US Macroeconomics

November 15, 2022

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Making Sense of Long-term Interest Rates

The yield on the 10-year treasury note peaked at 4.24% on October 24th and has rallied substantially since then with yields hovering around 3.80%. Two catalysts are behind the move. **Inflation expectations** have fallen, and the futures markets' expectation of the **terminal fed funds** rate has declined.

Since October, the breakeven rate of inflation has declined 20 basis points (bps) to 2.37%. As we can see from the lefthand-side chart below, even though inflation has been running at a four-decade high, bond investors do not believe it will persist. We agree.

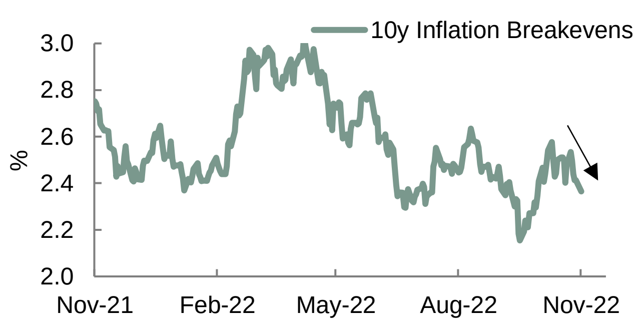
Remember the breakeven rate is calculated from the consumer price index whose annual growth rate tends to run 40 bps above the personal consumption expenditures deflator. Since the latter is the Fed's preferred metric, the **current breakeven rate is already implying future price stability**. If underlying economic activity continues to weaken, price pressures should further dissipate.

Against this backdrop, the futures market no longer projects a near 5.25% terminal rate. Instead, the market is discounting a peak funds rate between 4.75% to 5% as shown in the righthand-side chart below. More importantly, **the fed funds futures are now looking for nearly 50 bps of easing in the second half of next year**, up from a 25 bps previously. No doubt this is helping to depress 10-year yields, which could fall more.

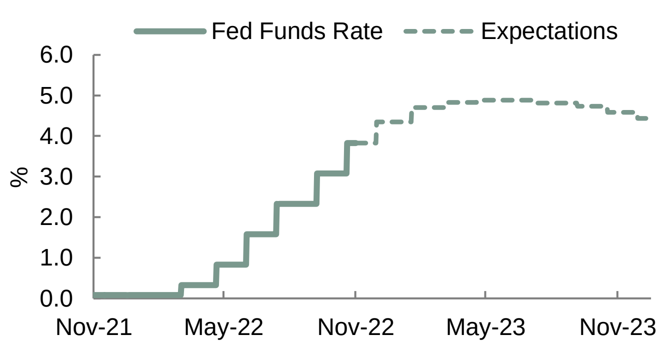
If 2023 real GDP growth softens as much as we anticipate, thereby pushing the unemployment rate above 5% from 3.7% currently, inflation could come down faster. If so, breakeven inflation will fall. The series was as low as 2.15% are recently as six weeks ago.

In addition, while Fed verbiage has essentially locked policymakers into a 50 bp hike on December 14th, further hikes beyond December are not guaranteed. As our work has demonstrated, monetary policy works with a lag and the Fed's tightening actions this year are without precedent. Hence, **the possibility of even larger second half 2023 rate cuts should be contemplated**. Stay tuned

Inflation Expectations Falling as the Futures Markets Begins to Discount 2023 Easing



Sources: BLS, Haver, SMBC



Sources: BLS, Haver, SMBC

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