Maybank

Group Wealth Management Research

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Taking stock of rising Treasury yields

Sharp spike in Treasury yields

The 10-year U.S. Treasury (UST) yield hit an intraday high of 1.61% before retreating to close at 1.41% last week. In fact, the Treasury yield has risen rapidly from the lows of 0.91% since the beginning of this year (Figure 1). The sharp spike in yields led to a sell-off in the equity markets amid heightened volatility. Notably, the tech-heavy NASDAQ composite declined 3.5% last Thursday, its worst session since October last year. The volatility (VIX) index also jumped again after witnessing an earlier spike in end January triggered by the retail trading frenzy.

Why are investors concerned?

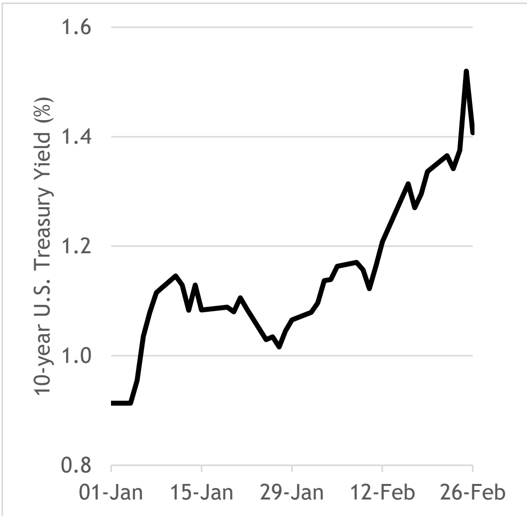
A rise in Treasury yields is often seen as a reflection of improving growth prospects and inflation expectations. However, the recent surge in yields has stoked fears of runaway inflation that may lead to a reversal of the U.S. Federal Reserve (Fed)'s current easy monetary policy stance. In particular, investors are concerned that the Fed may taper its bond purchases or even hike its policy rate much earlier than expected.

On top of that, the surge in Treasury yields also has the effect of reducing the relative attractiveness of equities over bonds. Notably, the spread between S&P 500 earnings yield and 10Y UST yield has narrowed although it is still above historical average levels. In addition, the higher rates are deemed to have a negative impact on the value of future cash flows and consequently equity valuations, particularly for the high-flying tech stocks that are typically more expensively valued. More broadly, the 10-year UST yield is often used as a benchmark for mortgage rates and auto loans in the U.S. so there are concerns that the rapidly rising yield could hamper the nascent growth recovery.

What is our view?

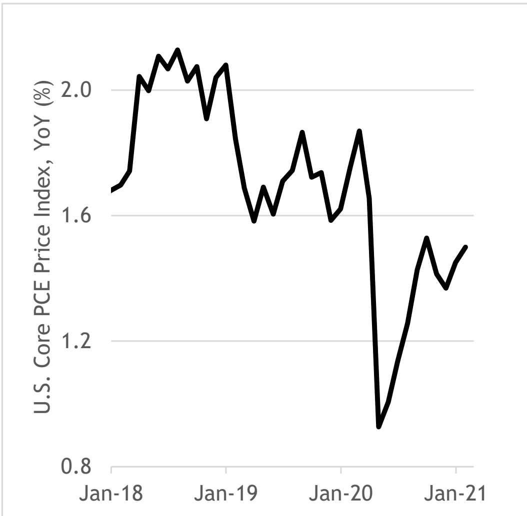
We believe the current spike in the Treasury yields is more likely driven by expectations of inflation, and not necessarily the reality. As such, it is premature to project that inflation will run away and trigger an earlier-than-expected monetary tightening. While the latest U.S. Core Personal Consumer Expenditure (PCE) price index, a key inflation metric tracked by the Fed, showed an uptick by rising 1.5% year-on-year (YoY) in January 2021, it is still well below the Fed's target of 2%. Although inflation could spike in the short-term due to low base effects and post-pandemic reopening, it is unlikely to be sustainable given the considerable slack in the economy and still soft employment market.

Figure 1: Rapid rise in 10-year U.S. Treasury yield since the start of 2021



Source: Bloomberg I 26 February 2021

Figure 2: U.S. core inflation remaining benign despite recent uptick



Source: Bloomberg | 26 February 2021

The Fed seems to agree. In a recent Congressional testimony, Fed Chair Jerome Powell said it may take more than three years for inflation to hit the Fed's target, signalling that the central bank is prepared to look beyond any short-term spike in inflation. Powell also reaffirmed that the labour market was far from the Fed's goal, saying there is still "a long way to go" before the US reaches maximum employment. It reinforces our take that the rise in inflation is transitory and easy monetary policy will not be ending anytime soon. While talks of Fed eventually tapering its bond purchases could lead to heightened volatility from time to time, the equity market should be able to sustain its uptrend amid a healthy growth and benign inflation environment.

Investment implications

While the markets may remain volatile in the near-term, we maintain a constructive investment outlook underpinned by the aggressive vaccine rollouts, supportive monetary and fiscal policies as well as robust corporate earnings recovery. In addition, we believe the Fed will likely step in should the Treasury yields surge further lest the rate increase disrupt the growth recovery. This could be achieved by more dovish guidance, altering its bond purchases, or even introducing yield curve control if necessary.

Still, it remains critical for investors to maintain a diversified portfolio given the lingering uncertainties. Within equities, we continue to favour businesses that are exposed to secular growth trends such as digital consumption and cloud computing. In addition, investors may selectively consider value cyclicals that could benefit from the re-opening of economies including those from Energy and Financials sectors. Apart from growth, we would continue to seek stable income through corporate credits. In particular, we believe Asia credits offer better carry opportunities over government bonds given the former's resilient fundamentals and attractive valuation. Lastly, we would maintain some exposure in gold which can serve as an effective portfolio diversifier during times of uncertainties.

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