

## Rates: Back to the noughties!

Our premise here is simple – choose a decade that saw the type of inflation that would be broadly acceptable for the Federal Reserve today, and then extrapolate. The answer? The noughties. Back then, the funds rate averaged 3%. The 10yr average? 4.5% – where we are now! It's a level we'll return to post a rate cut-induced 10yr yield overshoot to the downside

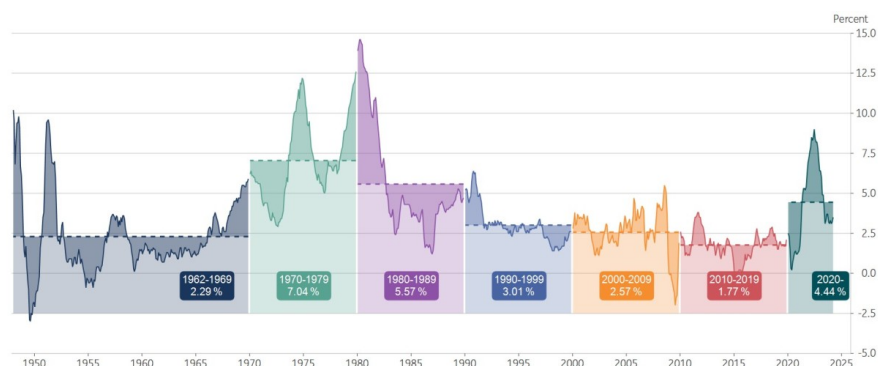


### The noughties saw inflation average 2.5%. That's an interesting point of reference

The 1950s and 1960s saw average inflation of 2.3%, which is very acceptable. But it's quite far back. A better, more recent reference is the noughties. It's the only decade since the 1960s to produce average inflation of around 2.5%. It was book ended by the dot.com boom and bust and the beginning of the great financial crisis (GFC), but ultimately it produced an average inflation experience that the Federal Reserve would likely accept today. Moreover, it provides an intriguing frame of reference for us..

## US CPI inflation back to the 1950s – the noughties is a reasonable recent reference

The boxes identify the decade averages...



Source: Macrobond, ING estimates

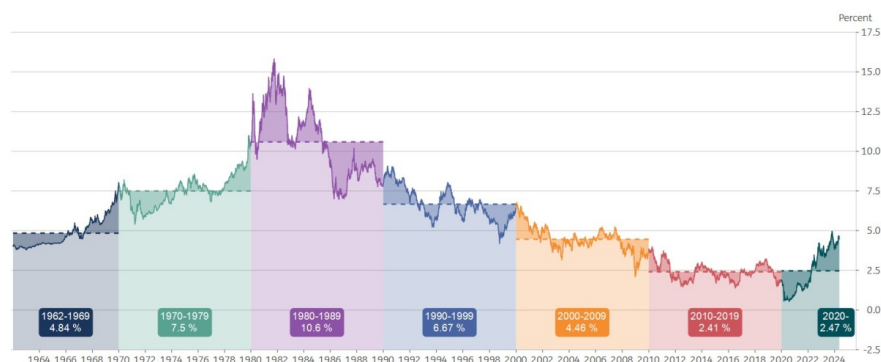
## The Fed funds rate averaged 3% and the 10yr averaged 4.5% through the noughties

The interesting question now is, where was the Fed funds rate back then? There was quite some variability through the decade, but the average funds rate was 3%. That's a number we can work with from a theoretical perspective as a neutral funds rate today. It backs out an inflation expectation of around 2.5% and a real rate of about 0.5%. We'd argue that 3% to 3.5% with a central point at 3.25% is closer to the truth, but we can work with 3% as a neutral valuation (neither restrictive nor stimulatory).

And what about the 10yr yield? Well, it averaged 4.5% through the noughties. That's broadly where we are today. The level of 4.5% for the 10yr feels high as we've just come through a decade and a half with an average 10yr yield of 2.5%. But in fact, the 2.5% 10yr yield regime should be seen as the outlier (heavily impacted by exceptional GFC and pandemic responses). Looking forward, it makes far more sense to view 4.5% as the more likely equilibrium level with which to reference the future against.

## US 10yr Treasury yield back to the 1960s

The boxes identify the decade averages...



Source: Macrobond, ING estimates

What about the 2yr, 5yr and 30yr? They averaged a respective 3.3%, 3.9% and 5.0% during the noughties. The 30yr yield today is 4.6%. That looks and feels high, but is it really? It's not if the noughties present a sensible reference. The biggest anomaly with today's curve is on the front end, as the funds rate is at 5.3% and the 2yr at 4.9%. The part of the curve that needs adjusting is the front end, and it will as the Fed eventually cuts rates.

But there is a lesson here. As the funds rate ultimately gets cut and front-end rates fall (and they will, see [here](#)), any material fall in longer tenor rates is questionable in terms of longevity. Why? Material falls in longer tenor rates would move them away from equilibrium, not towards it. A new lower rate equilibrium should only obtain if something breaks in the system, or we have a really damaging recession. Neither of these are the central thesis at this juncture.

We still expect to see longer tenor Treasury and SOFR rates falling as the Fed cuts. That reflects a typical bond market reaction to rate cuts, at least in the early phase. However, don't view that as a move towards a new equilibrium. It's not. We are currently at a more credible equilibrium with the 10yr Treasury yield at around 4.5%. Any shoot down to 4% or lower on rate-cut enthusiasm will be reversed within a matter of months, not years.

### Any fall in long tenor rates as the Fed eventually cuts are at risk for a swift reversal

Directional from here? We remain of the view that a path towards 5% is viable for the 10yr yield until we get clarity that recent inflation pops are nothing more than that – just one-off pops. As inflation ultimately slows, the Fed cuts, the Treasury market rallies, and the 10yr can break back down towards 4% (or briefly below).

But once the Fed gets a few cuts done and the market starts to view a bottom for the funds rate somewhere in the 3% to 4% range, then the 10yr yield can quickly back right up to 4.5% again. In fact, barring a damaging recession, the 10yr is more likely to settle at 5% than 4% on an 18-24 month view.

For issuers (or fixed rate hedgers), that identifies opportunity for lower all-in rate levels later in 2024; likely in the three to six month window after the Fed starts to cut. Be careful

though, as the window could well be at the shorter end (factoring in ongoing deficit-related issuance pressure). That window will close, with all-in issuance levels on the rise again as we get back to where we are now for the 10yr yield, or arguably higher.

For asset managers, we're 1mth tactically short duration. Then tactically long as inflation falls and the rate cut discount really hardens. But the structural view through all of that is in fact short (although the running yield provides some decent, but not full, protection).

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