American National Bank & Trust™
TRUST AND INVESTMENT SERVICES

Market Comment: Higher Yields
January 31, 2018

Are we finally entering a new phase in the economic cycle where we are seeing a strong economy, a tighter labor market and the possibility of higher inflation? It has been awhile since investors saw a bear market in bonds. In fact, Ronald Reagan was President and Michael Jackson was leading the pop music charts. So an environment in which yields on bonds actually can go higher over time is a new experience for many investors.

But in order for yields to go higher, we must start to see inflation. To this point, inflation remains fairly muted, but the bond market is, perhaps, starting to adjust to higher yields. Much of this is because of strong data from the economy and business optimism. The National Federation of Independent Business (NFIB) optimism survey recently eclipsed 2003 levels and is approaching the most optimistic levels not seen since 1983. Optimism along with strong economic growth has historically resulted in increased inflationary pressures.

In last night's Presidential State of the Union Address, President Trump cited rising wages in his speech. Without getting into the debate whether low unemployment leads to higher wages or the economic theory of the Phillip's Curve, we know the current administration is focused on reflating wage growth through policy. Recent tax cuts and certain trade measures, along with limiting the supply of immigrant labor, should boost wages faster than waiting on the theoretical Phillip's Curve to kick-in. Wage growth historically has led to inflation. We are still in the early stages of seeing if these policy changes will, in fact, lead to wage growth, nevertheless we have to acknowledge a likely chance of inflation returning through reflating labor wages.

Most economists expect Gross Domestic Product (GDP) to continue climbing towards 3% year-over-year in the coming year. In addition, the Federal Reserve (Fed) has telegraphed increasing rates throughout 2018. Our analysis is consistent with a recent survey showing that most economists and fund managers believe the Fed will move its target federal funds rate from the 1.25-1.5% range to the 2.00-2.25% range by the end of 2018. This increase of 0.75% is expected and, perhaps, could be revised up if economic indicators show little signs of slowing.

Our last Market Comment *"Asset Prices and Inflation" on December 8, 2017*, we indicated the excess money from quantitative easing has come full circle and is possibly inflating asset prices. We are seeing record prices in real estate, art work, oil & gas leases, and stocks. We also believe there still is a long way to go to a more "normalized" Fed policy, and this could be inflating bond prices too. One could argue yields have been slow to rise because of such.

The benchmark for measuring interest rates in the bond market is the 10-year Treasury yield. Just 5 months ago, the 10-year Treasury yield was hovering around 2.1%, it has since moved to 2.7%. If inflation does reemerge into this economy, we have to expect 3% is not far away. And for now we stand by our call that there is a possibility of the 10-year reaching 4% within 12-18 months. We will continue to watch these developing changes and adjust accordingly.
