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PICTET WEALTH MANAGEMENT

US Treasuries - Update

Yields could drop from current levels, but remain structurally higher than in the past

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FLASH NOTE

SUMMARY

- The 10-year US Treasury yield rose from a low of 3.31% on 6 April to a high of 4.34% on 21 August, the highest level since 2007, primarily driven by higher real yields. This reflected, in part, more resilient-than-expected US economic activity, which opened the door for higher-for-longer US Federal Reserve (Fed) policy rates. The downgrade of the US's credit rating by Fitch at the start of August against the backdrop of a surge in the federal government's deficit as well as the Bank of Japan's (BoJ) tweak of yield curve control around the same time likely also contributed to the increase in long-term US yields.
- The term premium is a key component in any assessment of the future direction of the 10-year Treasury yield. A number of factors are likely driving the extra yield that investors are demanding for holding longer-dated US debt. These include the uncertainty surrounding the country's fiscal trajectory as a growing budget deficit could lead to ever-increasing Treasury supply. Greater macroeconomic volatility could also drive the term premium higher.
- Both the postponement of our call for a US recession to H1 2024 and the probability of a structural increase in the term premium lie behind our decision to raise our year-end forecast for the 10-year Treasury yield from 3.5% to 4%, which is still lower than the 4.26% at which it is trading currently (as of 8 September). There is a chance the 10-year yield ends lower than this if recession fears take hold in the market sooner than we expect. It is against this backdrop that we remain overweight US Treasuries.

TREASURY YIELDS SURGED OVER THE SUMMER

Bond market volatility has receded from the heights reached in March in response to the failure of several regional banks in the US. The 10-year US Treasury yield rose from a low of 3.31% on 6 April to a high of 4.34% on 21 August, the highest level

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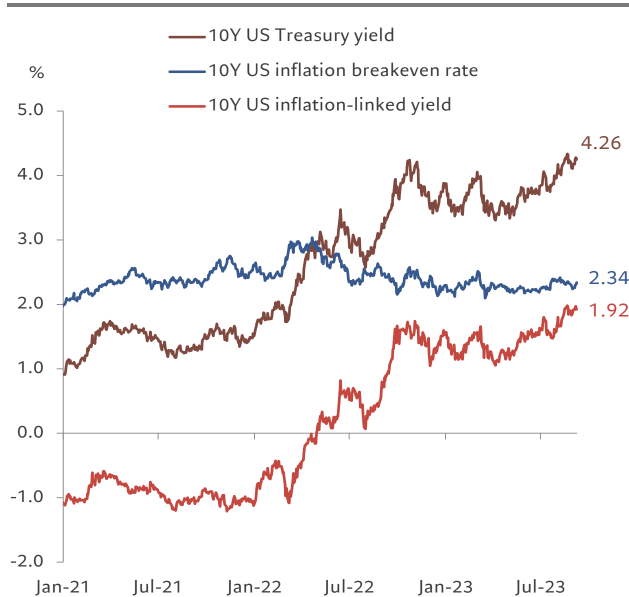
since 2007. The rise was primarily driven by higher real yields (*see chart 1*), reflecting more resilient-than-expected US economic activity (*see chart 2*), which suggested that Fed policy rates could remain persistently high. Indeed, the US consumer is holding up remarkably well for now, as shown by solid consumption numbers in H1.

Along with positive economic surprises, Fitch's downgrade of the US's public debt rating from AAA to AA+ on 1 August put upward pressure on the 10-year yield. The ratings downgrade was in part due to deteriorating US government debt dynamics and the expanded debt issuance announced by the US Treasury Department to fund the growing US deficit.

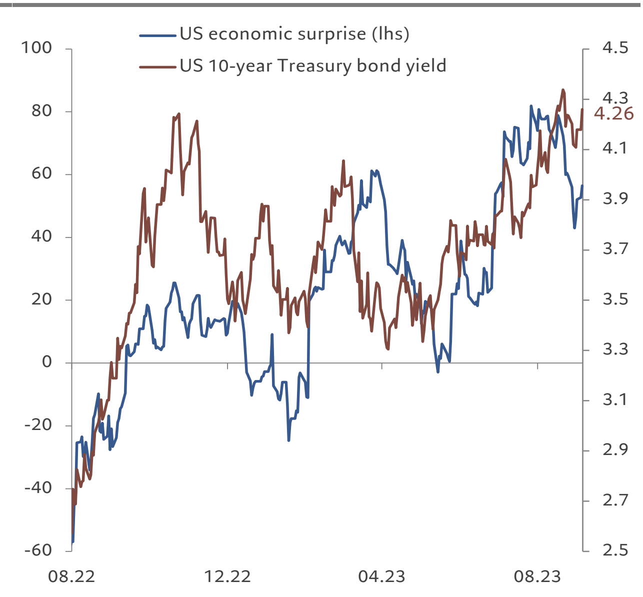
Another factor that maintained upward pressure on the US 10-year yield during the summer was the Bank of Japan's (BoJ) decision to further tweak yield curve control, which caught investors by surprise. Creating a degree of ambiguity about its intentions, the BoJ widened the previous +/- 50bps trading band for the 10-year Japanese government bond (JGB) yield, to +/- 100 bps in effect raising the hard yield cap to 1.0%. This decision could prompt Japanese investors to shift out of global markets and back to domestic bonds if yields in Japan continue to increase, as the 10-year JGB yield has already risen since the beginning of the year (by 24 bps, to 0.66% at time of writing).

Chart 1: 10-year US Treasury yield, breakdown between inflation-linked and breakeven



Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 08.09.2023

Chart 2: 10-year US Treasury yield vs. Citigroup's Economic Surprise Index



Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 08.09.2023

TERM PREMIUM AS A DRIVER OF US TREASURY YIELDS

On 31 July, the US Treasury Department released surprisingly elevated borrowing estimates for the coming quarters due to falling revenues and increasing outlays. The rising gap between spending and revenues led to a significant US deficit at USD1.8 trn in Q2 2023 The Congressional Budget Office (CBO) projects the deficit to increase further in the coming years. The fall in government receipts was partly

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due to delayed tax collection in California, reduced wealth and income taxes on financial assets due to poor market performance in 2022 and decreasing Fed's remittances.

Moreover, the US Treasury Department announced its intention to rebuild its cash balance to USD750 bn by the end of the year. It therefore revised up its expected net issuance for Q3 2023 to USD1.01 trn and announced a further USD852 bn of net issuance for Q4 (considering the Fed's System Open Market Account (SOMA) redemptions). Although most of this will still be financed by US Treasury Bills, US Treasury Notes and Bonds issuance was also set to expand.

The erosion of US public debt governance was also cited by Fitch as contributing to its decision to downgrade its rating of US sovereign debt. Repeated political cliffhangers involving the US debt ceiling have eroded confidence in fiscal management. Increased political polarisation in the US makes it difficult to find common ground on important fiscal matters.

The rise in Treasury yields is already having a painful effect on US government coffers. The rapid increase in interest payments, which reached a record high of USD970 bn in Q2 (*see chart 3*), representing 3.6% of GDP, has raised further concerns on how the government will cope with higher-for-longer interest rates. At 15% of total federal expenditures, the burden of interest payments has reached a level not seen for over 20 years.

In addition, recent estimates suggest that, instead of reducing the US deficit, as previously forecasted by the US Congressional Budget Office (CBO), the Inflation Reduction Act (IRA)[1] could have a neutral or negative impact on the federal budget. This is because the US government may have underestimated the demand for tax credits related to electric vehicles and advanced manufacturing, among other things.

Uncertainties surrounding the US fiscal trajectory have spread to investors, and likely pushed up the US 10-year Treasury term premium (the compensation that investors require for bearing the risk of holding longer-term bonds over short-term ones). Due to the rising US Federal government deficit and the related increase in Treasuries issuance, investors seem to be demanding a higher risk premium to absorb the additional net supply. According to the Adrian, Crump & Moench model[2], the term premium on the 10-year US Treasury yield has become less negative since the end of July, moving from -80 bps (on 28 July) to -24 bp on (6 September). But beyond increased supply, there are other factors to consider.

Macroeconomic uncertainty seems to be another important factor driving changes of the term premium (*see chart 4*). Considering today's resilient economy, macro uncertainty may recede temporarily as the disinflation process continues and the fears of an immediate recession diminish. However, data could start to deteriorate ahead of the recession we expect in H1 2024, increasing macroeconomic volatility. This, combined with investors' demands for a higher compensation for rising Treasury issuance, could lead to a structurally higher term premium and hence higher long-term yields even beyond this year.

[1] https://www.crfb.org/blogs/ira-energy-provisions-could-cost-two-thirds-more-originally-estimated

[2] Term premium based on Adrian, Crump & Moench model (2013): https://www.newyorkfed.org/research/data_indicators/term-premia-tabs#/overview

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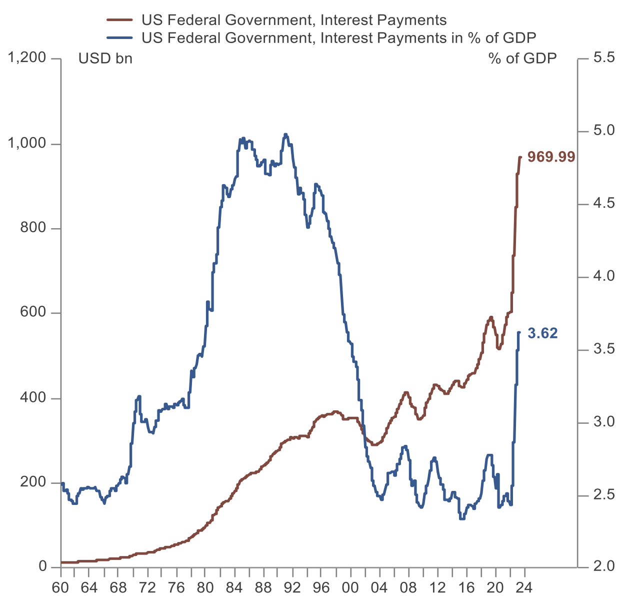
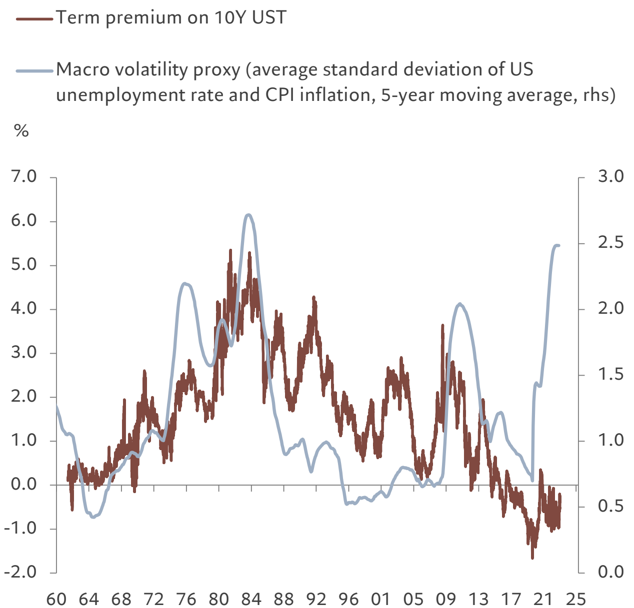
Chart 3: US Federal government interest debt payments



Source: Pictet Wealth Management, FactSet, as of 08.09.2023

Chart 4: 10-year US Treasury term premium[1] vs. macro volatility



Source: Pictet Wealth Management, Bloomberg finance L.P., as of 06.09.2023

MACRO UNCERTAINTY IS THE MAIN RISK TO OUR FORECAST

The US economy has proved remarkably resistant to the Fed's rate-hiking cycle so far and lags in monetary policy transmission to the real economy seem to be taking longer than in previous cycles. We are now expecting the US economy to decelerate in Q4 (rather than Q3) and to tip into a shallow contraction in H1 2024. Hence, we have raised our real US GDP growth forecast for 2023 to 2.1% from 1.6%. Due to our expectations for negative growth in H1, along with decelerating inflation, we expect the Fed to start cutting policy rates at the end of Q2 2024, with a total of 150bps of cuts in the Fed funds rate by the end of next year. This compares to the 90 bps of cuts currently being priced in by the Fed funds futures market (on 8 September).

Both the postponement of the US recession from H2 this year to H1 next year in our scenario as well as the likelihood of a structural increase in the term premium lie behind our decision to raise our year-end forecast for the 10-year US Treasury yield from 3.5% to 4%. But the 10-year yield could end the year lower if recession fears take hold in the market sooner than we expect. It is against this backdrop that we remain overweight US Treasuries.

On the fiscal front, talks over the federal budget for 2024 could lead to a government shutdown if no agreement is reached by 1 October 2023, bringing the erosion of fiscal governance in the US back into focus. In the medium term, our scenario may also be challenged by the US's fiscal trajectory, especially as the 2024 presidential and congressional elections approach. Future budgetary policy, and hence the supply of Treasuries, will largely depend on the outcome of these elections.

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