COMPASS Market Insights

A Monthly View from the US

December 2019

2020 Outlook for the Benchmark US 10-Year Treasury Bond

- **In 2019, 10-year US Treasury bonds traded in a range of 1.46%-2.78%, the fourth-widest range since 2010.**
- **In 2020, we think the 10-year may trade in a similar range, with additional volatility arising from many of the same factors that drove volatility in 2019. We don't expect the benchmark bond to exhibit a particular bias towards going higher or lower, assuming certain outlier scenarios are avoided.**
- **The current cyclical slowdown phase calls for caution, but investors may also want to prepare for a U-turn if and when earnings and economic growth reaccelerates. A macro environment marked by stabilizing growth and a patient but supportive Federal Reserve should be positive for risk assets in general.**

2019 10-Year Treasury Review

In 2019, the 10-year Treasury traded in a range of 1.46%-2.78%, the fourth widest range since 2010. The 10-year yield rallied due to uncertainty over US-China trade negotiations and ongoing concerns about a weakening global economy. Fueling the rally further was a dramatic pivot in the Federal Reserve's monetary stance from hawkish to dovish, which led to three rate cuts, and finally to neutral. This backdrop was a catalyst behind a strong 10% increase in the US 10-year yield in 2019. Historically, Treasury performance often suffers following a 10% return the preceding year, as the chart shows.

2020 Scenarios for the US 10-Year Treasury

As we look ahead to 2020, there are enough uncertainties in the geopolitical and global economic environment to result in heightened volatility in the 10-year yield. We highlight a few scenarios that could affect the 10-year in 2020.

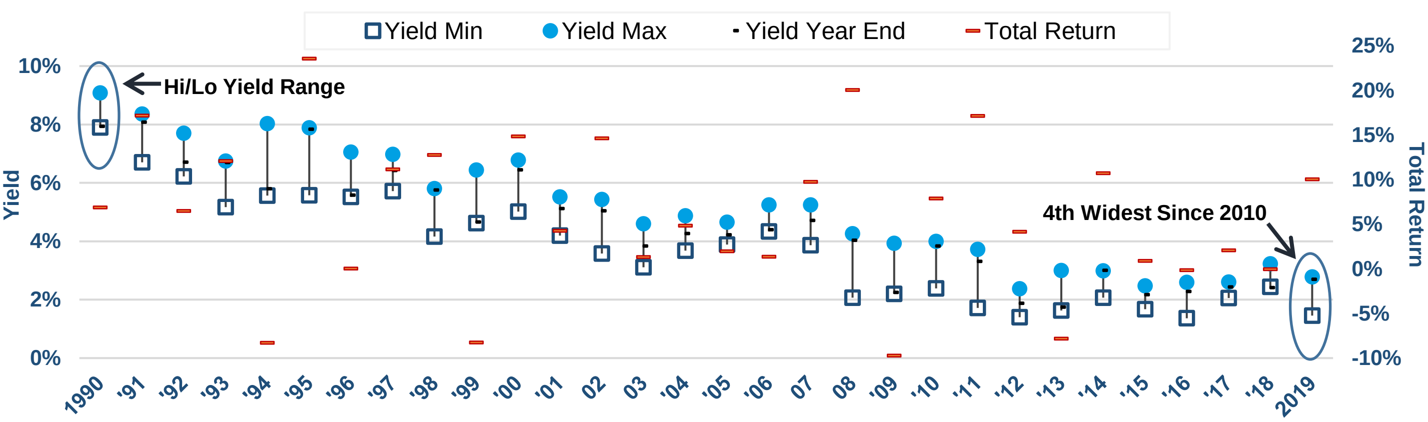
1. **Modest recovery in global growth.** Amidst a relatively benign macroeconomic environment with resolution to much of the geopolitical uncertainty, the global economy could begin a nascent but fragile recovery. This implies a détente in US-China trade tensions, including incremental progress, such as a likely Phase 1 trade deal. With this backdrop, the US economy could continue to grow at a decelerating pace, slowing GDP from 2.3% year-over-year in 2019 to 1.7% year-over year in 2020, and the global economy could hold steady at 3.2%. The Fed would likely remain on an extended pause. Under this benign scenario, the 10-year yield could remain in a range of 1.50% - 2.25%, with perhaps a slight bias towards higher yields. A recovery in global growth, particularly in the EU, could push core European 10-year yields back above 0%.

2. **Setback in global growth.** Geopolitical discord and an escalation in US tariffs against China could provide a headwind to capital expenditures and China growth. As a result, US growth could weaken further below the 1.75% trend. The Fed could respond by easing policy with two to three rate cuts. In this scenario, global 10-year yields continue to rally, and markets could begin to contemplate the prospect of negative yields in the US. Initially, US 10-year yields could trade in a range of 1.00% - 1.75%.

3. **Idiosyncratic factors.** A more cautious consumer, uncertain business sector and debt-laden government could retrench and induce a US recession. Negative US growth is a prerequisite for the 10-year yield to fall below 1%, as the Fed would aggressively cut rates toward 0% (Zero Lower Bound).

On the other hand, a credible and final resolution to the US-China trade war and other tariff threats could remove the single biggest anchor to business sentiment and investment. The Fed could respond to an ensuing surge in economic activity and inflationary pressures by tightening

US 10-Year Treasury Annual Yield Differential and Returns History



Source: Bloomberg and Amundi Pioneer. Last data point 11/30/19.

monetary policy with incrementally higher short term rates, potentially pushing 10-year yields above 2.50%

Other near-term factors could impact the 10-year yield.

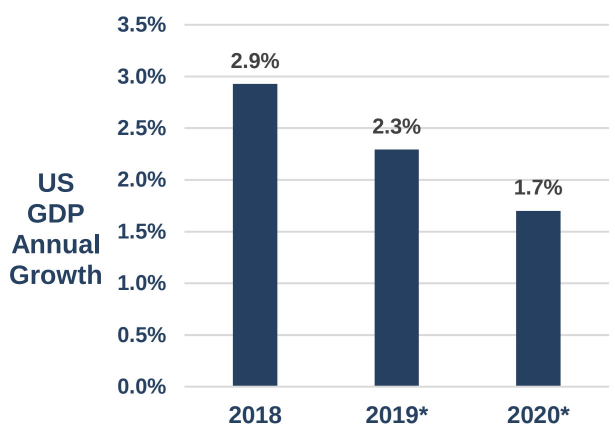
- **Fed inflation framework review: yields higher.**

  Since the beginning of 2019, the Fed formally began a process to review its inflation targeting framework, which has not demonstrated a convincing ability to hit its 2% mark. Since the Fed began explicitly targeting 2% inflation in 2012, inflation has been below target 74% of the time, raising questions over the Fed delivering on its dual mandate. We believe the Fed is likely to complete their review by Q2 2020, and any recommendation that entails tolerance for higher inflation would most probably push up 10-year yields.

- **US Treasury issuance: yields lower.**

  Despite rising fiscal deficits and the resulting funding needs, net Treasuries in circulation are likely to decline from $963 billion in 2019 to $686 billion in 2020 as the Fed steps up purchases of mortgage-backed securities (MBS) and short-term T-bills. This should provide support for 10-year yields.

US Economic Growth at a Decelerating Pace



*Source: Amundi. *Estimates as of 11/30/19.*

Longer-term factors that could suppress the level of Treasury yields

While the short-term economic outlook certainly impacts bond yields, longer-term expectations for growth and especially inflation are the most meaningful drivers, accounting for the bulk of 10-year Treasury beta, at 0.25 and 0.45, respectively. (Beta is a risk measure related to market volatility, with 1 being equal to market volatility and less than 1 being less volatile than the market.)

The current and longer-term inflationary picture remains benign and well contained. Except for a brief period in 2018, Personal Consumption Expenditure (PCE), the Fed's preferred measure of inflation, has remained below the Fed's 2% target since 2014, while the survey measure has been on a noticeable downward trend since 2013, falling from an average of 2.9% in 2013 to tying a record low of 2.3% in November 2019.

The relative flatness of the yield curve suggests expectations for subdued US growth in the medium- to long-term. While there is a risk of higher yields in the US in 2020, the extent of the rise is potentially capped by the combination of trend-like growth and lack of meaningful inflationary pressures.

Investment Implications – Fixed Income

US growth continues be driven by the consumer, who remains confident due to a healthy income statement and balance sheet. Holiday retail sales are strong, especially for internet sales; however, retailers who lack online strategies are suffering. Manufacturing continues to be weak in the face of uncertainty surrounding a US-China trade agreement.

A macro environment marked by stabilizing growth, loose financial conditions, and an accommodative Fed should be positive for risk assets in general. While we see greater potential for spread tightening in securitized credit than in corporate bonds, we expect both sectors to generate an important carry advantage over Treasuries, which we expect to nudge slightly higher.

U.S. corporations have elevated levels of leverage, which are affordable with low interest rates and spreads at multi-year tight levels. Watch for stress in the event of higher rates.

High yield is attractive on an idiosyncratic basis, especially given technical conditions in the lower quality bank loan segment.

Structured securities, including both agency and non-agency residential mortgage-backed securities (RMBS), are relatively attractive, especially as housing market affordability and valuations have been buoyed by low mortgage rates and steady demand.

Investment Implications – Equities

Most leading economic indicators suggest that the global cycle has already bottomed, and we would expect the recovery to consolidate if we have a trade agreement. Earnings forecasts should start to improve in the second half of next year, and 2020 is likely to be better than 2019 in term of earnings per share growth: we expect +7%-8% in the US. Valuations are historically reasonable given low rates.

With this as a backdrop, we favor value stocks over growth stocks given the greater exposure within the value universe to cyclical sectors, which would benefit from a re-acceleration of economic growth.

The financial sector is particularly attractive in our view, as it should benefit from a steepening of the yield curve if GDP growth improves, but has limited downside given that consumer debt levels are reasonable and are not likely to result in massive credit losses should a recession occur.

The biggest risk to the equity markets near-term continues to be trade. A continuation of the US-China trade war could cause global economic growth to slow further and earnings to decline next year. The Fed, however, has supported growth with three interest rate cuts this year, and is likely to provide additional support if growth slows further. Because of the sector composition of the market and the flexibility of its corporations, we think the US remains the safest way to invest in equities. Non-US equities could have greater upside, however, if a trade deal is reached and global growth reaccelerates.

The US election cycle may also contribute to equity volatility in the coming year if candidates that are less pro-business were to gain traction.

Overall, we believe equities are attractive for 2020. We also believe that integrating ESG to traditional economic analysis will improve the potential for active management to deliver solid risk-adjusted returns. In fact, as investors move from risk aversion to a more positive outlook, security selection and active management will be critical to navigating the equity investment landscape in 2020.

Important Information

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