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Federated adopts neutral view on yields in the near term

Risks between upward and downward moves appear relatively balanced.

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Having fallen significantly immediately following the Federal Reserve's "no hikes this year" message at its March 20 meeting, Treasury market yields have rebounded somewhat and now appear to have settled around the high point of the Fed's current target range for the federal funds rate of 2.25%-2.50%. Federated's fixed-income duration committee now perceives balanced risks around market yields moving higher or lower in the near term, prompting a shift to a neutral view on duration.

Factors apt to keep market yields narrowly range-bound in the near term are dominated by inflation—or more accurately, its lack of acceleration. The core PCE price index has hovered at 2% or below on a year-over-year basis, not rising sustainably above the Fed's 2% target despite a 50-year low in unemployment and an economy on the verge of its 10th year of expansion. Without a sustained break higher for inflation, the Fed could be done for this cycle, which would be consistent with a 10-year yield just above 2.50% as historically it converges to the terminal funds rate in a cycle. Unless inflation heats up, we might be at that terminal rate.

Outside the U.S., the European Central Bank's willingness to remain accommodative amid Europe's growth slowdown should weigh on German Bund yields and, indirectly, U.S. yields, to some degree.

What could cause Treasury yields to break up or down? Upside lift could come from China either finding a floor in its economic deceleration or actually reaccelerating on stimulus. This, in turn, could goose European growth. A good bit of expectation about a possible U.S.-China trade deal already is priced into the market, suggesting a deal may not have much impact on market yields unless the deal is surprisingly favorable. Conversely, downside risk on rates could emerge from a disappointing trade deal, a lack of growth in China or a potential U.S.-European showdown on trade.

Notably, risk assets have had an incredibly strong run this year while Treasury yields remain lower, suggesting the markets may be assigning high probability that the Fed can achieve the elusive soft landing for the U.S. economy. If the markets were anticipating overall economic reacceleration and a Fed back in tightening mode, Treasury yields would have risen this year as stocks rallied and spreads—the gap between yields on corporate or emerging-market bonds relative to Treasuries—tightened. In other words, the classic "risk-on" behavior (stocks up, spreads tighter, yields up) may not apply to the first half of 2019 if the Fed is indeed close to done.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

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