Truist Advisory Services, Inc.

Fixed income perspective from the Investment Advisory Group

Negative real yields suggest higher rates ahead

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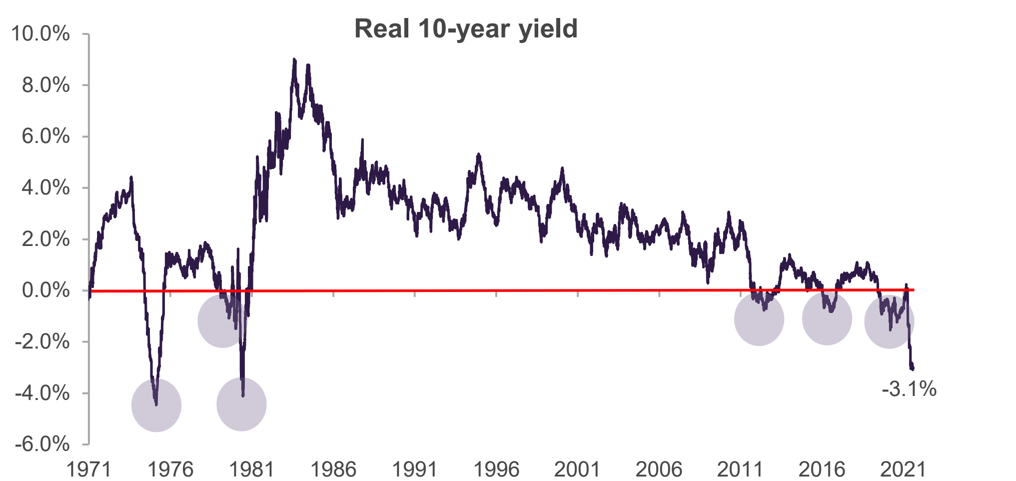
What happened

Real yields, also known as inflation-adjusted yields, show the annualized return an investor receives after accounting for the effects of inflation. Today, real 10-year U.S. Treasury yields are at a 40-year low due to low nominal yields and high year-over-year inflation readings. Stated another way, investors are losing roughly $3 for every $100 invested in 10-year U.S. Treasuries after subtracting the most recent core Consumer Price Index (CPI) readings.

Currently, real 10-year yields sit at -3.1% (i.e., 1.25% 10-year yield minus 4.3% core CPI). Negative real yields are not unheard of, but they are rare. Over the past 50 years, real 10-year yields bottomed in negative territory just six times: 1975, 1979, 1980, 2012, 2016, 2020, and today. More importantly, real rates don't typically stay depressed for extended periods.

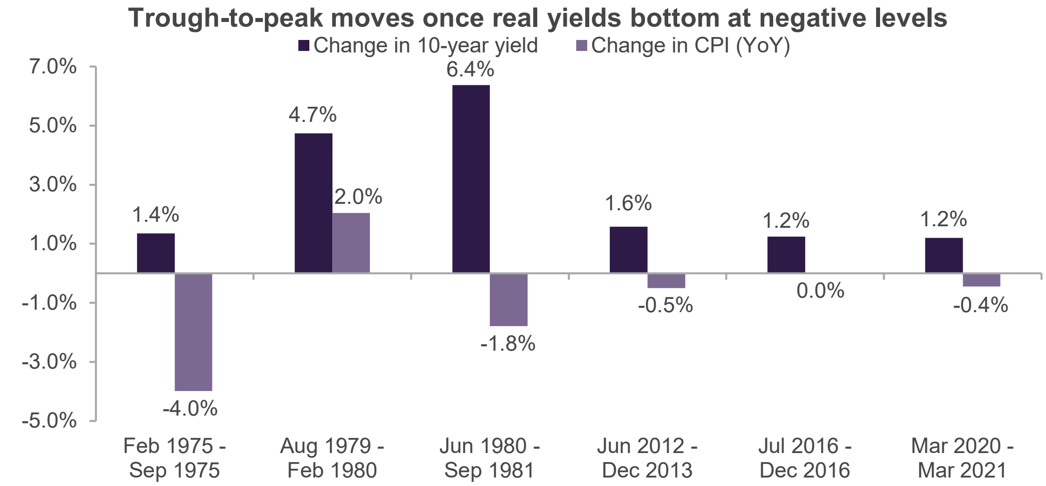


Data source: Truist IAG, Bloomberg

Our take

In the previous six instances where real U.S. yields bottomed in negative territory, real yields tended to rise rather sharply over the next 6-18 months. Higher real yields were achieved through a combination of moderating inflation and rising nominal yields. It is worth noting this aligns with our expectations that inflation will begin to cool in the months ahead and nominal yields will rise from current levels.

Nominal U.S. Treasury yields (shown in dark purple) have tended to rise after real yields bottom in negative territory.



Data Source: Truist IAG, Bloomberg

Year-over-year U.S. inflation has jumped dramatically from the lows reached in the months following the start of the pandemic. Simultaneously, nominal U.S. yields have remained severely depressed by the Federal Reserve's (Fed) quantitative easing program, concerns surrounding the economic impact of the COVID-19 delta variant, and relentless foreign demand for U.S. fixed income. This has resulted in negative real yields across the U.S. Treasury curve.

Although the delta variant is delaying a further reopening of the economy, we expect year-over-year inflation readings will continue to cool in the months ahead. For instance, used vehicle prices, which jumped more than 40% year over year, have started to recede. Average lumber prices have fallen 70% from their May peak. The current pace in price growth is not sustainable over the longer term. However, there are some stickier pockets of inflation, such as wages and rents. Our view is that, while inflation readings will soften, they are likely to remain above the pre-pandemic pace, commensurate with higher growth. Nonetheless, higher-than-anticipated inflation readings should encourage U.S. yields to move higher.

Additionally, we expect the Fed to begin slowing the pace of its monthly asset purchases in the fourth quarter of this year. The reduction of Fed support should also encourage yields to move gradually higher. The Fed is gaining comfort with the idea of less accommodation on the basis of its constructive economic outlook. We agree the U.S. recovery still has ample room to run, which generally fosters a rising yield environment. If these expectations hold true, the combination of rising nominal yields and falling inflation readings should help boost real yields from their current levels.

Bottom line

Despite very different growth environments, inflation trends, and Fed regimes over the past half-century, U.S. yields have tended to rise after periods when inflation-adjusted rates bottom in negative territory. Real yields should begin rising from their current lows due to moderating inflation and modestly higher nominal yields, validated by better economic growth and reduced Fed asset purchases later this year. This supports our below-benchmark duration bias within fixed income portfolios. We also expect to see rate volatility stay elevated given the uncertainties associated with the delta variant and expected shift in the Fed's policy stance.

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