Rising Up, But Not All at Once

Why Long-Term Rates are Rising as Short-Term Remain Near-Zero

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Most expect the domestic economy to surge in the months ahead as states begin to re-open for business and as the result of multiple rounds of fiscal stimulus. Simultaneously, inflation expectations are rising, as are bond yields.

Yet, despite the headlines about rising rates, investors in the short end of the yield curve aren't seeing the same increase as their long-term counterparts. Long-term rates have been rising, while short-term remain anchored near-zero. Let's examine some of the factors driving this.

The Current Macroeconomic Backdrop Sets the Stage

Economists are currently forecasting U.S. gross domestic product (GDP) to exceed 6% in 2021, which if achieved, would be the best reading in over 35 years. The stock market has looked favorably upon these expectations, as evidenced by the fact that both the S&P 500 and the Dow Jones Industrial Average indices reached record highs on March 17, 2021.

Of course, the economy, the stock market and the credit markets have also benefitted from an unprecedented amount of monetary and fiscal stimulus. The Federal Reserve (Fed) cut rates to near zero in March of 2020, created an "alphabet soup" of programs to support various sectors of the bond market and has pumped more than $3 trillion of liquidity into the financial markets through purchases of Treasuries and agency mortgage-backed securities (MBS).

Not to be outdone, U.S. Congress also initiated the largest economic stimulus packages in U.S. history – the $2.2 trillion CARES Act, a $900 billion stimulus package at the end of 2020 and then the $1.9 trillion American Rescue Plan Act in early 2021. Taken together, these provided direct payments to households, aid to state and local governments, increased unemployment benefits, forgivable loans to small businesses, and billions in funding to fight the COVID-19 pandemic.

These measures were unprecedented in terms of speed, size and scope. And, there might be still more to come! So, it's not particularly surprising that inflation expectations are increasing.

Long-Term Rates are on the Rise. Short-Term, Not So Much

As shown below, the yield on the 10-year Treasury note has risen from a low of 0.52% in August 2020 to 1.69% as of March 22, 2021. Over that same period, the yield on 2-year Treasury notes has stayed between 0.10% and 0.20%, and currently stands at 0.15% as of March 22, 2021.

Thus, long-term rates have surged, but yields on shorter-term investments have remained stubbornly low.

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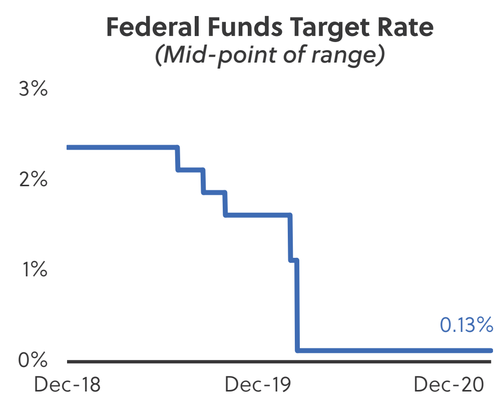
What about yields on even shorter-maturity investments, like those in money market funds and local government investment pools (LGIPs)?

The charts below show the yield on the 3-month Treasury bill and overnight repurchase agreements (as represented by the secured overnight financing rate) – common investments for short-term funds and LGIPs. Note that very short-term rates have fallen to almost zero, and on occasion, have actually been negative!

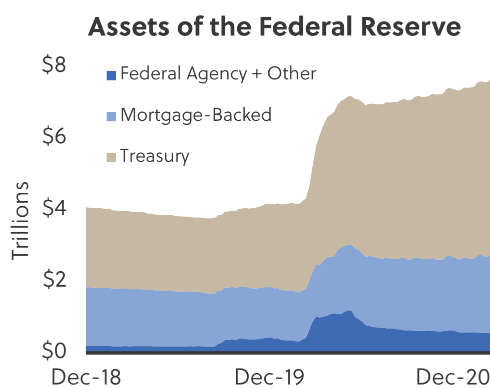
The bottom line: **Though yields on longer-term investments are rising due to economic optimism and rising inflation expectations, short-term yields have continued to fall.**

What's Been the Driving Force Behind Low Shorter-Term Yields? Federal Reserve Policy

Below we show the history of the federal funds rate – the rate set directly by the Fed. In addition, we show the size of the Fed's balance sheet and its growth during the pandemic – all part of the Fed's massive "kitchen sink" approach to supporting the financial markets.

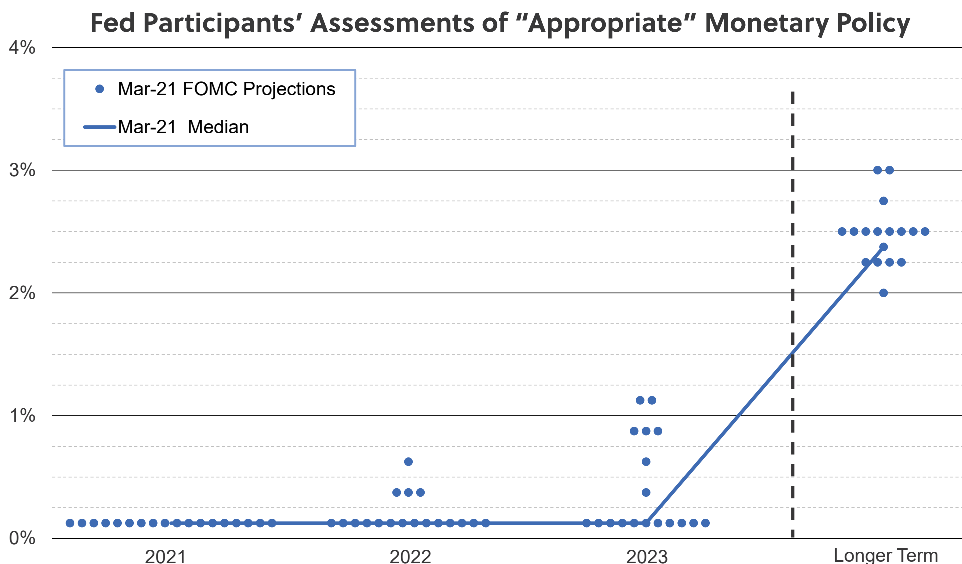


Source: Bloomberg, as of March 22, 2021.



Source: Federal Reserve Bank of St. Louis, as of March 22, 2021.

The Federal Open Market Committee (FOMC) target range for the federal funds rate is currently 0% to 0.25%. **By targeting near-zero rates, the Fed policy acts as an anchor for short-term rates. That anchor weighs down yields on even 2-year investments because the Fed's own outlook is for near-zero rates to persist.** As shown below, the Fed's latest "dot plot" (released March 17, 2021) shows that FOMC participants' assessments of appropriate monetary policy indicate near-zero short-term rates through 2023 (although seven of the 18 participants view a slightly higher level as appropriate at that time).



Source: Federal Reserve and Bloomberg. Individual dots represent each Fed members' judgement of the midpoint of the appropriate target range for the federal funds rate at each year-end. Fed funds futures as of March 18, 2021.

Further, the Fed has consistently reaffirmed its commitment that monetary policy will remain highly accommodative, at least until "labor market conditions have reached levels consistent with the Committee's assessments of maximum employment" and inflation also reaches the Fed's 2% average target.

When will that occur?

With the unemployment rate currently at 6.2%, maximum employment certainly seems well off into the future. And, given the Fed's revised stance on inflation — to target 2% over time, but allow inflation "to moderately exceed 2% for some time" — any liftoff from near-zero rates is likely to be pushed well down the road. And, while long-term Treasury yields are rising due to a confluence of factors, shorter-term Treasury yields, tethered to the Fed's interest rate policy, are not likely to move up anytime soon.

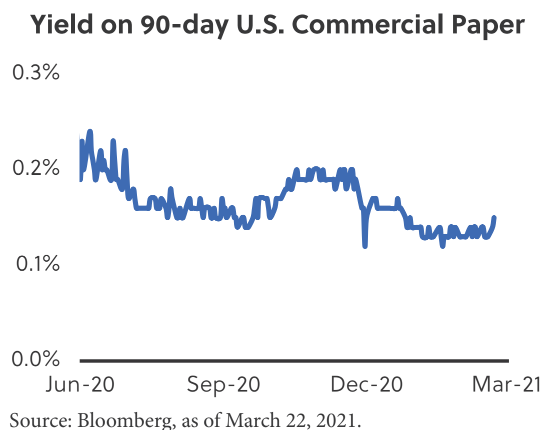
As the proverbial saying goes, **"You can't fight the Fed."**

What about commercial paper and bank certificate of deposits (CDs); don't they have higher yields?

Yes, but the flood of liquidity in the short-term markets has created insatiable demand, driving yield spreads lower. At the same time, many traditional borrowers have used the low rates to lock up low-cost, longer-term borrowing, so the issuance of short-term products has been constrained. In other words, there is just too much cash chasing too few investment opportunities. **This is great news for borrowers; tough news for LGIP investors.**

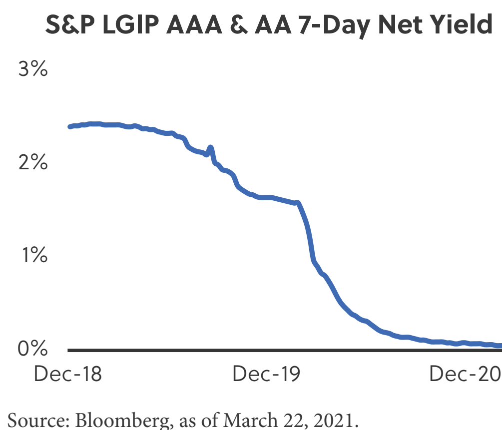
The following charts show the yield on 3-month commercial paper and the downward trend for the S&P LGIP Index. Clearly, the industry is grappling with the same challenges.

Yield on 90-day U.S. Commercial Paper



Source: Bloomberg, as of March 22, 2021.

S&P LGIP AAA & AA 7-Day Net Yield



Source: Bloomberg, as of March 22, 2021.

What is PFM Asset Management LLC (PFM) doing to combat these challenging factors?

- Carefully managing the weighted average maturity of our LGIPs as we seek to capture value while maintaining a primary emphasis on safety and liquidity,
- Casting a wide net and diligently canvassing the market every day for relative value opportunities among various sectors and issuers, and
- Staying committed to our longstanding credit philosophy that emphasizes safety.

PFM recognizes today's market challenges. We've been here before (during the Fed's last round of near-zero rates in 2008-2015) and we know what to do. We remain committed to meeting your safety and liquidity needs while seeking competitive yields in this challenging environment.

To learn more or discuss in greater detail, please contact your PFM representative.

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