Markets

Plunge in Treasury yields reverberates around markets

Equities are churning and borrowing costs for corporations are tumbling

Colby Smith, **Joe Rennison** and **Eric Platt** in New York 55 MINUTES AGO

A furious plunge in Treasury yields is reverberating through global financial markets, propelling shares of fast-growing tech companies to new records and driving down corporate borrowing costs, but raising fresh concern about the outlook for financial returns.

An investor consensus that took months to build, namely that robust economic growth and elevated inflation would bring about substantially higher interest rates, has been coming apart, and the pain for those caught in that trade has heightened with moves in the past couple of days.

Across Wall Street, investors are suddenly being forced to think how to reposition against the backdrop of what Jim Caron, a portfolio manager at Morgan Stanley Investment Management, has described as a "peak in growth, a peak in inflation and a peak in policy stimulus".

The market has taken its cue from signals that the Federal Reserve is considering cutting its monetary support sooner than previously expected and looks likely to raise rates in plenty of time to keep inflation from running away. Meanwhile, with the US having thrown off most of its coronavirus pandemic restrictions — and with the more transmissible Delta variant now prevalent in the country — strategists see less scope for growth to surprise on the upside.

The 10-year Treasury bond yield, which peaked at 1.77 per cent in March, fell by 0.11 percentage points in just two trading sessions this week and slid below 1.3 per cent early on Thursday.

“The cost of cash is decreasing and people are looking for places to deploy that cash,” Caron said. “This is supportive of broader asset markets.”

10-year US Treasury yield slides to lowest level since February

Yield (%)

Source: Bloomberg
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Equities: a record and a reversal of a rotation

The US benchmark S&P 500 has hit eight highs in the past nine trading days, and Apple — the largest company in the index — closed at a peak on Wednesday, its first closing high since January, before a burst of profit-taking on Thursday.

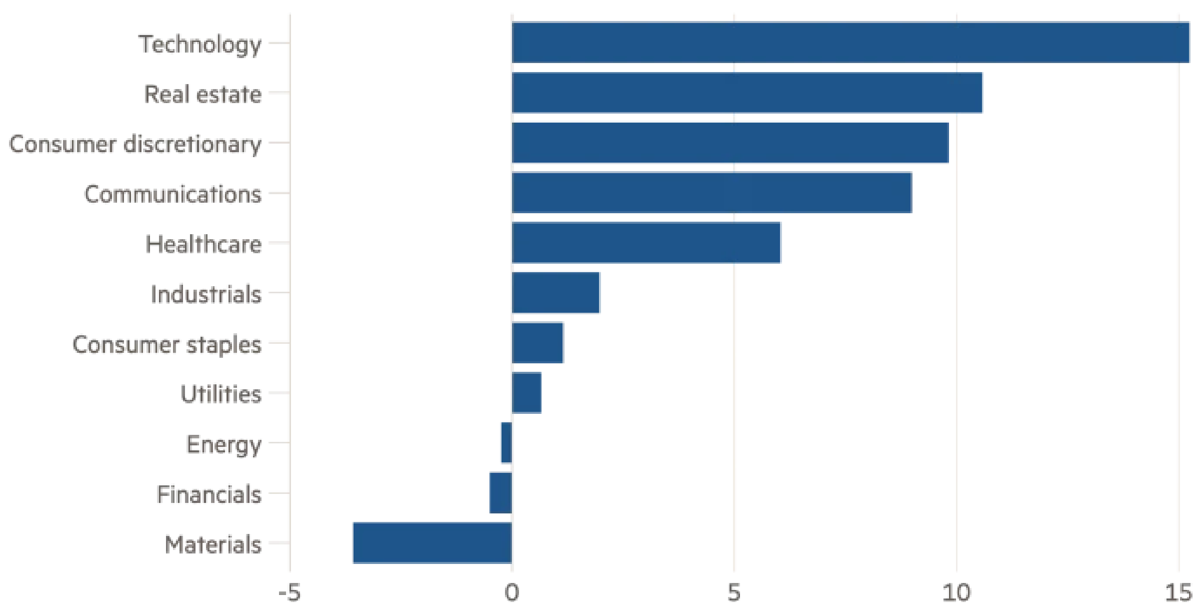
In fact, shares of fast-growing business like Apple have been driving the market rally since inflation expectations peaked in May, reversing what had been a multi-month rotation in value stocks, whose fortunes are more closely tied to the economic cycle.

Year-to-date returns on growth stocks within the S&P 500 surpassed returns from value stocks on Tuesday after lagging for much of the year.

The S&P 500 technology index was up less than 1 per cent between the start of the year and mid-May. But since then it has rallied more than 15 per cent to Wednesday's close, with shares of Microsoft, Salesforce and Qualcomm all up more than 10 per cent. Value stocks have trodden water since mid-May.

Technology stocks surge amid market rotation

S&P 500 sector price returns since inflation expectations peaked in May (%)



Source: Bloomberg

Banks, in particular, have lagged as interest rates have fallen and investors have started to question the durability of US economic boom. The drop in yields on long-term Treasuries threatens the profits banks earn from lending to clients, a point reflected in the closely followed KBW bank index, which has fallen 5 per cent since mid-May.

"The market may be at a major inflection point," said Margie Patel, a portfolio manager at Wells Fargo Asset Management. "There is a feeling that after mid-year the fabulous

That nervousness over the economic recovery came to the fore in early trading on Thursday in a broad equity market sell-off that caused the S&P 500 to open more than 1 per cent lower.

"We do not expect the reflation and rotation trades to return to their former glory," said Oliver Allen, a markets economist at Capital Economics, adding that there was "limited scope for growth expectations to improve further".

US growth stocks re-take the lead from value

Year-to-date performance (%)

Source: Bloomberg
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Corporate bonds: time to load up on debt?

The corporate bond market has been dancing to the same tune as the Treasury market.

As government bond yields rose earlier this year, so did yields on higher-rated debt in the corporate bond market — albeit by a smaller amount. Now the sharp reversal in Treasuries has sent investment-grade corporate bond yields to their lowest level since February, according to data from Ice BofA Indices.

Margaret Kerins, global head of fixed income strategy at BMO Capital Markets, said she expected sharply lower borrowing costs to prompt a number of companies to tap the bond

"If you didn't issue already, you are going to jump on it now," she said. "How can you not take advantage of that?"

Some investors and analysts are growing cautious, as credit is extended to increasingly risky companies at low rates.

BlackRock this week downgraded its outlook for US high-yield bonds, warning that the potential yield on offer was too low to compensate for the risks involved in lending to such lowly rated companies.

The yield on junk debt has fallen below 4 per cent in recent weeks and this week registered its lowest reading since ICE BofA Indices began tracking the data in 1992.

Others, while wary, remain optimistic about the resilience of US markets against a backdrop of supportive growth, even if they expect rates to retrace some of their steps and rise later this year.

"Markets are like pendulums. They go too far one way and then too far the other," said Adrian Miller, chief market strategist at Concise Capital Management. "We went too far in March worrying about inflation. We are too complacent today."