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How low can yields go?

From here, they could break either way. But Federated's base case remains a recession isn't imminent.

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It has been a massive bond rally! Just this morning, the 10-year Treasury yield had fallen to a 3-year low and flirted with inversion relative to the yield on the 2-year Treasury note. Fortunately, Federated's fixed-income team added duration at various points during the year in our bond funds, capturing some of this rally. That said, the recent sharp move lower in Treasury yields surprised many, including us.

For most of the past nine months, we felt slower global growth, easier monetary policy among many foreign central banks and deceleration in the U.S. could be "cured" or at least countered by a U.S.-China trade deal. That, of course, has proven elusive, with trade confrontation only intensifying between the two countries. This has served to worsen an already slowing global economy, prompting the Fed to shift from tightening in late 2018 to easing in 2019 as it reacted to market signals and attempted to cushion the downside to the U.S. economy even though domestic growth appeared OK. With subsequent further easing by global central banks, pushing the volume of negative-yielding bonds to $15 trillion and counting, the weight on U.S. yields from abroad is clear.

Where to next on rates? We hate to be noncommittal, but we are holding duration at largely neutral. This view may sound exceptional given the market talk about negative yields and recent bond market momentum, but we still feel the near-term direction could break either way. Clearly, the risk of recession in the U.S. in the next 12 months has risen, but that is not our base case. While a trade deal in the near term remains unlikely—and has been mostly priced out of the market—conversations continue. Fed easing won't fix the myriad challenges the global economy faces, but it could foster a soft landing at home given the still-strong labor market and the degree to which the U.S. is less reliant on global activity, in part because of the comparatively smaller role trade plays in our economy.

If we get that expected soft landing as the Fed eases two or perhaps three more times, U.S. rates should edge somewhat higher. *But if* the U.S. is heading toward recession, again not our base case, the Fed is certain to ease many more times and new lows in yields will be reached—possibly even some negative yields. Central banks in Europe and Japan, where negative bond yields abound, have adopted negative policy rates. The Fed, on the other hand, has been skeptical about using negative policy rates and, unless that position changes, the prospect of negative bond yields in the U.S. should remain somewhat limited.

In short, we do not share the view that recession is imminent. But our conviction is fading in an increasingly uncertain world and we remain poised to adjust accordingly as events and trends unfold.

TAGS

INTEREST RATES

FIXED INCOME

DISCLOSURES

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.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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