Article | 9 December 2021

Rates Outlook: If the 10yr Treasury can't hit 2%, the Fed can forget about it too

The 10yr rising to 2% in 1Q and the 2yr at 1% by 2Q are key calls for 2022. This would pave the way for Fed rate hikes in the second half, with more following in 2023. Before that, the curve needs to re-steepen, but subsequent flattening should dominate for 2022 as a whole. Conditions should tighten too, as the debt ceiling is lifted and bank reserves are reined in

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Heading for 2%, and prefer higher than lower beyond that

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
10Y USD swap	1.55%	Higher	1.50%	2.00%	2.25%	2.25%	2.25%

US direction - being pulled higher from both ends

The journey from sub-1% for the US 10yr to the 1.5% area has been the story of 2021. The move, in fact, played out in the first quarter. For the rest of the year, the struggle was to make a material and sustained break away from the 1.5% area to the upside. The elevated inflation dynamic presented an open goal for higher market rates. After all, nominal rates contain an explicit inflation component.

That said, the remarkable demand for fixed income throughout the year continued to dominate available supply, where availability has been curtailed by central bank buying. Although the Fed will wind down the bond buying, their bloated balance sheet will continue to constrain the volume of available securities on the marketplace.

> *The 2% handle for the nominal 10yr is an ongoing call for us, one that we roll into 2022*

These themes will persist as we journey through 2022, and on balance, we see enough to tempt market rates higher still. The 2% handle for the nominal 10yr is an ongoing call for us, one that we roll into 2022. Getting there has been a tough nut to crack, but we remain of the opinion that elevated inflation along with the delivery of rate hikes should be enough to pull the curve higher from both ends.

> *On the front end, the 2yr should be targeting a handle of 1% by mid-year*

Large negative real rates are an anomaly that should fade, assuming the post-Covid recovery is a structural one, which we indeed assume it is. The ultimate goal would be to get to a zero real rate in the 10yr, but it may not be till 2023 and beyond before that happens. On the front end, the 2yr should be targeting a handle of 1% by mid-year, and closer to 1.5% by the end of the year, as the Fed delivers at least two 25bp hikes (with three more to come then through 2023).

Steeper from back end, but then flatter from the front end

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
USD 2s10s slope	80bp	Flatter	75bp	100bp	75bp	50bp	40bp

US curve - The Fed will want the curve to steepen before coming in to flatten it

Typically, three to six months before a first hike is when the 2yr really begins to sit up and take notice, and can then trade some 100bp over the funds rate. Currently, we are in the wind-up phase, where a steady grind higher in yield dominates. During this preliminary phase, we can and should see some re-steepening of the yield curve, as back-end rates begin to make way for future rate hikes. This is an important phase, as the degree to which the 10yr yield rises will determine the extent of rate hikes the Fed can ultimately deliver. This is why getting to a 2% handle on the 10yr is a minimal first step if the Fed has an ambition to get the funds rate anywhere close to that down the line. If not, the Fed would find itself inverting the curve through hikes, which is traditionally not what it wants to do.

The call on the 2/10yr segment is for it to steepen first from the back end. It has flattened into the 80bp area (65bp on swaps) in the past number of weeks, but ahead, we'd expect it to see 100bp at least one more time. The driver should be a relative steepening on the 2/5yr segment versus the 5/10yr segment, as the 5yr area continues to underperform.

> *The dominant move over the course of 2022 is liable to be flattening*

That said, the dominant move over the course of 2022 is liable to be flattening as the 2/10yr segment ends the year at closer to 40bp. The key driver of this is the delivery of Fed hikes. The anticipation of these hikes is what drives the 5yr cheaper to the curve. Actual delivery should prompt a re-richening of the 5yr and a flattening of the curve led by the 2/5yr segment, as the 2yr shoots up to move closer to the 5yr. In the background, the 10/30yr should have flattened out to zero, leaving the 5/10yr as the steepest segment on the curve by the end of the year.

SOFR for new business, but USD Libor remains a player for 2022

	Current value	Year ahead	4Q21	1Q22	2Q22	3Q22	4Q22
Libor 3M	20bp	Higher	25bp	30bp	40bp	60bp	80bp

US money markets - Debt ceiling elevation plus bank reserves shrinkage to push rolling rates up

When we turn to the ultra-front end the debt ceiling elevation is a key early move. As it is, the US Treasury is right up against it, and in consequence needs to be careful in terms of issuance. This is happening against a backdrop of excess liquidity in the system. Fed bond buying has stretched bank reserves to the max, and a liquidity overflow into the Fed's reverse repo window has been the consequence. This is also reflective of an excess of liquidity over collateral, which has pushed market repo rates down to the low single digits. In consequence, the Fed's 5bp on offer at the reverse repo window looks as good as any market alternative.

The elevation of the debt ceiling at least allows the US Treasury to push some more collateral back into the system. As the Fed tapers to zero in the coming months we will also get to the point where the Fed's bond buying is no longer generating additional excesses of (potential) liquidity. By the end of the first quarter it's likely that the Fed will be near to concluding its taper. After that, the next big focus will be on the delivery of the first hikes in the cycle. That will push the risk-free rate up from mid-2022, similarly impacting repo.

> *The situation will morph from one where the Fed is adding to bank reserves, to one where the Fed will be taking bank reserves out*

The significant nuance here is the change from the current situation where the Fed is adding to bank reserves, to one where the Fed will be taking bank reserves out of the system. This will largely be unseen, but ends up pressuring the price of liquidity higher. That will be the precursor to a first hike, and the combination should have an overall tightening effect that will tempt market rates higher generally, and this should be echoed right out the curve.

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