INTEREST RATES IN TURMOIL

The fourth quarter of 2023 begins with interest rates at multi-year highs after a very choppy nine months. In the early months of the year, rates were generally steady while the yield curve became more inverted.

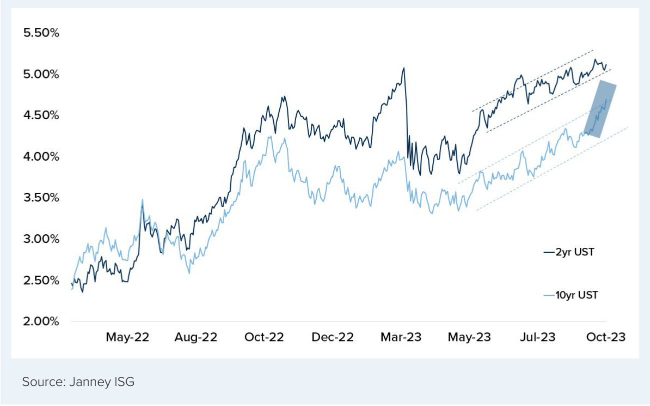
Key Takeaways

- As the fourth quarter begins, bond markets are on track for a third year of higher interest rates, the first such occurrence since the early 1980s.
- While inflation ruled the markets in late 2021 into early 2023, the calculus is ironically much more complex now that the Fed has eased off its campaign of raising rates.
- Supply of longer-term bonds is a grinding factor that is putting pressure on the markets, day in and day out.
- The chance of such a boom is enough to reprice the interest rate markets to include a term premium for bonds over and above the market's expectations for overnight interest rates.
- With bonds offering their highest level of income generation in 15 years, we like adding to fixed income allocations overall, but suggest staying relatively short as the skew in interest rates is still to the upside.

In the wake of the March regional banking crisis, interest rates fell and the shape of the yield curve fluctuated widely. In the last several months, however, the yield curve has steepened (become less inverted), and interest rates have risen considerably. Today, the 2, 5, and 10yr Treasury notes are all yielding the most they have since 2007 after having charted increases in 2021, 2022, and now 2023 as well. If we hold near these levels for the last few months of the year, it will mark the first time since the early 1980s that the world has seen bonds rise in three consecutive years as well as the first time in history that bond markets have delivered negative returns three years running.

Although rates are rising across the curve, the dynamics governing the interest rate markets have shifted notably. In late 2021 through early 2023, the primary feature of the U.S. economy was crisis-level inflation. During that crisis period, the core PCE peaked at a 5.6% YoY inflation rate, the worst in a generation. Today, while price levels are high in absolute terms, they are no longer rising sharply. As of August's data, the same core PCE is trending at a 2.2% annualized rate over the last three months. During that crisis period, the Federal Reserve was slamming the brakes on the economy by raising interest rates 0.50% - 0.75% at a clip. Today, the Fed is no longer hiking, and if they do so again, it will be at a 0.25% per meeting rate.

Chart 1: Yields Resumed Upward Trend After Midyear Break; Trend Accelerated for Longer Term Bonds



Source: Janney ISG

BEHIND THE SELLOFF

With inflation normalized and the Fed on hold, we see two major factors still driving rates higher. The first of those is duration supply. In August, at its "Quarterly Refunding Announcement," the U.S. Treasury Dept indicated it would need to issue substantially more notes and bonds to fund the U.S. budget deficit—$15 billion per month more, to be exact, with $6 billion of the increase coming in longer-term bonds with maturities of 10 to 30 years. Short-term Treasuries have lower durations, less volatility, and less risk, making them easier for markets to absorb. The same cannot be said for long-term Treasuries.

Table 1: Treasury Auction Sizes Increased $15bln

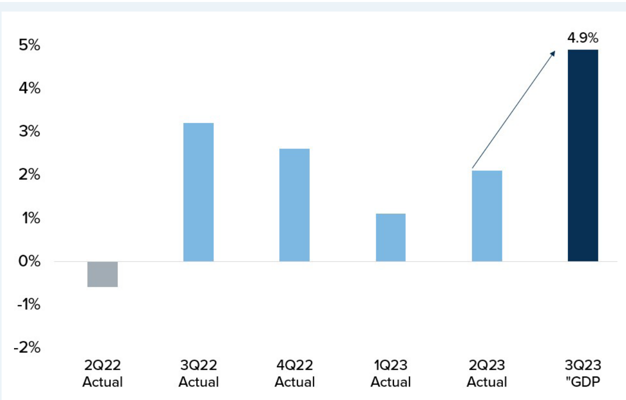
Maturity	Aug 2023	Change*
2yr	$45bln	+$3bln
3yr	$42bln	+$2bln
5yr	$46bln	+$3bln
7yr	$36bln	+$1bln
10yr	$38bln	+$3bln
20yr	$16bln	+$1bln
30yr	$23bln	+$2bln

**Change is vs last qrtly refunding in May*

Source: Janney ISG, US Treasury Dept.

Compounding the U.S. supply increase was action from the Bank of Japan (BoJ), which functionally increased duration supply in the Japanese Government Bond (JGB) market. In July, the BoJ announced it was loosening its yield curve control, a mechanism by which it "capped" 10yr JGB yields. A bond whose yield is capped does not have volatility and therefore does not have meaningful market risk. When it relaxed the cap, the BoJ allowed risk to come back into the JGB markets and effectively created a new supply of duration for the global bond markets. Unlike the Treasury's issuance, it is tough to measure the effect of the BoJ's actions with simple numbers. These two supply issues might have been tolerable independently, but in concert, they have added more interest rate risk than the global bond markets could readily absorb.

Chart 2: Economic Growth Appears to Be Accelerating

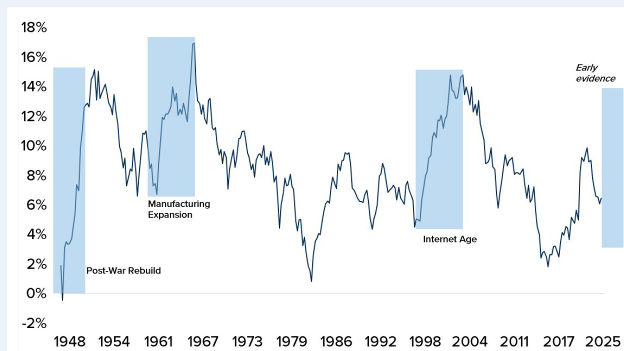


Source: Janney ISG; Federal Reserve Bank of Atlanta

In addition to supply, economic activity is the second factor pressuring interest rates in the back half of 2023. Despite prominent recession risks—Janney ISG noted a high probability of mid-year recession in our Outlook 2023 note, as did many other economists and strategists—one has thus far refused to emerge. Instead, the economy experienced a series of sectoral slowdowns while overall growth continued apace and even accelerated into 3Q23. A mild recession is still the most likely end to the economic cycle, but the evidence does suggest a growing chance of an alternative: instead of a slowdown, the U.S. might be on the verge of a productivity boom.

Productivity is an economic concept that (roughly) represents the amount of economic output per worker. As an economic society, we are very bad at measuring productivity in the short term, but it does trend in the long term through periods of slow growth and booms. Booms are rare. Robert Solow, the godfather of productivity economics, famously quipped that "productivity was obvious everywhere but in the statistics." Today, there is something of an echo of that quip. Everywhere we look, economic risks abound, from higher interest rates to bank failures to commercial real estate collapses, yet somehow economic activity powers ahead. An acceleration of productivity growth might explain some of this theme.

Chart 3: Economic Productivity Goes Through Peroidic "Booms" Every Few Decades



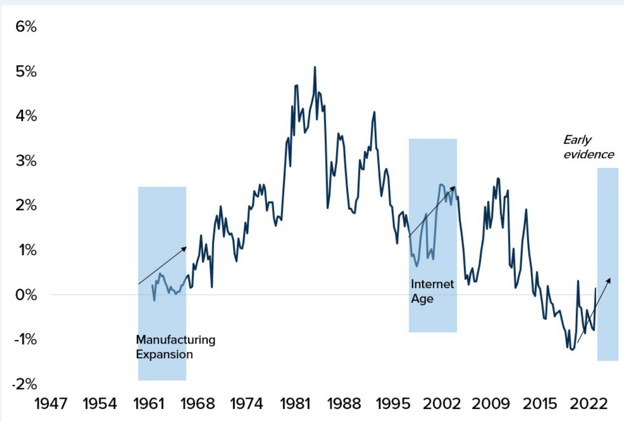
Source: Janney ISG; Bureau of Economic Analysis

It is impossible to be confident that a productivity boom is emerging until several years into one. For example, many economists were skeptical of how the Internet age would advance productivity until well into the late 1990s. Today, a forecaster might point to advances in AI, investment in domestic infrastructure, and reshoring of physical supply chains as three things that could give rise to improved economic productivity. But more realistically, the pandemic-era tech investments, the work-from-home movement, and the corporate need to survive in an employee glut could well spur future gains. Regardless, unemployment can remain low for much longer than expected if a boom emerges. But the nature of productivity means we can never be more than, say, 25% confident that a boom is happening.

PRODUCTIVITY & INTEREST RATES

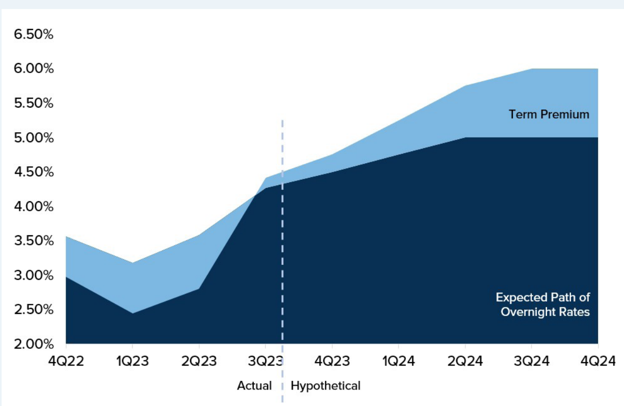
One place we see indirect evidence for improvements in productivity is in the bond market and, specifically, in the return of a term premium. The term premium is a fixed income concept that represents the level of term interest rates relative to the expected path of overnight interest rates. While there are many ways to measure the term premium, one robust way is through something known as the ACM Model[1]. Today, for the first time in roughly a decade, 10yr bonds are offering a (small) premium to the markets' expectations for the fed funds rate over the next 10 years.

Chart 4: 10yr Term Premium Increases During Periods of Productivity Growth & Inflation Uncertainty



Source: Janney ISG; Federal Reserve Bank of New York ACM Model

Chart 5: While Not a Forecast, In Productivity Boom Scenario, "Normal" Could be 10yr Yields at 6%



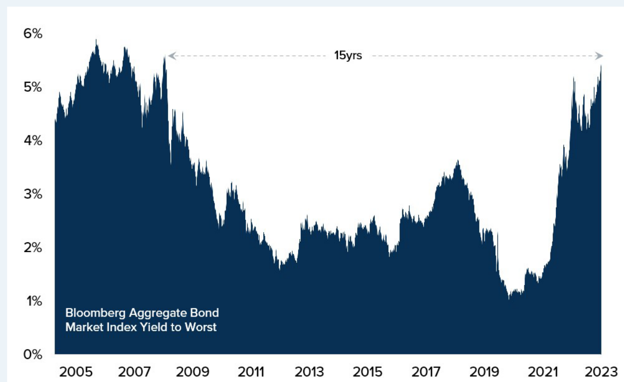
Source: Janney ISG; Bloomberg; Federal Reserve Bank of New York ACM Model

Notable of late is that more than 100% of the 3Q23 increase in 10yr interest rates can be attributed to increases in the term premium from negative levels to +0.10% today. Moreover, the long run "normal" for the ACM Term Premium is about 1%. In a world in which economic growth can persist for a surprisingly long time (i.e., a productivity boom), it seems reasonable that the Fed will not cut overnight rates, but rather leave them in the low-5% area. Over time, the markets' expectations for overnight rates will then come up as well. It also seems reasonable that the term premium will return close to its long-run average if not higher. Simple arithmetic then puts the 10yr Treasury "fair value" in a productivity boom environment at 5% fed funds + 1% term premium, or about 6%. This 6% figure is not our forecast for 10yr Treasury yields, rather it is a benchmark for how high interest rates might rise if we indeed see a productivity boom, an event which will never have better than 1 in 4 odds. As the odds have increased from basically zero, markets acknowledged the chance of a productivity boom, and interest rates have risen to reflect that chance.

FIXED INCOME OUTLOOK

To sum up the current situation, interest rates have risen to the point where fixed income generates the highest level of income in about 15 years. Many investors have meanwhile underweighted fixed income holdings relative to equities over that period, and for those investors, it likely makes sense to add to fixed income holdings and capture that better income generation.

Chart 6: Raising Fixed Income Allocations Makes Sense, But Stay Shorter Duration to Avoid Curve Steepening Risk



Source: Janney ISG; Bloomberg Indices

To summarize the outlook, the U.S. economy has a good chance to experience a garden-variety slowdown over the next 12 months and a small but growing chance to experience a multi-year productivity boom. If there is a mild recession, interest rates should fall somewhat. By contrast, if productivity growth does indeed accelerate, there is a lot more room for interest rates to rise. There is still an upside skew to the potential level of interest rates 3–12 months down the road.

The resolution to these two conflicting situations is to add to fixed income allocations today but keep those allocations relatively short duration. In the past, we have advocated for barbelling portfolios using short-term bonds for a large portion and intermediate to longer-term bonds for a smaller portion, and that position continues to make sense today. Barbells work well when the yield curve is inverted, and while we are not so deeply inverted as a few months ago, short-term rates are still higher than long-term ones.

It will be some time before we know which way the outlook will resolve—either rate cuts into recession or resurgent term premiums into a productivity boom—but we do have some indications of what could cause the outlook to break one way or the other. Economy-wide job losses and an increase in the unemployment rate of more than +0.3% would signal the onset of a material slowdown. Conversely, a violent supply-led selloff (perhaps in concert with the BoJ finally ending its yield curve control policies) would signal that the final upside risk to rates has been realized. Despite the 3Q23 selloff, it is still too early to say we have reached that point.

WORKING WITH JANNEY

Depending on your financial needs and personal preferences, you may opt to engage in a brokerage relationship, an advisory relationship or a combination of both. Each time you open an account, we will make recommendations on which type of relationship is in your best interest based on the information you provide when you complete or update your client profile.

When you engage in an advisory relationship, you will pay an asset-based fee which encompasses, among other things, a defined investment strategy, ongoing monitoring, and performance reporting. Your Financial Advisor will serve in a fiduciary capacity for your advisory accounts.

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By establishing a relationship with us, we can build a tailored financial plan and make recommendations about solutions that are aligned with your best interest and unique needs, goals, and preferences.

Contact us today to discuss how we can put a plan in place designed to help you reach your financial goals.

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1. Adrian, Crump, & Moench (2013)