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US Treasuries - Update

A surge in yields that reflects a (finally) positive term premium

AUTHOR

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FLASH NOTE

SUMMARY

- The US 10-year yield has surged since September, briefly touching 5% on 23 October (before retreating to 4.76% on 1 November). Contributing to this surge have been market participants' expectations for 'higher-for-longer' policy rates and the fast increase in the term premium (the compensation that investors require for the extra risk entailed in holding longer-term bonds) given elevated macroeconomic uncertainty and a growing fiscal deficit. This is making our year-end forecast of 4% for the 10-year US Treasury yield look optimistic. The decision in September to raise our projections for the 10-year Treasury yield has proved correct, although the year-end rate could be more in the 4-4.5% range than the 4% we have been pencilling in.
- Longer term, the 4.3% policy rate expected by market participants in 10 years' time looks aggressive. It looks to us that the US Federal Reserve (Fed) is done with its hiking cycle, especially as US economic growth could slow in the coming months. This could progressively push market participants to lower their longer-term expectations for policy rates.
- Regarding the 10-year term premium, fiscal uncertainty is likely to remain high in the US as a federal budget for the 2024 fiscal year has yet to be agreed. This factor, along with the high net supply of US Treasuries and still elevated macroeconomic uncertainty could push the term premium further up.
- Overall, a possible decline in long-term policy rate expectations that is offset by a higher term premium could mean the 10-year US Treasury yield at the end of December is closer to 4.5% than to our previous prediction of 4%. While there is upside risk to our forecasts for US economic growth and the Fed funds rate, the recent widening of credit spreads and fall in equity indices point to tightening financial conditions. If this continues and triggers a recession at some point, the safe-haven status of US Treasuries could come back into focus, helping to bring the term premium back down. However, the surge in US Treasury supply could still mean the premium remains positive.

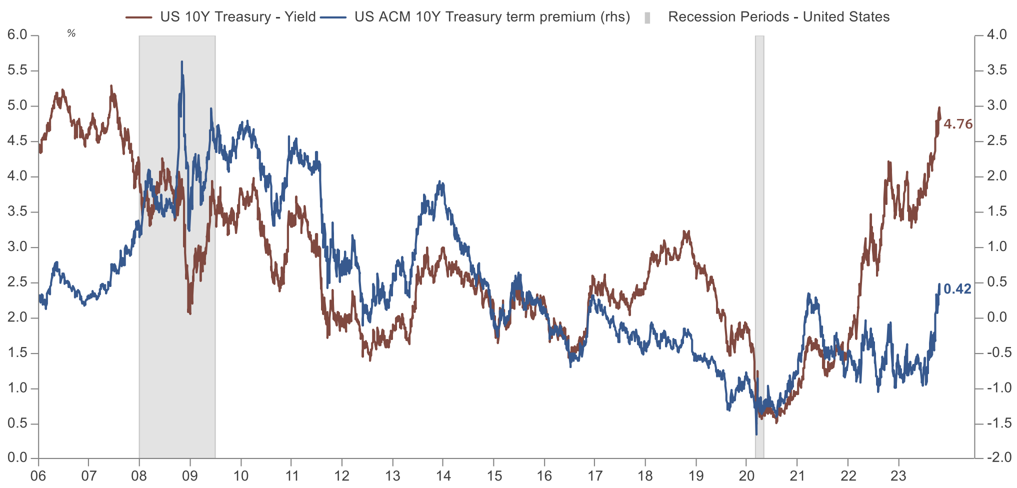
A FASTER INCREASE IN THE TERM PREMIUM

A Flash Note we published on US Treasuries in September (see Treasury yields could drop back, but remain structurally higher) explained why we were raising our year-end forecast from 3.5% to 4.0% for the 10-year yield. The main drivers for this change were:

1. **Expectations for a 'higher-for-longer' policy rate environment** thanks to the surprising resilience of the US economy to substantial increases in funding costs;
2. **Elevated macroeconomic uncertainty** (reflected in a higher term premium), as both the trajectories of US inflation and growth have confounded market participants over the past year. Inflation has been more persistent than forecast and economic growth more robust (as shown by the annual GDP growth of 4.9% in Q3); and
3. **A growing US fiscal deficit** (reflected in a higher term premium) that could push up US Treasury supply over the coming year, with an expanding share of longer-term notes and bonds rather than short-term bills.

We identified these three factors as likely to maintain the US 10-year Treasury yield elevated until the end of the year—in part through a higher term premium. Nevertheless, we expected the increase in the term premium to be gradual. But over the past month, the term premium (as calculated by the Adrian, Crump & Moench (ACM) model) has moved sharply up and is positive again at 0.42% (on 31 October), compared with a low point of -0.95% (on 19 July, *see chart 1*). Reflecting both market participants' expectations for 'higher-for-longer' policy rates and the fast increase in the term premium, the 10-year US Treasury yield has surged, briefly touching 5% on 23 October before retreating to 4.76% (on 1 November).

Chart 1: Ten-year US Treasury yield and ACM term premium



Source: Pictet Wealth Management, FactSet, as of 01.11.2023

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'HIGHER-FOR-LONGER' IS WELL PRICED IN

Although we believe that we were correct in identifying the three drivers for higher US 10-year yields, the magnitude of the increase requires more detailed explanation.

First, market participants have been increasingly integrating the prospect that policy rates will remain high for some time. On 1 November, the US dollar overnight index swap (OIS) curve showed they expect the US federal funds rate to stabilise at around 4.3% over the next five and 10 years (*see chart 2*). This is well above the longer-run median estimate of 2.5% in Federal Open Market Committee's (FOMC) most recent 'dot plot' forecast.

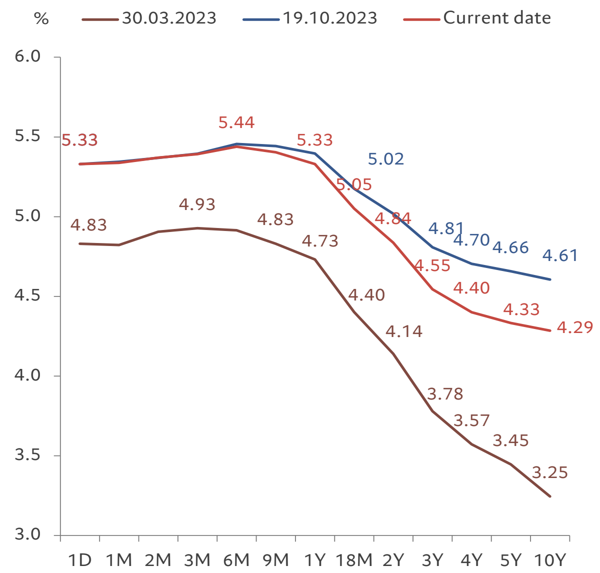
A Fed model decomposes the 10-year Treasury yield (the D'Amico, Kim, and Wei (DKW) 2018 model) between the real policy rate and inflation expectations in 10 years' time adding to that the inflation risk premium and the real term premium (*see chart 3*). We use it as a framework for our year-end forecast for the 10-year Treasury yield. This model suggests that the expectation for policy real rates in 10 years' time had moved up to 1.6% by end September. This translates into a nominal policy rate expectation of 4.4% (when 10-year inflation expectations are added), which is close to the 4.3% expected by market participants according to the OIS curve.

We believe that the resilience of the US economy to the higher rate environment up to now and the substantial energy transition investments being made (notably through the Inflation Reduction Act) likely mean that the US's potential growth is higher than it was pre-covid. Combined with continued tightness in the labour market, US inflation could also remain structurally higher for the same reason. Nevertheless, while the 'dot plot' forecast of 2.5% could prove too low, 4.3% seems elevated given that 'higher-for-longer' policy rates could drastically cut growth in a highly indebted US economy.

Including government, households and corporations, US indebtedness reached 254% of GDP in Q1 2023, according to the Bank for International Settlements. It is true that the US economy is less sensitive than it was to movements in rates as households and corporates have turned increasingly to long fixed-rate debt. But the elevated level of indebtedness likely means that monetary transmission—the time it takes for Fed rate hikes to hit the real economy—could still hurt, but with a greater lag than in the past.

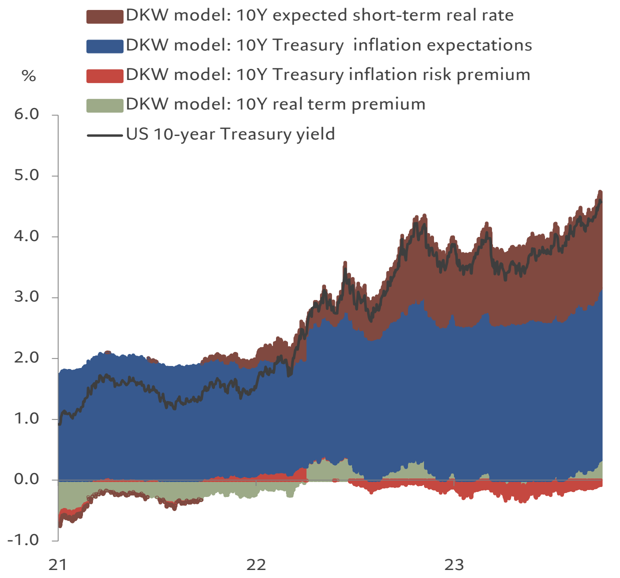
In this new post-pandemic regime, we believe that the longer-run policy rate could prove higher than Fed forecasts, but probably lower than market participants' forecasts.

Chart 2: US dollar overnight index swap curve



Source: Pictet Wealth Management, Bloomberg Finance, L.P., as of 01.11.2023

Chart 3: Breakdown of 10-year US Treasury yield



Source: Pictet Wealth Management, federalreserve.gov, Factset, 29.09.2023

A CHALLENGING ENVIRONMENT FOR FORECASTERS

Since the pandemic of 2020-21, economists and market participants have had a hard time correctly forecasting inflation and GDP growth. Inflation has been higher and more persistent than thought, with the headline US consumer price index (CPI) peaking at 9.1% in June 2022, while economic growth has proved more resilient than forecast, with expectations for a recession being continuously postponed. Whereas many economists had been expecting the US economy to record negative growth by now, GDP growth actually accelerated to an annual rate of 4.9% in Q3, far higher than expected. This is another proof of this increased economic uncertainty. As we commented in our previous note, macroeconomic uncertainty seems to be an important factor driving changes of the term premium and it has likely contributed to its increase lately.

In addition, the US fiscal deficit surprised to the upside in fiscal year 2023 (which ended on 30 September), coming in at USD1.7 trn, up from USD1.4 trn the previous year. Most of this deficit has been financed by T-bills (with maturities up to one-year), while the issuance of T-notes (Treasuries with maturities ranging from two to 10-years) has remained negative over the last 12 months. But market participants are worried about the ongoing surge in US Treasury issuance since the temporary agreement to raise the federal debt ceiling in June, especially in light of a higher-than-expected federal deficit (*see chart 4*). Nevertheless, US T-bills have found willing buyers in the form of money market funds. Attracted by high yields, these have been parking their cash in T-bills, significantly reducing the size of their reverse repurchase agreement operations at the Fed in the process.

A higher term premium has considerably narrowed yield-curve inversion since the summer, with the 10-to-two-year slope at only -20 bps on 1 November. In this context, we had expected the US Treasury Department to announce a reduction in

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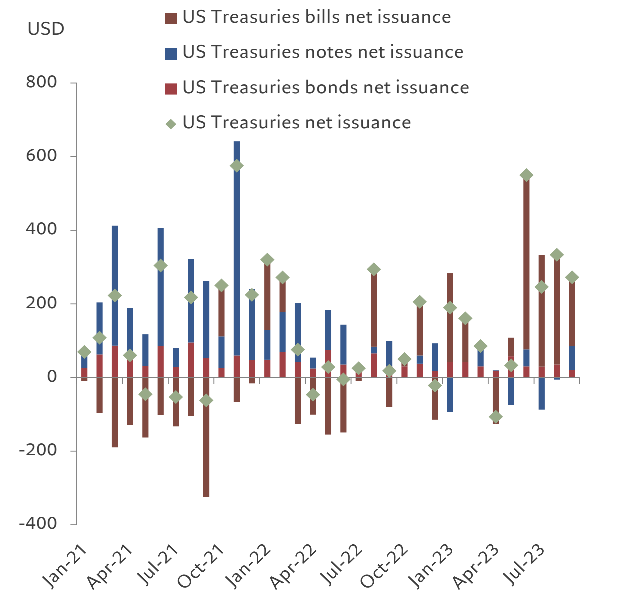
coupon issuance (bonds with a maturity between two and 30 years) in favour of bill issuance at its quarterly refunding announcement on 1 November. Not only did the US Treasury Department refrained from increasing the auction sizes of the 10-, 20- and 30-year tenors as much as in its August quarterly announcement, but it also lowered by USD76 bn its net borrowing estimates for the coming three months, while signalling that only an additional quarterly increase in coupon auctions sizes would probably be necessary. Such a development could provide more respite for long-term US Treasuries by further increasing the share of T-bills as a total of Treasury debt outstanding (*see chart 5*).

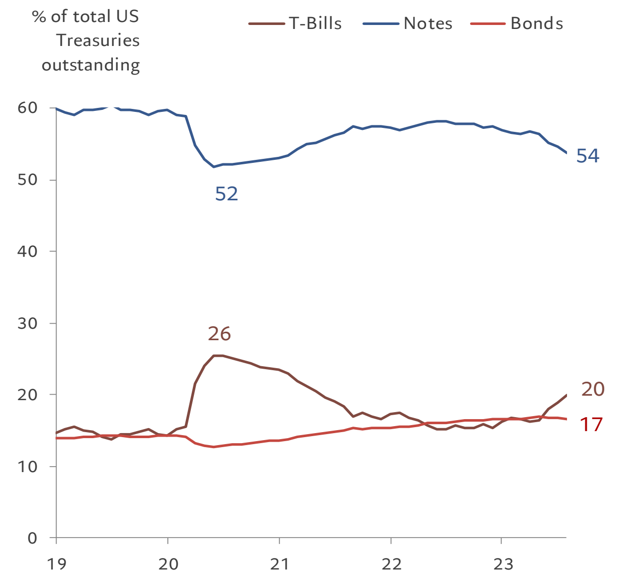
As we commented in our September Flash Note, part of the recent rise in the term premium was triggered by the surprisingly elevated borrowing estimates announced by the US Treasury Department on 31 July. Past rounds of quantitative easing (QE, outright purchases of government bonds by central banks) kept the term premium negative—in part by reducing the net supply of US Treasuries. But the reverse has been true since June 2022, when the Fed started passive quantitative tightening (QT, the non-reinvestment of maturing government bonds to shrink its balance sheet).

Chart 4: US Treasuries, net issuance



Source: Pictet Wealth Management, FactSet, Securities Industry and Financial Markets Association (SIFMA), as of 30.09.2023

Chart 5: Breakdown of US Treasuries by type



Source: Pictet Wealth Management, FactSet, Securities Industry and Financial Markets Association (SIFMA), as of 31.08.2023

CONCLUSION

The US 10-year yield has surged since September, briefly touching 5% on 23 October (before retreating to 4.76% on 1 November). Contributing to this surge have been market participants' expectations for 'higher-for-longer' policy rates and the fast increase in the term premium given elevated macroeconomic uncertainty and a growing fiscal deficit. This is making our year-end forecast of 4% for the 10-year US Treasury yield look optimistic. The decision in September to raise our projections for the

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10-year Treasury yield has proved correct, although the year-end rate could be more in the 4-4.5% range than the 4% we have been pencilling in.

Longer term, the 4.3% policy rate expected by market participants in 10 years' time looks aggressive. It looks to us that the Fed is done with its hiking cycle, especially as US economic growth could slow in the coming months. This could progressively push market participants to lower their longer-term expectations for policy rates.

Regarding the 10-year term premium, fiscal uncertainty is likely to remain high in the US as a federal budget for the 2024 fiscal year has yet to be agreed. This factor, along with the high net supply of US Treasuries and still elevated macroeconomic uncertainty could push the term premium further up.

Overall, a possible decline in long-term policy rate expectations that is offset by a higher term premium could mean the 10-year US Treasury yield at the end of December is closer to 4.5% than to our previous prediction of 4%. While there is upside risk to our forecasts for US economic growth and the Fed funds rate, the recent widening of credit spreads and fall in equity indices point to tightening financial conditions. If this continues and triggers a recession at some point, the safe-haven status of US Treasuries could come back into focus, helping to bring the term premium back down. However, the surge in US Treasury supply could still mean the premium remains positive.

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