Caron's Corner Transcript – 1.13.2025

Ask Not Why Yields Are Rising – Ask Why the Curve Is Steepening

What About Bond Yields?

- U.S. Treasury (UST) 10-year yields have risen 100 basis points (bps) from their trough on September 16, 2024, when the Fed started cutting rates.
- UST 30-year yields are 4.90% today, nearing levels not seen since their 2023 spike of 5.15% (before that their highest level would have been in 2007).
- UK (United Kingdom) 30-year bonds have reached their highest levels since 1998
- A **key point** here is that it's important to note which yields are rising and which are not:
    - **Front-end yields have stayed low,** consistent with central bank plans to cut policy rates.
    - **But back-end bond yields are rising,** such that the **yield curve is steepening.**
    - As we are not seeing a wholesale rise in yields across the curve, expectations for Fed and other central bank rate cuts remain intact.
    - To be clear **this is not just nuance, it is the key point.**
- So instead of merely focusing on the narrative that bond yields are rising, which is only partially true, we should ask why the yield curve is steepening and what does that imply.
- Steeper curves are traditionally associated with stronger growth and better equity performance. But is this the case today? Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Ask not why yields are rising, ask why the curve is steepening. So bond yields are the big story as we start 2025. After all, U.S. Treasury (UST) 10-year yields have risen 100 basis points from their trough back in September 16, 2024, right around when the Fed started cutting interest rates. UST 30-year yields are nearing levels not seen since the 2023 spike at around 5.15% in yield and you'd really have to go back to 2007 to see where yields were much more commensurate with where they are today. 30-year bond yields in the UK probably take the cake. They have reached levels not seen since 1998. So look, the key point here is that we need to watch which yields are rising and which yields are not really rising very much.

If we look at front-end yields, front-end yields have really stayed relatively low, and that's consistent with central bank plans to cut policy rates. But back-end bond yields are rising. In other words, the yield curve is steepening, and we're not seeing a wholesale rise in yields across the curve. Yet, there are still expectations for the Fed and other central banks to continue to cut interest rates. So this is not just nuance, but it is the key point. So instead of just focusing on the narrative that bond yields are rising, which is only partially true, we should ask why the yield curve is steepening and what does that imply. Usually a steeper curve is associated with stronger growth and better equity performance, so let's get into it.

OK, so what's happening? Fed expectations for only two cuts in 2025 down to a level of about 4% is less than what the market had been previously expecting, but that's not the whole story. It's really about term premium, which is increasing. The yield curve is steeping, and we have to ask why. Well, one of the common narratives around this is there are expectations for potential tariffs, and that creates uncertainty risk premium that gets associated with it based on inflation. But when we look at the US 10-year 2s to 10s curve, it's the steepest it's been since going back to May of 2022. Inflation seems to be stickier, not falling as much as hoped, and 10-year breakevens are rising, somewhere around 2.4%. Jobs data came out relatively strong on Friday and continues to be strong. But what's also very interesting about the jobs number is that the inflation component of that wage earnings actually fell about 0.1 of a percentage point. So we're getting stronger headline jobs creation also consistent with the JOLTS data, but we're not really seeing the inflationary element to this. In some ways this keeps the Fed in the game to continue to cut interest rates and maybe contain those front-end yields. But back-end yields are seeing higher growth potential and potential inflation that goes along with that, and the curve is steepening. There's also concern about deficits, that is also going to add to the term premium and could make yields rise as well. Now look in the back-end, where there is some bad positioning. This is a technical in the market, which is that investor’s have gotten longer duration and given that yields have been rising, they're starting to get a bit stopped out.

So will a rise in bond yields impact equities and credit spreads negatively? Well, it depends on why yields are rising and which ones. For equities if U.S. growth prospects remain robust, say 2 to 2.5% growth, which is around potential, with earnings expansion and broadening of breadth, then equities can keep trending higher. Why? Because it's more about the E, the earnings, and the P, the price. When we look at the PE multiple, we have to factor that in. As long as earnings growth is maintained across broader sectors, margins are maintained, free cash flow yields and profitability remain robust, then it's still a good story. The risk is if yields rise and a stronger U.S. dollar tightens financial conditions, reducing borrowing and curtailing spending and consumption, then that would be bad. The market is trying to solve for the level at which 10-year yields rise to where things start to break. Now many think it's around 4.5%. We think it's closer to 5%. Of course, what matters is how quickly yields rise and for what reasons. For instance, if it's deficit and debt related, it could trigger a negative confidence shock. But barring that, once bond yields reach a steady state and no longer are trending higher, then we think equity valuations can tolerate. A 10 year yield somewhere in the 5% area. Effectively this represents a Fed policy rate that could fall toward 4%. And the spread between 3-month T-bills and 10-year yields around 75 to 100 basis points, which is typically historically where it sits. This is a relatively stable area for markets.

When we look at bonds and credit spreads, our base case is for no recession. Thus, default rates remain low. In this scenario, higher yields make bonds more attractive, especially on spread. This will bring in buyers for two reasons. One, the potential return one can get from bonds at yield levels north of 4.75% or 5% in 10-year USTs can actually start to rival equity returns. The other is that higher quality bonds at those yield levels may represent a good hedge against riskier assets, good value for money. As a result, we think bond yields will remain in a range and not become destructive for markets. After all, isn't a steeper yield curve associated with good economic outcomes? This is the antithesis to the flattener and inverted curves that have been associated with weakness, if you remember that narrative in 2024.

To be sure, the reshaping of the yield curve to a more normal positive slope will cause back-end yields to rise. Risky assets will not initially like the rise in yields, but perhaps the yield curve is signaling higher growth and lower inflation dynamics ahead, and this is what we're going to be watching.

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