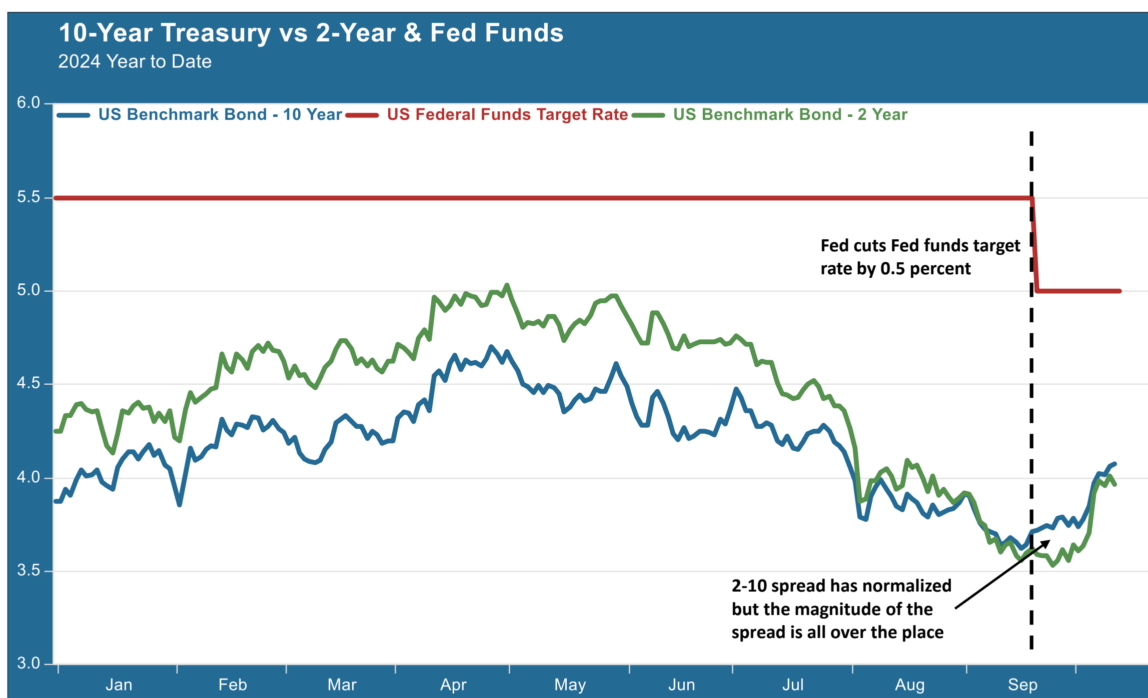
MV CAPITAL MANAGEMENT

Weekly Market Flash

Rates Go Down, Rates Go Up

October 11, 2024

A lot of things have been happening in the bond market as of late. What to make of the fact that, subsequent to the Federal Open Market Committee reducing the Fed funds target rate by a larger than usual 0.5 percent on September 18, Treasury yields across maturities from six months to 30 years have gone up? The benchmark 10-year yield is more than half a percent higher than where it was one month ago. The two-year yield, which sits in closer proximity to the Fed funds rate (the overnight bank lending rate) is up a quarter percent from where it was last week. And while the spread between the two-year and ten-year yields is no longer inverted, it has waxed and waned like a harvest moon in the three weeks since the FOMC's rate cut move.



Source: US Federal Reserve, MVF Research, FactSet

More Time, More Variables

When we meet in our weekly investment committee to discuss our fixed income strategy, we start with what we know with a high degree of certainty, and move from there into the fog of the unknown. What do we know at present? We know that the Fed is moving from a pause on monetary tightening into an easing cycle, which we expect will continue for the foreseeable future. Interest rates clustered around the Fed funds rate, which the Fed influences directly through its open market operations, should come down over the course of this cycle. We can posit with fairly high confidence that interest rates on Treasury bills (maturities up to and including one year) will be lower than they are today.

Moving farther out the yield curve, though, things get trickier. Consider the above chart, with the post-FOMC spike in intermediate Treasury yields. Yields out here rise and fall as the market ingests multiple data points about anything that can have an impact on the global economy. Notably, the last couple weeks

have served up several important insights into the strength of the economy. Last week's blockbuster jobs report erased all those concerns about a tanking labor market that impacted risk assets back in August. This week's Consumer Price Index report showed that, while inflation appears to still be on its downward trajectory, price growth in September was a bit higher than economists expected. Ongoing strength in the economy suggests the absence of an environment that would prompt the Fed to accelerate its monetary easing, hence the pronounced rise in rates. But buyer (or seller) beware – that could change on a dime as yields lurch from one data point to the next. Volatility in the Treasury market, according to the Ice BoA Move index (a measure of expected bond market volatility) is at its highest level since the beginning of the year. Every macro report, every quarterly corporate earnings call, every unexpected flare-up somewhere in the world, adds to this cocktail of volatility.

De-inversion Tea Leaves

Then there is that persistent question about what the de-inversion of the yield curve means. After more than two years of inversion, the 2-10 Treasury spread normalized in early September. According to the textbook theories about inverted yield curves, it is when the curve returns to a normal shape that we should all start to worry about a recession. But – as we noted above – the economy is currently showing no convincing signs of any approaching recession. Is this the event that puts paid to the predictive powers of the inverted yield curve?

Here's the thing: since 1982 – the year in which for many reasons we argue that the modern age of securities markets began – we have had a total of four recessions. One of those – the 2020 Covid recession, was manufactured by human hands. The other three – the 1990 cyclical downturn, the 2001 event adjacent to the tech stock crash and the 2008 Great Recession – have very little in common with each other.

Simply put, there just is not a lot of statistical significance behind the argument that "recessions follow inverted yield curves." Maybe we'll have one at some point next year, maybe we won't. In the meantime, we will continue to position our fixed income portfolios according to the things we know with more confidence, and tread more carefully in the more uncertain terrain of intermediate and long durations.

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