

Rates Spark: The lost term premium to return

The term premium represents a compensation for being in long tenors. Currently there is virtually none. Back in October we had a 40bp term premium in the 10yr yield. A re-build towards that is the cleanest route to 5% for the 10yr yield. And even at that level, that's a mild term premium. Only a 0.2% on next week's PCE deflator can keep us from hitting these levels



Historically the term premium was much larger. It should widen if we are really returning to normal for rates (which we are)

There are three main components in play that help rationalise continued upwards pressure on Treasury yields. First, is the ongoing unwind in rate cut expectations; now down to just two 25bp cuts for 2024. Second, is the lack of a term premium in long yields; still around zero in the 10yr yield. And third, the extrapolation of less rate cuts beyond 2024; the bottom for the funds strip is now north of 4%.

These are all important for related but different reasons. Theoretically the 10yr Treasury yield can be broken into two key components. The first component is centered on future expectations for

where the Fed funds rate will get to into the medium term. In simplistic terms, an average of this for the next 10 years should have an impact on the absolute levels of the 10yr yield today. Second, on top of that we should add a term premium. Remarkably, at the moment, there is no implied term premium in the 10yr yield. So, it's effectively just an average of future fund rates (the market discount).

But there should be a term premium. We like looking at data back to 1988 as it includes a high rate environment and a low rate one while also excluding the 1970's. The choice of time period is never perfect, but for what it's worth, the term premium in the 10yr yield over this period is a little over 100bp. If we included the 1970's it would be 150bp. If we just focused on this millennium its around 70bp. It went negative during the pandemic years. But now, it should be positive. Especially if we postulate that we've returned to a pre-GFC-style normality (which we do).

Back in October when the 10yr Treasury yield hit 5% the 10yr term premium was 40bp. We can see both of these metrics being hit in the coming few weeks. And there is a floor to the down side, at just above 4%, identified by the trough on the Fed funds strip. It does not matter that the 10yr was at sub-4% at the beginning of the year. Back then the funds rate trough was sub-3%. That was then. Now, the floor is above 4%. With that, the 10yr can easily hit 5%.

The only way out of this is for next week's PCE deflator to hit 0.2% month-on-month. If we get 0.3% or higher (as discounted), the journey towards 5% continues for the 10yr yield. And the curve directionally dis-inverts from the back end as a term premium is re-built.

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