Behind Bond Market’s Stall, Investors See Hard Times Ahead

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Yields on U.S. government bonds have stalled near all-time lows, a sign that investors are anticipating a difficult economic recovery and years of aggressive monetary stimulus.

For much of the past month and a half, the yield on the benchmark 10-year U.S. Treasury note has hovered around two-thirds of a percentage point—a shade above its all-time low of around
0.5% set in March.

Taken together, the low level of the 10-year yield and its stability suggest that bond investors not only hold a dreary economic outlook but also are unusually confident in that perspective, a contrast with the optimism that has carried stocks to their highest levels since early March.

The S&P 500 gained 1.7%, Wednesday, leaving it just 12% below its record high set in February. The Dow Jones Industrial Average added about 369.04 points, or 1.5%, and the Nasdaq Composite rose 2.1%.

An important benchmark for interest rates across the economy, the ultralow 10-year Treasury yield has facilitated an explosion of corporate-bond issuance from the likes of Costco Wholesale Corp., Apple Inc. and Clorox Co. News that an experimental coronavirus vaccine from the drugmaker Moderna Inc. had shown promise in an early trial helped push the 10-year yield to the top of its recent range on Monday. But the yield—which falls when bond prices rise—has declined again since then, leaving it at roughly half of its low from before this year.

Two factors typically determine longer-term Treasury yields. One is investors’ estimates of the average federal-funds rate set by the Federal Reserve over the life of a bond. The other is what is sometimes referred to as a risk premium, or an extra amount of yield investors demand to be compensated for the chance that short-term interest rates could rise higher than anticipated as a result of scenarios such as accelerating economic growth and inflation.

Wednesday’s closing 10-year yield of 0.679% suggests many investors believe that the Fed could basically repeat its postcrisis playbook: leaving the federal-fund rate near zero for about seven years before raising it to around 2%. Yields are lower than they were a decade ago in large part because investors feel more assured about that outcome, having seen the central bank implement such policies before without spurring a significant pickup in inflation.

The risk premiums embedded in Treasurys “are basically zero or nonexistent,” said Thanos Bardas, global co-head of investment grade at Neuberger Berman.

Expecting yields to remain rangebound over the next few quarters, Mr. Bardas said he likes Treasurys in the seven- to 10-year range and has high hopes for the new 20-year bonds that were reintroduced by the Treasury Department on Wednesday in a $20 billion auction.

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The stability of Treasury yields is particularly notable because it comes even as an unprecedented deluge of new debt floods the market. Not only has the Treasury Department ramped up the size of bond auctions to fund trillions of dollars in economic-relief measures but higher-rated companies also have been bombarding investors with new bond sales as they try to replace revenue that is being lost as a result of the coronavirus pandemic.

The Fed, meanwhile—after saying in March it would buy an unlimited amount of Treasurys—has slowed the pace of its purchases to $6 billion a day from $75 billion a day.

Still, yields have barely budged, indicating that “globally, there’s tremendous demand for that high-quality debt,” said Colin Robertson, head of fixed income at Northern Trust Asset Management.

Treasury yields that are reliably this low have wide-ranging implications for markets and the economy. For investors, paltry yields might signal a gloomy future. But they can also propel them into riskier assets in search of returns, a likely factor in the surprisingly strong rebound in stocks since their sharp decline earlier in the year.

Low yields have also encouraged borrowing. For a brief period in March, corporate borrowing costs shot upward as fear gripped markets and investors sold bonds from even the safest companies. Since then, though, the average extra yield investors demand to hold investment-grade corporate bonds over Treasurys has shrunk, enabling businesses to benefit from the low benchmark rates.

Last month, Costco sold 10-year notes with a 1.619% yield, the lowest on record for that maturity, according to LCD, a unit of S&P Global Market Intelligence. Other companies that have recently issued 10-year bonds with sub-2% yields include Apple, Clorox and International Business Machines Corp. Overall, through Tuesday, nonfinancial companies had issued $150 billion of investment-grade bonds this month after selling a record $231 billion in April, according to Dealogic.

Treasury yields could turn even less volatile if the Fed adopts a policy known as yield-curve control, several analysts said. A cousin of quantitative easing, yield-curve control entails purchasing an unlimited amount of bonds at a particular maturity to peg rates at a target.

Yield-curve control has been used for years by the Bank of Japan to keep the yield on 10-year Japanese government bonds at around 0%. In March, the Reserve Bank of Australia said it would set a target of 0.25% for the country’s three-year government bond.

In the U.S., Fed Chairman Jerome Powell said last fall that “short-term yield-curve control is something that is worth looking at” as a tool to fight the next recession. Minutes of the Fed’s
April 28-29 meeting released Wednesday also revealed that “a few participants” at the meeting discussed the possibility of capping short-to-medium term Treasury yields for a period of time, while “several” said bond purchases could generally be used “to keep longer-term yields low.”

It is far from certain that the Fed will embrace yield-curve control. Still, the mere discussion has likely contributed to the bond market’s calm, analysts said.

Something similar happened to corporate bonds after the Fed said in March it would start buying the securities, said Thomas Simons, senior vice president and money-market economist in the Fixed Income Group at Jefferies LLC. Though it was nearly two months before the Fed started implementing the program, the announcement alone sparked a rush into the asset class as investors anticipated the Fed’s backing.

“Just knowing that the Fed could do something is almost the same as the Fed actually doing it,” Mr. Simons said.

Not all investors are unconcerned about a pickup in inflation that could push longer-term yields higher. A welcome surprise—such as an early vaccine available for emergency use this fall—could provide a major boost to the economy. Some also see risk in the tremendous amounts of money that the federal government is spending to help the economy, coupled with the promise of unlimited bond-buying from the Fed, which essentially helps finance that spending.

“The Fed wants to push inflation higher, and is willing to keep monetary policy accommodative even as the economy recovers from the Covid-19 shutdown to get inflation expectations up,” said Donald Ellenberger, senior portfolio manager at Federated Hermes.

Mr. Ellenberger said he therefore sees value in Treasury-inflation-protected securities, or TIPS.

Still, he said, his team’s strategy is to “trade the range”—betting on higher yields when the 10-year falls below 0.6% and lower yields if it approaches 1% in large part because of the Fed’s continued bond-buying and desire to support the economy.