Economics

Bond Yields Can't Stay This Low Forever

It might take a while, but normality will return.

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Can't get much lower. *Photographer: Alexander Hassenstein/Getty Images*

See if you can figure out which of these data points conflicts with the others: The U.S. economy grew at an annualized, inflation-adjusted rate of 6.5% last quarter; it added an estimated 850,000 jobs last month; consumer prices have risen 5% over the past year; and the 10-year Treasury note yield has recently fallen to 1.2%.

If you guessed the Treasury note yield, you're right. Such a low long-term interest rate is totally inconsistent with rapid economic growth, strong job gains and high inflation. What gives?

Let's start our forensic exercise by decomposing the nominal Treasury yield into two parts: The compensation for expected inflation, and the "real" return after inflation.

Based upon the difference between the yields on nominal 10-year Treasury notes and 10-year Treasury inflation-protected securities (TIPS), the market is expecting consumer prices to increase at an average annual rate of about 2.4% over the next 10 years. There's nothing unusual here. Investors appear to agree with the Federal Reserve that, once the current inflation surge passes, inflation will settle somewhere close to the central bank's 2% average target. The match is particularly close when you consider that the Fed's preferred measure of inflation tends to run about one quarter to one half a percentage point lower than the one the Treasury market is implicitly forecasting.

The surprise is the extremely low level of "real" yields. This past week, 10-year TIPS yields fell to a record low of negative 1.2%. This is shocking not just because the level is low but also because real yields have been falling even as the economy recovers.

I see two main explanations for this extraordinary outcome. First, as the developed world's population ages, its savings are exceeding desired investment – a secular trend that isn't likely to change anytime soon. This is pushing yields down in the U.S., and even lower in Japan and Europe.

Second, the Fed is buying a lot of longer-term Treasury securities. The effect of such quantitative easing has been evident in real yields since the time the Fed began its asset purchases in 2008: They typically decline whenever the central bank ramps up its purchases. This happens because the Fed takes long-dated securities out of circulation and replaces them with bank deposits and reserves. Investors respond by seeking to replenish their holdings of long-term securities, pushing yields down. But the cash they spend to buy the bonds becomes someone else's near-zero-yielding deposits, perpetuating the broader impetus to keep buying slightly higher-yielding securities. And the Fed adds to the demand by buying even more. This is why QE may be considerably more powerful than generally appreciated.

How long can this go on? The Fed is still buying $80 billion of Treasuries and $40 billion of mortgage backed securities each month, and probably won't even start to taper its purchases for several months. Bank deposits reached $17.3 trillion last month, up from $13.4 trillion in February 2020. Reserves at the central bank amount to nearly $4 trillion, up from $1.6 trillion before the pandemic. With short-term interest rates near zero, investors feel that they have little choice but to keep buying longer-

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dated securities, with the urgency presumably growing as bond prices keep rising.

Eventually, though, the Fed will start raising short-term interest rates to keep inflation in check. At that point, the Treasury market will finally face tougher competition. The choice will no longer be between deposits with a zero yield and 10-year government bonds yielding 1.2%. And, given the Fed's willingness to let inflation overshoot, it might have to raise rates significantly, pushing up yields across all maturities.

Quantitative easing has sustained the bull market in bonds beyond what is consistent with longer-term fundamentals. This suggests that investors would be wise to take advantage of the recent rally and take some money off the table before the Fed's largesse ends.

(Corrects fifth paragraph to specify negative 1.2% yield.)

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