Citi Global Wealth
Investments

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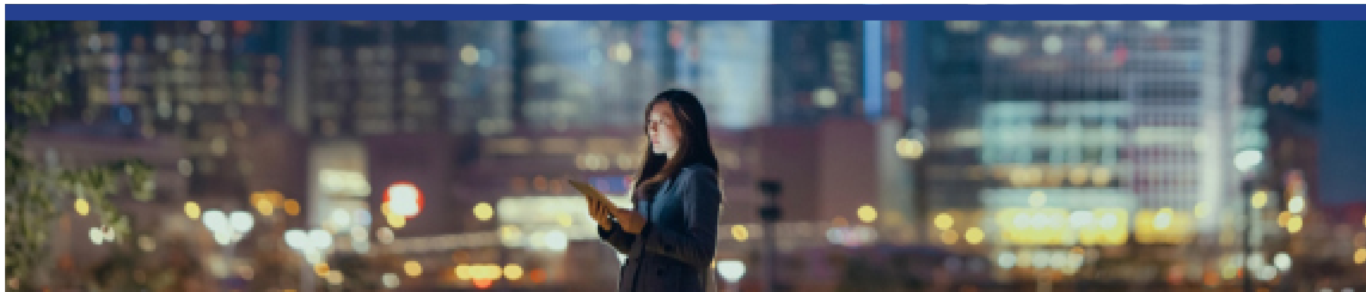

October 29, 2023

# CIO Strategy Bulletin

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## We Think Investors May Earn Higher for Longer

- US Treasury yields have moved to multi-decade highs. These are the highest yields since the mid-2000s and are near 80% of their maximum yield since 1998.
- Real yields– what an investor earns after inflation – are also near 80% of their maximum yield since TIPS were first introduced back in 1997.
- We expect Inflation to slow to 2.5% by year-end 2024 and so does the Fed. We also think that employment growth will slow and unemployment in the US will rise modestly next year. This could likely lead to the Federal Reserve to cut interest rates to avoid a recession. It would also likely result in lower intermediate bond yields.
- We believe current yields on high quality bonds provide a compelling potential opportunity to lock-in durable portfolio income for many years.

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## The Potential Opportunity from Higher Yields

US Treasury yields extended their August "bear steepening" trends as yields surged in September and October (see our August 12th CIO Bulletin). The 10-year yield set a multi-decade high above 5% this past week, before settling back down. With yields across the curve at very high levels relative to the past 15 years and even a few months back, we discuss….

## What to Consider

We believe that intermediate rates are at or near their peak. While US growth measures rebounded in 3Q, we see sufficient tightening from the Fed to believe that inflation is abating, US employment will slow, and supply and demand equilibrium is being reached broadly across the US (see our October 18th Quadrant).

At some point in 2024, we believe the Fed will change its focus to sustaining employment gains rather than forcing them down. We therefore suggest that suitable investors move from cash to a variety of intermediate-duration bonds with an average duration of 5 years. Not only will this lock in high real yields, but it will add meaningful core income in suitable portfolios. We do not think that these rates will remain at current levels for years to come. In 2024, we can imagine intermediate rates moving lower as economic events unfold.

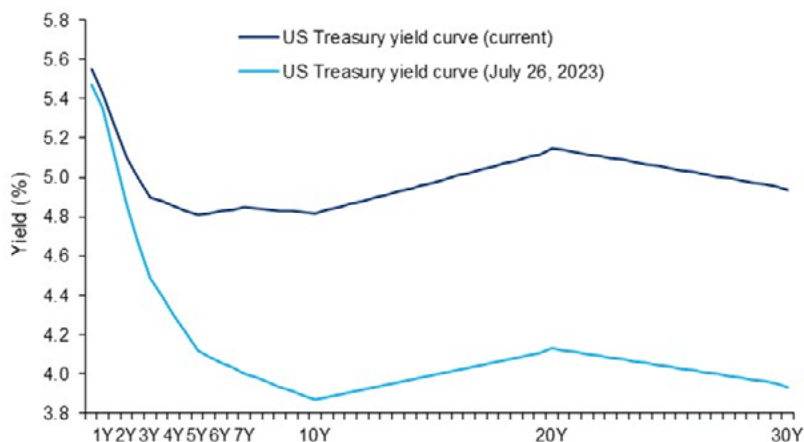
It important to note, bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk.

## Is Rapid US Growth Sustainable?

Since late July 2023, 5yr yields have gapped higher by about 75bps, with 10-year yields up almost 100bps (**Figure 1**). This is unusual for bonds, especially *after* the Fed has taken so many steps to raise rates while reducing its bond holdings by over $1T. This is truly a breathtaking jump driven by a confluence of material factors as well as greater volatility (**Figure 2**).

Although inflation is coming down, growth in the US economy remains unusually strong. The 3Q real GDP, released this past week, showed a massive 4.9% gain. This strength suggests to many investors that the US economy is resilient and can withstand higher interest rates. It contradicts predictions implied by an inverted yield curve. If the expected weakening of the economy does not appear, then the likelihood of Fed rate cuts fades. This sequence of events has led to the "un-inverting" of the yield curve where longer rates rise to "compete" with short-term T-Bill rates that are expected to remain "higher for longer". It is this change in expectation that changed the shape of the yield curve so powerfully (**Figure 3**).

**Figure 1: US Yield Curve, Current vs July 2023**




Source. Bloomberg as of October 24, 2023. Past performance is not indicative of future results. Real returns may vary.

**Figure 2**: MOVE vs VIX index

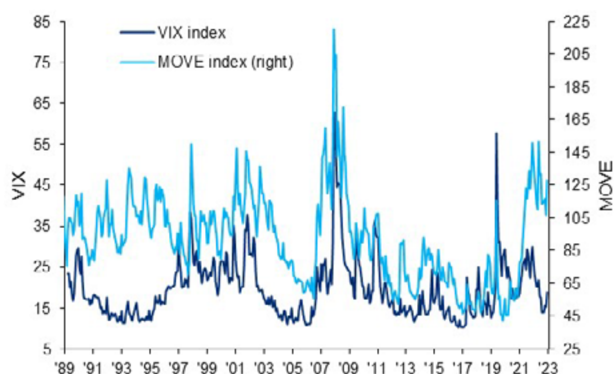



**Figure 3**: US 2s10s Treasury Yield Curve

Source: Bloomberg as of October 25, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

## Large US Treasury Supply Meets Limited Demand

A second major factor contributing to the move in higher yields is a large increase in net Treasury supply of about $1.8 trillion year-to-date. This level of issuance in unusually large due to the size of the federal deficit and the desire for the Treasury Department to maintain a large cash reserve. Meanwhile, the Fed is adding to the net supply of bonds as it reduces its balance sheet by about $700bn a year, via a process called “Quantitative Tightening”, or QT (**Figure 4**).

And the Fed is not the only major buyer no longer adding to their holdings. Foreign central banks and even US commercial banks have been sitting on the sidelines or also actively reducing their holdings for varying reasons, also adding to supply.

As it turns out, the biggest buyer of Treasuries has been “US Households”, meaning US retail account and investment funds. This Household category has added about $1.5T of Treasuries over the past 18 months (**Figure 5**). Money market deposits at the Fed (placed through the Reverse Repo Program “RRP”) have dropped from almost $2.6T at the end of 2022 to just about $1.1T currently, in effect funding the Treasury purchases. This cannot go on forever. Once the remaining RRP balances are gone, presumably bank reserves placed at the Fed will decline in order to support net issuance.

**Figure 4**: US Treasury Net Issuance, by year (with estimates for 2024

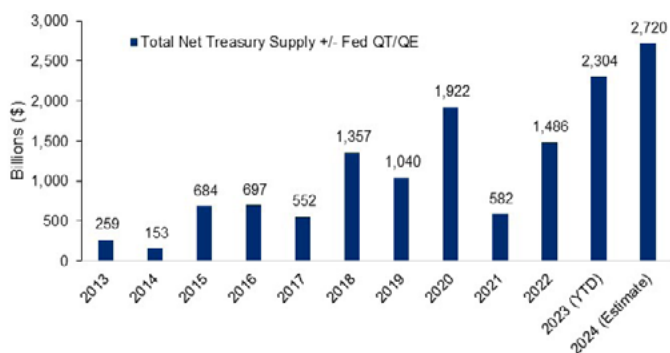



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**Figure 5**: Fed Reverse Repo Facility vs Household holdings of US Treasuries

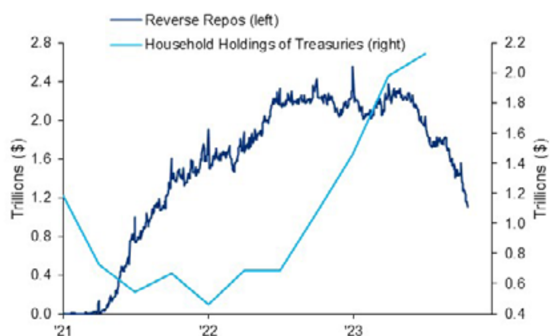


**Figure 6**: US nominal, TIPS and Breakeven Inflation Treasury yields

Source. Bloomberg as of October 24, 2023. Past performance is not indicative of future returns. Real results may var

## Yields Add Term Premium

The Term Premium is the additional yield demanded by investors to stay in longer duration bonds rather than getting repayment sooner. It encompasses uncertainties such as increased geopolitical risk, the possibility that inflation could spike unexpectedly, possible fiscal deterioration, and most importantly the risk that short-term yields could be higher in the future. The Household category of bond buyer is currently demanding additional yield to take on this “uncertainty risk”.

Although “real yields” as measured by TIPS do not capture term premium alone, the spike in real yields to one of the highest levels since the early 2000s illustrates that term premiums have risen. Even as inflation expectations (as measured by TIPS) have been largely stable between 2.25%-2.50%, nominal yields continued to rise (**Figure 6**).

**Figure 6**: US nominal, TIPS and Breakeven Inflation Treasury yields

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Source. Bloomberg as of October 24, 2023. Past performance is not indicative of future returns. Real results may vary.

## Our More Cautious Macroeconomic Forecast

Monetary policy acts with a time lag, often as long as 24 months. We remind investors that this is almost month 20 since the Fed’s first rate hike on March 16th, 2022. A moribund US residential housing market, significant commercial real estate financing stress and the large regional bank failures of March are early casualties of the Fed’s rate-hike policies.

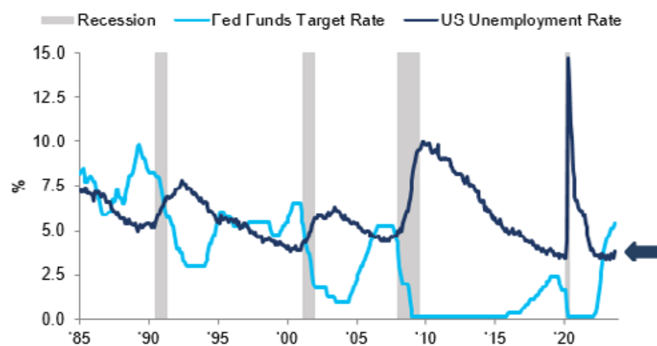
We already see headline inflation abating from 9.1% in June 2022 to 3.7% in September 2023. This suggests progress in rebalancing supply and demand as supply disruptions have cleared and demand has stabilized. And if we reach a 2.5% inflation rate by the end of 2024, it will almost certainly get there due to the retrenchment of the important “shelter inflation” category (**Figure 7**).

The risk of and economic recession grows as rates move higher. The effect of higher-for-longer rates and the recent bear steepening of the curve slows economic growth and suggest that unemployment may rise more sharply than is currently expected (**Figure 8**). Geopolitical risk has also increased, leading to higher market volatility generally. If long term rates remain durably higher, then additional pressures on the economy may yet emerge.

It is our view that the market will shift its thinking and begin to build in expectations of rate cuts, leading the Fed to actively engage in cutting rates by the second half of 2024 to keep employment losses to a minimum.

**Figure 7**: US CPI Year over Year% less food, energy, and shelter components

**Figure 8**: Fed Funds Rate vs US Unemployment Rate (%)




Source: Bloomberg as of October 25, 2023 for **Figure 7** and Haver Analytics and Bloomberg as of October 25, 2023 for **Figure 8** . Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

## Enter The Bull Steepener?

The last shift in the yield curve – one of full normalization – is likely to be a "bull steepener" where short and intermediate rates fall further and faster than long-term yields. As we don't know precisely when sufficient negative economic data will emerge to shift the Fed and market sentiment towards rate cuts, we think that suitable clients should consider a shift from cash and shorter-term bonds to intermediate duration instruments. This may avoid reinvestment risk after the Fed starts cutting.

Remember that the high level of yields provides a cushion if rates move a bit higher for a time. The yield earned through coupon income will offset losses from price markdowns to some degree. And any price declines are earned back upon bond maturity in any case, assuming no credit issues. In addition, should yields fall as we expect over the coming year, rather than earning out the yield over time via coupon payments, one may instead earn capital gains through bond price appreciation (**Figure 9**).

**Figure 9**: Estimated US Treasury bond returns based on certain yield curve shock scenarios

| Total Return Estimates for US Treasuries, 12-month time horizon | | | | | |
|---|---|---|---|---|---|
| **Scenarios (chg. in basis points)** | -100 | -50 | 0 | 50 | 100 |
| **5yr US Treasury** | 8.62 | 6.61 | 4.65 | 2.72 | 0.84 |
| **10yr US Treasury** | 12.07 | 8.30 | 4.69 | 1.22 | -2.10 |
| **30yr US Treasury** | 22.28 | 12.81 | 4.38 | -3.12 | -9.83 |
| **US Treasury Index** | 9.86 | 7.20 | 4.68 | 2.29 | 0.02 |

Note: US Treasury bond index has an average duration of 5.8 years. Scenarios are based on parrell shift of the US Treasury curve. Estimates were calculated with 10yr US Treasury yield at 4.65%.

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The performance information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a methodology and selection of securities in hindsight. Each scenario illustrates hypothetical performance of varying treasury durations based on incremental basis points changes of 50 bps. Estimates used the 10-year UST yield of 4.65% to reflect recent yield trends. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of hypothetical performance information, all of which can affect actual performance. The returns shown above are for indexes and do not represent the result of actual trading of investable assets/securities. The asset classes used to populate the allocation analysis may underperform their respective indexes and lead to lower performance than the analysis anticipates.

## The Potential to Earn Higher for Longer

Investment grade bonds of intermediate duration as well as municipal bonds for suitable investors who may benefit from the tax treatment also offer extremely high yields compared to the past 15 years, with returns well above both the expected breakeven inflation rate as well as the "longer-term" Federal Reserve "neutral" Fed Funds rate of 2.5% (**Figure 10**). IG bonds with maturities of 5 years currently offer yields around 6.25-6.5%, while intermediate highly rated municipals pay around 3.5% before tax adjustments. We also think investors may want to consider even slightly lower-rated securities, such as BB-rated bonds that currently pay over 8%, or even investment grade preferred securities which also yield slightly over 8% (**Figure 11**).

In summary, there's been a "great reset" in the bond market – from history's lowest yields as recently as two years ago – to real yields that are well above long-term averages. While the Treasury and Fed are working against bond investors with high issuance and purposeful monetary restraint to slow the economy, we see a turn in the tightening cycle in the coming year as US labor markets finally slow.

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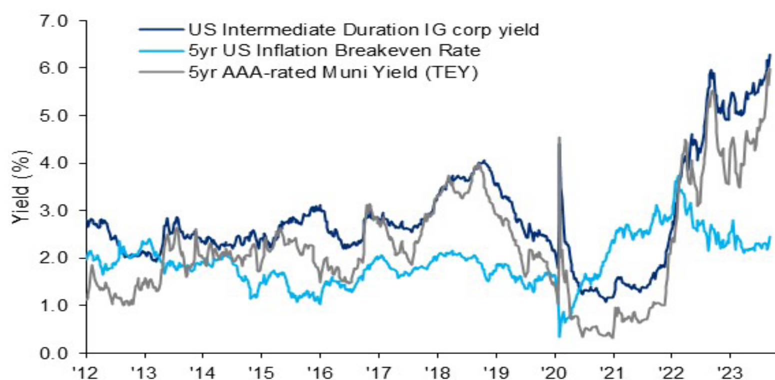
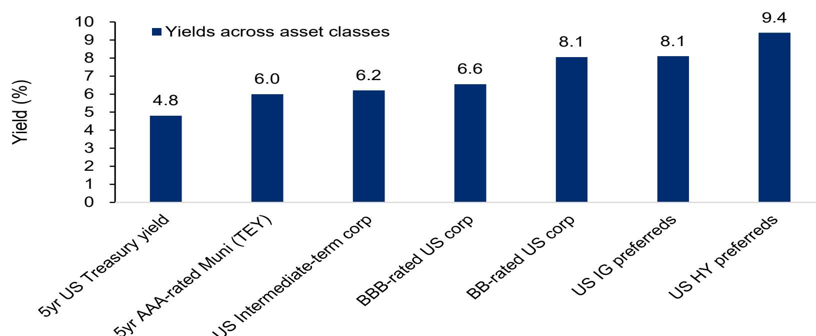
**Figure 10**: IG intermediate duration yields vs 5yr Breakeven Inflation Rates




Source: Bloomberg as of October 24, 2023. Past performance is not indicative of future results. Regal returns will vary.

**Figure 11**: Yields across fixed income asset classes




Source: Bloomberg as of October 27, 2023. Note: Tax equivalent yield (TEY) adjusts for top Federal and Affordable Care Act tax rate (40.8%).

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|---|---|---|---|
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| **Investment Grade** | | | |
| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

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