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CREDIT MARKETS

Treasury Yields Signal Investors' Waning Economic Exuberance

Yield on 10-year note fell roughly a quarter-percentage point in second quarter as traders scaled back expectations for fiscal and monetary stimulus



Shoppers on Rodeo Drive in Beverly Hills, Calif., earlier in June.

PHOTO: JILL CONNELLY/BLOOMBERG NEWS

By [Sam Goldfarb](#)

Updated June 30, 2021 4:10 pm ET

The recent drop in U.S. Treasury yields reveals some investors' doubts about how strong the economy will be in the coming years, even as inflation pushes to its highest level in more than a decade.

Yields, which fall when bond prices rise, have surprised many by sliding in the second quarter of the year. That marks a reversal from the sharp rise of the year's first three months, when markets generally rode a wave of optimism that stimulus and reopenings would spur a roaring '20s type of acceleration.

The yield on the benchmark 10-year U.S. Treasury note settled Wednesday at 1.443%, up from 0.913% at the end of last year but down from 1.749% at the end of March.

Yield on 10-year U.S. Treasury note



Source: Tradeweb

Treasury yields play an important function in the economy, helping set borrowing costs on everything from mortgages to corporate bonds. They are also a closely watched economic barometer, with longer-term yields in particular tending to rise when the growth outlook improves and decline when it falters.

Yields on conventional and inflation-protected Treasuries still suggest the economy will grow at a healthy pace in the coming years. But expectations aren't as buoyant as they were in March. Back then, yields reflected forecasts that the Federal Reserve's benchmark federal-funds rate would remain near zero this year but start climbing by 2023 and steady at around 2.5%—without causing the inflation rate to fall to below the central bank's 2% target.

Today, investors still expect the Fed to raise rates at roughly the same time, if possibly a little sooner. But projections for rates over the longer term have subsided somewhat, as have inflation expectations—indicating a slightly weaker economy, less able to withstand interest-rate increases.

Investors' economic confidence has been eroded by waning expectations for both fiscal and monetary stimulus, some investors and analysts said.

From the start of the year, many investors have bet that large-scale government spending, near-zero short-term interest rates and continued bond buying by the Fed would lift an economy already rebounding from the pandemic.

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Expectations reached their recent peak in March, when Democrats passed a larger-than-expected coronavirus-relief bill with no Republican votes, fueling bets that they could have similar success in passing other priorities such as spending on infrastructure.

Since then, however, progress has been slow, with moderate Democrats insisting on a bipartisan infrastructure bill. Meanwhile, Fed officials have started discussions about tapering bond purchases and have pushed forward the time frame when they expect to raise interest rates.

Such developments have more than offset the recent increase in inflation. Over the course of April and May alone, the consumer-price index jumped 1.4%, with core prices, excluding volatile food and energy categories, logging their biggest year-over-year gain in May since 1992. Many investors, though, have largely dismissed such gains as aberrations related to the reopening of the economy. Fed Chairman Jerome Powell recently pointed to the recent decline in sky-high lumber prices as a possible sign of things to come.

“Markets are forward looking,” said John Bellows, a portfolio manager at Western Asset. “Even with high inflation prints, forward inflation has been reassessed lower.”



The TCL Chinese Theatre in Los Angeles reopened in March.

PHOTO: MARIO ANZUONI/REUTERS

A good number of investors still expect unusually strong growth over the next couple of years and argue that inflation may also remain elevated, eventually driving a more aggressive response by the Fed.

As of April, economists surveyed by The Wall Street Journal anticipated that the economy —after shrinking 3.5% last year—will grow 6.4% this year and 3.2% in 2022.

In a June report, the Jefferies economists Aneta Markowska and Thomas Simons forecast 5% growth next year, thanks in part to the lingering impact of recent stimulus payments that “have left household finances in the best shape in decades.”

Core inflation should “remain well above 3% through at least April of next year,” as consumers keep spending, the economists wrote in another report. By then, they added, a tight labor market could be leading to wage increases, so that “any easing of inflationary pressures is likely to be transitory.”

Caught off guard by the recent decline in yields, some investors and analysts have blamed idiosyncratic factors such as demand from pensions and foreign central banks.

One popular explanation is that the bet on higher yields became too crowded. “When everybody is short and the market just rallies a little bit,” hedge funds can be forced to buy bonds to reduce their risk of further losses, said Zhiwei Ren, a portfolio manager at Penn Mutual Asset Management. That causes yields to fall even further.

Still, investors and analysts generally agree that Treasury yields are at least eventually determined more by economic fundamentals and the outlook for interest-rates set by the

Fed than by technical factors.

“There is a growing contingent of market participants that are buying into the idea that we’ve reached peak growth—essentially that the most impressive days of the recovery are behind us,” said Mr. Simons of Jefferies.

His view, he said, is that investors have just become too pessimistic and that the 10-year yield could still rise to 2% by the end of the year.

Appeared in the July 1, 2021, print edition as ‘Treasurys Signal Waning Exuberance.’

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