r/explainlikeimfive • 6 yr. ago
decorumic

ELI5: What is Treasury yields and why does it cause the market to slide?

Economics

What does it mean when the news reports that US Treasury yields?

What's the Treasury's relationship with the market that causes it to slide over the week?

I've tried to read up about it, but it just gets more confusing. I was surprise to find that there are 3-month US treasury, 1-year US treasury, 2-year treasury, and so on. What are they?

The one that has gone up recently is the 10-year treasury. Why that 10-year treasury but not other intervals of treasuries? And why does that 10-year treasury have such impact to the market?

So there so many questions running in my mind. It will be great if someone can explain this to me. Thanks!

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money to them for a certain period of time. 10-year treasuries are the long term benchmark rate, they're the bench mark because they're a very liquid market. All the other rates are just different terms (pretty similar to a 3-year, 5-year, or 7-year car loan) the government can get more money for less interest by offering a variety of terms.

Now the why:

Treasuries are like the basic unit of investing. The US government has a very good reputation with investors, so treasuries are the safest return one can get over a period of time.

That means that when treasury rates rise, all other investments need to adjust (because if riskier investments don't provide at least that much return, investors are better off selling the other investment and buying the treasury). Sort of like an employer known to hire essentially everyone paying more than other more selective employers, the selective employer is going to have to keep their wages higher than the employer who hires anyone if they want to keep getting employees.

So when treasury yields rise, all other investment income rates also have to rise, and that means most investment prices fall.

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Thanks for your explanation!

So when treasury yields rise, it's expected that the other forms of investment will have yields on par with the treasury yield. And the part you said "that means most investment prices fall", does it mean the stock prices fall because their yields are not on par with the new treasury yield?

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Yep, exactly. Stock yields may be lower than treasuries (because unlike treasuries the dividends are expected to grow in the future), but they'll still fall for that reason and the company's borrowing costs rise with treasury rates.

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would choose to put their money in either depending on their risk tolerance.

If treasury yields rise to say 0.8% though, while risk remains 0.5%, it would suddenly provide a better risk/benefit for investors than stocks, and investors will sell stocks and buy treasuries. Stock prices will fall as a result, until the stock yield becomes 8% (remember yield = return/price, so lower price for the same return equals higher yield), at which point the equilibrium on the risk/benefit of treasuries vs stock is restored.

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The National debt that you often hear about? That is the result of the government selling bonds to investors. The government collects money now, and agrees to pay it back down the road with interest.

These bonds are called Treasury Bills, or T-bills. The yield is the % of interest they pay out to buyers. The time frame is how long the money is loaned for, ie. a 10 year treasury gets paid back after 10 years. The longer the timeline, the higher the risk that things like inflation will counteract the interest gains, so longer term bonds pay a higher interest rate then shorter ones, where the external risks are better known. An increase in yield means that an investor get more money for the same (super low) risk investment.

If, as an investor I have the choice of low risk 2% return or higher risk 5% return, I may be more likely to take the higher risk. If the low risk option pays 4% vs. high risk 5%, I am a lot more likely to choose the safe option. So I might sell high risk stock and buy low risk T-bills instead. Less demand for stocks (more sellers than buyers) causes their price to fall.

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I know that it is ELI5 and we shouldn't be super pedantic, but I want to add a note on the terminology just so that people don't get confused when other people use correct terminology.

T-Bills are very short term things. 1 week to 1 year. T-Notes are from 1 year to 10 years, and T-bond are anything longer.

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of years, then pay back the full amount of the loan in one single final payment. For example, the US treasury takes out a loan for $1000 over 10 years at 1%pa interest. They pay back $10 (interest) each year, then after 10 years, they pay back the full $1000.

What if you lend the treasury $1000 for 10 years, then 2 years later you need that $1000 back? Treasury won't give it back early, but you can sell the loan to somebody else. You might find someone willing to pay you back the full $1000. That person will then get the remaining $10 yearly payments and the final $1000 payment. From this person's point of view, they have lent the treasury $1000 for 8 years at 1% interest.

However, maybe you can't find anyone willing to pay back the full $1000. So, desperate for money you agree to sell the loan to someone who will only pay you $900. However as the new owner of the loan, they are still entitled to the full $10 annual payments and the full $1000 final payment. This is basically the same thing as earning a higher rate of interest. In fact, from this person's point of view, they have lent treasury $900 for 8 years at something closer to 2.5% interest.

This effective interest rate is called the yield. It matters because anyone wanting to sell an 8 year treasury bond at the same time as you are trying to offload your one must offer an effective interest rate equal to 2.5% to compete with you. Especially, even the US treasury won't be able to sell new bonds for 8 years unless they offer an interest rate of 2.5%.

The yield is a reflection of how willing people are to buy "second hand" loans at any particular time.

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"Treasury yield" refers to the interest rate you get by buying bonds issued by the U.S. federal government. Essentially, it's a promise to pay you back at a later date - right now, the yield for a 2 year U.S. bond is 2.889, meaning if you buy $100, in 2 years you get back $102.889.

This affects the wider economy because it's one of the safest options you can choose. As long as the U.S. government doesn't collapse, you can count on getting paid back at a certain rate, so any investment you make other than buying treasury bonds has to beat out that return or it won't be worth it. For example, if investors are nervous about the stock market, they might choose to buy treasury bonds and lock in that return rather than risk it on other investments. It's not just the stock market though - mortgage rates are largely based on it, as are student loans, and most types of long term debt.

Another part of this is the Federal Funds Rate, which is what you see on the news as "The Fed raised interest rates today". This is the rate at which banks lend money to other banks, and is under direct control by the U.S. Federal Reserve. Generally this is a signal to how they see the economy going - low rates means the economy needs boosting, as low interest rates discourage saving and encourage spending. High rates mean they think the economy needs cooling, to prevent inflation. This doesn't directly change treasury yields, but is a factor.

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economy might go up and down quite a bit making the deal on the government bond a better or worse way of investing your money. However what you can do is sell the bond to someone else like say after 5 years the price of that someone else will be prepared to pay will vary depending on how much money they will yield compared to investing that money elsewhere.

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The only thing they are missing is that T bills are considered a cash equivalent because they are traded widely between businesses when they need a safe investment vs just storing money in their accounts.

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