SK Market Insights

Market Insights - Issue 3 | 2023

The Inconvenient truth about Interest Rates

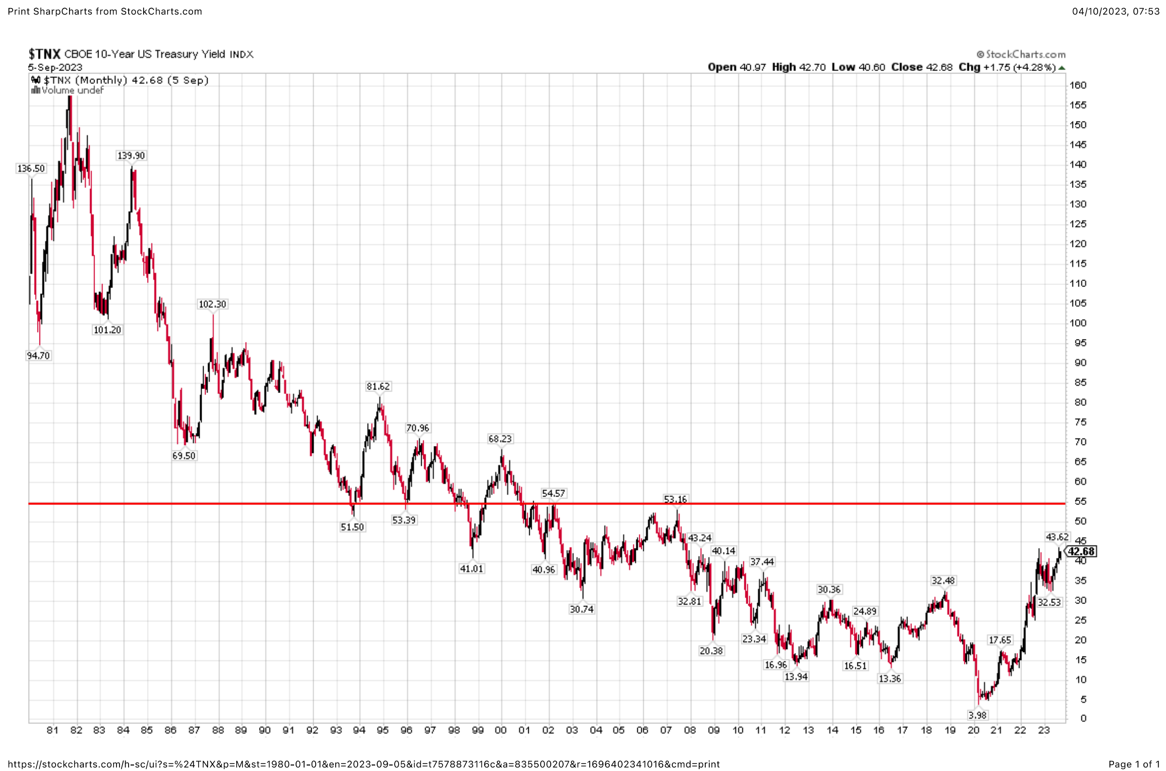
▼ Summary

- **The benchmark US 10 yr. Treasury yields recorded a high at 4.8% this week, a level not seen since the Lehman crisis.**
- **Equity markets are coming to terms with higher for longer interest rates, a paradigm shift from an earlier narrative that inflation was "transitory".**
- **The underlying causes are manyfold and have been well debated in the media.**
- **Purpose of this note is to bring out, through technical analysis, what lies ahead for interest rates in the near term, particularly the 10-year yields.**

▼ Navigating the Global Interest Rate Shift

Starting with the long-term monthly chart of US 10-year treasury yields going back to 1980, shown in Figure 1, the downward trajectory since 1980 took an abrupt turn in 2020 with the onset of COVID, disruption of supply chains and the onset of Ukraine war, among others. A structural change in interest rates had occurred globally. Suddenly, zero and negative interest rates in the West had become a thing of the past with the bond market signaling a reversal in trend.

Figure 1: Monthly chart of 10-year US Treasury yields with key level of support and resistance



Source: SK Market Insights, StockCharts.com

▼ Yields are trending higher targeting 5.5 – 5.7% in the next few months but a corrective phase is likely sometime in late 2024

To determine if this change is permanent and where interest rates are headed from here, we take a closer look at the post 2020 period shown in the monthly chart of 10yr UST yields in Figure 2.

Yields have trended up, marked by higher highs and higher lows. Applying Elliot Wave Analysis, which is based on Fibonacci retracements, to this chart, **we see yields moving higher** in a sequence of five wave impulse moves marked by the Roman numerals I-II-II-IV-V. At the present time we are on wave V of this sequence with a **projected target of 5.5 - 5.7% in the next few months**. This theory postulates that an impulse wave sequence is followed by a corrective wave sequence that retraces 38-62% of the entire up move. A minimum **38% retracement could take us to a potential target of 3.5-3.6% sometime in late 2024**.

The fifth wave target of 5.5-5.6% in Figure 2 matches up well with a level that had served as support in 1994 and 1996 and resistance in 2002 and 2008 shown in Figure 1 and serves as a confirmation of the EW analysis.

Figure 2: US 10yr Treasury yields are moving higher in a sequence of five wave impulse moves (shown in blue)

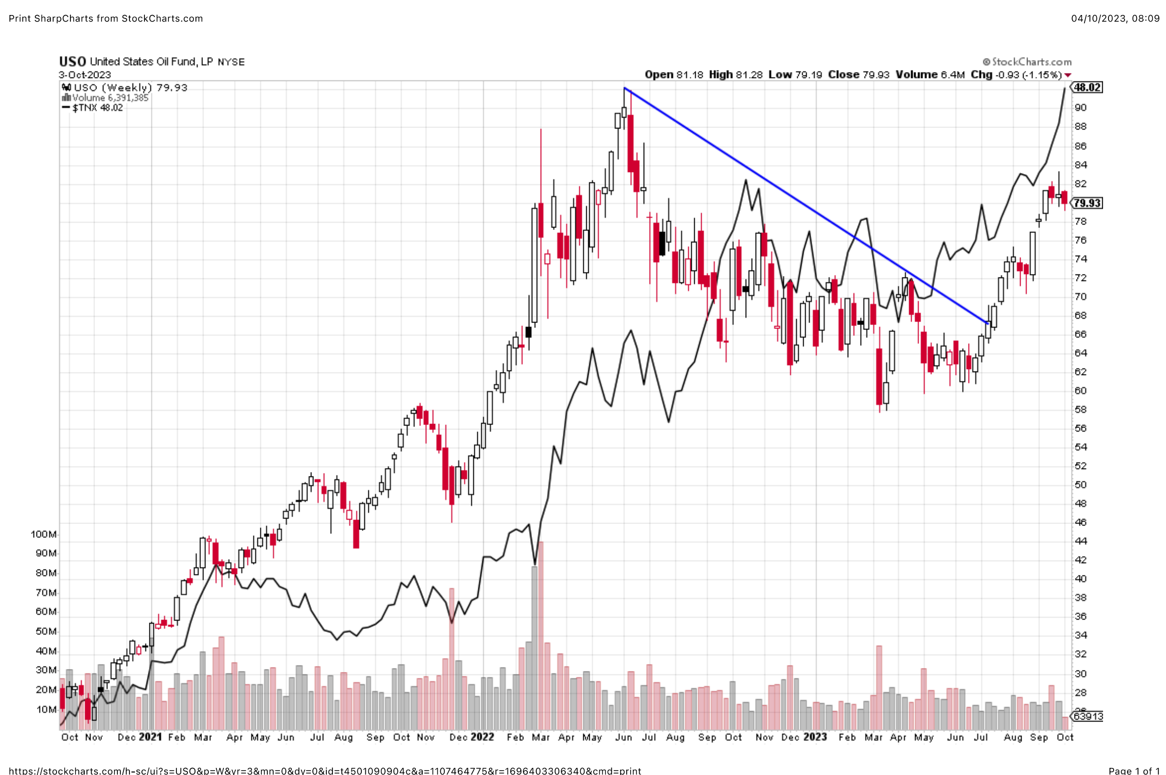
Source: SK Market Insights, StockCharts.com

▼ Oil Prices are driving the rise in 10-Year yields making it unlikely a correction will occur until oil prices turnaround

Many factors influence the increase in 10-year yields, however, one notable actor is energy or oil prices. Oil prices are usually driven by supply/demand balances, however, in a tight supply situation as we have currently, demand takes the front seat and can be a proxy for growth. The US economy has shown remarkable resilience in the face of rising interest rates and this growth is now reflected in higher oil demand and hence prices. Shown in Figure 3 is the ETF USO (proxy for oil) along with the 10-year Treasury yields (black line). Oil prices recorded a high in June 2022 and corrected through till June 2023 when the long-term downtrend

was broken and prices moved higher. As if on cue, the 10-year yields started their ascent in June 2023. **Any correction in 10-year yields would most likely have to await a turnaround in oil prices**. This could happen as oil prices move higher towards $100/bbl. adversely affecting global demand. History has shown that under these circumstances oil importing nations resort to alternate sources. Alternatively, a slowdown in economic growth resulting in a soft landing or recession and could bring down oil prices.

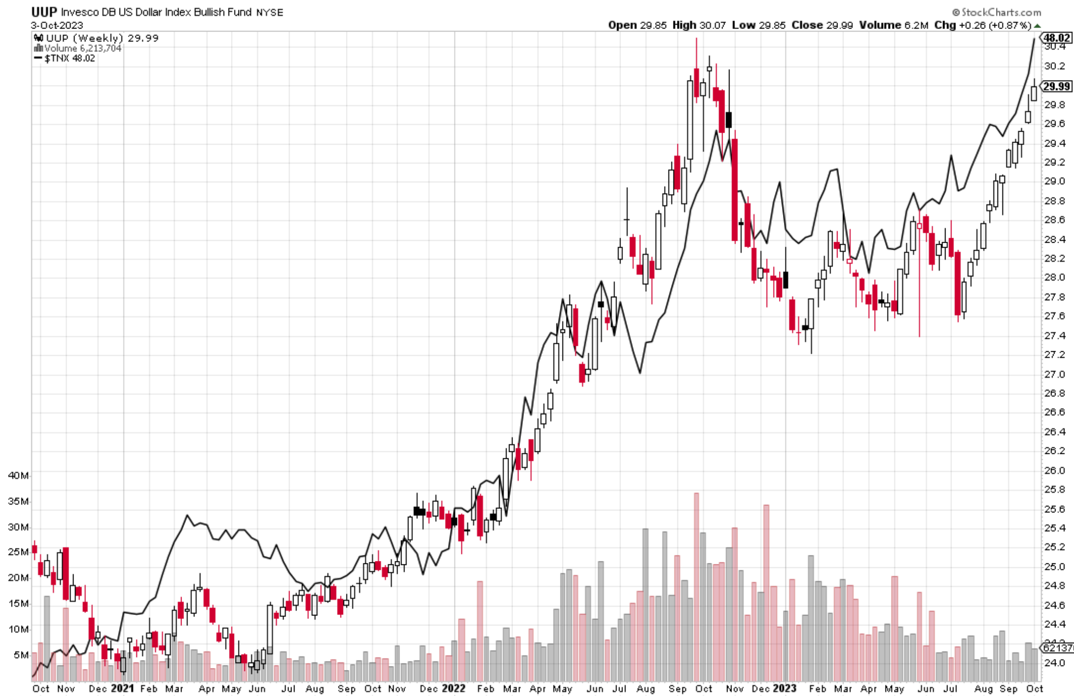
Figure 3: The rise in oil prices is seen as a driver of higher US10 Year rates



Source: SK Market Insights, StockCharts.com

The strengthening of the USD is usually based on interest rate differentials between the US and the developed world. With the Federal Reserve being the first mover in raising rates, **the USD has been a prime beneficiary of higher US 10-year yields**. Shown below (Figure 4) is a chart of the ETF UUP which captures the USD price movement overlaid with the 10-year yield in the background as a dark line.

Figure 4: The US Dollar has benefitted from higher bond yields



Source: SK Market Insights, StockCharts.com

▼ Higher interest rates could be here to stay with USD benefitting while Equities, commodities and EM adversely affected

A rising dollar benefits US imports but adversely affects exports as well as overseas operations of international companies. It is perhaps a reason that equity markets are starting to see a selloff in the recent past. **Higher interest rates are less of a hurdle for large multinationals** who are better prepared to handle it. Mid-to-small caps are more likely to be adversely affected by higher rates and hence borrowing costs. However, they are insulated from the strong dollar as their earnings are mostly from domestic sales.

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▼ Conclusions

In summary, **a paradigm shift has occurred in the benchmark US 10-year Treasury yields** wherein a 40+year downtrend since 1980 is seen undergoing a reversal. Several fundamental factors have contributed to this sea change, and we could be shifting to a new normal in interest rates. The impulsive nature of this shift in 2020, as seen through EW analysis, is further confirmation of this change. Impulse moves usually occur in the direction of the primary trend. **Higher interest rates could therefore be here to stay** and the US **Federal Reserve could face a tough battle to achieve its target of 2% inflation**.

Current analysis of the monthly chart of 10-year yields points to a likely target of 5.5% by year end before settling down to lower levels around 3.5% by end 2024. Yields in the longer term could very well move sideways to higher as nations come to grips with the new paradigm. The **immediate beneficiary of higher interest rates is the USD. Equities, commodities, and emerging markets are likely to be adversely affected** by higher rates in the near term. Small cap US equities are less impacted by the strong USD. US Treasuries continue to remain a safe haven in the current environment.

For further details or clarification feel free to contact me.

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Oct 6, 2023
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Sowmi is a Chartered Market Technician (CMT)and a member of the CMT Association, N.Y., U.S.A.; as well as an Associate Member of the Society for Technical Analysts, U.K. After completing a 35 year career with Mobil/ExxonMobil in a variety of roles in the across U. S. A., Asia Pacific and Europe, including an 8 year stint in a number of oil trading roles for Mobil in Asia Pacific, he has decided to embark on a new career in technical analysis, leveraging on his prior experience. In addition to his CMT, Sowmi has a Ph. D in Chemical Engineering and an M. B. A. in Finance. He is an avid sports enthusiast and has a keen interest in golf.

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