US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

How High Long Rates Go Depends on The Fed

The yield on the 10-year treasury note has pushed up through 4%, causing investors to worry about new highs in government bond rates. Last fall, the 10-year yield rose to 4.24%. The recent increase has been dramatic given the fact that 10-year notes were yielding just 3.37% in the middle of January compared to 4.08% at present. **To know where yields are going from here, investors need to know what caused yields to rise over the past six weeks**. It is a bit more complicated than simply elevated inflation readings.

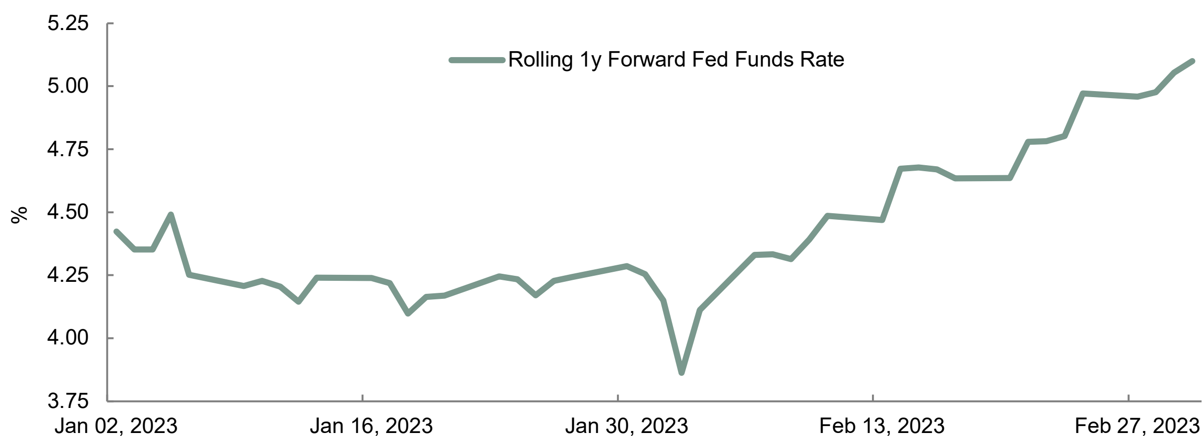
Our statistical modeling efforts have found that the expected terminal fed funds rate coupled with the 10-year breakeven inflation rate explains approximately 90% of the movement in 10-year treasury notes. See “Whither Long-term Interest Rates?” February 16, 2023. Since the January 2023 low in 10-year yields, the rolling one-year forward fed funds contract has increased about 100 basis points (bps). In fact, the March 2024 fed funds contract is yielding 5.09% versus 4.10% on January 18th. Consequently, **the entire 71 bp increase in 10-year yields is more than explained by bond market expectations of a higher terminal rate**. What about inflation?

Granted some of the increase in projected fed funds is indirectly related to inflation, which is why Fed rhetoric has been so hawkish. Policymakers have successfully jawboned the fed funds market higher. The 10-year breakeven rate of inflation has risen 36 bps from its January low. Still, **at 2.47% currently, the implied PCE deflator is just a smidgeon above 2%, which implies price stability**. Essentially, the bond market continues to believe that long-term inflation is anchored. This explains why the yield curve has inverted further. The Fed is going to tighten more against contained inflation expectations.

Therefore, if our simple model holds, the path of 10-year notes will continue to be determined by expectations of the terminal rate. But since the yield curve is already inverted, the rise in peak fed funds will not have a one for one relationship to 10-year yields. As we wrote last week, **to push 10s through 4.24% and higher, the terminal funds rate must rise well above 6%**. We calculated 6.5% to be exact.

But at 6.5% fed funds, recession risks would massively intensify. In fact, a downturn would be almost guaranteed in our view. After all, the latest increase in 10-year yields has already pushed mortgage applications back down to a near 27-year low. Residential housing, historically an excellent leading barometer of the economy, is in recession. A meaningful rise in bond rates from here may be difficult. Bond bears beware.

Rising Long Rates Are Due to Shifting Expectations on the Fed



Sources: Bloomberg, FRB, Haver, SMBC Nikko

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