Bull & Bear Bulletin

November 2023

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An on-line publication by The Investment Committee

To Pause or Not to Pause!

The U.S. 10-year Treasury Note yield declined from a high of 5.02% on October 23rd to 4.45%. This important asset's price is used as a reference to value riskier debt instruments in the investing space. In the span of weeks, new data releases, declining treasury market liquidity and the current pause in rate hikes have all contributed to the decline in interest rates. When comparing its relative value to corporate investment grade and speculative grade high yield bonds, it may still be attractive from a relative standpoint. For example, we can look at the high yield spread, which is the increase in interest rates over that of the U.S. 10-year Treasury Note yield that an investor would require to assume the higher risk of the corporate bond space as opposed to buying the treasury paper. As of November 13th, this spread is at 4.31%, which is only slightly above the 5-year average of 4.24% and the 10-year average of 4.10%.

Treasury bulls may point to weakness in recent data releases as signs of a slow-down further supporting the case for a pause in rate hikes. In the month of October, ISM Services Purchasing Managers' Index was at a level of 51.8. A reading above 50 indicates expansion and a reading below indicates contraction. In October, nonfarm payroll increased by 150,000 jobs, which was below consensus expectations of 180,000. Finally, the Federal Reserve agreed to hold the federal funds rate between 5.25%-5.50% and reiterated being data dependent in its continued fight against inflation. All this could point to a treasury bond rally, which would bring down yields further against a backdrop of slowing growth and increased odds of a recession.

Bears may point to the current strength in consumer spending and the resilient economy as a case for further rate increases. Q3 GDP came in at 4.9%, beating expectations. Real average hourly earnings year-over-year are still strong and have been rising year to date. For the month of October, this reading came in at 0.8%, beating consensus estimates of 0.5%. On a weekly basis, real average weekly earnings year over year have also been rising year to date and came in flat for the month of October. Continued earnings and spending strength could necessitate the need to restart rate hikes down the line, if inflationary pressures re-emerge.

Combined with rapid rate hikes and a rise in the 10-year yield, we tend to believe that U.S. treasuries hold decent relative value over corporate and high-yield bonds at this moment in time, where corporate default risk is rising. On an absolute basis, it is true that corporate and high-yield bonds offer investors a higher return than treasuries, but the point is that the extra yield potential may not be so attractive as to not include some treasury exposure in portfolios given the additional credit risks being taken.

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