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Don’t Fight the Fed: It’s Lower for Longer for Bond Yields

Few analysts and traders expect rates to keep rising for long

The central bank’s Federal Open Market Committee is expected to raise interest rates at its Dec. 15-16 meeting.
PHOTO: ANDREW HARRER/BLOOMBERG NEWS

By MIN ZENG

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Bond investors aren’t fighting the Fed, but they aren’t panicking about higher interest rates, either.

Futures-market bets on rising U.S. interest rates have reached a six-month high, reflecting expectations that the Federal Reserve will raise short-term rates next month for the first time since 2006. The yield on the benchmark 10-year Treasury note has risen, too, trading Friday at 2.280%, near the highest level since July.

Yet, few analysts and traders expect rates to keep rising for long. Many investors say the yield on the 10-year note is likely to trade between 2.25% and 2.5% for the remainder of this year, reflecting uneven economic growth, soft inflation and strong demand for high-quality debt that has consistently foiled expectations for rising rates since the financial crisis.

“It is very hard for long-term Treasury yields to rise substantially in this environment,” said John Bellows, portfolio manager at Western Asset Management Co., which had $446.1 billion in assets under management at the end of September. “It could take a long time for long-term Treasury yields to normalize.”

Even so, signs are abundant that investors are preparing for higher rates.

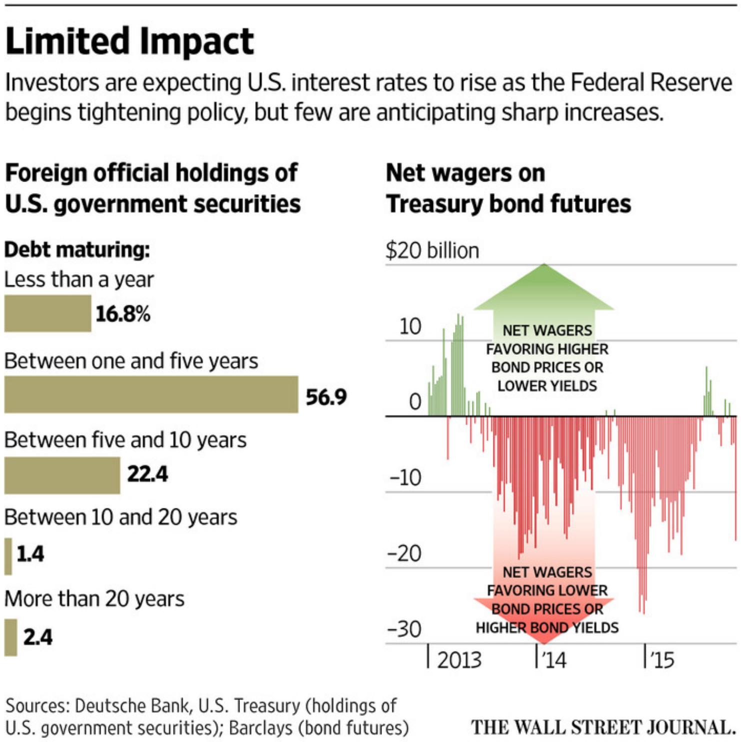
Fed funds futures, used by investors and traders to place bets on central-bank policy, have risen to reflect a 70% likelihood of a rate increase in December, according to data from CME Group. That is up from 38% on Oct. 28, when the Fed said a rate increase at the December meeting remains on the table.

Investors including hedge funds and money managers have accumulated $16.4 billion in net short positions on 10-year Treasury note futures for the week that ended Nov. 3, the highest level since May, according to data from Cheng Chen, interest-rate strategist at TD Securities. A short position is a wager on lower bond prices and higher yields.

U.S. bond funds and exchange-traded funds targeting U.S. government bonds posted $2.126 billion net cash outflow for the week ended Nov. 11, according to data from fund tracker Lipper. It was the biggest weekly outflow since May and the fifth consecutive week of net redemption, a sign that fundholders are selling bonds in anticipation that their prices will fall as rates increase.

At the same time, robust demand will set a cap on rates. Sales of 10-year and 30-year Treasury debt last week attracted strong demand from home and abroad. Indirect bidding, a gauge of foreign demand, was 60.5% for the 10-year note auction, the fourth largest on record for a 10-year-note sale.

Sales by foreign central banks prevented bond yields from falling significantly in August and September when global stock and commodity prices swooned.



Foreign private investors have been filling the void. Such investors bought a net $208.5 billion of Treasury notes and bonds in the 12 months through August, the fastest pace since May 2014, according to Deutsche Bank. The purchases reflect in part a global stock selloff in August, which prompted many investors to buy government debt.

Torsten Slok, chief international economist at Deutsche Bank Securities, said the nature of overseas central banks’ Treasury holdings helped mitigate the impact of their selling on U.S. rates.

Foreign central banks held 56.9% of their overall investments in U.S. government debt in securities maturing in one to five years. Investments in Treasury debt maturing in a decade or more accounted for only 3.8% of the total, which cushioned the impact on long-term bond yields, Mr. Slok said.

Many investors say low inflation driven by weak commodities prices and a stronger dollar supports the case for the Fed to raise rates slowly, minimizing the impact on markets.

“With the Fed signaling a very shallow tightening campaign and with inflation where it is, why should the 10-year yield rise dramatically?” said Tom Girard, head of Fixed Income Investors, an investment division of NYL Investors, which has $137 billion of assets under management.

Mr. Girard said he has bought long-term Treasury bonds recently as yields rose. He said the 10-year yield could fall to 2% or lower by the end of the year should riskier markets such as stocks suffer a large pullback.

The S&P 500 Index fell 3.6% last week to 2023.04, snapping a six-week winning streak. U.S. crude-oil futures tumbled 8% for the week, to $40.74 a barrel, and copper prices dropped to the lowest level since July 2009.

To be sure, not everyone is certain the Fed’s tightening campaign will be as measured as the market expects.

“The Fed’s gradual and shallow path has been on people’s radar screen for a while, so the risk for the bond market is that the Fed may tighten more aggressively than people think,” said David Donabedian, chief investment officer at Atlantic Trust Private Wealth Management, which has $26.1 billion assets under management.

In part, limited rate-increase expectations reflect gains in the dollar against other currencies, which has driven up returns on U.S. assets for overseas investors.

U.S. government debt overall has posted a total return—including bond-price gains and interest payments—of 0.5% this year through Thursday, according to data from Barclays PLC. The return amounts to 13% in euro terms, 3.1% in British pounds and 3% in yen.

Andrew Milligan, head of global strategy at Standard Life Investments, which has $393.1 billion of assets under management, said a stronger dollar “is doing part of the Fed’s work” by tightening financial conditions in the U.S.

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