Rodney’s Take

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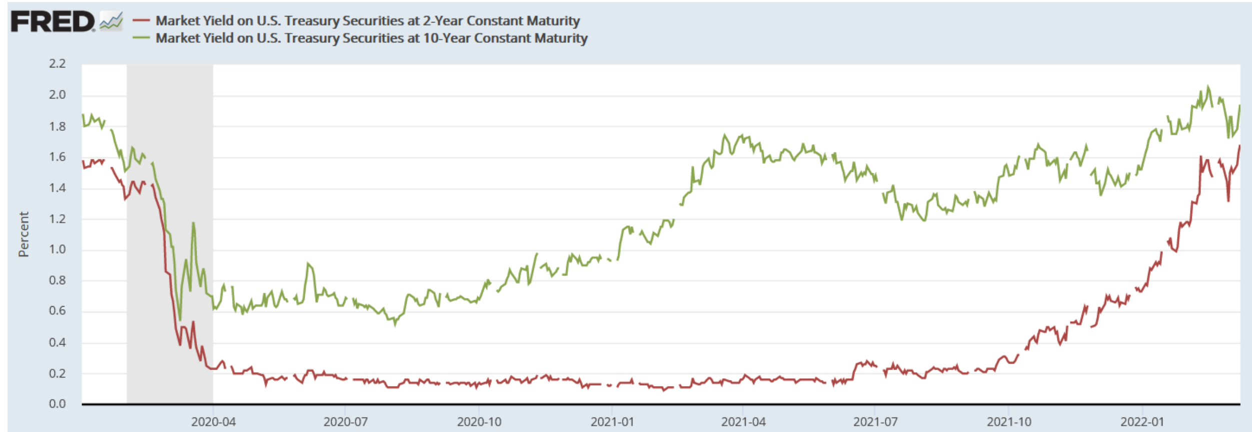
Is it Time for Leisure Suits and Disco?

The bond market is getting weird. Before Ukraine, all eyes were on the Fed, as central bankers mused in various speeches about how high they should be raising short-term rates this year and what they might do with their $9T balance sheet. I’ve always thought that the answer to the second question matters a lot more to the economy than the first, but that doesn’t mean interest rates aren’t important.

By watching rates, we can get a sense of where fixed-income investors (institutions, pension funds, hedge funds, etc.) think that the economy will be in the months and years ahead. Granted, we couldn’t learn much from interest rates as long as the Fed sat on the scale, printing money to buy bonds no matter what the cost. But the Fed has been winding down its bond-buying program since last November and likely will end it completely next week. The remaining buyers are people with real skin in the game. Unlike the blind-buying Fed, other participants win and lose depending on what happens with rates. Today, rates all along the yield curve are moving higher, but the short end of the curve is moving up faster than the long end. That’s a problem.

The chart below shows the yield on the 10-year constant maturity Treasury bond in green and the yield on the constant maturity 2-year Treasury bond in red. The wider the distance between the two, the so-called “2s10s spread,” the more an investor will earn on 10-year bonds compared with 2-year bonds.



When the 2s10s spread is big, it means that medium-term interest rates are significantly higher than short-term rates. Two-year Treasury bond interest rates are heavily influenced by the federal funds overnight rate, which the Fed sets. Unless the Fed is weighing heavily in the markets by purchasing bonds, long-term interest rates reflect what investors think will happen in the economy in the years to come. Lower long-term rates, which indicate a small 2s10s spread, imply low inflation and low growth.

We had a small 2s10s spread just before the pandemic, as we dealt with weak GDP growth after the effects of tax reform wore off and Congress impeached President Trump. The spread jumped in the early days of the pandemic, when the Fed cut the overnight rate to zero and then trended higher as the economy rebounded from the pandemic with successive stimulus bills in late 2020 and the early months of 2021. But since late last fall, the 2s10s spread has fallen dramatically. We've gone from a 1.5% spread last March to just 0.26% today.

There's no doubt that investors believe the Fed will start raising overnight rates this week, which pushes the 2-year Treasury yield higher and narrows the spread. But something about the weak growth of the 10-year Treasury yield should give us pause.

Inflation is running just under 8% and likely will cross that mark this month. Fourth-quarter GDP increased 7%. Both of those numbers are hot, and yet

the 10-year Treasury bond is 6% lower than inflation and 5% less than GDP growth!

It could be that we're merely living through an adjustment period during which it takes long-term bond yields a while to march higher as the Fed stops buying bonds… maybe. Or it could be that bond investors don't expect much growth in the near future. If that's the case, then red-hot inflation without growth will cause a redux of the 1970s stagflation. We won't have all of the same problems, because unemployment should remain low, but investors will have to deal with negative real interest rates and workers will watch rising prices eat up more of their paychecks.

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Got a question or comment? You can contact us at info@hsdent.com.