# The US 10yr heads back to 4%, but then it's 5%+ for 2025

Front-end yields can get lower and remain low, but will still end up at least 50bp above what we see as neutral (2yr at 3.3% is neutral). The 10yr yield is ending 2024 below neutral, but will revert to above neutral by around 50bp to 100bp as we progress through 2025 (10yr at 4% to 4.5% is neutral). The 2yr trends around 4% while the 10yr heads for 5%+ in 2025


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## The US 10yr should settle above neutrality, heading for 5%+

US market rates reached local highs following Trump's win but have been drifting lower since. A significant retracement is appropriate after the nearly 100bp rise in the 10yr yield, which was triggered by the first Fed rate cut in mid-September. This move culminated in Trump's clean sweep in the November elections. But as we pushed through December, we returned to basic data watching. To the extent that if the data softens, there is justification for testing lower yields.

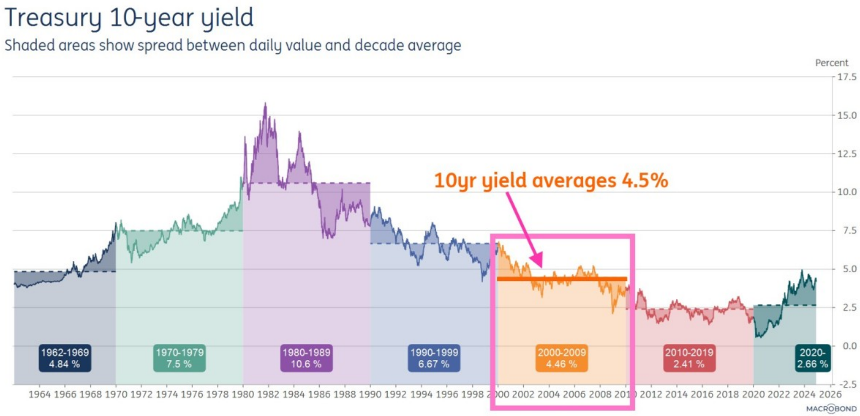
Another factor is the end-of-year effect. It's not uncommon for bonds to do well into the turn of the year. Cash is often parked as risk trades are wound down to some extent. January is often a month in which liquidity comes back into the market, acting to help all types of bond products.

That said, we identify a floor at 4% for both the 2yr and the 10yr yield. The rationale for the 4% floor centres on the market discount for the funds rate, which is only just under 4% by late 2025 (now around 3.75%).

As we progress through 2025, our vision is for the US 10yr Treasury yield to head toward the 5-5.5% range. Today a 4% SOFR rate coincides with a 4.5% 10yr Treasury yield (50bp spread vs SOFR), and 4.5% was the average Treasury yield seen during the noughties. We find this relevant as during this decade, US inflation averaged 2.5% and the Fed funds rate averaged 3%, which smacks of an equilibrium (on average).

## The noughties as a neutral reference?

During the noughties (2000-09) inflation averaged 2.5% and the funds rate averaged 3%. And the 10yr?




Source: Macrobond, ING estimates

## The difference between the 2yr and the 10yr is that the latter is far too low

Trump's tax-cutting agenda likely means the Federal Reserve lands above neutrality by some 50bp. Specifically, at 3.50%-3.75%. We also think the 10yr rate should end up above neutral. Given the inflation risk from tariffs and issues relating to the fiscal deficit, logic suggests that the 10yr rates should land at least 50bp north of neutrality. The 5-5.5% range translates to 50-100bp above a neutral 10yr yield, and translates to 10yr SOFR getting to at least 4.5%.

When we look to the front end, we find that the 2yr Treasury yield averaged 3.3% during the noughties, effectively at a 30bp spread over the funds rate. Currently, the 2yr yield trades some 40bp through the effective funds rate. If, as we expect, the Fed cuts by 100bp and nothing else happens, that would pitch the funds rate at 60bp through the 2yr yield. Based on that, there is some room for the 2yr yield to test lower, likely to the 4% area. And there is scope to dip below 4%, even if briefly.

The difference between the 2yr yield and the 10yr yield is that the 2yr yield is more likely to be held down by the pull of the funds rate as it dips below 4% and likely stays there as a theme for a decent chunk of 2025. In contrast, if the 10yr yield gets down to 4%, it's unlikely to stay there. It's far more likely to get pulled higher, up to the 5-5.5% area, partly on a pull from deficit pressure. That can be negated to the extent that the Trump administration manages to take action on it. It remains to be seen.

## Deficit pressure, tax cuts and tariffs are all issues for longer rates to worry about

Even if the deficit pressure is reduced (and we won't assume this just yet), the rates market will still have to contend with the impact of a tax-cutting agenda to be legislated in 2025, taking effect from 2026. On top of that is the threatened implementation of tariffs, whose effect on prices would be a thing through the second half of 2025 and 2026. We view 2026 as being closer to a 3% inflation environment than a 2% one based on this.

Currently, we have a 2% real 10yr yield. On top of that, there's a 3% inflation risk and that brings the nominal 10yr yield to 5%. Then bear in mind that the 10yr real yield averaged 2.3% during the noughties (our preferred neutral reference), and that adds another 30bp to our 10yr yield. Hence the 5% to 5.5% range.

The direction of travel for the funds rate beyond the bottoming process envisaged is a tad opaque. Normally, a bottom in the funds rate would mean just that, a bottoming. And that would mean the next move is up. The markets will likely view it this way until or unless there is a material impulse in the other direction. At this juncture, we don't have enough policy clarity to develop a conviction view in either direction. No doubt this will evolve as we progress through 2025.

## We like structural fixed-rate payers and short duration positioning for 2025

In the meantime, the call is for the 10yr yield to touch 4% around the turn of the year, but then to target 5% to 5.5% as we progress through 2025. And for the 2yr yield to hit 4% but then to retrace back up towards 4.5%. The implied curve hits 100bp. This applies to the 2/10yr Treasury curve, and the Fed funds to 10yr SOFR curve, as the 10yr SOFR rate ultimately heads to 4.5%. Based on that and our neutral references, we like structural fixed-rate payers and short-duration positioning for 2025.

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