

# AIN'T NO CURE FOR THE SUMMERTIME BLUES

Kevin Flanagan — Head of Fixed Income Strategy

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Since Election Day, the focus in the [U.S. Treasury \(UST\)](#) market has been essentially domestic-driven. In other words, market participants have been setting their sights on potential [fiscal policy](#) developments and, of course, the latest actions from the [Federal Reserve \(Fed\)](#). However, as the calendar turned to summer, investors were greeted with a new twist for Treasuries—more [hawkish](#)-than-expected rhetoric coming from other developed markets' central banks, elevating global [bond yields](#) in the process. The question that lies ahead on the rate front is whether words become deeds; if so, the fixed income arena could be in for a case of summertime blues.

Two of the more noteworthy developments from the global central bank perspective involved the European Central Bank (ECB) and the Bank of Canada (BOC), each occurring in just the last few weeks. The genesis was at an ECB forum in Sintra, Portugal, where President Draghi made remarks that the bond market viewed as being on the hawkish side. Although the ECB tried to walk back the comments, stating they were misinterpreted, the damage was done, and yields nevertheless finished higher. Interestingly, the [FOMC](#) minutes released last week were a nonevent, but the ECB minutes were a different story, as the headlines stated that policy makers "discussed removing the easing biases in their policy communication," specifically on their [Quantitative Easing \(QE\) program](#). These news events were accompanied by earlier comments from BOC president Poloz that intimated that Canadian policy makers may be considering a [rate hike](#) at one of their upcoming meetings.

## U.S. 10-Year vs. 10-Year German Bund



Source: Bloomberg, as of 7/7/17. Past performance is not indicative of future results.

Needless to say, the shift in tone was not expected in the global bond markets. In the [eurozone](#), 10-Year German bund yields have risen more than 30 [basis points \(bps\)](#) since June 26 and are now at their highest levels since January 2016. From a technical perspective, as of this writing, the 10-Year bund was just 1 bp below its one-year 100% retracement level. Along the same lines, UK and French 10-Year yields were also up at least 30 bps during this time frame, with Italian 10-Year rates posting an increase of nearly 45 bps. On this side of the Atlantic, CAD 10-Year yields now reside at two-year highs, and the implied probability for a rate hike at tomorrow's policy meeting has risen to 94.7% versus 34.9% on

June 26.

So, what does that mean for the UST market? Well, utilizing the same period, the 10-Year yield has risen by just under 25 bps. Even though both bund and UST 10-Year yields have moved higher, the [spread](#) between the two has continued to narrow from its post-election high-water mark, as the increase in German rates has outpaced its U.S. counterpart. Thus, much like the spread widening to its highest readings since 1989 was viewed as Treasury supportive, it would seem logical to reason that this narrowing trend to pre-election levels could represent a negative development for Treasuries, if it is sustained.

## **Conclusion**

The bottom-line message is that developed countries' government bond markets had become too complacent and were not priced for any "counter" news. So, what we're seeing are adjustments, especially from a potential [monetary policy](#) perspective. News stories that the "bond bulls" are capitulating and that higher yields are in the offing are already circulating. In my opinion, for the UST 10-Year, we've already seen well-established resistance once we get to the 2.64% mark, so barring any surprises, in the near term that would seem to still represent a top, but things look like they're going to be fluid as we get deeper into summer. Against this backdrop, fixed income investors may wish to consider [shortening duration](#) in their portfolios in order to mitigate the potential risk for higher rates.

***Unless otherwise noted, data source is the Federal Reserve, as of July 7, 2017.***

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## **DEFINITIONS**

**Treasury** : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Fiscal Policy** : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Hawkish** : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

**Bond yield** : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

**Federal Open Market Committee (FOMC)** : The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Quantitative Easing (QE)** : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

**Rate Hike** : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**Eurozone (EZ)** : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

**Basis point** : 1/100th of 1 percent.

**Spread** : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Short (or Short Position)** : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

**Duration** : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.