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US TREASURY YIELD - UPDATE

A BUMPY RIDE AHEAD

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SUMMARY

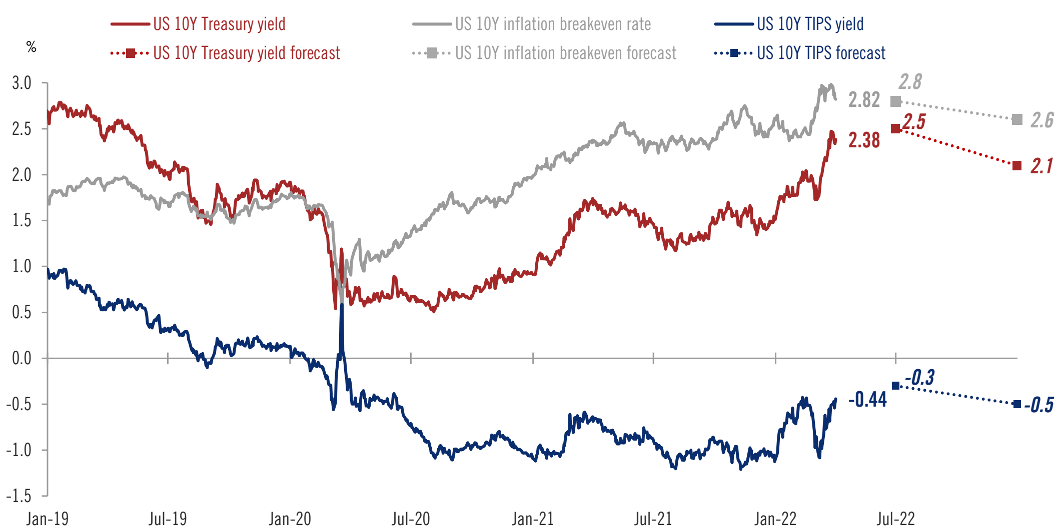
› While it rallied in the aftermath of Russia's invasion of Ukraine, hawkish communications from the US Federal Reserve (Fed) mean that the 10-year US Treasury yield is still considerably higher than at the start of the year, while the US 10-to-two-year yield curve has inverted.

› Our central scenario (to which we assign a 55% probability) is for the Fed to hike rates gradually, albeit with a one-off 50 bps hike in May, and then to pause in H2 as inflation falls and US economic growth slows down. This could lead to the 10-year US Treasury yield falling from 2.38% on 1 April to 2.1% by the end of the year. In the short term, however, the 10-year Treasury yield could hover around 2.5% as the Fed threatens to hike rates by 50 bps several times and growth data remains solid.

› In our alternative, more positive, scenario (20% probability), US economic growth could remain robust, leading to a stronger rise of the 10-year US Treasury yield to 2.5% by the end of the year. In our negative scenario (25% probability), we see it falling to 1.9% in response to a sharp slowdown in economic growth.

› We maintain our neutral stance on US Treasuries despite the sharp recent increase in yields as we expect yields to fall back in H2. Despite the considerable uncertainty about the lagged economic effects of higher yields, we still see US Treasuries as good (albeit costly) protection in the event of economic growth slowing down.

CHART 1: US 10-YEAR TREASURY YIELD AND FORECASTS



Source: PWM - AA&MR, Factset, 01.04.2022

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A wild ride

The 10-year US Treasury yield has swung wildly since the beginning of the year. **Although its 87 bps rise to 2.38% between the beginning of 2022 and 1 April led to its worst quarterly performance since 1973** (at -5.6%, as measured by the Bloomberg US Treasury Index), it has not been increasing in a straight line. The Fed's hawkish shift since late last year contributed to Treasury yields rising in the first few weeks of this year, but Russia's invasion of Ukraine on 24 February led to risky assets selling off and the 10-year yield falling to 1.73% by 1 March.

However, market expectations that surging energy prices in the wake of the war would translate into higher inflation and even tighter monetary policy quickly led to the 10-year yield rebounding to above 2%. What's more, **Fed Chairman Jerome Powell's hints of a 50-bps hike at the May Federal Open Market Committee (FOMC) meeting resulted in it spiking to 2.47% on Friday 25 March, having surged by 30 bps over the week**. Market participants' expectations of quicker Fed rate hikes mean that Fed funds futures are now pricing in further rate hikes of 217 bps by the end of the year, with a 50-bps hike in May almost fully priced in as of 1 April (*see chart 2*).

Ongoing supply-chain disruptions, rising housing prices and the energy-price shock due to the invasion of Ukraine have contributed to US headline inflation's continued rise, with a print of 7.9% in February. Although the Fed's favoured measure of inflation, the core Personal Consumption Expenditures (PCE) index, is lower at 5.4% and less likely to be impacted by surging energy prices, it has still been above the Fed's 2% target for several months. High inflation, coupled with market expectations that the war in Ukraine will see it rise further in the short term (the US one-year inflation swap rate was up 60 bps since the invasion to 5.31% as of 1 April), has seemingly reinforced the Fed's resolve to accelerate the pace of monetary tightening.

Taking into account the Fed's change of tone, **our US economist has revised his expectations for Fed rate hikes**. **He now predicts a 50 bps hike in May instead of 25 bps**, but after further 25 bps hikes in June and July **he still expects the Fed to pause in response to weakening US economic growth and softening inflationary pressures**. However, he believes that risks are tilted towards further hikes, especially if US wage growth continues to accelerate, as this could fuel a wage-price spiral (see Fed looks to accelerate policy tightening).

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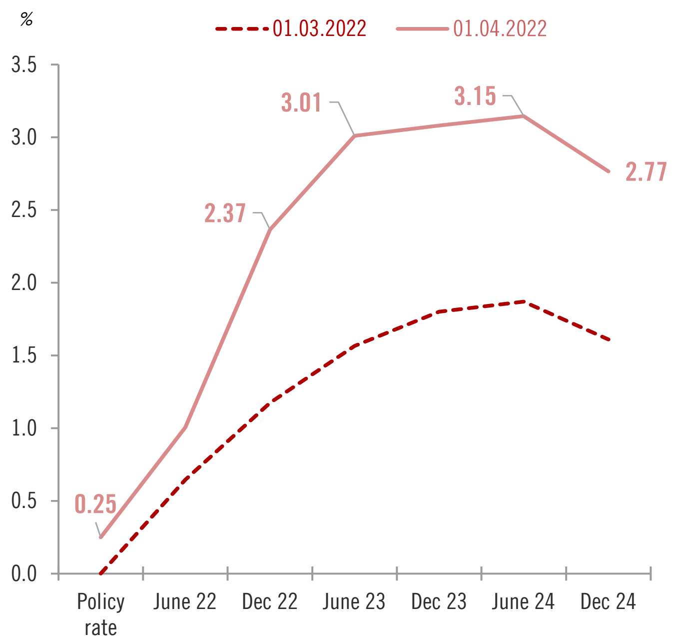
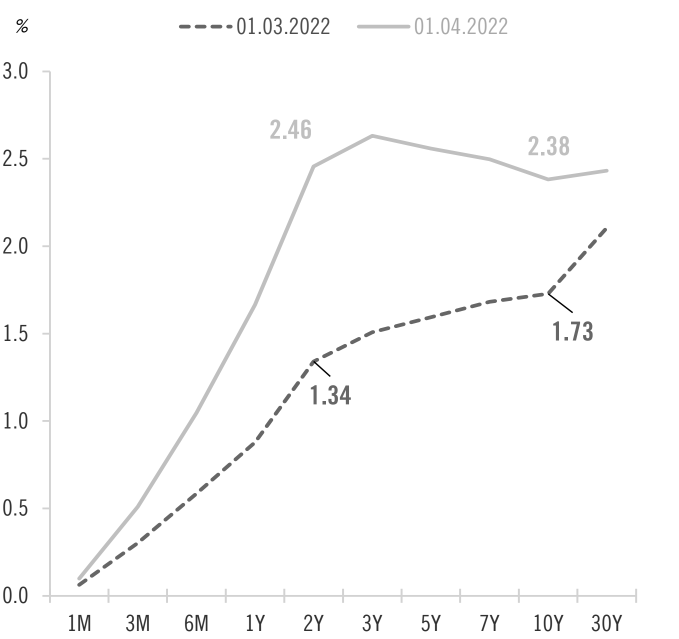
CHART 2 : US FEDERAL FUND RATE FUTURES CURVE EVOLUTION



Source: PWM - AA&MR, Bloomberg Finance L.P., 01.04.2022

CHART 3: US TREASURY YIELD CURVE EVOLUTION



Source: PWM - AA&MR, Bloomberg Finance L.P., 01.04.2022

Which recession signal?

The two-year US Treasury yield has also risen sharply so far this year, up by +89 bps to 2.46% as at 1 April as market participants price in steeper rate hikes (*see chart 3*). According to futures pricing at 1 April, **the high point for Fed fund rates is expected to be 3.15% in June 2024** (*see chart 2*). **Such a level is even higher than the latest FOMC projection of a median Fed funds rate of 2.8% in 2023 and 2024**[1]. Although we do not rule out the possibility of the 10-year yield hitting this kind of high in the coming months, **we see the FOMC's longer-run median of 2.4% as a potential anchor for the 10-year US Treasury yield, and as such we have adjusted our mid-year forecast for the 10-year Treasury yield up from 2.1% to 2.5%** (*see chart 1*).

Against this backdrop, **the 10-to two-year slope of the US Treasury yield curve has inverted recently**, with the two-year Treasury offering 5 bps of yield more than the 10-year Treasury on 1 April. The movement in yields has caught market participants' attention as **inversion between two-year and 10-year yields has always occurred prior to recessions in the US over the past 70 years**. However, it is noteworthy that for the first time ever, the 10-to-three-month slope has been steepening while the 10-to-two-year slope has been flattening.

Many explanations have been brought forward to explain this divergence, and also **why the recessionary signal sent by the 10-to-two-year yield curve inversion might be**

[1] https://www.federalreserve.gov/monetarypolicy/fomcprojtable20220316.htm

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distorted this time around. First, the three-month Treasury yield is closely anchored to the Fed funds rate. As the Fed has only hiked once so far, to arrange of 0.25-0.50% in March, the three-month yield was anchored at a low level of 0.51% as of 1 April despite market participants expecting the effective Fed funds rate to reach 2.37% by the end of the year. This suggests **the 10-to-three-month slope could start flattening as the Fed hikes rates further.**

Second, according to a recent paper published by the Fed,[2] **the abnormally high difference between short- and long-term inflation expectations**, with the two-year inflation breakeven rate at 4.4% and its 10-year equivalent at 2.8% on 1 April, **may in part explain why the two-year yield has risen above the 10-year yield**. Another possible explanation for the **comparatively low 10-year US Treasury yield is that it is being compressed by certain risk premiums**. One of these often referenced is the term premium, as estimated by Adrian, Crump and Moench at the Federal Reserve Bank of New York (ACM, 2013)[3]. This calculates the premium that compensates investors for the higher interest-rate risk involved in holding long-term bonds. **Although the 10-year ACM term premium briefly rose into positive territory in 2021, it had fallen to -0.5% by 1 April**. This means that investors are **actually ready to pay a premium** (in other words, to accept lower yields) **to hold long-dated US Treasuries**. This has contributed to the flattening of the US yield curve.

Looking at the one-year forward rate for the 10- and two-year US Treasury yields and their yield differential, **it seems that market participants are expecting the recent flattening to continue, translating into an inversion of -58 bps in a year's time** (as of 1 April). Although the jury is still out regarding the potential validity of the recessionary signal sent by an inverted yield curve**, the relatively limited rise in the 10-year yield over recent months probably still signals that market participants are expecting the US economy to slow down in the coming quarters**. This is in line with our central scenario, which we describe below, and to which we assign a 55% probability.

Central scenario is still for yields to fall

In our central scenario we expect US economic growth and inflation to decelerate in H2, enabling the Fed to pause after hiking rates to a range between 1.25–1.50% (which is below current market expectations). **With the Fed sticking to its gradual approach, we still expect the 10-year US Treasury yield to fall in H2**, albeit to a slightly higher level than we previously expected. As such, **we have revised our year-end forecast for the 10-year US Treasury yield up from 1.9% to 2.1%** (see Our 2022 scenario for US and German government bonds).

This change is because we expect the 10-year inflation breakeven rate to fall somewhat from its elevated level of 2.8% on 1 April towards 2.6% as inflationary pressures ease. Although we expect the 10-year US Treasury Inflation-Protected Securities (TIPS) yield to rise from -0.44% on 1 April towards -0.3% by June (underpinning our forecast of 2.5% for the 10-year nominal yield in June), **we expect the 10-year real yield to fall back to -0.5%**

[2] https://www.federalreserve.gov/econres/notes/feds-notes/dont-fear-the-yield-curve-reprise-20220325.htm

[3] http://libertystreeteconomics.newyorkfed.org/2014/05/treasury-term-premia-1961-present.html

as economic growth slows down and the Fed becomes less hawkish. As both are key drivers of long-term real yields, growth rates and Fed policy should ensure **the 10-year TIPS yield remains negative this year.**

In our alternative, **more positive scenario**, to which we assign a 20% probability, US **economic growth would remain robust in H2** thanks to resilient US household consumption despite elevated inflation and higher rates. This resilience could in part be supported by people spending their stockpile of savings and in part by an increase in nominal wages, which is particularly important for low-income households. Such developments could alleviate investors' fears of recession and **lead to a slight rise of the 10-year US Treasury yield to 2.5% by the end of the year.**

In our more **negative scenario** (25% probability), we see **the 10-year Treasury yield falling to 1.9% in response to a sharp slowdown in economic growth**. In this scenario, the US yield curve (including the 10-to-three-month slope) would invert further as the Fed carries on hiking rates aggressively, such that they reach 2% by the end of the year. **Fears of recession provoked by excessive Fed tightening would become acute and could lead to risky assets selling off. In these conditions, US Treasuries' safe-haven status could come to the fore**, resulting in the 10-year yield falling below 2%. Although we believe the **Fed is most likely to reduce its balance sheet passively** (passive "quantitative tightening") by setting a cap on monthly redemptions of US Treasuries and mortgage-backed securities, **in this negative scenario we could envisage the Fed resorting to active selling in an attempt to steepen the yield curve**—but probably without much success, in our view.

In summary, **we are sticking to our neutral stance on US Treasuries** despite the sharp recent increase in yields as we expect the 10-year yield to fall in H2. Despite the considerable uncertainty regarding the lagged economic effects of higher yields, **we still see US Treasuries as good (albeit costly) protection against our expectations of a slowdown in economic growth.**

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