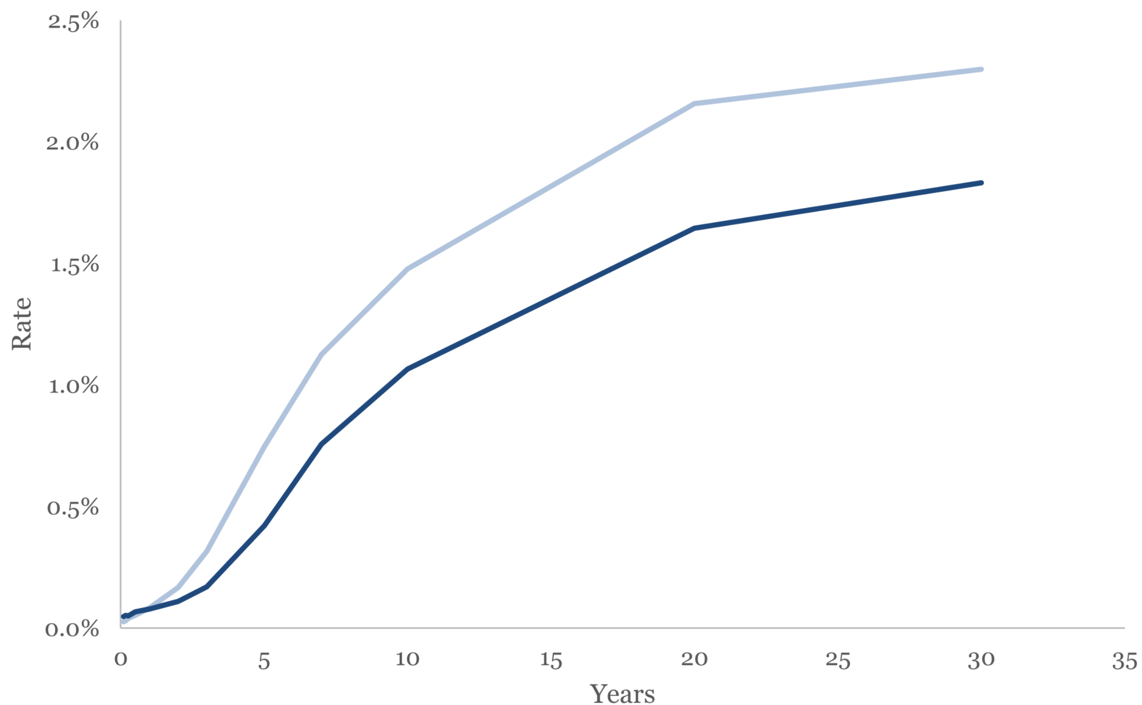
A NEW TAPER TANTRUM?

Market interest rates moved considerably higher in February. Bond prices decline when interest rates increase, which led to negative returns in most fixed income portfolios for the month. In this commentary, we address:

- The market shift in interest rates,
- The likely reasons interest rates have accelerated upward,
- Our positioning within fixed income portfolios.

The Treasury yield curve, a visual representation of interest rates for various maturities, rose across the board in February (Fig. 1). The 10-year Treasury, for example, started the month at 1% and finished around 1.5%. Similar shifts occurred within the municipal and corporate bond markets as well.

Fig. 1: The Treasury yield curve shifted higher in February



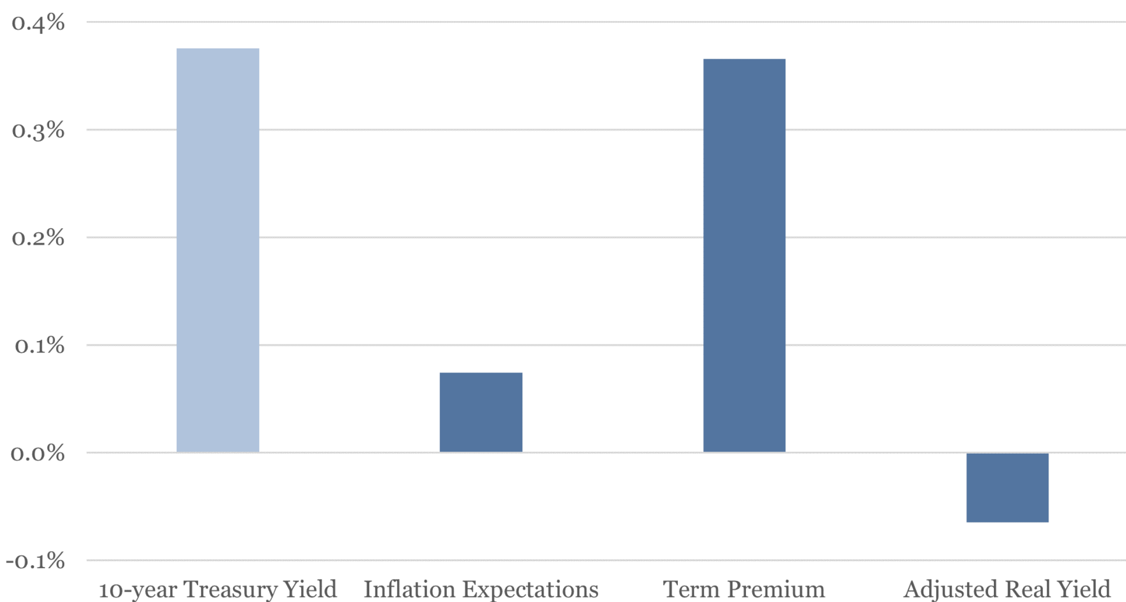
Source: Bloomberg, Mill Creek

WHY HAVE RATES MOVED HIGHER?

In our white paper, "Taxable Fixed Income: What Hath COVID Wrought," we presented a framework for thinking about Treasury yields in three components: (1) compensation for inflation, (2) compensation for the risk that short term rates may not evolve as expected in the future (this is known as the term premium), and (3) a real rate of return after adjusting for the first two factors (we refer to this as the "adjusted real yield"). These three components add up to the Treasury bond yield.

February provides an interesting look at how those components evolved as Treasury rates increased during the month (Fig. 2).

Fig. 2: The February change in Treasury yields were mostly attributable to rising term premia



Source: New York Fed, Cleveland Fed, Bloomberg, Mill Creek. This figure shows the change in each factor over the course of February.

The media has focused on the potential for higher inflation, but inflation expectations only increased slightly in February. In fact, some measures of future inflation, like inflation swaps, declined during the month.

We also do not see any indication that long-term rates rose in anticipation of the Fed moving more quickly to hike rates than they have indicated. Such a shift would have push adjusted real yields upward, but they remain near zero. The Federal Open Market Committee and Fed Chair Powell have been crystal clear that market participants should not expect any rate hikes even if the economy heats up over the coming months. In fact, during the second half of his testimony

in front of the House Financial Services Committee, Powell suggested that it might take three years to reach the Fed's inflation target.

Our model indicates that the main catalyst behind rising rates has been the term premium. Investors simply require more compensation to hold longer-term bonds due increased uncertainty around the future path of interest rates. In addition to questions about the timing and pace of balance sheet tapering (likely to start in 2022), Treasury bond holders must weigh the impact of additional fiscal stimulus, the Fed's new policy framework, and the impact of an economic reopening. It is impossible to know how all those factors will come together and impact interest rates — hence higher term premia.

Does the recent rate move qualify as a 2013-esq tantrum? A slightly longer-term view of the Treasury term premium (Fig. 3) suggests we've been through a taper spat — maybe a taper outburst — but we're not yet to a full-blown taper tantrum. February was analogous to a toddler waking up grumpy from a nap, not a complete meltdown because she wanted a yellow cup instead of the red one.

Fig. 3: The 10-year Treasury term premium has risen quickly but remains low

Source: NY Fed, Mill Creek

OUR CURRENT FIXED INCOME POSITIONING

We published a table of Treasury yield scenarios in the white paper referenced earlier (Fig. 4).

Fig. 4: Potential 10-Year Treasury Rate Outcomes

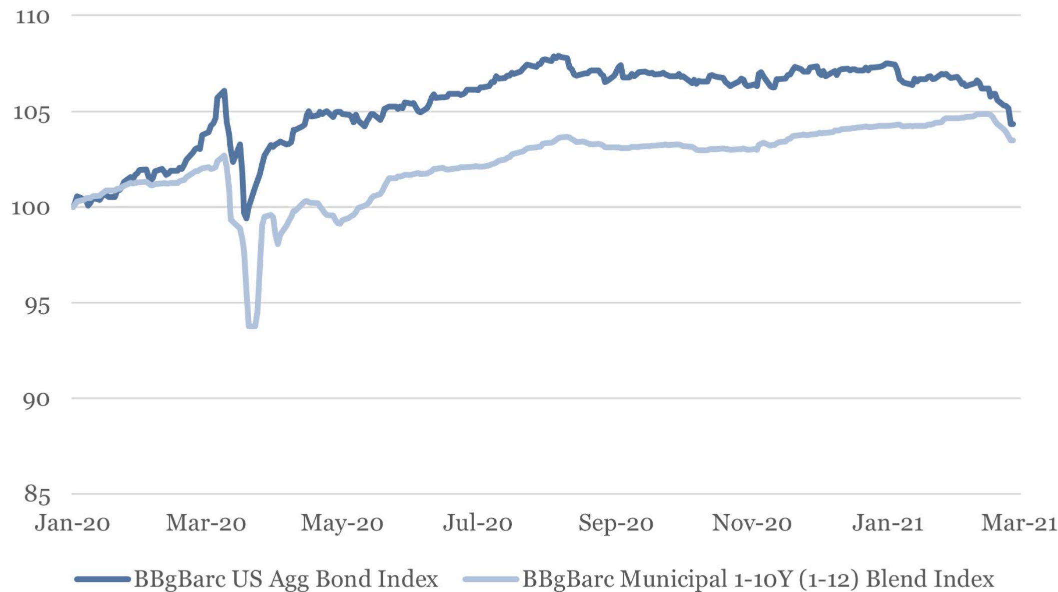
		Base case	Accelerated growth	Double Dip	Yield curve control
	Inflation expectations	1.5-2%	2.5%	1.5%	2.0%
+	Treasury term premium	0.0%	1.0%	-0.5%	-1.0%
+	Adjusted real yield	0.5-1%	1.0%	-1.0%	1.0%
=	10-Year Treasury Yield	2-3%	4.5%	0.0%	2.0%

Source: Mill Creek

The current state of the Treasury rate market is somewhere between our “base case” and “accelerated growth” scenarios. Inflation expectations are near the top end of our base case and the term premium has risen earlier and faster than we anticipated. At the same time, adjusted real yields remain low, indicating further room for rates to rise.

The main and immediate investment risk from rising rates are negative returns in bond portfolios. Most bond indices declined in February (Fig. 5). However, over the last few months we have taken steps within our taxable and tax-exempt fixed income programs — including lowering interest rate exposure and increasing certain types of credit risk — to mitigate some of the risk from rising rates. Those positioning changes helped protect the portfolios in February.

Fig. 5: Bonds have given back some of last year's gains



Source: Bloomberg, Mill Creek. Performance as of February 25, 2020.

CONCLUDING THOUGHTS

Despite the headwinds from rising rates, we believe investors should continue to hold appropriately sized fixed income portfolios. There are plenty of risks to our view that rates will rise gradually for the remainder of the year, including unanticipated Fed action to cap long-term Treasury rates. More importantly, COVID-19 continues to be the most important risk factor in financial markets. Any setback, including new vaccine resistant strains, would likely push rates back down (benefiting bonds) and negatively impact risk assets. High quality fixed income remains the best protection investors can hold against such an outcome.

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March 1, 2021

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