Thoughts on the State of the US Bond Market

BLOMINVEST BANK

September 05, 2023

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The bond market's massive repricing has meant the possibility of earning the highest real yields since 2011 with less risk relative to other investments. This paper aims to provide a summary of the current state of the US bond market. It highlights that tighter monetary policy, inflation uncertainty, and recessionary fears have pushed short-term yields above long-term yields, as shown by the recent inversion of the US Treasury yield curve. In turn, higher yields have fed through to the corporate bond market. Corporate bonds are starting to price in the risk of a recessionary environment through higher corporate credit spreads. Looking ahead, inflation and labor-market tightness are key macroeconomic factors that will influence the Federal Reserve's future interest-rate decisions. In addition, higher liquidity risk in the bond market could affect future term premia. Finally, constraints to monetary and fiscal policy could imply more macroeconomic volatility in the future and increase bonds' attractiveness due to their lower riskiness. This paper aims to provide a summary of the current state of the US bond market.

1. Bond Markets

1.1. The US Treasury Market

The US Treasury yield curve, which displays the yields of US government bonds of increasing maturities, has been inverted. Short-term yields have exceeded long-term ones since late 2022 (Figure 1), with various implications for expectations around economic growth, inflation, and credit-market risks. First, the yield curve reflects market expectations of where short-term interest rates will be over different horizons. Recently, it has reflected expectations of higher short-term rates in an effort to subdue inflation from its stubbornly high level, with core annualized inflation only recently dropping from its February high of 6.9% to reach 3.22% in July 2023[1]. As inflation stabilizes, we would expect less contractionary monetary policy and lower short-term rates in the future, and these expectations are reflected in lower yields for longer-term US Treasuries. In addition, lower longer-term yields reflect expectations of lower future inflation relative to current inflation[2], and this is plausible in today's context given the Federal Reserve's hawkish stance on inflation. Indeed, these expectations have been revealed in the spread between nominal and real Treasury yields (known as breakeven inflation), with the 5-year breakeven inflation rate having remained higher or on par with longer-term breakeven inflation since early 2021 (see Figure 2).

[1] Federal Reserve Bank of Atlanta

[2] Board of Governors of the Federal Reserve System: *TIPS Yield Curve and Inflation Compensation*

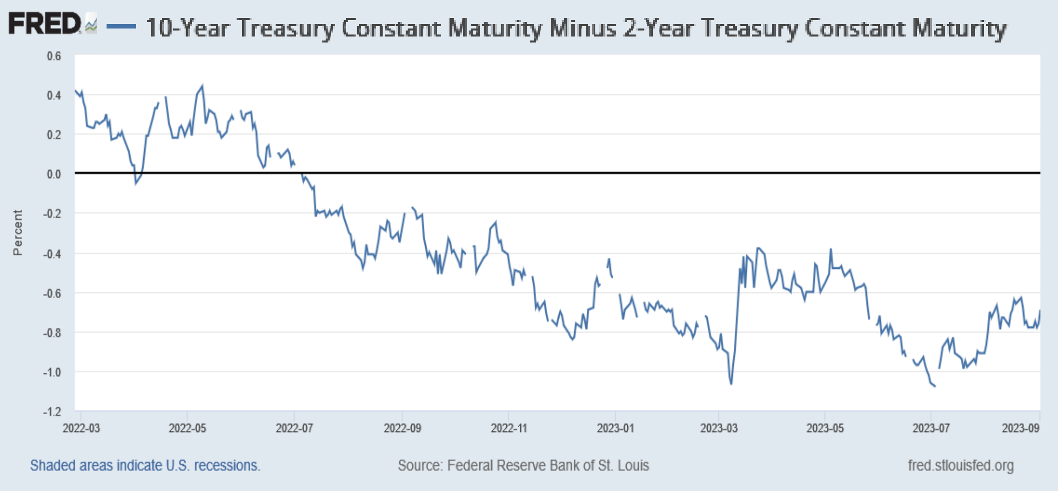

Figure 1: 10-year minus 2-year Treasury spread

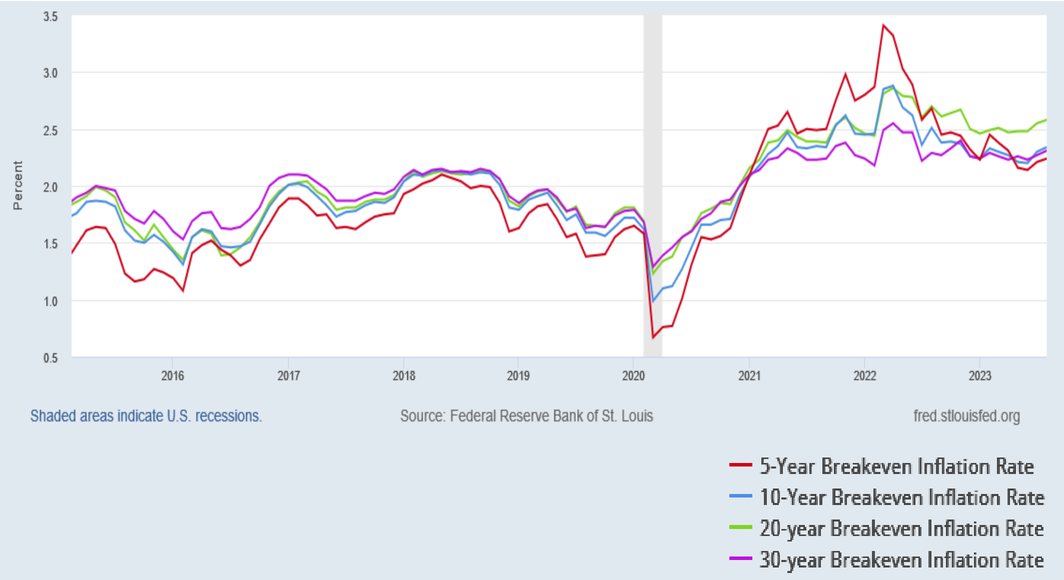

Figure 2: Breakeven Inflation for Various Treasury Maturities (Monthly)

Moreover, lower longer-term yields can also reflect a lower perceived risk of holding long-term bonds, as measured by the term premium. This premium is an estimate of the extra compensation investors require to hold a longer-term bond instead of investing in a successive series of short-term securities.3 In particular, uncertainty surrounding future inflation can push the term premium on long-term bonds higher. Since November 2018, however, the 10-year Treasury term-premium has remained persistently negative, bar a short period between March and October 2022 (Figure 3). Concurrently, inflation uncertainty, as proxied by the dispersion of 10-year-ahead Consumer Price Index forecasts, more recently dropped to reach levels seen before 2020 (Figure 4). Lower inflation uncertainty can help keep the term premium and possibly long-term yields down.

[3] Bernanke, B.S. (2015) *Why are interest rates so low, part 4: Term premiums.* Brookings Institution

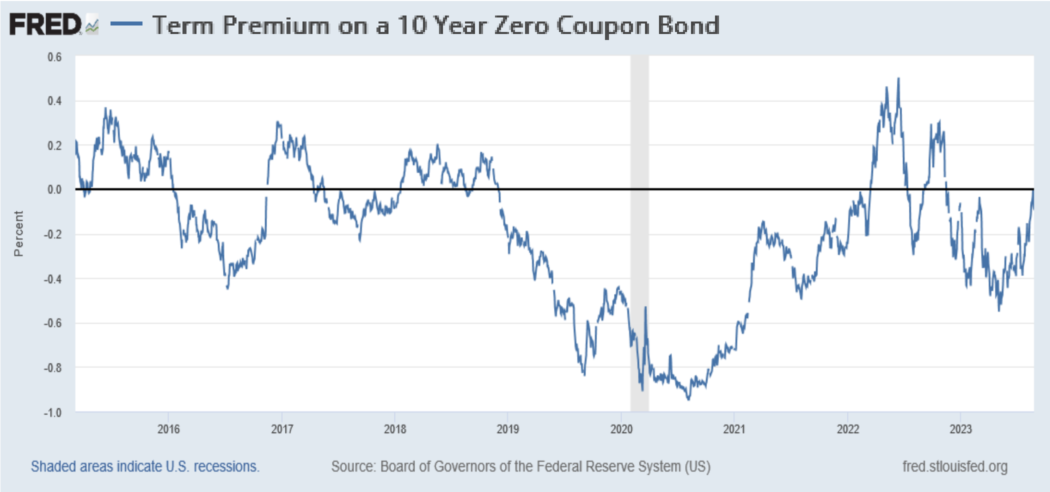

Figure 3: Term Premium on a 10-Year Zero Coupon Bond

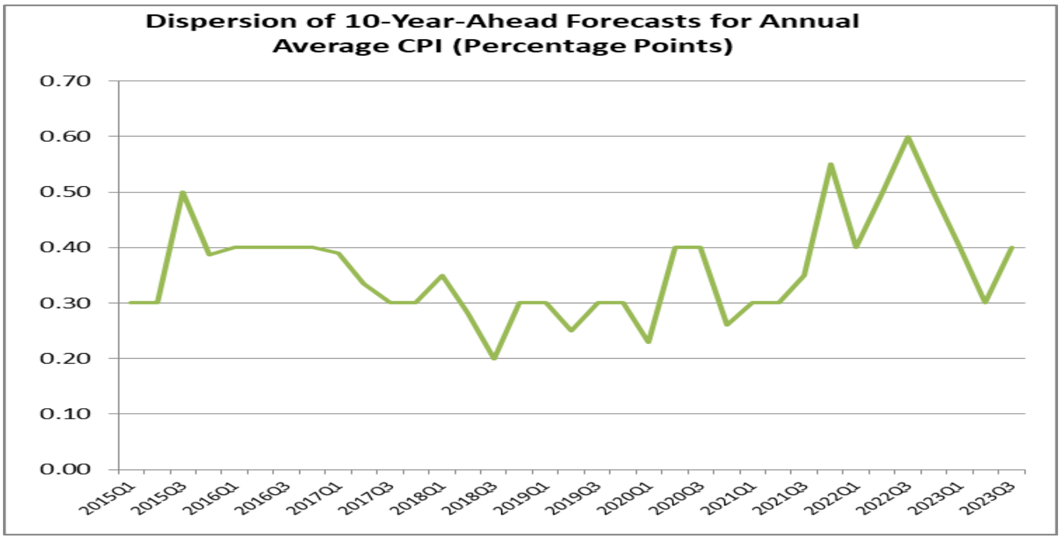

Figure 4: Adapted from Survey of Professional Forecasters . Dispersion is calculated as the difference between the 75th and 25th percentile predictions.

On the other hand, more proximate causes are pushing short-term Treasury yields to higher levels. In early May, the US Treasury Department unexpectedly announced a buyback program (beginning in 2024) targeting long-term issues exceeding one year, while also replacing these issues with short-term Treasury bills. This decision addresses the recent rise in public deficits, the need to manage fluctuations in public revenues and outlays, and concerns of illiquidity in the long-term Treasury market.[4] As inflation and steep interest rate rises have resulted in significant mark-to-market losses from long-term bond holdings, big market participants – like US commercial banks, foreign governments, and life insurers – became less enthusiastic about investing in long-term Treasuries. Additionally, the Treasury Department's recent issuance of 3-month bills, coupled with money market funds' withdrawals from the Reverse Repo Facility, has driven the 3-month bill to overnight rate spread closer to zero[5]. Three-month Treasuries are expected to face more discounting as 3-month bill issuance continues. In tandem, the repurchase of long-term Treasuries would keep their term premia down, in a manner similar to how Quantitative Easing helped compress term premia toward zero from 2011 till now.

1.2. Corporate bonds

[4] Duehren, A. (3 May 2023) *Treasury to Launch First Buyback Program since 2000*. Wall Street Journal
[5] Harris, A. (8 August 2023) *Treasury Bill Demand Is So Strong It's Crowding Out Money Funds* . Bloomberg

Corporate credit spreads the difference between corporate bond yields and Treasury yields of the same maturity have shrunk compared to August of last year (Figure 5). Although fears of corporate delinquencies have raised concerns about possibly higher spreads, overall corporate delinquencies remain low by historical standards, driven by strong company balance sheets and more conservative financial management of corporations.6 The former is particularly because companies have shifted from short-term commercial paper financing to long-term public and private credit instruments locked in at very low pre-pandemic rates.7 This shift has encompassed many sectors and has seen the share of investment-grade corporate debt maturing after 2028 rise from 48% to 56% since the end of 2020 alone. Surprisingly, net interest costs have been falling according to Q2 2023 earnings data for most companies, despite higher interest rates across all maturities.8

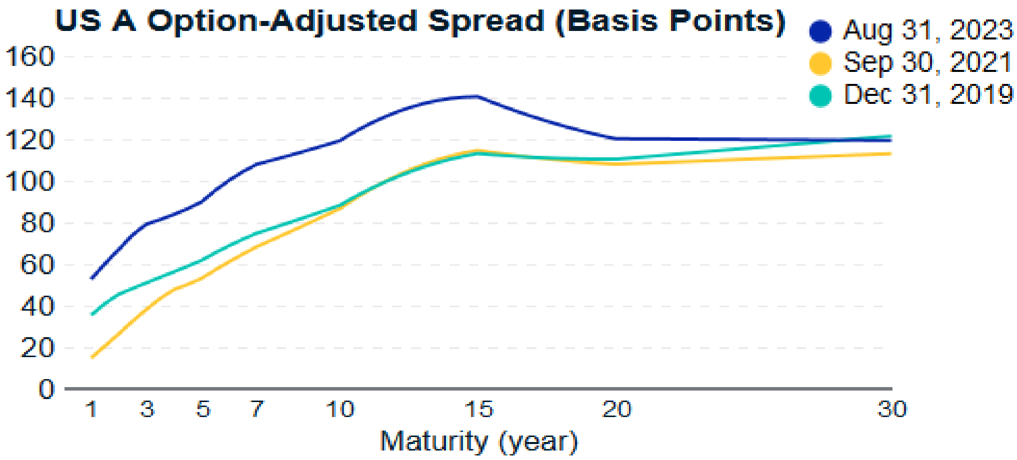

Figure 5: A-grade US Corporate Credit Spreads - Source: MSCI

However, the economic outlook in the corporate sector is cautious overall. While the July Manufacturing PMI of 46.4 marked an eighth consecutive month of contraction, the Services PMI remained expansionary but decreased 1.2 percentage points to reach 52.7. Although the services sector has expanded in 37 of the last 38 months, a decrease in each of business activity growth, new orders, and employment growth, in addition to faster delivery times (indicative of a slowing economy) imply that businesses are less positive with regard to investment in new production, commercial space, or hiring9.

Slowing consumer demand seems to justify businesses' concerns of a slowing economy. Credit card delinquencies, while low by historical standards, have continued their rise to reach 2.77% of credit card loans in Q2 2023 (Figure 6). Purchases of consumer durables are growing but at a decreasing rate (Figure 7). Meanwhile, bank lending standards for middle and large markets seem to be tightening; according to the Fed's Senior Loan Officer Opinion Survey (SLOOS), the difference between Senior Loan Officers reporting tighter versus easier lending standards increased from 24.2% in Q3 2022 to reach 50.8% in Q3 202310. Overall, a slowing economy, declining consumption, fading corporate pricing power, and higher interest rates are poised to weigh in negatively on corporate profits in the next year, with the corporate credit market possibly pricing in this risk through higher credit spreads11.

[6] Morgan Stanley (14 July 2023) *Are we there yet?*
[7] Clarida, R., Ivascyn, D.J., and Stafford, K. (12 July 2023) *Bond Market Outlook: Valuations Suggest Potential for Equity-Like Returns With Less Risk*. PIMCO
[8] Dover, S. (29 August 2023) *The Fed's Rate Hikes Were Supposed to Kill Corporate Profits. Why They Didn't.* Barron's
[9] Institute for Supply Management: *ISM Report On Business®*
[10] St. Louis Federal Reserve Economic Data
[11] Morgan Stanley (14 July 2023) *Are we there yet?*

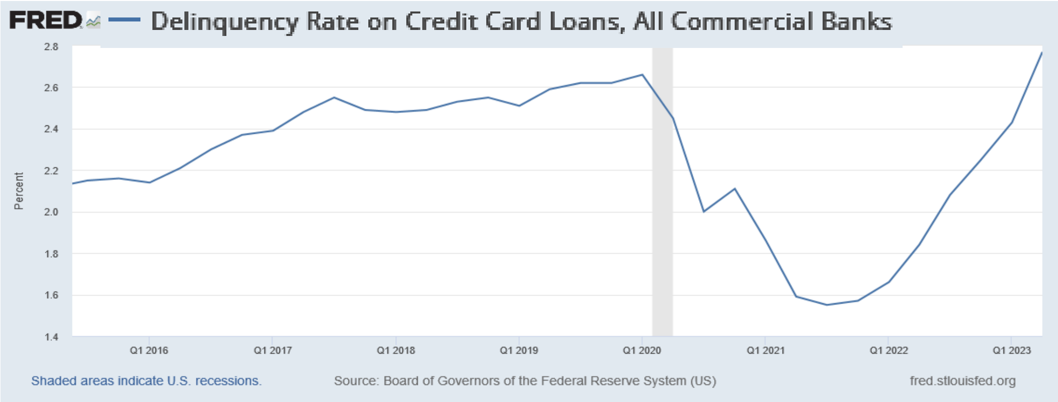

Figure 6: Credit Card Delinquencies Rate

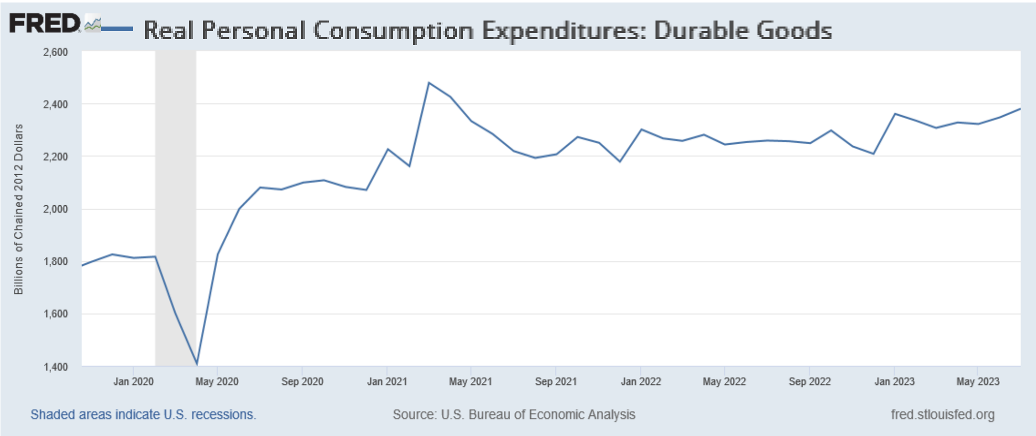

Figure 7: Durable Goods Consumption in Real Terms

2. What are future macroeconomic effects that might change market expectations of the Fed's interest-rate policy?

2.1. Inflation

In April of this year, Deloitte[12] outlined four possible inflation scenarios through the end of 2025, highlighting four uncertainties that likely to impact future inflation: consumer spending habits, future Fed policy, labor-market tightness, and the persistence of supply chain disruptions.

Soft landing: Inflation recedes without a recession as supply chain disruptions ease and consumer demand for goods and services reverts to pre-pandemic levels. This does not look likely – although costs from supply-chain disruptions fell more than 50% on average in 2022 compared to a year prior, labor-market tightness, raw material constraints, and other unforeseen disruptions remain possible in the short term, in addition to the weakening consumer demand discussed above[13].

Bumpy landing: Inflation falls slowly but remains above the 2% target over the next few years as supply-chain disruptions ease, but the labor market remains tight. This looks more plausible, as the most recent Federal Open Market Committee (FOMC) forecasts expect inflation to remain slightly above 2% till 2025, in addition to expressing higher levels of uncertainty around inflation not seen since 2008[14].

Hard landing: Inflation falls below target as supply-chain disruptions ease but higher interest rates feed through to weaker consumer and industrial demand. This could be possible given the more hawkish tone expressed by Fed Chair Jerome Powell, indicating a preparedness to do "whatever it takes" to bring inflation back down to 2%[15]. If recent inflation remains unexpectedly stubborn in recent months (which is not shown in the recent trends), this hawkish stance could materialize.

[12] Deloitte: *The inflation outlook - Four scenarios for 2023-2025*
[13] Reuters (9 August 2023) *Costs from supply chain disruptions drop by over 50% but headwinds remain - survey*
[14] Federal Reserve (14 June 2023) *Summary of Economic Projections*
[15] Barron's (28 August 2023) *Jackson Hole News: Powell Sounds a Hawkish Tone*

Crash landing: Inflation remains above target as supply-chain disruptions persist from geopolitical shocks and China's economy rebounds to fuel higher demand in energy markets. Weak economic growth figures for China and the specter of deflation suggest otherwise16 (in the short term at least), so this scenario could be unlikely.

Depending on how hawkish the Fed is, we might see further drops in Treasury prices and the rest of the bond market. Meanwhile, higher carry (interest income) rather than capital appreciation seems to be the attractive feature of bonds. Expectations of a steeper yield curve have been echoed in the Q3 2023 Survey of Professional Forecasters, with median four-quarter-ahead forecasts for the 10-year/3-month Treasury yield spread widening to reach -1 percentage point (Figure 8). The dispersion in these forecasts has decreased since Q4 2022 yet remains high relative to pre-2020 values (Figure 9), indicating lingering uncertainty in future short-term rates as influenced by the Fed.

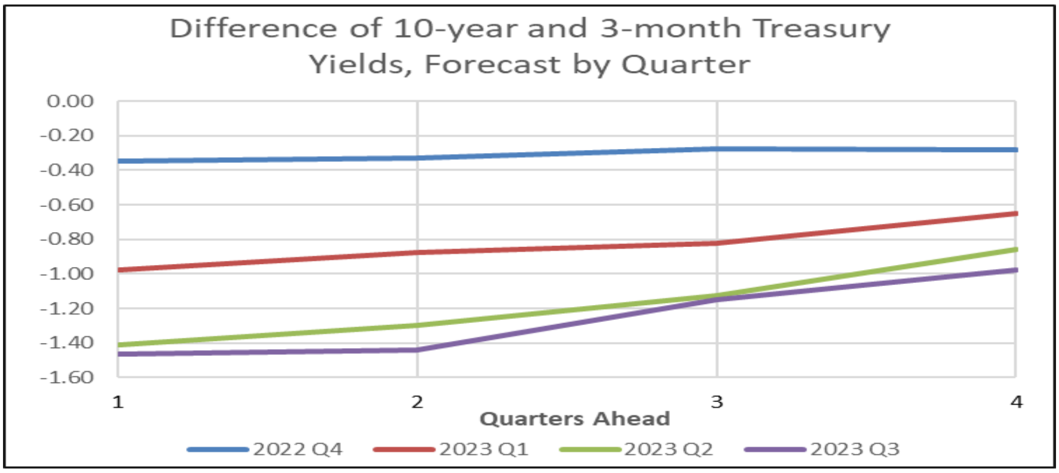

Figure 8: Adapted from Survey of Professional Forecasters.

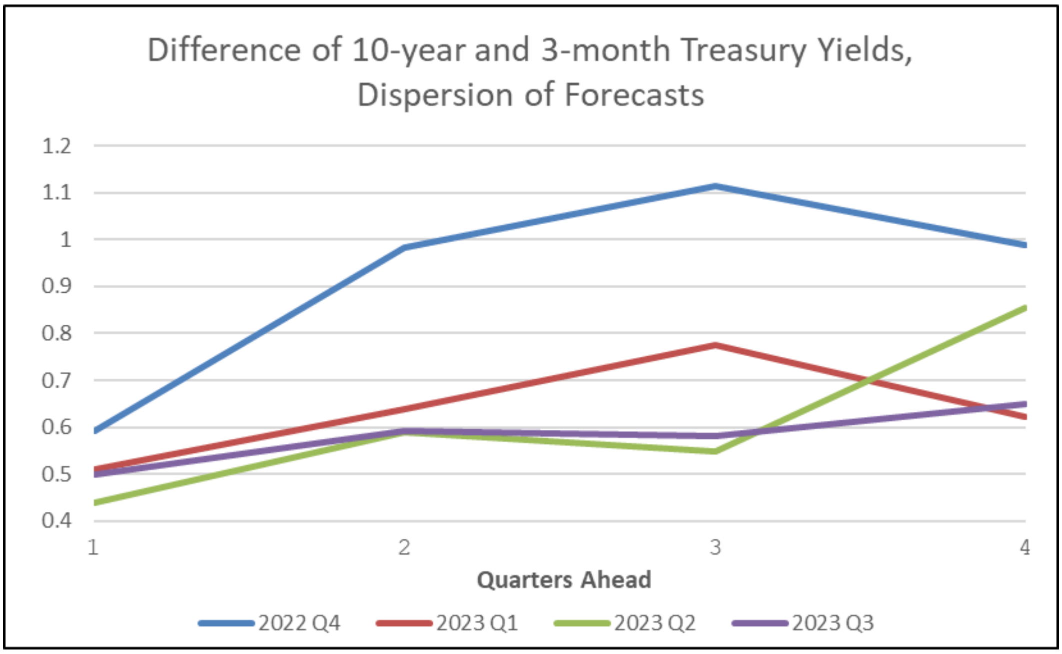

Figure 9: Adapted from Survey of Professional Forecasters. Dispersion is calculated as the difference between the 75th and 25th percentile predictions.

2.2. Labor market performance

[16] Tan, C., Se K.K., and Li, G. (30 August 2023) *China in charts: Missing economic boom points to slowing post-COVID growth*. Nikkei Asia

Unemployment increased by 0.3 percentage points to reach 3.8% in August 202317, with some weakness starting to appear in the labor market. Companies, having faced difficulties in hiring during the pandemic, seem to be hesitant in laying-off workers. The following labor-market trends have been seen according to highlights from the most recent Job Openings and Labor Turnover Survey18 (JOLTS) report:

The number of US job openings dropped to its lowest level in nearly two-and-a-half years to 8.8 million, showing a less tight labor market and possible downward pressure on inflation. The job openings rate, which measures job openings as a proportion of all filled and unfilled jobs, continued its steady decline since January 2022 (around 7%) to reach 5.3% in July 2023.

The job quits rate, a measure of confidence in the labor market, continued its steady decline from 3% in April 2022 to reach 2.3% in July 2023. This decrease possibly indicates that employees are less optimistic about finding alternative employment opportunities, which can reflect impending labor-market weakness. Layoffs and discharges as a percentage of employment remained constant at 1%.

In addition, median wage growth (three-month moving average) has continued its steady decline from its August 2022 peak of 6.7% to reach 5.7% (July 2023), indicating high yet decreasing pressure on inflation.

These trends indicate that, while the labor market is slowing, it may take time for the current interest-rate hikes (which have lagged effects) to tame inflation. In tandem with declining consumer demand and cautious industry sentiment regarding output growth, these trends give potential for more disinflations, although the possibility of further rate hikes cannot be ruled out. More generally, a trade-off exists between demand-driven employment growth and inflation, known as the Phillips curve. The increase in demand that firms face feeds through to the labor market in the form of increased employment and higher wages, encouraging firms to raise prices to account for the increase in labor costs. More recently, the drop in inflation despite stable and low unemployment has implied that the Phillips curve has steepened. While this statistical phenomenon might not necessarily imply a change in the underlying trade-off between inflation and unemployment, it might imply that a smaller fall in employment will be needed to decrease inflation[19].
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3. What future events could change the term premia?

3.1. Liquidity risk

Although some illiquidity has been seen in the US Treasuries market, this does not seem to be reflected in a higher term premium for 10-year Treasuries, as an example. Liquidity in private capital markets has not been affected by the issuance of 3-month Treasury bills either – rather, liquidity seems to have been shifted from the overnight repo market by the money market funds. In addition, banks are already tightening lending standards and face less risk for illiquidity. However, companies with leveraged financing are at an increased risk of default as less liquidity in the leveraged finance market coupled with higher interest rates makes it harder for these companies to refinance their short-term debt20. Delinquencies are also expected to rise in the high-risk office sector, driven by stronger property valuation declines and higher funding costs at the time of refinancing21.

Away from high-risk sectors, the corporate bond market has exhibited more positive sentiment, as demonstrated by credit spreads remaining low. The market seems to be pricing in expectations of a soft landing inflation scenario where a recession and delinquencies are mitigated, despite more recent indications to the contrary22. Overall, less liquidity in a bond market would translate to a higher term premium as investors, who might need to sell their long-term investment before maturity, find it difficult to find buyers. In addition, less liquidity and refinancing opportunities in high-risk sectors might weaken the balance sheets of companies and lead to more delinquencies, which can increase the credit risk of these companies. Therefore, there is potential for rising corporate credit spreads in the short term if more persistent inflation and tighter monetary policy materialize.

Conclusion:

[17] US Bureau of Labor Statistics (1 September 2023) *Employment Situation Summary*
[18] US Bureau of Labor Statistics (29 August 2023) *Job Openings and Labor Turnover Summary*
[19] Hobijn, B., Miles, R., Royal, J., and Zhang, J. (January 2023) *The Recent Steepening of Phillips Curves*
[20] Fitch Ratings (30 August 2023) *Liquidity, Refi Risk Were Key U.S. Loan Default Drivers in August*
[21] Vidal, K.A., Guevarra, J., and Hudgins, C. (24 August 2023) *Lower valuations, tough refinancing ratchet up risk for US office sector*. S&P Global - Market Intelligence
[22] Langton, J. (August 25, 2023) *Bond market suggests "soft landing" for U.S.*. Investment Executive

Where are the long-term opportunities in the bond market?
In general, economic volatility is expected to rise in the next five years relative to the pre-pandemic decade. The capacity of the US government to employ fiscal stimulus in mitigating volatility is likely to be impaired, given the worsening US fiscal position as demonstrated by the recent Fitch long-term ratings downgrade from AA+ to AAA. Weaker federal revenues, a rising interest rate burden, and increasing fiscal outlays are expected to increase the general government deficit from 3.7% (2022) to 6.3% of GDP (2023). Weaker GDP growth in the medium term is likely to weaken tax revenue, while the interest-to-revenue ratio is expected to reach 10% by 2025 due to higher overall debt and sustained interest-rate increases. Without fiscal policy reforms, an ageing population and rising healthcare costs will increase government social spending[23].

Moreover, a future move toward reducing the size of the Fed's balance sheet could mean less capability to intervene in economic downturns. Overall, fiscal and monetary policies have possibly been reduced in effectiveness, implying more macroeconomic volatility[24].
Overall, the bond market's massive repricing has meant the possibility of earning the highest real yields since 2011 (Figure 10) with less risk relative to other investments given volatility in the economy. While the possibilities of price downsides remain due to tighter monetary policy, the attractive yield is poised to drive high carry returns on bond investments.

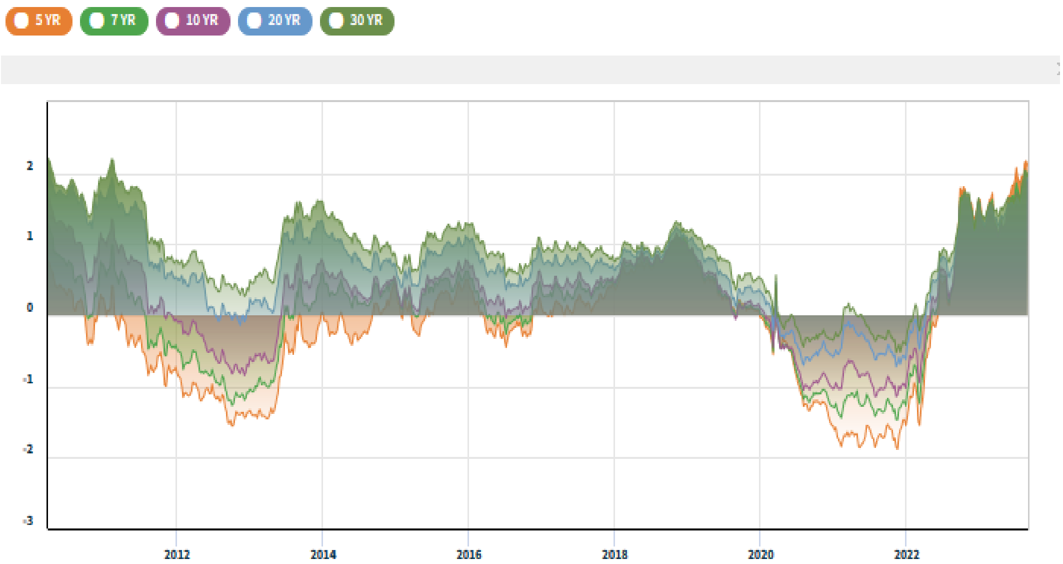

Figure 10: Real Yields on US Treasuries of Various Maturities - Source: NASDAQ

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[23] Fitch Ratings (1 August 2023) *Fitch Downgrades the United States' Long-Term Ratings to 'AA+' from 'AAA'; Outlook Stable*
[24] Clarida, R., Ivascyn, D.J., and Stafford, K. (12 July 2023) *Bond Market Outlook: Valuations Suggest Potential for Equity-Like Returns With Less Risk*. PIMCO

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