

US Macroeconomics

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Technical Factors Pushing Long-term Rates Higher

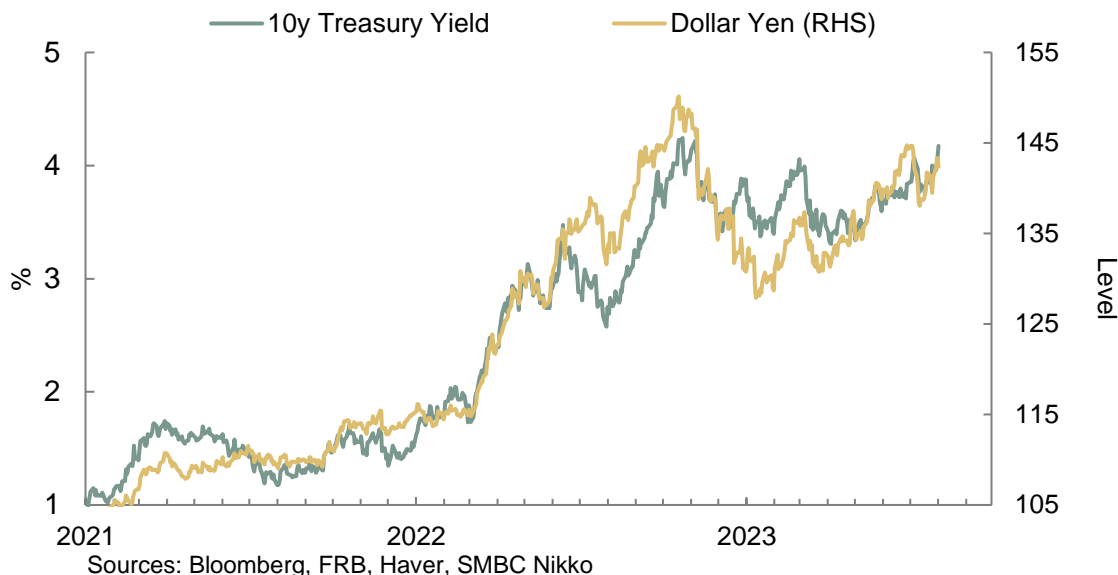
On July 10th we wrote that the sell-off in 10-year Treasury notes could be overdone because their 4.0% yield at the time was inconsistent with economic fundamentals. While yields did soon fall to an intra-month closing low of 3.75% on July 19th, they have since risen to a statistically significant 4.18%.

Our work shows that just two components explain 90% of long-term nominal yields — one is the projected change in the fed funds rate over the next 12 months and the other is the 10-year breakeven inflation rate. The model also has a standard error of 20 basis points (bps). **Fundamental current fair value on 10-year notes is estimated at 3.80%** with a confidence interval between 3.6% to 4.0%.

Over the past several weeks, the yield on 10-year breakeven inflation has risen from 2.23% to 2.38% or 15 bps. Since nominal yields tend to move one-for-one with Treasury inflation-indexed protected series, the former should only have risen to 3.90% and not well above 4%. Meanwhile, expectations of the one year ahead fed funds rate have declined slightly over this time, down 4 bps to 4.67%. Hence, nearly 30 bps of the recent increase in interest rates is unaccounted for. What could be the reason?

Two factors are likely behind the increase. One is Bank of Japan (BOJ) policy. The BOJ did not adjust yield curve control as much as some investors had anticipated. In turn, the yen has weakened over the past few weeks from around 139 to 143. **A weaker currency could induce Japanese-related selling of Treasuries** if there is desire to limit the pace of yen depreciation (i.e., the proceeds from Treasury selling are used to buy the yen). The high correlation between the yen and 10-year notes is shown in the chart below.

The other factor is massive Treasury supply. Earlier this week, **US debt managers announced second half net marketable borrowing needs of nearly \$2 trillion**. Excluding the pandemic, this is a record large amount. And the Fed is no longer a net buyer (QE) of debt but rather a net seller (QT) of debt. Worsening government finances were a factor behind Fitch Ratings' decision to downgrade Treasuries. This also has weighed on sentiment. The bottom line is that until there are more noticeable signs of economic slowing, these two technical factors are likely to continue to dominate the Treasury market. This means that yields can continue to move in a direction that is inconsistent with underlying economic fundamentals.



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