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TRANSCRIPT:

Preferred market update with Kevin Lynyak

Hello, folks. This is Kevin Lynyak, Fixed Income Portfolio Manager at Parametric, here with a fixed income update. Today is Monday, November 6.

And we just had a massive rally in Treasuries and rates last week as we got a trifecta of less bond supply from Treasury, a dovish pause from the Federal Reserve, and then weaker-than-expected payrolls data. I'll break down what I think caused the massive rally and what we think you should do moving forward.

All right, just over a week ago—I think it was October 23 that we saw the 10-year note trade above 5% for the first time since 2007, and I think that 5% will be a kind of a key technical level kind of on the high side that we bounced off of. I've been saying that I think it'll be very hard to get the 10-year note above 5% if the Fed is done hiking rates. I think you need to have the Fed more in play with a more continued rate-hiking scenario to get the ten-year note trade well north of 5%, but I could have been wrong, and we definitely could have seen more term premium priced into long-term Treasuries if the US Treasury backloaded supply in the back end of the curve. I think that's something that we've been seeing here the last couple months.

And it appears to me that both Janet Yellen at the Treasury and Jay Powell at the Fed have been listening to the markets. They've been watching markets very closely, and I think the reaction that we saw last Wednesday and last week in bond markets is a reaction from Treasury and the Fed who've been watching bond markets reprice the last couple of months.

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Before last week, there had been a market debate on what actually caused the surge in bond yields in the last couple of months. So some have suggested the strong economic data. Remember, we saw third-quarter GDP come in at 4.9%. Well, we had a little bit of weaker data with payrolls last week, as well as weak ISM data. You look at the Atlanta Fed GDP Now. We're starting off the fourth quarter much slower at 1.2%.

Some have suggested that the move higher in yields was caused by the Fed, because they have caused the markets to price in higher for longer. Recall their last dot plot, where they had one more rate hike penciled in for this year and then only two rate cuts for next year. After Friday, the market has taken out the rate hikes for this year, and they price in almost four rate cuts for next year. So the market's gone back a little bit against the Fed here so far.

There's also been a fiscal component to this. Treasury supply has been a major theme ever since the August refunding announcement came out on August 1. This recall was much higher than expected, especially in the long end of the Treasury curve.

Also on August 1, we got a US debt downgrade from Fitch, and I think that reminded the markets of the size of the current budget deficit and then how that needed to be funded in markets. So long-term buyers decided to be a little more judicious about what prices they were paying for 10-year and 30-year debt. This is known as term premium, and in an inverted yield curve you have none. Recall at the beginning of July the 10-year note was at 3.81%, and the two-year note was at 4.87%, over 100 basis points inverted. So with all that supply, the market participants wanted to have more term premium. They wanted to get paid to own longer-term debt.

And I think another thing to think about is, Who's going to buy all this debt? And in a post-quantitative-easing world, the price-insensitive buyers like the Federal Reserve, foreign central banks, and even US Banks who are swimming in reserves, you know, they have stepped aside for more price-sensitive buyers like households and hedge funds. So it makes sense to me that more term premium has been priced into the markets.

But I think Janet Yellen and the folks at the Treasury, they were paying attention to this. So I think they surprised markets a little bit, and they were listening to markets. And in the November refunding announcement that was issued the morning of November 1, the same day as the FOMC meeting, they basically announced smaller-than-expected increases to longer-term bond issues. But I think they also suggested to markets that they were willing to overstep the informal guideposts for how much to issue in short-term bills.

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I think the overall number we were looking for was like $114 or $115 billion, and the overall refunding was $112 billion. So we're only talking about a couple billion here. As Everett Dirksen said, "a billion here, a billion there." So I don't think it was the overall number. I really just think it was the message that the Fed wasn't going to flood the market, and that caused a little bit of short covering.

And then, later in the day, we moved on to the FOMC meeting. As expected, the Federal Reserve held rates steady. This is the second meeting in a row where the Fed has held rates between 5.25% and 5.5%, breaking the kind of trend where they pause and then they raise by 25 basis points. So the second meeting in a row that they paused.

The market had been questioning whether the July rate hike, the fourth at 25 basis point rate hike here in 2023, was the last rate hike in the cycle, and I think this is important for longer-term bond holders. As usual, we wanted to hear Chair Powell's press conference to read the tea leaves for future rate hikes.

I think Powell left the door open for an additional rate hike in December and beyond, giving a nod to the recent strong economic data. However, he pointed to financial conditions that have tightened significantly, causing many to think that the Fed doesn't really need to raise rates further. Essentially, why? Because the market's been doing that for them.

So what are financial conditions? They are various indices that follow different financial data, such as moves in bond yields, equities, credit spreads, and the dollar—so essentially all parts of the market. So once again, like Janet Yellen, Jay Powell has been watching the markets, and the markets have been tightening for him. Bond yields have moved up significantly since the summer. Credit spreads have widened. The S&P 500® was 10% off the highs. The dollar was stronger.

So we've seen these tightening financial conditions, and I think by the Fed alluding to them, that had many thinking that the Fed was actually done hiking for this cycle. That's why they characterized this as a dovish pause.

So the Fed and the Treasury got the markets rolling, a little bit of short covering, and a little bit of adding to longer-term creation debt. And then we got a softer-than-expected employment number on Friday. I think all those things in tandem caused a pretty significant rally, almost 50 basis points in the 10-year note, looking from the highs that we saw intraday back to around a 4.55%, which we saw on Friday.

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So I think this leaves us with a few questions. Is this market move sustainable? What do we do now? And with the markets having rallied so much at the end of last week and financial conditions having eased, does that actually put the Fed back in play?

Short answer is, I don't think so. But we saw a massive rally in high-yield bond yields in 40 basis points. So over a 5% move in the S&P 500®, and we saw a decent rally in the 10-year Treasury in the back end of the yield curve.

I don't think we're fully out of the woods yet. First of all, we've got a lot of supply to come in various bond markets. I think we're at the Treasury quarterly refunding coming up soon, and I think this could provide us with some volatility. We saw just here this Monday morning, we've got 13 investment-grade bond deals as investment-grade corporations take advantage of these lower yields. And they've had a little bit of pent-up demand to do that.

We've also got some economic data. And I think to hang your hat on just one payrolls number, I think, would be a mistake. We've got CPI coming up next week. I think in CPI we bottomed in June. But core CPI next week will still be probably around 4%, which is well above the Fed's 2% level. It means the Fed can be on hold for longer, and these four rate cuts that are being priced into markets, I think, are very premature.

So quantitative tightening, stubborn inflation, CPI, fiscal deficits getting funded in the bond market. I think another thing to watch is potentially oil prices with the geopolitical risk that we've seen. And so far here on Monday we've actually seen equities and bond yields retrace a little bit.

So I think the major takeaway from last week is the rapid move that we saw is why you want to have on some duration and why you want to step out of cash. I think things will remain volatile here into the fourth quarter, but my strong view is that the Fed is now done, and this is a decent time to step out of cash. I would use the 5% level of the 10-year as a ceiling, and use any volatility and backups due to oversupply of bonds as a buying opportunity here. Thank you.

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