that the taper tantrum was only a huge deal for longer-term yields, because the "tapering" was only going to affect longer-term bonds (the Fed hadn't yet talked about hiking short-term rates). In short: it's all about deciding what's going to matter for rates, and when.

With all of the above in mind, 5-year Treasury yields have been a sort of hybrid, blurring the lines between the quintessential short-term debt (2yr Treasuries) and the quintessential long-term debt (10yr Treasuries). They are increasingly **telling a story**--saying that investors are starting to believe that the short-term considerations causing upward pressure on short-term rates ALSO deserve some of our belief in their ability to cause upward pressure on longer-term rates.

Bottom line: it's been easy to decide that short-term yields should rise due to the recent realities in financial markets and monetary/fiscal policy. It remained to be seen whether those realities would radiate out to longer-term rates. The strong economic data seen so far in September, talk of another tax bill, a Federal Reserve that is persistently more willing to hike rates, inflation holding ground at the highest post-crisis levels, and the generally anticlimactic market response to trade war drama is all **adding to that radiation.** That's why longer-term rates are so willing to be moving back to long-term highs.

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Whereas many traders/analysts/pundits/investors thought the economic and monetary outlook would have begun to cool off by now, it's actually only become more threatening for rates. Something would have to happen to reintroduce fear and skepticism about the future in order for rates to make a meaningful shift back toward lower levels. We can't know exactly when or why that will happen. We just know **it hasn't happened yet.** Between now and the time we begin to wonder if that's changing, it makes a ton of sense to be very defensive about rates either remaining high or moving higher. Our best case scenario in the short term is to find next week that investors were bracing for Wednesday's Federal Reserve Announcement, and for their guard to quickly be lowered on Thursday/Friday.

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