Why It’s Important to Pay Attention to the 10-Year US Treasury

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Why the focus on the 10-year US Treasury Bond?

The 10-year US Treasury rate is a key benchmark interest rate that has broad implications for the economy and financial markets. Let’s talk about some of the impacts of a higher 10-year US Treasury rate.

- **Economic Growth**: Higher interest rates can slow economic growth. As borrowing becomes more expensive, consumers may reduce spending on big-ticket items that often require financing, like homes and cars. Companies may be forced to cut back on capital expenditures due to the increased cost of financing.

- **Stock Market Valuations**: Generally, higher interest rates can lead to lower stock valuations. The discounted cash flow models used to value stocks will use a higher discount rate, which can result in lower present values for future earnings or dividends. Furthermore, as bond yields rise, they might become more attractive relative to stocks, causing a shift in asset allocation.

- **Cost of Borrowing Increases**: As the yield on the 10-year Treasury rises, it can lead to higher borrowing costs across the economy. This includes not only the government but also corporations and consumers. Mortgage rates, for instance, are often closely tied to the 10-year yield, so a rise can make housing more expensive for buyers.

Why the focus on the 10-year US Treasury Bond?

- **Consumer Spending**: Higher interest rates can increase monthly payments on variable-rate debts, such as credit cards or adjustable-rate mortgages. This can decrease disposable income and reduce consumer spending.

- **Financial Sector**: Banks can benefit in the short term from a steeper yield curve if they can borrow short-term at lower rates and lend long-term at higher rates. However, if higher rates lead to a slowdown in lending activities or an increase in loan defaults, the benefits might be offset.

- **Housing Market**: As mentioned earlier, higher rates can lead to higher mortgage rates, which can reduce the affordability of homes. This could lead to a slowdown in the housing market.

- **Foreign Investment**: If U.S. rates are higher relative to other countries, it might attract foreign investors seeking better returns on fixed income. This could lead to an appreciation of the U.S. dollar, which has its own set of economic implications.

Why the focus on the 10-year US Treasury Bond?

- **Currency Value**: Higher interest rates tend to attract foreign capital inflows, which can lead to an appreciation of the domestic currency. An appreciating currency can make domestic goods more expensive for foreign buyers, potentially impacting exports.

- **Corporate Profits**: Companies that have significant debt may see their interest expenses rise, which can reduce profitability. Conversely, those with significant cash holdings can benefit from higher interest income.

- **Fixed Income Investors**: For those already holding bonds, rising interest rates will cause bond prices to fall. However, new bonds issued will have a higher yield, benefiting those looking to invest in fixed income at that time.

- **Retirees and Savers**: Individuals, especially retirees who depend on fixed income, may benefit from higher interest income.

- **Monetary Policy Implications**: A rising 10-year yield might indicate expectations of tighter monetary policy from central banks, or it might force central banks to reconsider their current policy stance.

What can cause the 10-year US Treasury Rate to Rise Rapidly?

- **Inflation Expectations**: One of the primary drivers of long-term interest rates is the market's expectation of future inflation. If investors believe that inflation will rise significantly in the future, they will demand a higher yield on bonds to compensate for the erosion of purchasing power.

- **Federal Reserve Policy**: If the Federal Reserve signals or implements a tighter monetary policy, such as increasing the federal funds rate or reducing its bond-buying programs, it can cause an upward movement in short-term rates, which can influence longer-term rates like the 10-year Treasury.

- **Economic Growth Expectations**: Strong economic data or expectations of robust future economic growth can lead to higher Treasury yields. As the economy grows, demand for credit increases, pushing up interest rates. Moreover, strong economic growth can fuel inflation expectations.

- **Decreased Demand for U.S. Treasuries**: If foreign governments, institutional investors, or other large purchasers of U.S. debt reduce their buying or start selling, it can lead to a decrease in bond prices and an increase in yields.

- **Increased Supply of Treasuries**: If the U.S. government significantly increases its issuance of Treasury bonds (for instance, to fund a large budget deficit), it can lead to higher yields, especially if demand doesn't keep up with the increased supply.

What can cause the 10-year US Treasury Rate to Rise Rapidly?

- **Changes in Global Interest Rates**: If major economies around the world see an increase in their interest rates, it can put upward pressure on U.S. rates as investors seek higher returns elsewhere.

- **Shift in Investor Risk Appetite**: If investors shift their preferences from bonds to riskier assets like equities, it can lead to selling pressure on bonds, resulting in lower bond prices and higher yields.

- **Expectation of Future Rate Increases**: Interest rates can be influenced heavily by expectations. If the market starts to believe that rates will be higher in the future, they may start selling bonds now, leading to a self-fulfilling increase in rates.

- **Loss of Confidence**: If there's a loss of confidence in U.S. fiscal policy, political stability, or repayment capability, it could lead to higher risk premiums demanded by investors, thus pushing up yields.

- **Credit Rating Changes**: A downgrade in the U.S. government's credit rating (or even the threat of a downgrade) can result in higher yields as investors demand a higher return for perceived increased risk.

- **Changes in Currency Value**: Movements in the value of the U.S. dollar can influence demand for U.S. Treasuries from foreign investors, which can, in turn, impact yields.

What can cause the 10-year US Treasury Rate to Rise Rapidly?

- It’s important to recognize that the interaction of these factors can be complex, and multiple elements can be at play simultaneously.
- Also, the speed and magnitude of the rate change can be influenced by how unexpected the causative events are to the market.

What Are Some Of The Impacts We Are Seeing Now From Significantly Higher Interest Rates?

Debt

The U.S. national debt has risen 43% from $23.2 trillion in the first quarter of 2020 to over $33.4 trillion today owing to an unbalanced federal budget. And through the first nine months of this year alone, the national deficit exceeded $1.5 T.

The US Treasury is selling about $85 B/week worth of bonds through the end of 2023.

Bond buyers are seeking to increase the yield of the 10-year Treasury to compensate for the now much greater risk of holding U.S. debt. But it's not just these bond market leaders driving the 10-year yield higher.

There is additional supply from the Fed's QT operations to reduce its balance sheet by selling or allowing part of its bond portfolio to mature.

But the question is, what yield will bond buyers require in compensation for the increased risks of holding U.S. debt amid higher inflation and a seemingly unsustainable fiscal policy?

Debt

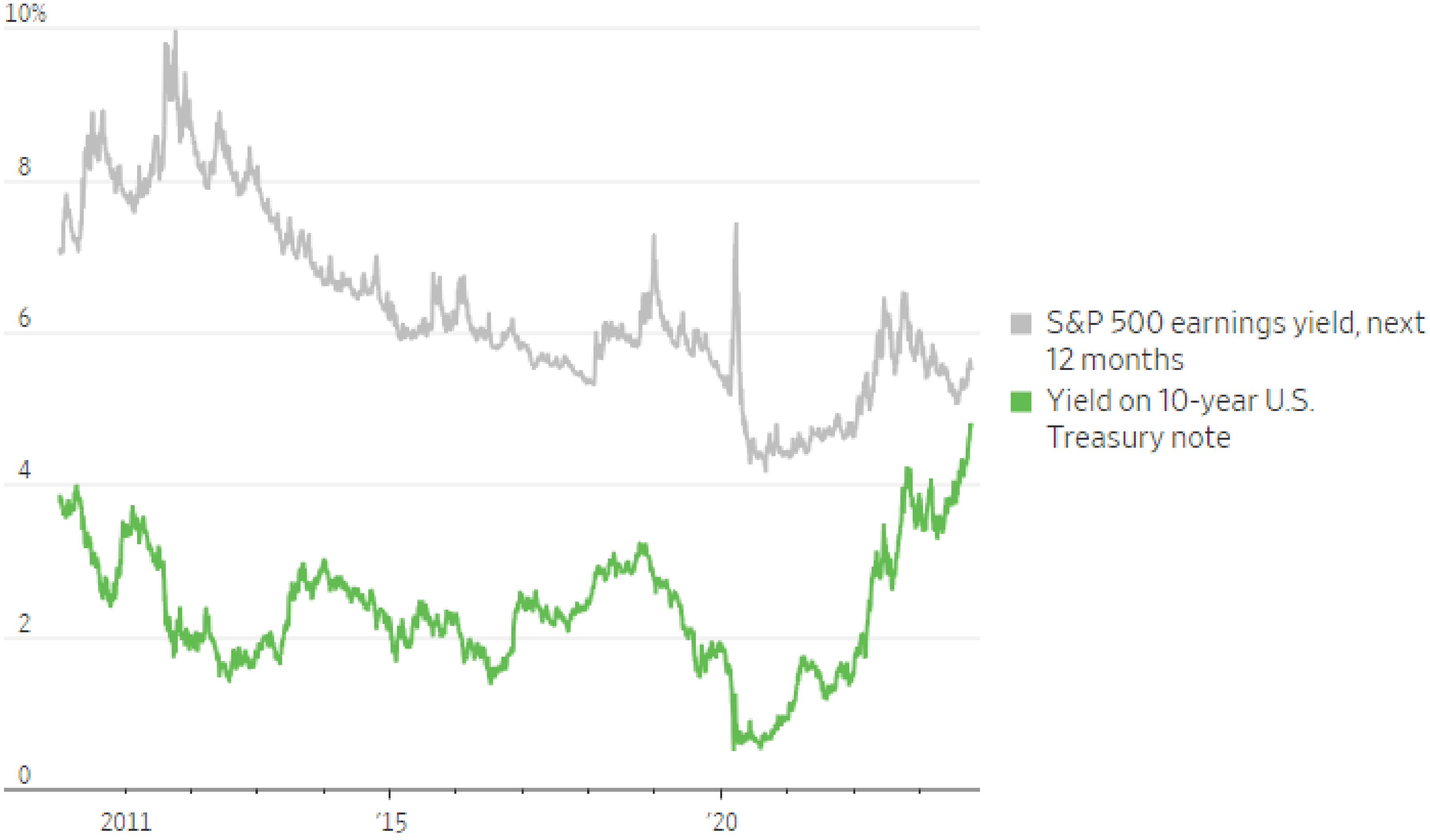
The recent banking stress has been a real test of capital and liquidity regulations enacted after the 2008 crisis. The banking system has been able to absorb the failure of three regional banks without creating systemic issues largely because of the Fed's Bank Term Funding Program. Additionally, banks have been scrambling to enhance their liquidity positions by parking maturing securities in cash, while greatly tightening lending standards, and generally shoring up their balance sheets.

On the deposits front, the banking industry has experienced large outflows, particularly at smaller banks, with most of those funds going into money market funds and short-term treasuries paying much higher yields.

All that results in making debt much more expensive and much harder to qualify for which impacts individuals, companies, as well as the government.

Impacts of Higher Bond Yields
Graphs & Charts

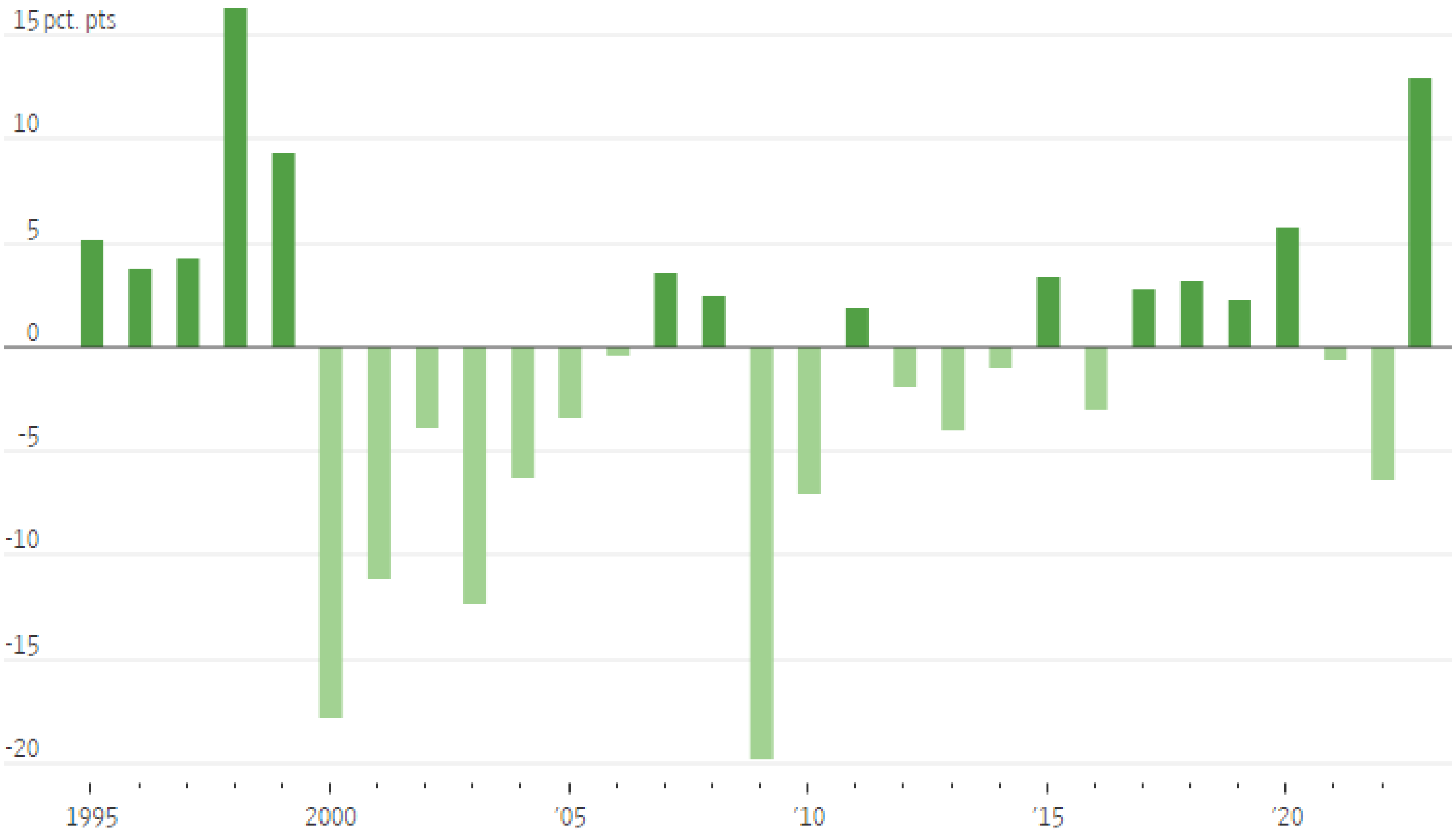
S&P 500 earnings yield and yield on 10-year Treasury



Note: Through Oct. 9

Sources: Dow Jones Market Data; FactSet; Tradeweb ICE

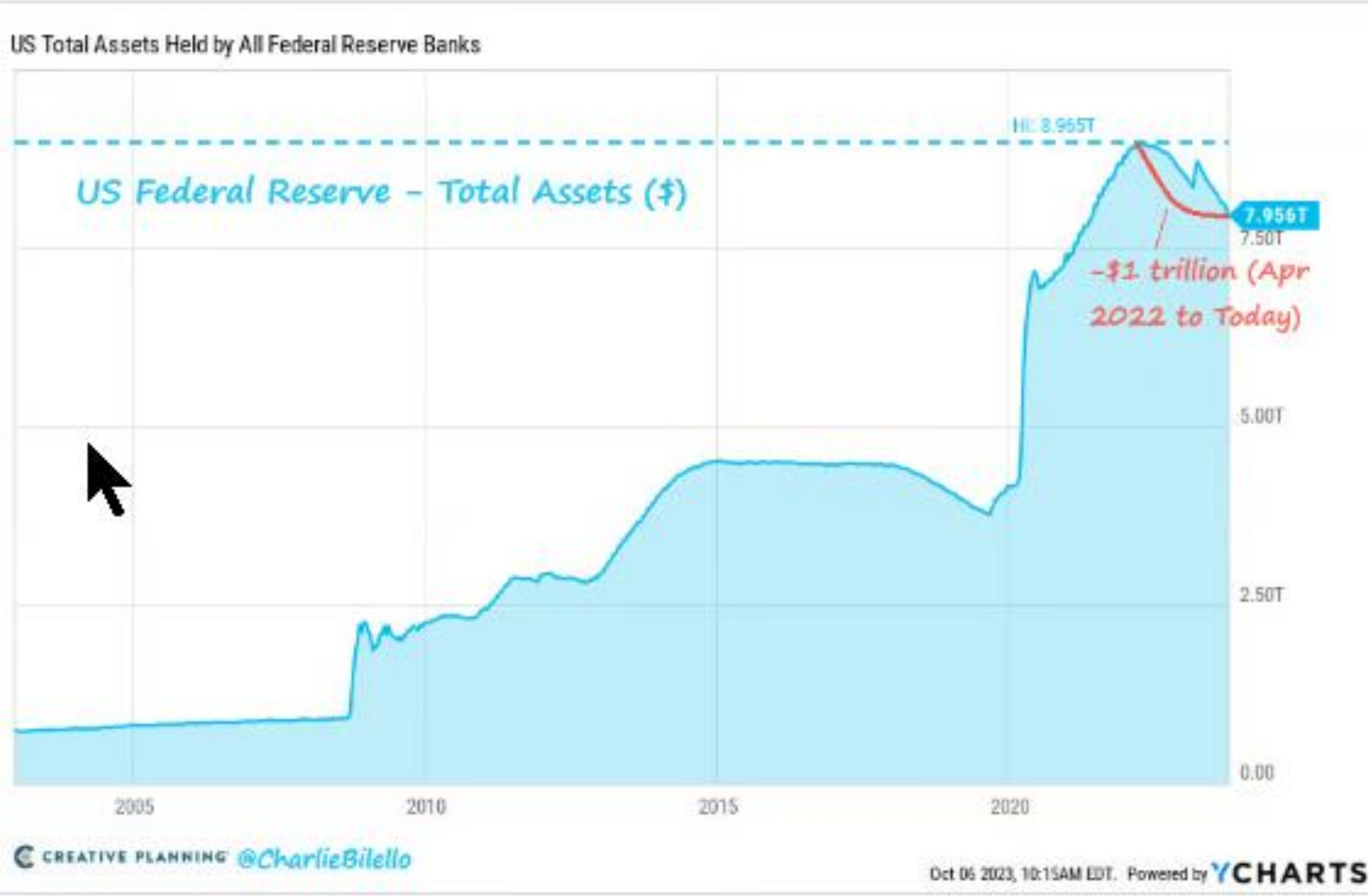
S&P 500 yearly performance lead over equal-weighted index



Note: Negative number means S&P 500 Equal Weighted outperformed S&P 500. 2023 data is preliminary.
Source: FactSet

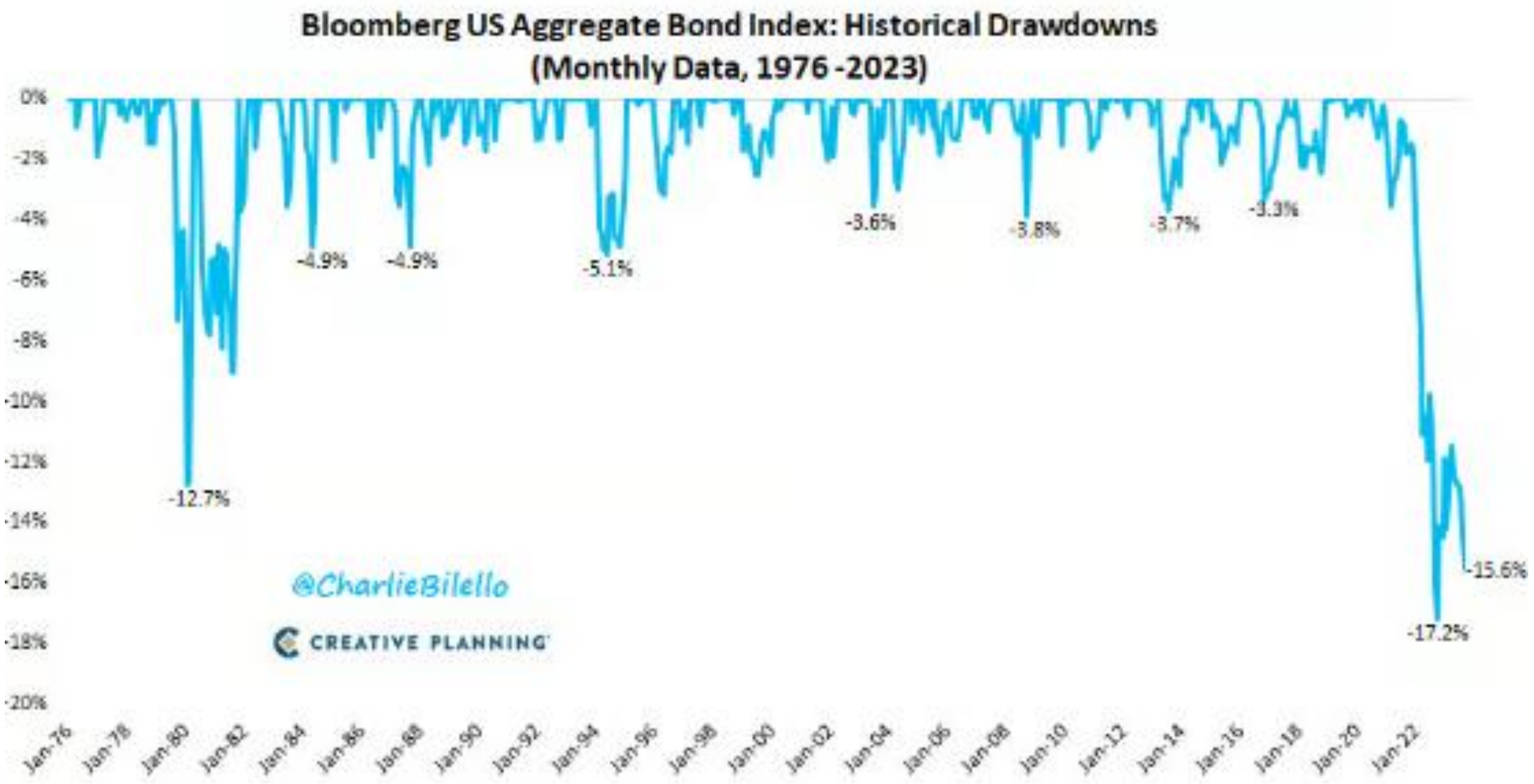
US National Debt (Last 4 Months)
$33,800,000,000,000
$33,300,000,000,000
$32,800,000,000,000
$32,300,000,000,000
$31,800,000,000,000
$31,300,000,000,000
@CharlieBilello
CREATIVE PLANNING
$2 Trillion Increase
(June 2 to Oct 3)
$33,474,904,868,026
$31,467,099,921,029
6/2/23
6/9/23
6/16/23
6/23/23
6/30/23
7/7/23
7/14/23
7/21/23
7/28/23
8/4/23
8/11/23
8/18/23
8/25/23
9/1/23
9/8/23
9/15/23
9/22/23
9/29/23

The Fed's balance sheet is now over $1 trillion lower than its peak in April 2022. How much more QT would be needed to unwind the massive QE from March 2020- April 2022? $3.8 trillion.



Impacts of Higher Bond Yields on Home Buying

Graphs & Charts


Bloomberg US Aggregate Bond Index: Historical Drawdowns
(Monthly Data, 1976 -2023)
0%
-2%
-4%
-6%
-8%
-10%
-12%
-14%
-16%
-18%
-20%
-12.7%
-4.9%
-4.9%
-5.1%
-3.6%
-3.8%
-3.7%
-3.3%
-17.2%
-15.6%
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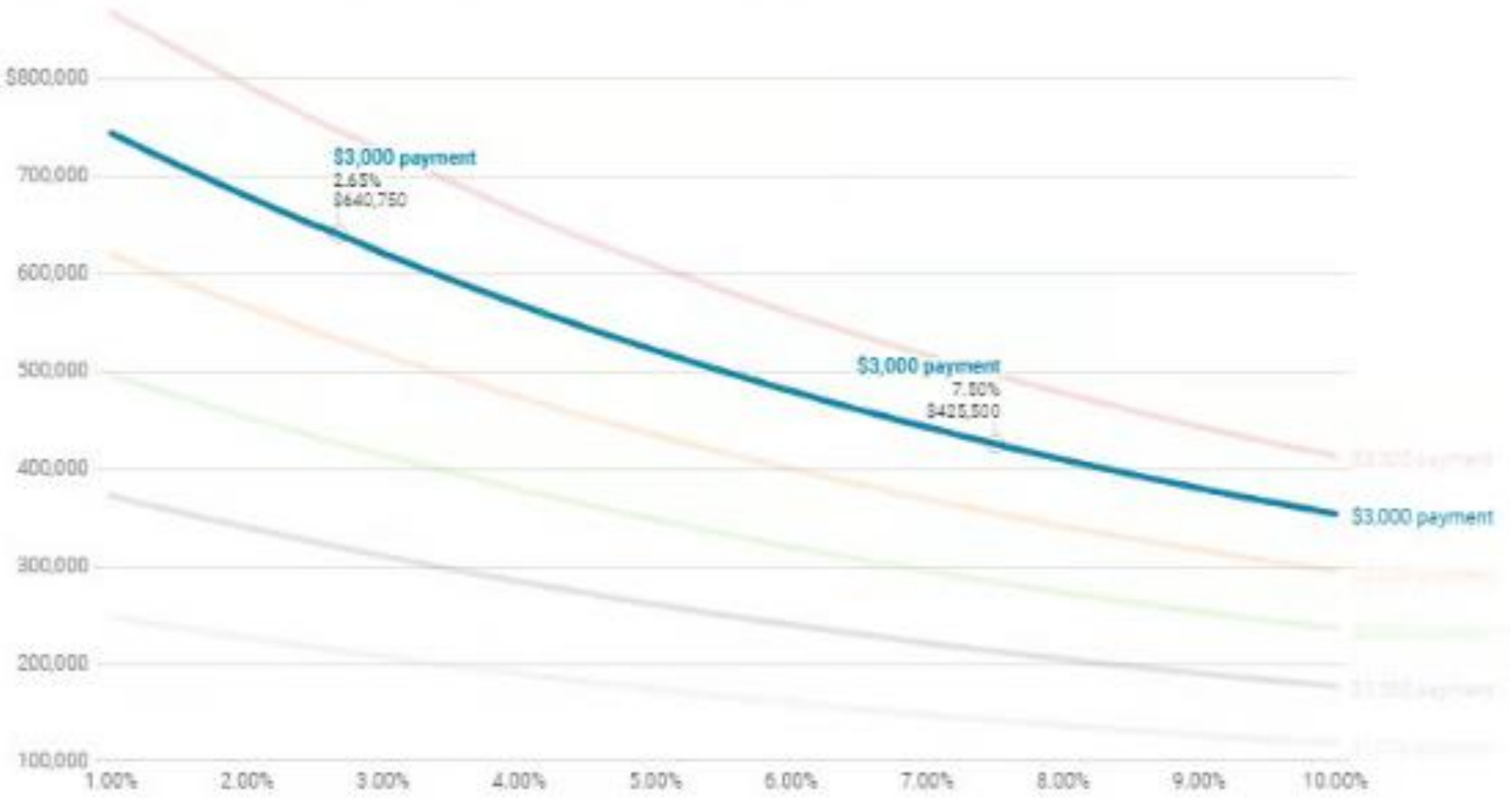
CREATIVE PLANNING
Jan-76
Jan-78
Jan-80
Jan-82
Jan-84
Jan-86
Jan-88
Jan-90
Jan-92
Jan-94
Jan-96
Jan-98
Jan-00
Jan-02
Jan-04
Jan-06
Jan-08
Jan-10
Jan-12
Jan-14
Jan-16
Jan-18
Jan-20
Jan-22

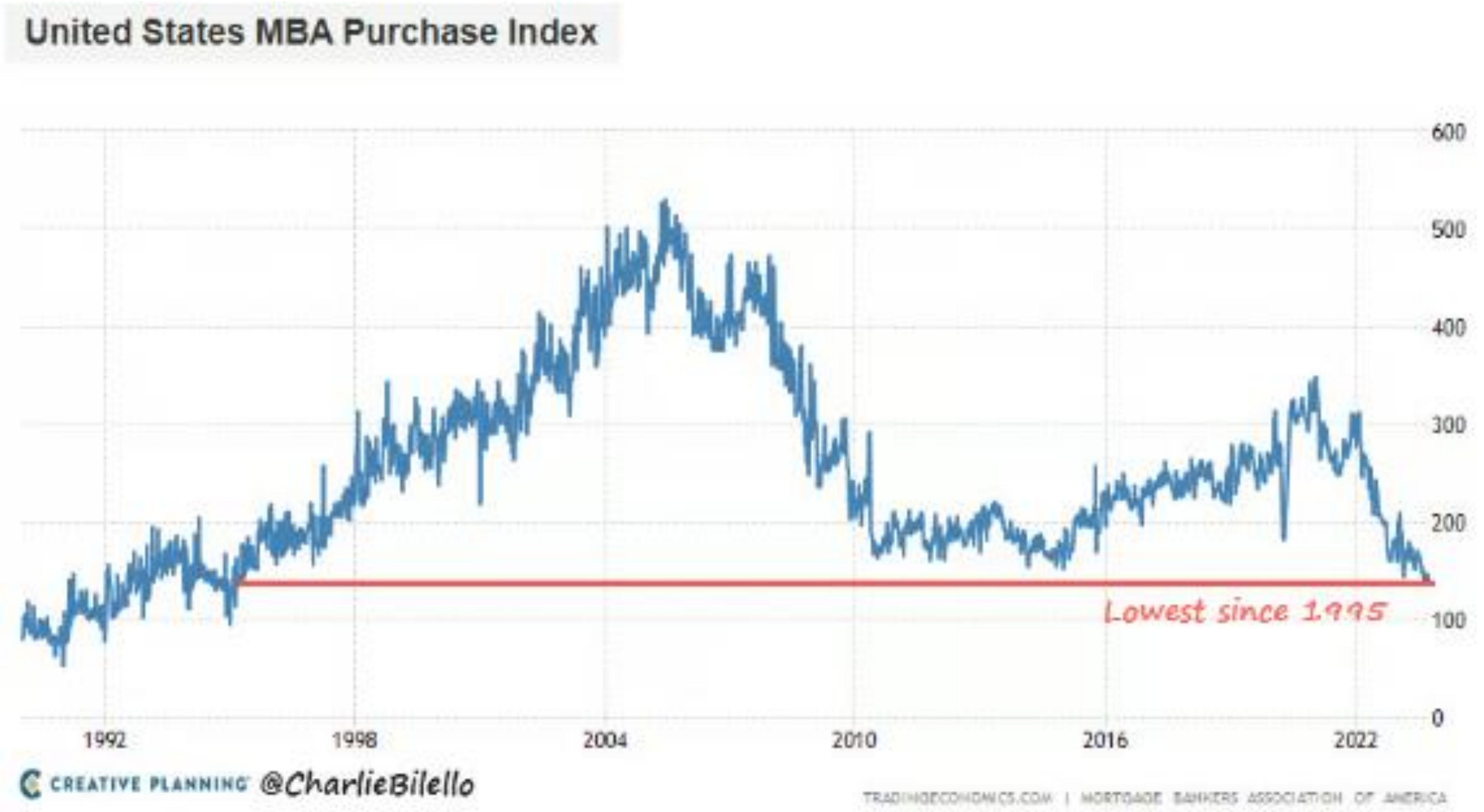
How much home can you afford as mortgage rates change?

Shows the home price you could afford for different monthly payment amounts, based on the mortgage interest rate. Assumes 20% down, a 30-yea mortgage,1.25% property tax rate, 0.5% homeowners insurance rate, and no HOA dues.



Source: Redfin • Get the data • Created with Datawrapper

Mortgage purchase applications in the US have fallen to their lowest level since 1995. The average American household simply cannot afford the average home at current mortgage rates and current prices.



Multi-Family financing costs have doubled what they were 18 months ago