First Trust
Monday Morning OUTLOOK
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December 10, 2018

The Long-Term Yield Conundrum

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Last Friday, the 10-year Treasury Note closed at a yield of 2.85%. That's up from 2.41% at the end of 2017, but down from the peak of 3.24% on November 8th, and well below where fundamentals suggest yields should be.

In the last two years, nominal GDP growth – real GDP growth plus inflation – has run at a 4.8% annual rate. Normally, we'd expect yields to be close to nominal GDP growth, but Treasury yields have remained stubbornly low.

Some analysts are spooked by the recent movement of 3-year yields above 5-year yields, thinking this "inversion" signals a recession. We think this is sorely mistaken. With a lag, recessions have often (but not always) followed periods when the federal funds rate exceeds the 10-year yield. If anything, that's the inversion to look out for; feel free to ignore the rest. But, at present, the 10-year is yielding about 70 basis points above the funds rate, well within the normal range.

One reason that the 10-year yield has remained below where economic fundamentals suggest it should trade is that the Federal Reserve set short-term interest rates near zero. Longer-term bonds, including the 10-year reflect the current level of short-term rates as well as the projected path of those rates in the future. So, back when yields were essentially zero, and the Fed was signaling they could stay there for a long time, this pulled down longer-term yields. The Fed has now lifted short-term interest rates by 200 basis points from where they were, but investors still don't believe they will go much higher.

Part of the issue is that many think low rates themselves are the only reason the economy came out of the Great Recession. So as the Fed lifts rates, many investors expect the next recession is a small tip of the scale from returning in force.

If you're buying 10-year Notes under the premise that a recession will happen sometime in the next ten years – and you also expect the next recession to tie (or beat) '08-'09 for the title of worst recession since the Great Depression – then the yield on the 10-year Treasury makes a lot more sense.

But we wholeheartedly disagree with your assessment. We think the bond market is anticipating a far weaker economy over the next ten years than the data justifies.

No matter how many believe it, the bond market is not all-knowing. In November 1971, the 10-year Treasury was yielding 5.81%. Over the next ten years, inflation alone increased at an 8.6% annual rate and nominal GDP grew at a 10.7% annual rate. In other words, 10-year note investors got hammered as yields soared. And notice that back in 1971 we had a Republican president (Richard Nixon) leaning heavily on the Fed to maintain a loose monetary policy. Sound familiar?

The next recession is unlikely to be like the last. Our calculations suggest national average home prices were 40% overvalued at the peak of the housing boom – pumped up by government rules and subsidies artificially favoring home buying. Meanwhile overly stringent mark-to-market accounting rules created a once in a 100-year panic. Mark-to-market rules have now changed to allow cash flow to be used to value assets, plus banks are much better capitalized. In other words, fundamentals suggest another panic is not in the cards.

What's more likely is that, when the next recession hits – and we don't see one happening until at least 2021 – it will be softer than usual, more like 1990-91 or 2001, than 1973-75, 1981-82 or 2007-09. As investors realize data trumps the rhetoric, we expect bond yields to rise. In the end, math wins.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-11 / 7:30 am	PPI – Nov	0.0%	**0.0%**		+0.6%
7:30 am	"Core" PPI – Nov	+0.1%	**+0.2%**		+0.5%
12-12 / 7:30 am	CPI – Nov	0.0%	**0.0%**		+0.3%
7:30 am	"Core" CPI – Nov	+0.2%	**+0.2%**		+0.2%
12-13 / 7:30 am	Initial Claims – Dec 8	227K	**228K**		231K
7:30 am	Import Prices – Nov	-1.0%	**-0.7%**		+0.5%
7:30 am	Export Prices – Nov	-0.3%	**-0.5%**		+0.4%
12-14 / 7:30 am	Retail Sales – Nov	+0.1%	**-0.1%**		+0.8%
7:30 am	Retail Sales Ex-Auto – Nov	+0.2%	**-0.1%**		+0.7%
8:15 am	Industrial Production – Nov	+0.3%	**+0.2%**		+0.1%
8:15 am	Capacity Utilization – Nov	78.6%	**78.5%**		78.4%
9:00 am	Business Inventories – Oct	+0.6%	**+0.6%**		+0.3%