Where Are Bond Yields Going?
It depends on what part of the curve you are asking about.

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Liquidity versus Solvency

The goal of the Fed’s policy response function is to prevent the liquidity crisis brought on by Covid-19 from becoming a solvency crisis. This is achieved by keeping interest rates low in the short- and intermediate-term segments of the yield curve, providing corporations with the opportunity to refinance debt at lower costs and have ongoing access to affordable capital. The ultimate goal is to minimize funding risks and keep companies solvent.

As such, the main focus of the Fed is to keep rates managed lower for maturities of less than 10 years. On the other hand, maturities greater than 10 years are at risk to rise and have their curves steepen.

Will the Fed succeed? Perhaps. Part of the answer relies on whether it can force the private sector to participate in the market. There is often some skepticism at the onset of Fed purchase programs and the risk that the private sector may not follow. But in that case we reiterate that the Fed will do “whatever it takes” to achieve their goals, and we do not think it wise to “fight the Fed” and end up on the wrong side of this trade.

In the end the impact of the Fed ultimately depends on the lingering impact of the coronavirus and the path and pace of the reopening of the global economy.

Supply and Demand: It’s all about the math

There is a massive amount of supply in the markets. The question is whether it can be effectively matched by demand.
Supply
The refunding of U.S. Treasuries (UST) was slightly larger than expected and skewed towards longer maturities:

- On the yield curve we saw a modest steepening for maturities less than 10 years and a more pronounced steepening for those greater than 10 years
  - UST 2-10-year peaked at 265bps in 2013, bottomed at -5bps in Aug 2019 and are now starting to re-steepen at 54bps, a 20% retracement.
  - UST 10-30-year peaked at 125bps in 2013, bottomed at 10bps in July 2018 and are now at 71bps, roughly a 50% retracement.
  - The supply of corporate bonds is currently estimated at $1 - $1.5 trillion in 2020 (and we expect it closer to $1.5 trillion as we are already at $840 billion YTD). This compares to $1 trillion in 2019.¹

- Negative interest rates? Fed Chair Powell says no! He stated in an interview with the Peterson Institute on May 13, 2020:
  - The current Fed tools are working, and it does not see it necessary to move to negative rates.
  - The Fed has seen mixed results on negative rates, no clear evidence that they work.
  - The risk of using negative rates is that it impacts the bank intermediation process, i.e. it impedes its ability to extend credit to the real economy.
  - We think that a move to negative interest rates would also mean serious structural and legal considerations, including a review of Dodd-Frank and prime and money market funds.

Demand
Demand is primarily a function of the Fed and their Quantitative Easing program. As of today, most of QE is focused on maturities of less than 10 years. Beyond that, the Fed has indicated they will keep policy rates at 0% for “as long as it takes,” perhaps until 2023.

¹ Bloomberg, 2019
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- Mathematically this keeps front-end, and to a large degree, intermediate-term rates anchored.
- Longer-term rates tend to be less impacted by near-term policy expectations.

A note on credit risk

The Fed purchase program is designed to support Investment Grade debt, but not most of High Yield. As we like to say at MSIM, High Yield is “outside the tent” and will not benefit from the Fed’s monetary policies. In the end the Fed cannot eliminate credit risk, an important consideration for active managers.

Reopening global economies

The pace and the path of the reopening of global economies is a linchpin of the Fed’s market outlook

- When the economy opens, it is assumed it will stay open. But will it?

- Does consumer confidence return? It is our view that this depends on medical developments, including therapeutics (a vaccine?) and improved preparedness of the healthcare system.

- A reopening of SMALL BUSINESS is absolutely critical, as small businesses account for roughly 65% of job creation. We recommend that investors pay attention to the NFIB small business confidence survey (released on the second Tuesday of each month at 6 AM EST). The survey is akin to the ISM or PMI, but for small businesses, and is the most underappreciated economic data point we receive each month.

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