The Rates Ruckus

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- We've seen a steep rise in rates around the world since the second half of 2020. The accelerating climb in U.S. Treasury yields since mid-February has caused an uptick in market volatility and risk aversion.
- The increase in rates came as the bond market quickly caught up to our "reflation" view of faster growth and higher inflation, driven by solid economic reports and leading indicators, as well as heavy support from fiscal and monetary policies.
- We expect this recovery to be sharper and swifter than that of a typical business cycle, with strong tailwinds from U.S. fiscal and monetary policies.

We've seen a steep rise in rates around the world since the second half of 2020, when promising vaccine results spurred a more optimistic view of the global economic trajectory. The accelerating climb in U.S. Treasury yields since mid-February along with another recent bout of dysfunction in the U.S. repurchase (repo) market—an important source of short-term U.S. dollar funding for banks and other entities—have caused an uptick in market volatility and risk aversion.

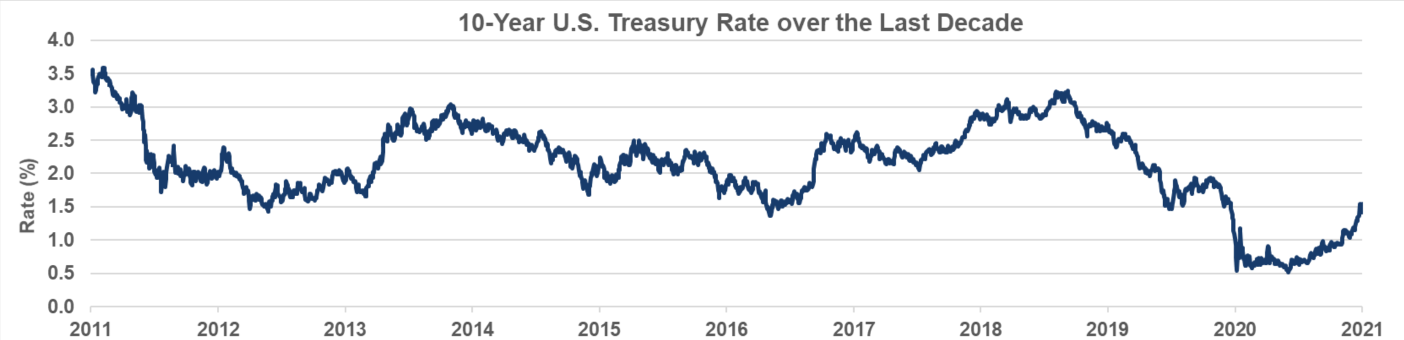
The Treasury market selloff has important implications (rates and prices have an inverse relationship, so prices fall when rates rise). One is that interest rates play a central role in valuing financial assets, and higher rates decrease the current value of future cash flows, all else equal, which presents a notable risk to more speculative growth stocks. These stocks are expensive compared to the rest of the equity market (as measured, for example, by the price-to-earnings ratio). This means investors will need more time to recover their purchase costs—via future-year company earnings—while rising rates offer investors an increasingly appealing return from lower-risk alternatives. Another potential consequence is that there may be less pressure for some investors to "reach for yield" as yields on Treasurys rise, which could translate to marginally weaker support for riskier assets.

Interest rates have increased as a result of improving growth and rising inflation expectations, both of which have gotten a boost from recent economic reports and leading indicators. Manufacturing has continued to experience robust growth globally with costs increasing at rapid rates. In some of the few regions where the services sector has started to exhibit a strong recovery, cost increases have reached decade-plus highs[1].

Taking a high-level perspective

Aside from the flight-to-safety rally that drove Treasury rates to all-time lows early last year, the 10-year U.S. Treasury rate has spent the last decade between 1.5% and 3.0%, with limited isolated exceptions (Exhibit 1). It has only recently returned to the bottom end of its pre-COVID-19 historical range.

Exhibit 1: Climbing Back Up After the Bottom Fell Out

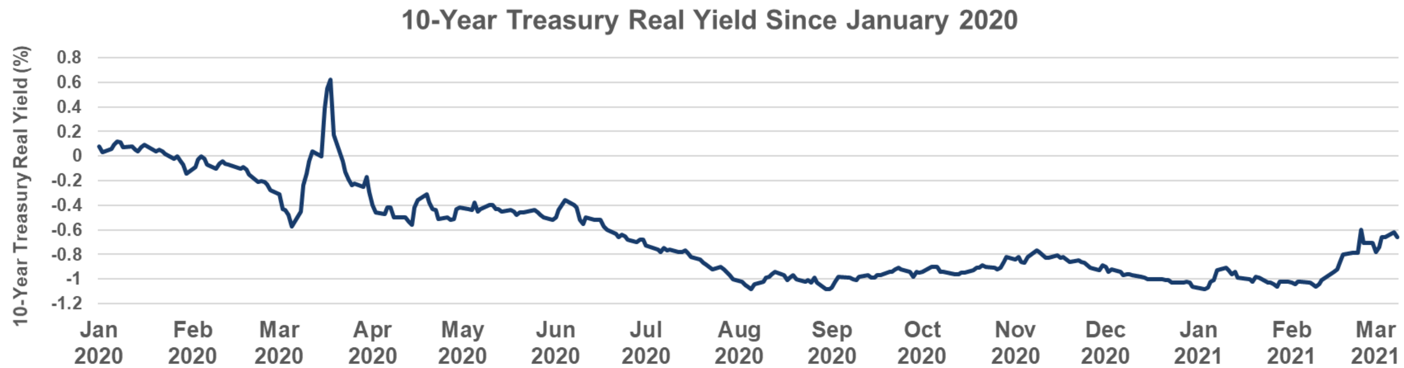


From March 4, 2011 to March 4, 2021. Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis

[1] See IHS Markit Business Outlooks for the U.S. and India. March 15, 2021.

A steepening yield curve (that is, when longer-term yields increase relative to shorter-term yields) is a normal feature of recoveries. While recent steepening has been abrupt, it's not unprecedented—and suggests a solid economic recovery from the COVID-19 crisis. Furthermore, real (inflation-adjusted) yields have risen, but they have done so from unusually negative levels (Exhibit 2).

Exhibit 2: Real Yields Stop Being So Negative



From January 1, 2020 to March 9, 2021. Source: U.S. Department of the Treasury. Past performance is not a reliable indicator of future results.

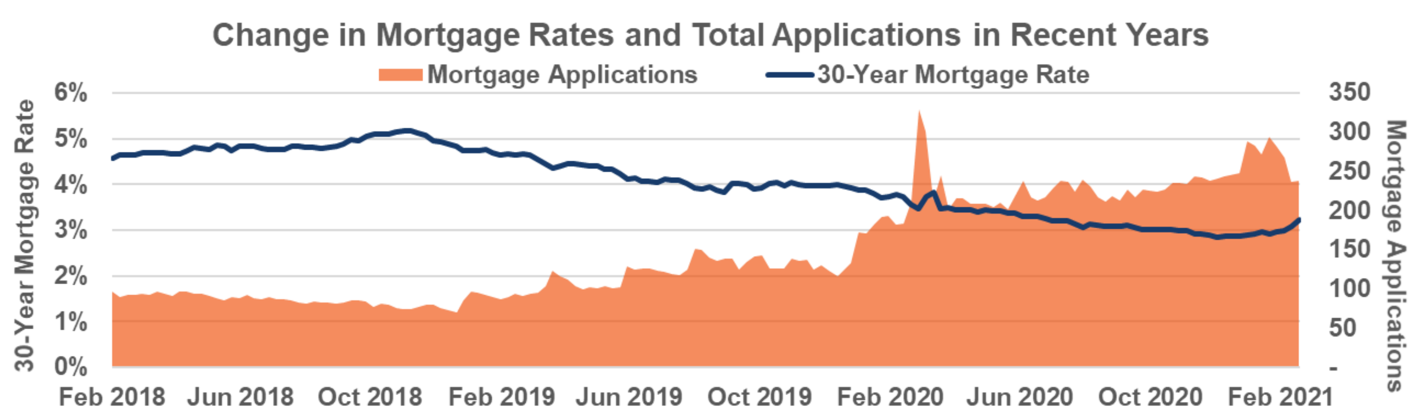
The move in rates could eventually cause aftershocks in credit markets. Thus far, however, spreads (that is, the additional yield over Treasurys associated with credit risk) and other measures of financial stress have remained well-behaved.

What are the risks?

Rising Treasury rates will impact the real economy—mortgage activity, for example, is sensitive to rate changes—but demand for homes is expected to remain robust. However, if rates get too high, they could negatively impact purchase and refinancing activity, which could have adverse repercussions for other areas of the economy.

The 30-year fixed-rate mortgage has historically averaged roughly 170 basis points (bps) more than the 10-year Treasury rate (although this spread can spend months closer to 200 bps when rates fall quickly and remain depressed, as was the case last year). A 10-year Treasury yield around 1.5% would not equate to a significant increase in borrowing costs on most new or refinanced mortgages compared to the historic low rates that were on offer in 2020—but another meaningful move higher could start to cause some stress, especially if it unfolds abruptly.

Exhibit 3: Home Owners Love Lower Rates



From February 14, 2018 to March 3, 2021. The level of mortgage applications rebased to 100 as of February 7, 2018. Source: Mortgage Bankers Association, Bloomberg

Will fiscal and monetary policymakers overshoot in their efforts to support the economy?

The U.S. federal government is planning another fiscal expansion of nearly $2 trillion, and the federal deficit (as a share of gross domestic product, or GDP) was already at levels not seen since World War II. There are reasonable arguments on both sides of the debate over the latest round of planned expenditures, but there's no doubt that such a drastic increase in spending meaningfully increases the risks of higher inflation and rising expectations for inflation.

Thus far, the U.S. Federal Reserve (Fed) has kept its promise to keep rates low and its overall monetary policy accommodative until the labor market and inflation hit levels historically associated with stronger growth. The U.S.

economy is still approximately 11 million jobs short of where it would have likely been if not for COVID-19, so the Fed's full-employment target could take some time to attain[2].

Meanwhile, we're clearly seeing signs of higher inflation. If this persists past the expected year-over-year effects over the next several months (growth can be expected to appear elevated as we measure against the economic-lockdown conditions that defined the beginning of the COVID-19 crisis), Fed dovishness (that is, when its monetary policy is oriented toward supporting shorter-term economic growth) could also risk pushing inflation expectations higher.

It remains to be seen whether or when the Fed would consider adjusting its current approach by selectively targeting certain points of the yield curve. So far, that doesn't appear to be on the table.

Another set of risks that could influence inflation expectations upward is the recent decision by OPEC+ (the Organization of the Petroleum Exporting Countries, led by Saudi Arabia—plus Russia) to keep oil output tight and the pricing pressures we've seen in many commodities over much of the past year's recovery.

SEI's view

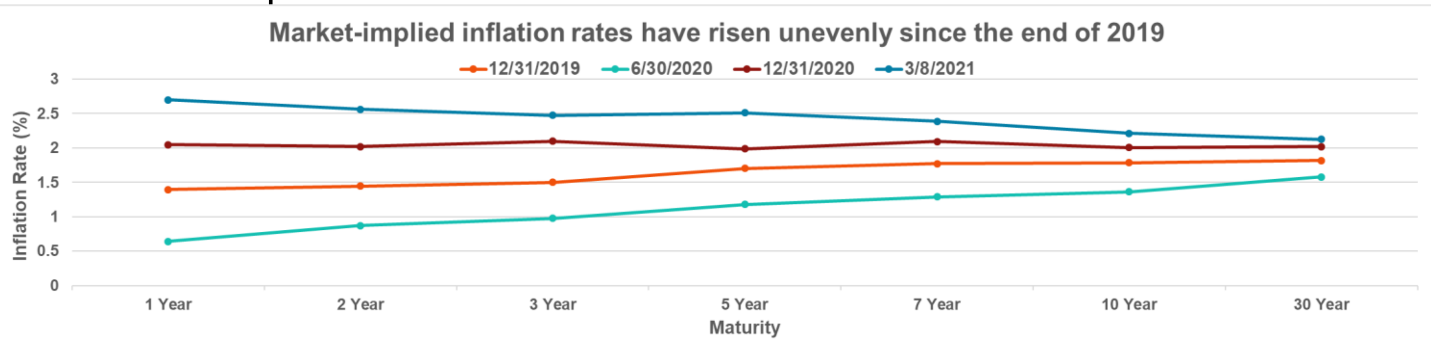
So far, rate dynamics have been fairly typical of past recovery phases, and we expect they will remain so as we transition to an economic expansion phase. Historically, rates markets periodically adjust their outlook—sometimes abruptly, which can cause bouts of indigestion for risk assets.

We believe that investors should take comfort in the relative regularity of this recovery, but we also know there's no denying that certain features of this cycle are unusual. The economic effects of COVID-19 are more akin to a natural disaster scenario, when recoveries tend to be sharper and swifter than a typical business cycle. Fiscal measures have also been far more forceful, and the Fed has been at least as dovish, than in past cycles.

For these reasons, we have remained attentive to the risk of eventually overshooting to unsustainably high growth levels and the market dislocations that such a sharp expansion could produce.

At this stage, the Treasury market has implied stronger growth and faster inflation over an intermediate-term horizon—but it has not pointed to run away or permanently higher inflation (Exhibit 4). Given these unusual developments, however, it is important to understand that the investment experience could be bumpier than usual at times.

Exhibit 4: Inflation Expectations on the Move



Breakeven inflation rates calculated by determining the rate at which U.S. Treasury inflation-protected securities and U.S. Treasurys of comparable maturities would produce comparable investment returns. Source: Bloomberg

The bottom line is that the bond market has quickly caught up to our "reflation" view of faster growth and higher inflation as sizeable and coordinated U.S. fiscal and monetary policies helped accelerate the progression toward a more normal, pre-COVID-19 environment. Generally, inflation-sensitive positioning, value factor exposures, and overweights to sectors like financials have done well in the year-to-date environment, while high-flying growth and stay-at-home names have struggled.

[2] Calculated by adding the approximate shortfall of 8.5 million jobs from February 2020 to February 2021 (via the increase in the unemployment level and decrease in the size of the labor force) to 12 months of projected job growth at an average monthly rate of approximately 200,000 (in line with the monthly average in the 12 months prior to the COVID-19 recession).

Glossary of Financial Terms

Fiscal policy: Fiscal policy relates to decisions about government revenues and outlays, like taxation and economic stimulus.

Monetary policy: Monetary policy relates to decisions by central banks to influence the amount of money and credit in the economy by managing the level of benchmark interest rates and the purchase or sale of securities. Central banks typically make policy decisions based on their mandates to target specific levels or ranges for inflation and employment.

Price-to-earnings ratio: The price-to-earnings ratio is the ratio of a company's share price to its earnings (typically trailing over the prior 12 months or projected over the next 12 months), which can be used to help determine whether a stock is undervalued or overvalued.

Repurchase (repo) market: The repo market is where borrowers who need short-term cash trade high-quality securities with lenders. Borrowers agree to buy back their securities (typically Treasury instruments) from lenders, usually on the next day. Repo market participants typically consist of banks, money market funds and other large financial institutions.

Yield: Yield is a general term for the expected return, in percentage or basis points (one basis point is 0.01%), of a fixed-income investment.

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