Investors Shouldn't Rush to Dump Treasuries

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Treasury bonds have had a rough time since last week's election, with a sharp selloff driving up yields on longer-dated Treasuries to their highest level of 2016. The 10-year Treasury's yield has shot up from under 1.9% on Election Day to as high as 2.3% on Monday in one of the fastest moves for yields in years.

The dominant storyline behind why investors are fleeing bonds: They're worried about a spike in interest rates if economic growth picks up under Donald Trump's administration. Higher growth rates typically correspond with rising inflation, which in turn could prompt the Federal Reserve to accelerate its pace for rate hikes. In a rising rate environment, existing bonds are generally less attractive, so their prices fall.

In our view, the bond market seems to be getting ahead of itself, as it often does when unexpected events occur. Long-dated Treasuries may be a bit on the expensive side, but we think the post-election selloff has been excessive and the outlook is overly pessimistic.

First and most importantly, we don't know beyond the most general terms what the incoming administration's plans and priorities are, so it's far too early to reliably predict how its actions may affect economic growth in 2017 and beyond. By extension, it's also too early to forecast how inflation may be affected and any Fed policy responses.

The most concrete Trump proposal is more spending on infrastructure, but details are scarce. We think increasing outlays for infrastructure could give the economy a short-term lift if it comes in a concentrated burst. That's an important caveat and a challenging one, as history shows that there may not be that many "shovel-ready" projects available.

KEY TAKEAWAYS

- In our view, the bond market seems to be getting ahead of itself. Long-dated Treasuries may be a bit expensive, but we think the post-election selloff has been excessive and the outlook is overly pessimistic.
- The primary concern is that significantly faster economic growth will lead to sharply higher inflation and interest rates. We need to know more about the new administration's plans and priorities before we judge the potential impacts.
- At this point, we're sticking with our view that the economy will continue its slow grind upward in the coming year and, as a result, that our "lower-for-longer" outlook for interest rates remains intact.

It's hard for us to see much impact from any large-scale infrastructure program before 2018 at the earliest. And while some recent economic data suggest improving conditions heading into next year, we don't see enough evidence yet of a significant steepening in the recovery trajectory, which has been weak since the Great Recession ended more than seven years ago.

Inflation has inched up closer to the Fed's 2% target, but it's being tempered by a strengthening U.S. dollar.

The greenback's gains are partly explained by expectations of higher U.S. interest rates, but it is also benefiting from political uncertainties in Europe that began with Britain's surprising vote in June to withdraw from the European Union. Now attention has shifted to a referendum in Italy next month, and its outcome could further disrupt the EU.

The dollar's rise is due in part to a reversal of a "carry trade," in which investors had borrowed in dollars to buy higher-yielding assets in emerging markets. As the EM yield advantage narrows, demand for dollars is increasing as those investors seek to pay back their loans.

Another positive for Treasuries is the strong demand from European and Japanese investors seeking more yield than is available at home. The currency effect of a strengthening U.S. dollar stands to make this trade even more attractive than it already is.

The Fed will probably raise short-term interest rates by a quarter of a percentage point at its December meeting — it would be the first hike since December 2015. The key reason for the wide spacing between moves has been the persistently slow economic growth that we see continuing into next year.

Assuming there's a rate increase in December, there could be another lengthy interval before the next one comes. The Fed does not want to risk choking off what little economic growth we're enjoying by tightening the money supply too quickly. This "lower-for-longer" approach would tend to be a positive for Treasury prices.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

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