U.S. TREASURIES: INTO UNCHARTERED WATERS

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Well, it finally happened: the U.S. Treasury (UST) 10-Year yield reached a new all-time low. Indeed, in the aftermath of the Brexit vote, the 10-Year note had, at various times, reached new lows on an intraday basis but tended to reverse course by the close of the U.S. trading session and finish the day just shy of a new record. However, that flirtation has finally come to an end, and we now have a new hallmark of 1.36% in the books, putting the 10-Year in uncharted waters. Certainly, the natural question to ask is: How did we get here? We've discussed the initial safe-haven demand resulting from the Brexit vote, but there is definitely more to the equation than that. It would appear the primary factor pushing the 10-Year yield to record lows is the investment backdrop of the developed world's sovereign debt market overseas. The "negative and sub-1%" club for 10-year maturities continues to grow. To provide perspective, as of this writing, the Swiss and German 10-year yields are at -0.69% and -0.19%, respectively, while in France and the Netherlands, the levels are barely above zero. Peripheral eurozone countries have also participated in this global rally, with Italy and Spain each registering rates below the 1.20% threshold. Closer to home in North America, the Canadian 10-year is posting 0.96%. Up until recently, we characterized activity in the UST market as being a "push/pull" dynamic, which was keeping the 10-Year yield in the range witnessed over the last 12 to 18 months. In other words, a "best house in a bad neighborhood" domestic economy was juxtaposed against the aforementioned favorable rate differentials. Thus, it would have been reasonable to expect Treasuries to experience some back-up in yield from their post-Brexit lows if an economic report, such as the monthly jobs data, came in noticeably better than expected. After exhibiting such behavior in a knee-jerk reaction to the much higher-than-anticipated June payroll number, up 287,000[1], the UST 10-Year yield quickly reversed course. Interestingly, it was not necessarily due to second thoughts about the veracity of the June employment report; rather, it seems as if we are at a point where any increase in UST yields will be met with a voracious global appetite. **Conclusion** So, where does that leave us? Without a doubt, the global rate backdrop appears to be the driving force in the aforementioned push/pull dynamic. In fact, it would probably take a visible economic surprise to the upside and/or an increase in inflation expectations to shift the focus away from the "search for yield" emphasis. Up until such a development occurs and investors become convinced it is not a temporary development, investors should get used to the new landscape where the UST 10-Year yield stays in a new and lower trading range and 2% could prove to be the top. Given that we are in those uncharted waters, the lower end of the band may yet to be determined. ***Unless otherwise noted, data source is Bloomberg, as of 7/8/2016.*** [1]Source:Bureau of Labor Statistics, 7/8/2016.

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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.

10-year government bond yield : Yields on the 10 year government debt security.

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

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.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.

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).

Inflation : Characterized by rising price levels.