PICTET WEALTH MANAGEMENT
CIO OFFICE & MACRO RESEARCH
30 June 2022

US TREASURIES UPDATE

YIELDS STILL LIKELY TO HEAD LOWER

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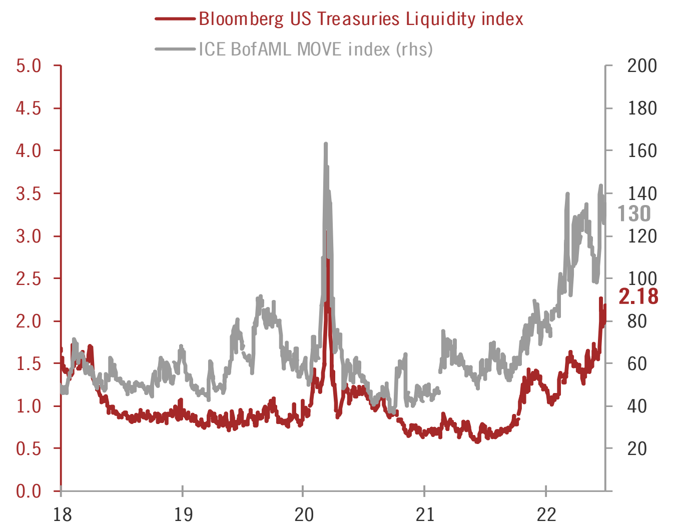
SUMMARY

- The 10-year US Treasury yield remains highly volatile, but it has fallen recently from a peak of 3.47% in mid-June to 3.09% on 29 June against a backdrop of a US Federal Reserve (Fed) that remains very hawkish.
- Judging by policy-rate futures, market participants expect the Fed to hike rates to 3.6% in 2023 and then cut them as they start pricing in the risk of a US recession. However, we believe the Fed's terminal rate will be closer to 3% and expect a mild recession in the US next year, so in our central scenario, to which we assign a 55% probability, we still expect the 10-year yield to fall to 2.6% by the end of the year.
- Nevertheless, we expect the Fed's communications to remain very hawkish until US inflation shows clear signs of falling. This means the 10-year US yield could remain within a volatile 3.0-to-3.6% range for some time. As the Fed's terminal rate is usually a good anchor for the 10-year yield in a hiking cycle, the latter is likely to keep moving in line with market participants' expectations for the policy rate path.
- Given the uncertainty about the resilience of the US economy and the high volatility of Treasury yields, we can envisage two alternative scenarios. Both involve the Fed hiking to 3.8% by early 2023, as signalled in the dot plot. In the upside scenario, the 10-year yield would reach a level of 4.0% by the end of 2022 if the business cycle holds up; we assign a 35% probability to this scenario. In the downside scenario, which we believe has a probability of 15%, we see it slumping to 2.4% if the US recession is severe and involves major turmoil in the financial markets.

CHART 1: US TREASURY LIQUIDITY AND VOLATILITY INDICES



Source: Pictet's wealth management division - CIO Office & Macro Research, Bloomberg Finance L.P., 29.06.2022

CHART 2: US 10-YEAR TREASURY YIELD WITH YEAR-END FORECASTS

Source: Pictet's wealth management division – CIO Office & Macro Research, Bloomberg Finance L.P., 29.06.2022

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Choppy conditions in the Treasury markets

US Treasury markets have been highly volatile since the beginning of the year, with liquidity having dried up (*see chart 1*). Although the Fed's decisions to taper its US Treasury purchases, and since June let part of its holdings mature without reinvesting them, has probably accentuated this phenomenon, **the high degree of uncertainty about the Fed's future rate path is also likely to be partly to blame**, in our view. As highlighted by the sudden decision to hike the Fed funds rate by 75 bps in June instead of 50 bps as had been previously signalled by Fed Chairman Jerome Powell, the Fed's forward guidance is currently in limbo. The Fed's new dependence on incoming inflation data is leaving market participants in the dark with regard to its terminal policy rate.

The Fed's terminal rate is usually a good anchor for the 10-year US Treasury yield in a hiking cycle, so the 10-year yield is likely to keep shifting in line with market expectations for the Fed funds rate. Judging by policy-rate futures since mid-June, market participants have revised their expectation for the peak in the Fed funds rate in 2023 from 4.0% to 3.6% (*see chart 3*). As they start pricing in the risk of recession, they are now expecting the Fed to cut rates in H2 2023. This explains why the 10-year US Treasury yield has fallen to 3.09% as of 29 June after peaking at 3.47% on 14 June, the day before the Fed's surprise 75 bps hike (*see chart 2*).

We expect the Fed's communications to remain very hawkish until US inflation shows clear signs of falling. **This means the 10-year US yield could remain within a high and volatile 3.0-to-3.6% range for some time.** Nevertheless, because we expect a mild recession in the US next year and expect the Fed to pause its hiking cycle after rates reach 3%, in our central scenario, to which we assign a 55% probability, **we still expect the 10-year US Treasury yield to fall to 2.6% by the end of the year**. This would mean the 10-to-two-year and 10-to-three-month parts of the US yield curve invert over the coming months as the market prices in a recession.

Yields likely to fall

Underpinning this scenario of a lower 10-year yield is the fact that 2.6% is close to the Fed's projected longer-run level for the Fed funds rate of 2.5%, usually referred to as the neutral rate (*see chart 4*). This is the rate level at which the economy is able to function at full employment, but with stable inflation close to 2%. Long-term market-based inflation expectations have fallen recently, with the US 10-year inflation breakeven rate down from 3.0% in April to 2.39% (on 29 June, *see chart 2*). This has happened at a time that the oil price has remained elevated (USD110 per barrel on 29 June) and the US Consumer Price Index high (8.6% in May) and still rising.

Coupled with the fall in the price of copper (a good leading indicator of economic activity) since April, **it seems that economic growth is slowing down, which, according to market participants' expectations, should in turn moderate inflationary pressures over the longer run.** For this reason, we expect the inflation breakeven rate to fall further to 2.2% by the end of the year, while a recession and a pause in the Fed's hiking cycle are likely to push real yields slightly down from 0.69% on 29 June towards 0.4% in our central scenario.

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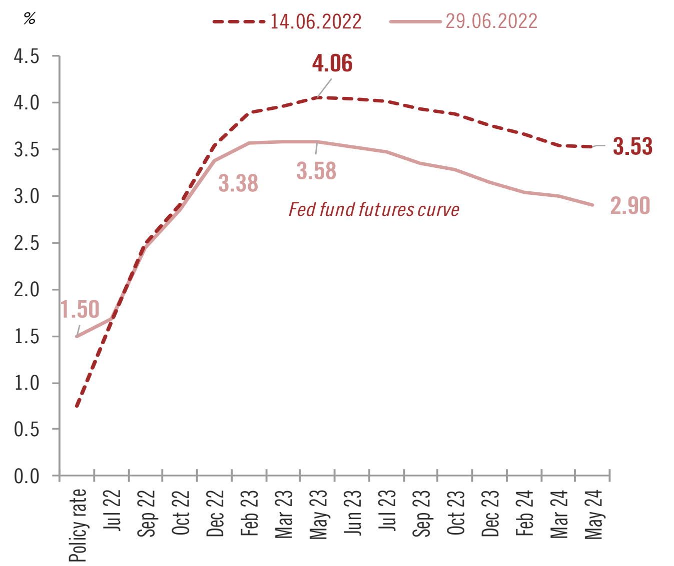
CHART 3: US POLICY RATE CURVES FUTURES PRICING



Source: Pictet's wealth management division - CIO Office & MR, Bloomberg Finance L.P., 29.06.2022

CHART 4: US TREASURY YIELD AND FED'S TERMINAL RATE

Source: Pictet's wealth management division - CIO Office & MR, Bloomberg Finance L.P., 29.06.2022

Given the uncertainty about the resilience of the US economy and the high volatility of US Treasury yields, we can envisage two alternative scenarios. In both, **we see the Fed hiking to 3.8%**, the high point signalled in the dot plot and a level slightly above current market expectations, by early 2023.

In our **upside scenario**, to which we assign a 35% probability, **the 10-year US Treasury yield would reach a level of 4.0% by the end of the year if the business cycle holds up.** In this scenario the resilience of the US consumer and households' and companies' large cash balances would enable the US economy to keep growing despite tighter financial conditions.

In our **downside scenario**, to which we assign a 15% probability, **the 10-year yield would fall drastically below the Fed funds rate to 2.4% if the US recession is severe and involves major turmoil in the financial markets**. This could send US high-yield corporate bond spreads shooting up to 1000 bps, a level considered as distressed. In this scenario, the US yield curve would invert significantly as investors would be likely to pile into long-dated US Treasuries due to their safe-haven status. In such a scenario we could envisage market participants expecting not only rate cuts from the Fed, but potentially also a resumption of quantitative easing.

For now, **we remain neutral in US Treasuries**, as even though we expect the 10-year yield to fall towards 2.6% by the end of the year, it is likely to remain above 3% and volatile until US inflation falls. **There is a greater probability that our upside scenario for rates is realised than our downside one**.

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