US Macroeconomics

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Whither Long-term Interest Rates?

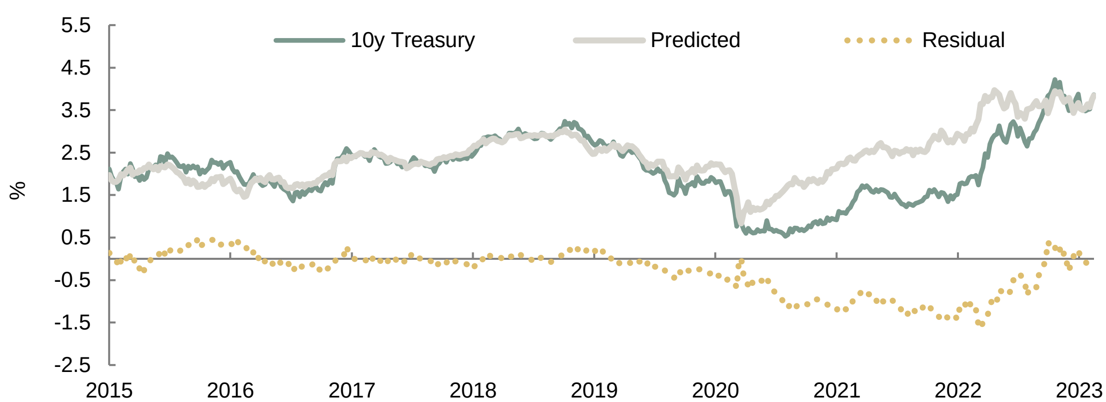
The 10-year Treasury note has traded within a wide range this year, yielding between 3.30% and 3.90%. With rates currently hovering near the high end of that range, investors are wondering whether the bond market will retest last October's 4.25% peak and then head higher. In short, how likely is it that we see a meaningful surge in long-term interest rates this year? Not likely in our view.

Considering the primary determinants of long-term rates, we probably have already seen the peak in long-term yields, at least until the Fed begins easing as such action could potentially lead to an increase in the inflation-risk premium. This assessment is based on the two dominant factors that determine the level of 10-year yields.

The first factor is the terminal fed funds rate. **Over the past couple of weeks, expectations of the peak funds rate have risen about 50 basis points, essentially accounting for all the increase in 10-year Treasury yields**. The second factor is the breakeven inflation rate, which is influenced by oil prices in the short-term but Fed credibility in the long-term. Fortunately, oil prices have been stable, and Fed credibility has been running high. This is evidenced by the deep inversion of the Treasury yield curve. Hence, it is expectations of future rate changes that should be the dominant driver of the 10-year yield from here.

In the chart below, we show the results of a simple two-variable model which explains 90% of the yield on the 10-year Treasury note. The latter is a function of the bond market's expectation of the peak fed funds rate and breakeven inflation. For the former, we use a rolling 12-month fed funds contract, and for the latter we use the TIPS market. Importantly, we run an out of sample forecast beginning in 2020. As we see, the residuals have been small in the last handful of months.

With stable inflation expectations, **the model says the Fed would have to lift overnight borrowing costs to approximately 6.5% in order to push 10-year yields beyond 4.25%**. In our view, this is highly unlikely because it would result in an even deeper curve inversion and thus potentially worse recession. And as Chair Powell stated numerous times, he would rather place the funds rate into mildly restrictive territory and leave it there than push the funds rate far into restrictive territory, which is what a 6.5% level implies! For these reasons, the yield on 10-year Treasuries likely has limited upside from its current level. Stay tuned.



Sources: Federal Reserve, SMBC

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