

The 2-Year Yields 5% - So What???

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Away from zero day to expiration options (ODTE), everyone in the market (and beyond) seems fixated on 2-year yields.

There are about 100 iterations of the following question:

“Shouldn’t I just put my money into 2-year Treasuries? They are yielding 5% after all.”

Where to invest on the yield curve is always on my mind, but suddenly everyone seems to be talking about the 2-year. It’s not just the bond “geeks,” but also mom and pop investors. It is a part of every asset allocation conversation. Bob Pisani and I spoke last night for this CNBC piece on [“tech and quality stocks”](#) and he mentioned that he was being inundated with calls from “unlikely corners” of the market about the investment merits of the 2-year Treasury.

To me, there are several questions that need to be answered to determine how much weighting you should have in the 2-year Treasury relative to normal:

- What is the right mix between stocks and bonds?
- Within bonds, what is the right mix between credit risk and rate risk?
- Within rate risk, where on the curve do you want to be?

I need to discuss this, because one major thesis making its way around the market is that:

“Everyone will sell equities and buy the 2-year Treasury.”

I feel compelled to fight against this thesis.

The Best Time to Buy the 2-Year was at 0.3%

This is backward looking, but it is worth thinking about.

The 2-year broke below 0.3% in March of 2020. The first time it traded above 0.3% was at the end of September 2021.

The 0.25% bond (issued 9/30/21) is trading at 97.25% of par right now. Not a particularly good investment in its own right, however:

- The 2% bond that was the “on the run” long bond then is now trading at 67.5% of par, which is at a loss orders of magnitude larger compared to the 2-year.
- The Nasdaq 100 is “only” down 21% since then and ARKK, which was a “must have special sauce” for any investor, is down almost 70% since then.

When people were **chasing yield and return** any way they could, no one wanted the “measly” yields provided by the 2-year. **TINA** (There Is No Alternative) and **FOMO** (Fear Of Missing Out) ruled the day back then. However, the Nasdaq 100 peaked in December 2021 and ARKK peaked in March 2021.

The “right” trade for buy and hold investors (anyone with a 1 to 2 year time horizon) would have been to buy the 2-year Treasury when it was yielding next to nothing, not because it provided a “solid” return, but because it had far less downside (and upside) than other choices.

Buying the 2-Year only to Chase Stocks up 7%

I know that no one who reads the T-Report believes this (and I swear it won’t happen to me), but one path seems so obvious that I need to mention it:

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- Buy the 5% yield today.
- Watch stocks rise 7% in 3 months.
- Sell bonds, having earned about 1.25% (a quarter of carry), while missing a 7% rally in stocks.

Yes, I understand that people are buying the 2-year because they are afraid stocks will fall further. But none of us “know” which way stocks will go next. What I feel comfortable “predicting” is that many of the people buying bonds instead of stocks today will be “forced” to buy stocks at higher prices (if they move higher) and in many cases will be too afraid to buy stocks at lower prices (if they move lower).

I’ve been bearish stocks off and on for the past 2 years. I have no trouble trading stocks or bonds (in fact that is what I’m paid to think about). But if you asked me “**what will provide the greater return in 2 years, a 10% holding of Treasuries or a stock investment?**” **I’d have to go with stocks.**

How I’m Thinking About the Opportunity

I’m going back to the three questions that I posited at the beginning of this rant.

What is the right mix between stocks and bonds?

Currently I like risk assets here (see Sunday’s [TGFFT-Report](#)). There is upside for stocks. Am I concerned that people are selling stocks to buy bonds? Sure, but will that help any squeeze? Definitely.

So, I’d be overweight risk assets here (more stocks than credit).

Within bonds, what is the right mix between credit risk and rate risk?

I’m comfortable with credit risk. I’d be overweight credit risk (particularly IG corporates and senior tranches of CLO risk) relative to Treasuries. If you lean towards high yield, leveraged loans, CMBS, or junior tranches of CLOs, then I’d count that against my equity allocation (as there is a risky element that will correlate well with equities).

So that leaves me with a smaller than normal weighting on rate risk.

Within rate risk, where on the curve do you want to be?

Now this is a trickier question and I could easily see over-allocating (even significantly over-allocating) to the 2-year.

For the moment, let’s move to the 3-year, because there are 3, 7, and 10 year “on the run” Treasuries.

Today, the 3-year yields 4.7% (not as “fun” as 5%, but it has a bit more duration). The 7-year is at 4.2% and the 10-year is at 4%.

The 7-year bond, 3 years forward, is at 3.6%.

So if you buy the 3-year bond today, the 7-year bond in 3 years (when this 3-year matures) would need to be 3.6% to match the total return of just investing in the 10-year bond today.

Buy a 3-year bond today. In 3 years, re-invest those proceeds in a 7-year bond instead of buying a 10-year bond today.

Do you think the 7-year bond, in 3 years, will be lower than today’s 7-year bond by about 0.6%?

Would the longer-term/stable rate for Fed Funds be around 3% or so? If they get inflation under control, why not? If inflation runs at 2% at some point in the next few years, then a 1% real rate gets us to 3% without any sort of term premium.

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Right now, even with the inversion of 110 bps between 2s and 10s, I prefer the duration.

Yes, a flatter yield curve would be nicer. I do think that the curve should be less inverted.

I'd run a shorter duration portfolio than normal, but I would NOT be 100% in the 2-year. With so many wildcards out there, many of them Geopolitical (see our [Geopolitical Summit West Summary](#)), I'm not completely afraid of owning some duration.

Funding Cost and The Great Financial Crisis

I will never forget that in the early days of the Financial Crisis, a bunch of attempts were made by policy makers to make it easier and cheaper to fund mortgage backed bonds (MBS squared, ABX, etc., all the stuff of "The Big Short" fame). Every announcement led to a pop in asset prices, but that was quickly faded because **it doesn't matter if I'm saving 2% per annum on funding a position that is leveraged and dropping 1% a day!**

Today's argument is a bit of a corollary to that, but funding, yields, and carry aren't the most important factors. Returns drive everything!

Just like lower yields couldn't avert the MBS mess, I don't think that higher yields can completely stop markets. **I will be bearish on risk again, but I'm not right now and the fear of people selling stocks to buy the 2-year is not high on my list of bearish worries.**

Bottom Line

The 2-year Treasury above 5% makes for some great headlines and it is an easy point for the nightly news to focus on. **5% has some appeal, but it is a bearish trade, and I'm not that bearish right now!**

Does it impact how I position my portfolio? Yes, but only at the margins. It is not a panacea.

Maybe it will turn out to be the "right" trade, but this is setting all of my contrarian alarm bells off and is another reason why I'm comfortable being long risk here (and hoping for another leg higher) as people get forced into the market. And yes, while I might be buying the 2-year at 4.75% in a week with stocks down 5% and my tail between my legs, this is the positioning that I'm most comfortable with right now.

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