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Rates

Anticipate Further Yield Curve Flattening

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Economic conditions, goosed by tax reform, call for a faster pace of Fed rate hikes.

The Treasury yield curve continued to flatten in the fourth quarter, a trend that was in place for the majority of the year. The front end of the Treasury curve underperformed, with two-year notes increasing 40 basis points in yield as the Fed delivered another 25 basis-point increase in the federal funds rate at its December FOMC meeting. At the same time, inflation remained moderate (see chart, top right), and robust demand for long-duration assets caused the long end of the Treasury curve to outperform, with the 30-year Treasury bond yield falling 12 basis points. The 2s/30s yield curve flattened by over 100 basis points over the year, with the two-year note yield increasing from 1.19 percent to 1.89 percent, and the 30-year bond yield decreasing from 3.07 percent to 2.74 percent.

The flattening of the Treasury curve during the quarter delivered mixed returns for the overall Treasury market. The Bloomberg Barclays U.S. Treasury index returned 0.05 percent for the quarter, bringing the total return for the year to 2.30 percent. The Bloomberg Barclays U.S. Treasury 20+ year index returned 2.55 percent for the quarter, delivering a total return of 9.00 percent for the year. The Barclays U.S. Agency index returned 0.06 percent for the quarter and 3.0 percent for the year. Globally, the Bloomberg Barclays Global Treasury index returned 1.10 percent for the quarter and 7.30 percent for the year.

Looking ahead, we expect the Fed to increase the fed funds rate by another 25 basis points at its March meeting. With the new tax law now taking effect, economic growth is likely to remain strong this year and cause the labor market to overheat, which should prompt the Fed to tighten at a faster pace. We expect the Fed to deliver four interest-rate hikes in 2018. Providing additional pressure on the Treasury market is the looming increase in supply. The recently released Treasury refunding schedule indicates that the marginal increase in Treasury issuance needed to fund a larger budget deficit and the runoff of the Fed's portfolio will be tilted toward shorter coupon maturities as well as bills (see chart, bottom right). Four rate hikes in 2018, combined with the expected tenor mix and amount of Treasury issuance, should disproportionately pressure front-end yields that should support further bear flattening of the yield curve. A more hawkish Fed could cause realized and implied interest rate volatility to rise from current low levels, which could result in attractive investment opportunities if it leads to a widening of high-quality Agency spreads.

Note: "Rates" products refer to Treasury securities and Agency debt securities.

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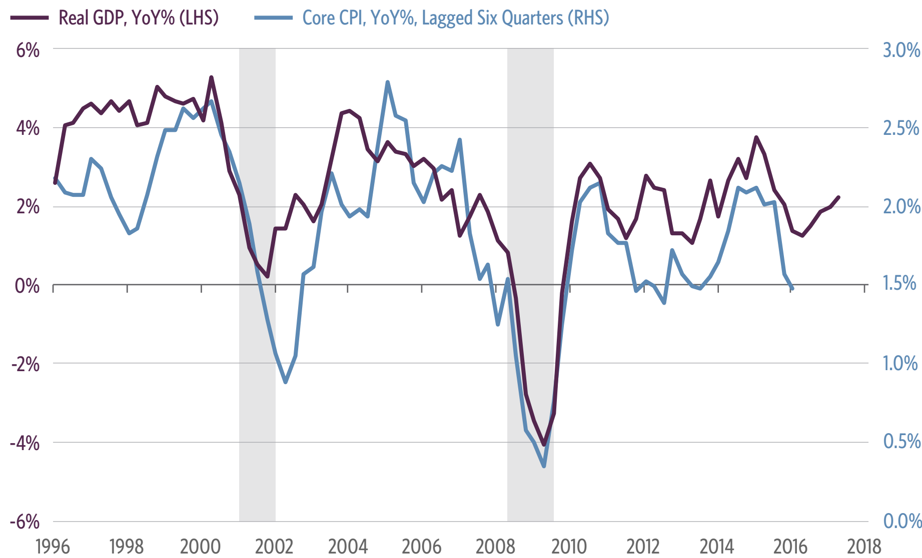
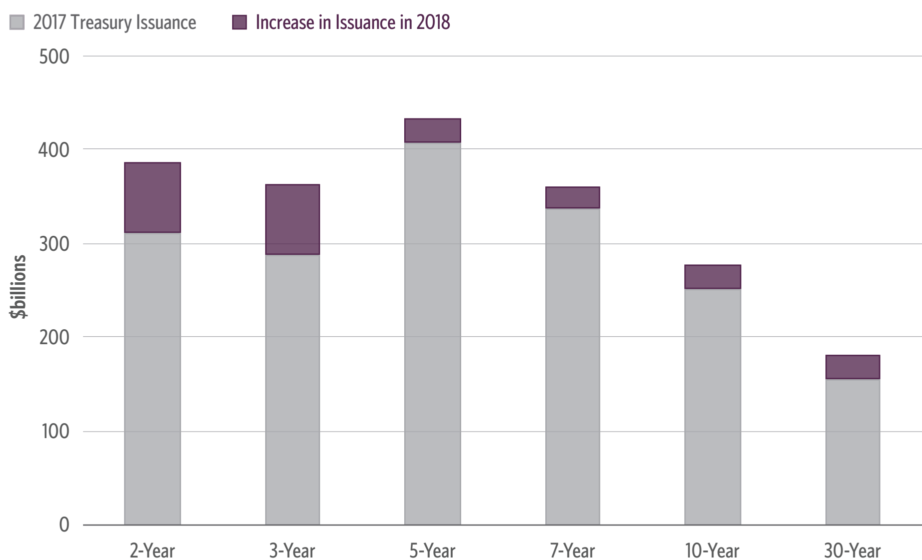
We See Four Fed Rate Hikes in 2018 in Response to Accelerating Growth and Inflation



Source: Bloomberg, Barclays, Guggenheim Investments. Data as of 12.31.2017.

The fiscal easing in the pipeline will boost real GDP growth, which leads core inflation by six quarters. In turn, the Fed will look to get ahead of a possible overheating of the economy by raising rates four times in 2018, rather than the three hikes they projected as of December.

2018 Treasury Issuance Will Be Concentrated in the Front End



Source: Bank of America Merrill Lynch, J.P. Morgan, Guggenheim Investments. Data as of 2.1.2018.

The U.S. Treasury Department's recent refunding announcement reflects an increase in the government's borrowing needs. The outcome will be increased issuance for every maturity, with extra emphasis on the two- and three-year tenors, as well as bills. The looming Treasury supply and tenor mix, combined with our expectation for four Fed rate hikes in 2018, will likely result in disproportionate pressure on front-end yields that should support further bear flattening of the yield curve.

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