Rates

The Long Way Home

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Opportunity knocks as Fed rate cuts are likely to be followed by a steepening yield curve.

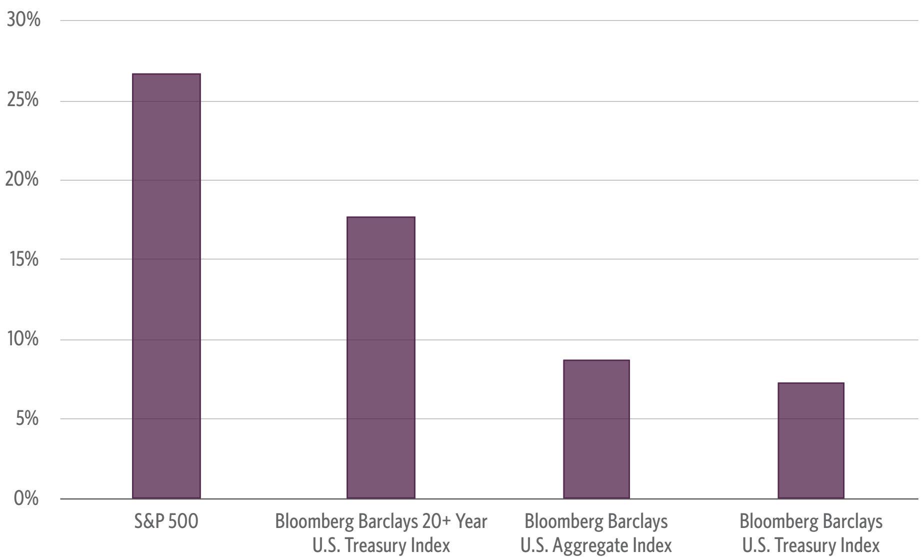
The third quarter brought a fair amount of uncertainty and volatility to global markets, primarily driven by trade tensions, political developments, and mixed signals for global growth. The Fed acknowledged the emerging risks of a more pronounced global slowdown and over the course of several months lowered the federal funds target range from 2.25–2.50 percent to 1.50–1.75 percent. Also in the third quarter, economic activity and trade wars were briefly overshadowed by funding market dislocations, which highlighted the reduced supply of short-term liquidity brought on by the decline in excess reserves, corporate tax day, and increasing Treasury financing needs. The magnitude of the market dislocation seemed to catch the Fed by surprise and led to the quick implementation of ongoing overnight and term repo operations to calm markets. These operations are ongoing. The Fed also began purchasing Treasury bills at a pace of $60 billion per month to increase the supply of reserves. This will continue into the second quarter of 2020.

Markets witnessed a significant bull flattening of the Treasury curve in 2019 and a shift lower in yields by 80–90 basis points across the curve. These moves made the Treasury market performance look almost equity-like, with the 20+ year Treasury index producing 17.6 percent total return year to date (see chart, top right). At an earlier point in the year, the long-dated Treasury index was up over 20 percent. In comparison, the Agency market delivered a total return of 7.3 percent year to date given its shorter duration profile.

In contrast to 2019, 2020 is more likely to see the Treasury yield curve bear steepen as markets price in the Fed's successful mid-cycle adjustment (see chart, bottom right). This also suggests that the equity-like performance is unlikely to repeat in 2020. Nevertheless, market volatility will create value in longer lockout callable Agency debt and fixed-rate bullet Agency bonds.

Note: "Rates" products refer to Treasury securities and Agency debt securities. Treasury and Agency returns are represented by the Bloomberg Barclays Treasurys index and the Bloomberg Barclays U.S. Agency index, respectively.

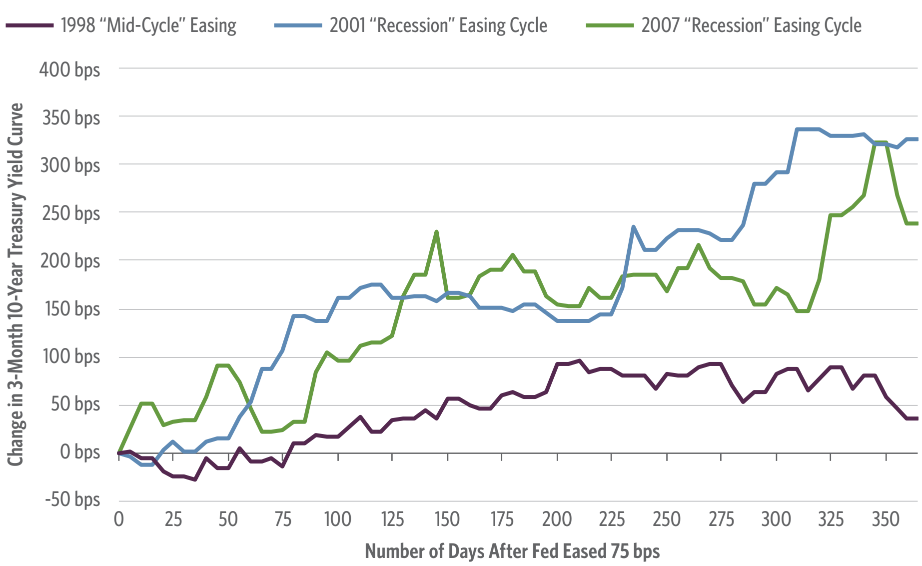
20-Year Treasurys Delivered Equity-Like Returns Year to Date



Source: Guggenheim Investments, Bloomberg. Data as of 12.6.2019.

The 20+ year Treasury market has delivered equity-like total returns of 20.2 percent year to date.

Mid-Cycle Easing or Recession Easing Cycle Have Both Led to Steeper Yield Curve



Source: Guggenheim Investments, Bloomberg. Data as of 10.29.2019.

We believe the yield curve is likely to bear steepen further as markets price in a successful mid-cycle adjustment by the Fed.