Interest Rates; Sea Change or Another Head Fake

"The test of a first rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." -- F. Scott Fitzgerald

The sudden and sharp movement of interest rates reflects the prevailing uncertainty in the fixed income world since the election of Donald Trump. Investors, potential issuers, corporations, and individuals have managed to show both angst and enthusiasm -- sometimes on the same day -- as they struggle to determine both the odds and implications of higher interest rates, and whether or not the recent move represents a sea change in the direction of rates or if this is simply yet another head fake experienced myriad times post Great Recession. At this time, Ambassador Financial Group believes the evidence is still inconclusive to go "All In" on a forecast for interest rates given the uncertainty regarding the ramifications of the election results and future economic policy. That said, and while our models need some time to gather incoming information, here is our attempt to make sense and shed some light on the current interest rate environment.

Before looking ahead it's important to review where we came from to provide perspective. Interest rates had been trading at very low levels across the curve having moved dramatically lower in 2016 after the FOMC raised interest rates in December of 2015. This outcome surprised many market participants who fully expected rates to move higher this year, but was consistent with Ambassador's view that rates were going to remain lower for longer. In fact, parts of the yield curve, particularly on the long end, reached all time historical lows following the Brexit vote in June with the 10-year treasury closing at a 1.359% yield on July 8, 2016. Rates grinded slightly higher through the summer months and into November on the expectation the Fed was on course to raise the overnight rate in December. This was precisely the phenomenon markets experienced one year ago when rates moved higher in anticipation of the Fed's telegraphed interest rate increase in December 2015. On the night of the election the 10-year was trading around a 1.71% yield and then something interesting and unexpected happened -- Donald Trump was elected as our nation's 45th President. Subsequent to the election results, the markets have experienced a rather dramatic move in interest rates with the 10-year treasury now trading at a 2.32% yield, representing a 61bps and 96 bps increase post-election and post-Brexit respectively. Clearly this has been a dramatic and unexpected move.

In assessing the move in rates, we are gaining a much better understanding of the contributing factors. First and foremost there is suddenly a euphoric majority of market participants and talking heads, many of whom were anti-Trump fear mongers, who are running with the narrative that Mr. Trump's election is going to fuel a Reagan-esque economic expansion that will spawn higher growth and higher inflation. There is certainly credence to this view as a repeal and replacement of Obamacare, an overhaul of the tax-code, and roll back of excessive and crippling regulation across industries and sectors is clearly a blueprint for faster growth. Stronger growth coupled with higher inflation would most certainly cause rates to move higher. And, what is frightening the bond vigilantes even more about Mr. Trump's policies is what his advisor Steve Bannon recently shared with a Hollywood reporter:

"I'm the guy pushing a trillion-dollar infrastructure plan. With negative interest rates throughout the world, it's the greatest opportunity to rebuild everything. Ship yards, iron works, get them all jacked up. We're just going to throw it up against the wall and see if it sticks. It will be as exciting as the 1930s, greater than the Reagan revolution -- conservatives, plus populists, in an economic nationalist movement."

In other words bond vigilantes are very concerned that Mr. Trump is going to run much larger budget deficits and exacerbate the national debt to even more unsustainable levels. This line of reasoning has delivered significant dollar strength post election forcing countries like China and Saudi Arabia to sell treasuries in an attempt to defend their respective currencies from collapsing which is putting further upward pressure on treasury yields. In turn, as prices fall and yields rise, leveraged funds and other market participants who were unprepared for this move are being forced to sell treasuries leaving us currently in a somewhat vicious cycle. Selling begets more selling as a declining market creates its own dynamic. It's impossible to call the bottom, but history proves that markets overreact and go way too far, way too fast, and we believe that will prove to be the case here.

Reasons for Higher Interest Rates:

- Republican control of the White House, Senate, and House portends pro-growth policies (less regulation, tax-code overhaul, etc) which could help lift the economy
- New political appointees could favor of an easing of fiscal policy (lower taxes/higher government spending)
- Higher growth and less fiscal discipline could revive inflation and inflation expectations

Reasons for Lower Interest Rates:

- The U.S Economy is still treading water and the rest of the world is struggling
- Global deflationary pressures persist
- Most of the world's central bankers are committed to low interest rates
- Growing divergence between U.S. treasury yields and global sovereign debt yields
- The herd is now under positioned and underprepared for lower rates (85%+ of asset managers are "certain" rates are rising)
- Black Swan event(s)

The combination of our collective experience and consensus building leads us to believe that the recent move is overdone and based much more around a desire for market participants who have been calling for higher rates to finally be right, rather than the likelihood that rates should be higher. In the short term, as highlighted above, markets can move too far and too fast in a massive overreaction to the news of the day, causing technical levels to come into play which can propel the move further. Consequently the move higher in rates might not be over and could have room to run. The best analog is the "Taper Tantrum" that commenced in May of 2013 which pushed the 10-year treasury from a 1.62% yield to 3.03% on December 31, 2013. That was a dramatic move that had bond bears shouting victory prematurely as 2014, 2015, and much of 2016 ushered in markedly lower interest rates -- a massive head fake. We view the recent move through the same lens, only this can be referred to as the "Trump Tantrum" that could push the 10-year higher in the short-term, only to reverse course later. In other words our bias is that this is most likely a hiatus of the bull market for treasuries, not unlike what occurred post-Taper Tantrum. Call it a short term cyclical sell off in the midst of the secular trend towards lower rates. Said differently and in layman terms, we believe this will prove to be another head fake as the reasons highlighted above for lower rates will trump (pun intended) the reasons for higher rates.

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