Why are 10y US Yields down?
Two expert views.

- 10-year Treasury yields have been bucking consensus ever since the start of Q2 2021, moving lower even as inflation chatter has only grown louder. History and current macro drivers explain why this is happening.

- DataTrek Research believes Treasury prices anchor on long-run historical inflation trends. Convincing this market that the next 10 years will be different from the last decade could take a long time. It took 25 years, for example, for Treasuries to fully reset after the 1970s.

- Quant Insight's proprietary data analysis shows oil prices need to rise materially – and quickly – from here to push yields higher. And even if US equity markets are calm just now, there is actually a relationship between credit concerns in other markets and declining Treasury yields.

- Bottom line: 10-year Treasuries don't trade on current US inflation data. They never have. To predict their next move, you need to look at a wide range of other macro drivers.

Is shorting the US 10-year Treasury the easiest trade out there? If you believe the US is about to see higher structural inflation, the answer is a resounding "Yes". At a 1.5 percent yield and inflation running well over the Fed's 2 percent long run target, it should just be a matter of time before Treasuries fall.

But … if this trade is so obvious, why is it not working? In fact, Treasuries have been rallying since late March. Shrugging off that move is a mistake, in our view, because when news flow (high CPI inflation prints) fails to coincide with price action it always pays to consider what other forces may be in play.

The long-run relationship between US inflation and Treasury yields across several economic cycles tells a useful story. The chart below shows 10-year Treasury yields (blue line) and US annual CPI inflation (red line) from 1965 – present.

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Here's what we see in the data:

#1: As US inflation rose during the 1960s – 1970s (left third of the chart), Treasuries struggled to accurately discount future price increases.

- They treated the first oil shock in 1973 (second grey recession bar from the left) as a transient increase in structural inflation and yields actually fell from 1974 – 1975.
- As inflation began to rise again from 1976 – 1978, yields rose. But not enough …
- The 1979 oil shock hammered home the structural nature of US inflation and yields actually did not peak until 1981, well over a year after inflation had topped out.

#2: Once bitten, twice shy, and Treasury yields remained well above inflation for fully 26 years afterward (1981 – 2007, middle of the chart).

- That is the very noticeable gap you see between the blue line (Treasuries) and the red line (inflation). Real rates remained positive for decades, even when it was clear inflation was no longer a systemic threat.
- Worth noting: the CPI calculation saw a dramatic remake in 1983, when the Bureau of Labor Statistics moved from an interest rate-based measure of housing inflation to the current Owners' Equivalent Rent (OER) calculation.

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- That highest-ever headline inflation reading of 14.6 percent in March 1980 was fully one third due to 22 percent home ownership inflation and directly tied to 16 percent mortgage rates. OER has never logged anything higher than 6.6 percent annual inflation, and that was in April 1986 when mortgage rates were 10 percent.

#3: Treasuries finally became convinced of low structural US inflation only after the Financial Crisis (2010 – present, right part of the chart).

- The gap between inflation and yields became negligible.

- The 2013 "taper tantrum" was short lived, with yields climbing from 2 to 3 percent that year but then going right back to 2 percent in 2014 when the Federal Reserve actually started reducing its level of bond purchases.

Summary: history shows that Treasuries anchor their inflation expectations on long-run historical patterns and only very slowly shift their view even after a new paradigm develops. As far as investable ideas that leverage that point:

- Shorting Treasuries based on a thesis that they will respond dramatically to even 1-2 years of hot inflation prints is problematic. There's very little in the historical record to support that perspective.

- At the margin, a Treasury yield curve that refuses to steepen materially is good for high multiple stocks like US Big Tech and bad for bank equities. Since the latter has dramatically outperformed the former this year, there may well be some mean reversion coming.

- While the Fed will taper its bond purchases at some point soon, any resulting sell off in fixed income is more likely to be a buying opportunity than the start of a regime shift to higher rates.

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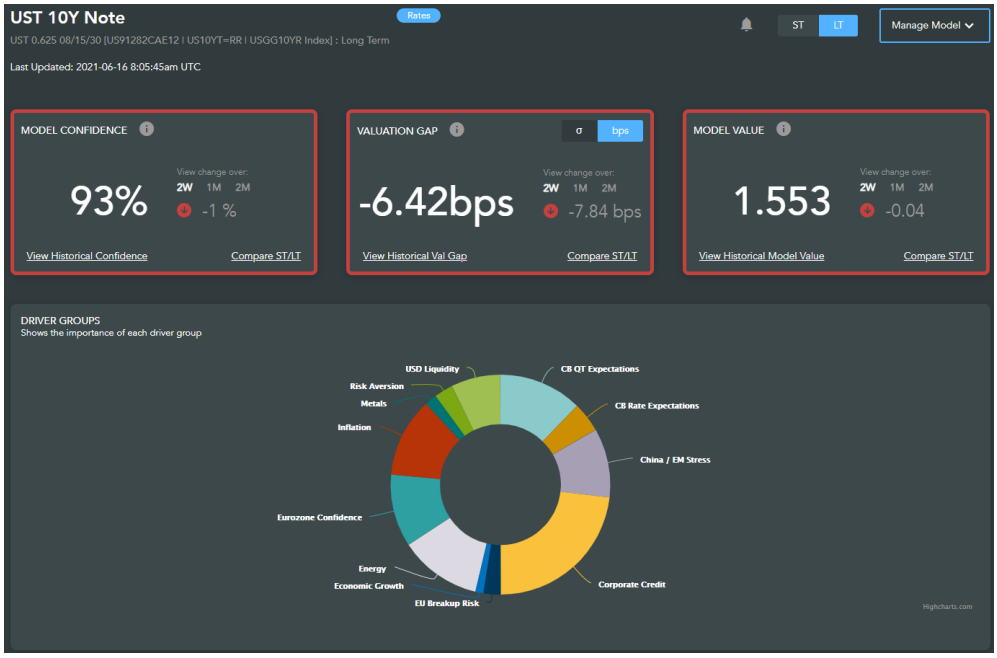
A key takeaway from the DataTrek analysis is **the importance of regime shifts** - monitoring how the relationship between US Treasury yields & inflation evolves over time. This is the core of Quant Insight's analysis.

Our algorithm takes classic macro factors like GDP growth, inflation expectations, financial conditions & measures of risk appetite & applies a proprietary mathematical technique to quantify the macro profile of any asset. In the case of 10y US Treasury yields, the derived output shows:

- Macro factors have strong explanatory power – explaining 93% of the variance in US 10s.
- The Fair Value Gap shows the difference between macro-warranted fair value (currently 1.55%) & spot price. Treasuries are within 6bp of model currently.



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The algorithm also derives the independent relationship between 10y Treasury yields & each macro factor. This enables investors to identify which factors are dominating & how regimes shift over time.

- Crude oil has been the dominant driver of late. **The sensitivity of 10y yields to Brent was negligible in 2020 & early 2021. Then, early in February, sensitivity exploded higher**. At the highs, a one standard deviation increase in crude oil, every other factor held constant, was consistent with a 16bp increase in 10y UST yields. By some margin, the biggest single driver amongst the entire factor set.

- After peaking at the end of March, the move lower in 10y UST yields over April was, to a large degree, a function of the fall in oil prices. More recently though crude has resumed its march higher & yet bond yields have accelerated lower still. Is there another factor leadership unfolding?

- Sensitivity to crude is showing signs of rolling over. The 16bp increase in 10y yields for a one standard deviation increase in crude was recorded end May; the same oil move today equates with a 14bp rise in yields.

- However, another factor has gained prominence. Qi uses sovereign credit default swaps as a measure of stress in Emerging Markets. As more market participants buy insurance protection on China CDS (widening spreads) that, on current patterns, is consistent with a 10bp fall in 10y UST yields.

While mainstream media focuses on low bond yields as a comment on inflation, the maths shows US Treasury's status as a safe haven asset has risen in importance of late.

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The push & pull between different macro factors on any asset price is a complex process. Using a quantitative approach to help identify key patterns is a useful first step before adding discretionary perspectives from experts such as DataTrek.

Main takeaways:

- Monitoring crude oil prices is more important now than it was in 2020. On current patterns, a spike in crude is the best chance bond bears have for a spike in yields.

- With VIX near the lows, market participants may deem US Treasuries role as the risk-free rate is dormant. Not so. Those worried about slowing credit impulse in China & the health of the credit cycle as typified by Huarong & others, should note **there is a direct pattern between stress in that time zone & lower UST yields.**

- DataTrek cite the importance of yields in the equity rotation trade. US Technology (NASDAQ, the US IT sector, SOXX semi-conductors) are all currently below Qi's threshold for a macro regime in Q1. Qi identified their vulnerability to a taper tantrum / fears of Quantitative Tightening early in 2021, but in Q2 other, non-macro factors (regulation?) have become more important.

- On financials we are aligned. The macro regime shows their reliance on a reflationary environment – rising inflation expectations, higher real yields, tight credit spreads. Indeed, that **re-pricing has already begun. XLF was 10% rich to macro at the end of May & now sits at macro fair value**.

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