

Rates Spark: The term premium – why so negative?

The FOMC minutes referenced a future plan for slowing QT, mentioned a peak in rates and talked of a slowdown and inflation successes. Nothing startling, but also nothing to negate 2024 rate cut hopes. There was also mention of a term premium collapse of late. Rate cut hopes can shield this as an issue. But it still remains one. Only saying – the Fed brought it up



Can we really justify a negative term premium if rates are back to 'normal'?

One of the interesting aspects of the Fed's minutes was the assertion that the fall in long-term yields from the recent peak came two-thirds from a fall in the term premium and one-third from a taming in rate expectations. That can be broadly confirmed by looking at the Fed's measure of the 10yr term premium, which peaked out at around 50bp in October 2023, around the time that the 10yr Treasury yield was at around 5%. The 10yr Treasury yield is now just below 4% while the 10yr term premium is back in negative territory at around -30bp. A negative term premium is a problem, as technically it implies no compensation for taking on rolling duration.

So what does this mean? First, a negative term premium is not normal from a theoretical perspective. It has however been featured in recent years, especially during the pandemic years (in particular in 2020 when it was below -100bp for an extended period). A negative term premium essentially means that the level of rates is being dominated by the future path of short-term rates. So when we look at the 10yr yield at 3.9% currently, this effectively is a future mapping of the average path for short-term rates in the next 10 years. There is no compensation for taking on duration. In fact there is negative compensation currently.

That does not mean that 10yr rates cannot fall. They of course can. They can overshoot to the downside at will. It's just that there is less buffer in 10yr yields than is ideal from a long-term perspective, where you average in on an ongoing basis. You are getting compensation for the changing interest rate environment, and benefit as the Fed cuts rates, and especially to the extent that it might cut by more than expected. But that's it. Theoretically you could do just as well from a running yield perspective by averaging in on 2yr paper and taking the ups with the downs over the interest rate cycle in the next 10 years.

In a sense this is a remaining anomaly that needs to rectify itself at some point. In many ways there has been a return to normal in the level of rates relative to the pandemic years and the post-Great Financial Crisis ones. The inverted curve that we currently have is not a structural thing, but is perfectly normal at the tail end of a rate hiking cycle. A positively sloped curve is more normal. It can be driven entirely by future rate expectations (as it currently is). But really it should have a term premium. When we think of a normal 100bp curve between a 3% (future) funds rate and a 4% Treasury yield we also infer that there should be a positive term premium.

At some point this will become a discussion point when we get beyond the novelty of the rate cuts to come, and the clearest driver of that will be the realisation that a 6% deficit is something that should command compensation from a bond holder's perspective. Not so much from an elevation in default risk, but more a weight of a supply one. That said, be aware too of the 3.5% primary deficit (ex-interest rate payments). That's the bit that jacks up the debt/GDP ratio over time. In fact, this heads to 200% of GDP in the coming couple of decades on unchanged policies.

Now what we are doing with a negative term premium against that in the foreground is anyone's guess.

Today's events and market views

The focus for Europe will be on regional inflation readings for December due on Thursday, along with a series of December PMI readings. The likelihood is for some stalling on inflation reduction alongside confirmation of ongoing manufacturing and business weakness. In the US on Thursday we get the pre-payrolls ADP report for December, which for what it's worth anticipates 125k of jobs creation, slightly below the historical average of 150k per month. We also get jobless claims which are anticipated still in the low 200k territory and indicative of a decent labour market. That said, watch continuing claims as these are on the rise and suggesting a slow creaking of negativity. We will also see the latest Services PMI reading for December, which is seen as unchanged at 51.3. While that is above 50 and technically in an expansion mode, it's below the average in the area of 54. Don't expect too much reaction from these data though ahead of Friday's payrolls report.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.