

# U.S. TREASURIES: FISCAL POLICY "TRUMPS" UNCERTAINTY

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If on election night you placed your bets on all the unexpected outcomes that came to fruition, well, you hit the trifecta. Indeed, Republican candidate Donald Trump won the presidency, the Republicans maintained majorities in both the House and the Senate and the [U.S. Treasury \(UST\)](#) market saw yields move up to levels we haven't seen since calendar year 2015 was turning into 2016.

So, what happened? Based on price action within the Treasury arena in the days leading up to the election, it looked as if we were following the [Brexiteer](#) blueprint. In other words, a Trump victory was seen as fueling uncertainty and a [risk-off](#) trade, with the Treasury market being the beneficiary of knee-jerk [safe-haven](#) demand. Well, this scenario did play out, albeit for just a few hours as the [UST 10-Year yield](#) dropped 14 [basis points \(bps\)](#) to 1.71% when it became more apparent that we could have a President-elect Trump, only to completely reverse course and end the day at 2.06%, representing a 35-bps turnaround.

Put simply, the initial safe-haven bid gave way to what the outcome of the election could mean from a fiscal policy perspective. In other words, not only is Mr. Trump the 45th president-elect, but, against conventional wisdom, the Republicans maintained control of both the House and Senate as well. This second point is what began to change the dynamic for Treasuries, as the market quickly pivoted to discount the possibility of certain pro-growth actions (tax reform/tax cuts, infrastructure spending) occurring sooner rather than later. This mindset then led to a pickup in [inflation](#) expectations, with the days of [deflation](#)/disinflation now in the rearview mirror. To provide some perspective, as of this writing, 10-Year [TIPS](#) break-evens have risen to 190 bps, the highest reading since July of last year and up 70 bps from the February low. Keep in mind that this reading is still visibly below the 260 bps levels seen in late 2012/early 2013.

## U.S. 10-Year Treasury Yield

### US 10 Year Treasury Yield

The UST 10-Year yield has continued to move higher and stood just below the 2.25% mark as of this writing. It was only four months ago that the yield hit its all-time low of 1.36%. From a technical analysis perspective, the UST 10-Year yield broke above the 76.4% [Fibonacci retracement](#) level (2.1254%) that was in place, with only one stop left to the upside, 100% retracement at 2.3563%. I always referred to the top of the UST 10-Year trading range as being 2.45% for working purposes. The actual recent high was 2.48% on June 10, 2015. (See the graph of the 10-Year Treasury yield going back to the end of 2013 for some further perspective.) Needless to say, the UST [yield curve](#) has experienced some visible shifts as well, with 2-year versus 10-year note spread steepening out to +125 bps, the widest since late December. Perhaps not coincidentally, at that time the UST 2-Year yield was straddling either side of the 1% threshold, while the 10-Year was doing the same thing around the 2.25% mark.

The post-election Fed outlook has made a 180-degree turn as well. Initially, expectations revolved around the Fed delaying a potential December [rate hike](#), but now Fed Funds Futures have the implied probability at 92%. Our base case still foresees a quarter-point boost to Fed Funds next month, and it will be very important to see how the Fed frames this action and what its outlook is for policy action in 2017 (that is, how many rate hikes does it foresee?). For the record, the December 2017 Fed Funds Futures contract is priced for only one additional rate hike occurring next year.

## Conclusion

The UST market's unusually quick pivot from "Trump uncertainty safe-haven bid" to "Trump/Republican Congress pro-growth-inflation" underscores the type of [volatility](#) we may witness in the money and bond markets as the transition period plays out into the first 100 days of the Trump administration. Early on, the credit-sensitive fixed income sector has outperformed the interest rate sensitive area, a scenario that could continue to play out as fiscal stimulus unfolds. In terms of Treasuries, yields have now returned to more "fair value," as the collective market has apparently "priced out" domestic economic fears, deflation/disinflation and any near-term safe-haven demand. Where rates could go from here,

and whether the UST 10-Year yield can eclipse the aforementioned top of the trading range, will now depend on what actually occurs on the fiscal and [monetary policy](#) fronts (trade being an important aspect that is not being considered up to this point) and when any such stimulus shows up in the economic data. As of now, most economic forecasters have not boosted their real [GDP](#) projections in a considerable fashion, so stay tuned.

***Unless otherwise noted, data source is Bloomberg, as of 11/14/16.***

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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.

**Brexit** : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

**Risk-on/risk-off** : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

**Safe-haven** : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

**10- Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.

**Yield** : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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

**Inflation** : Characterized by rising price levels.

**Deflation** : The opposite of inflation, characterized by falling price levels.

**TIPS** : Treasury Inflation Protected Securities.

**Fibonacci retracement** : A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.

**Yield curve** : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**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.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.

**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.

**Gross domestic product (GDP)** : The sum total of all goods and services produced across an economy.