

Here's how the US 10yr could re-test 3%

History shows that the US 10yr can break dramatically below the Fed funds rate. But only when Fed has peaked or is about to peak. If the Fed has an ambition to deliver a series of hikes from here (and it does), then the 10yr needs to back away from a break below 2.5%. Better for it to head for 3%, as any break below 2.5% really makes life tough for Fed



The peak in market rates is in, but not yet for the Fed

[We called a peak for market rates when the US 10yr hit 3.5%](#), noting that the richening in the 5yr part of the curve was consistent with a falling rates environment and / or a Fed that was approaching the end of the rate hike cycle. Both remain true. We also noted a re-visit to prior highs was entirely possible, but there has barely been a sniff of that. The peak has been followed by a relentless fall in yields, one that now sees us knocking on the door of 2.5% for the 10yr.

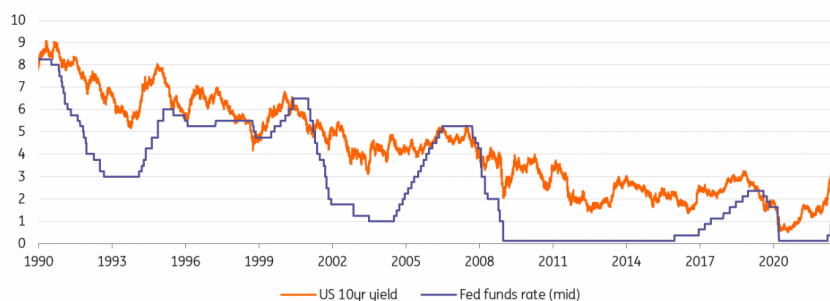
The issues here are numerous. The first question is to what extent can the Federal Reserve push against this and continue to deliver rate hikes. The part answer is the Fed is far from done. But then the extended second question is to what extent can market yields then continue to test the downside if the Fed is not done. And then the implicated third question is whether the Fed could be influenced by dramatic falls in market rates.

One more hike and the 10yr will trade through the funds rate

Right now the US 10yr is a mere 20bp above the effective fed funds rate. If the 10yr remains here and the Fed hikes in September (we think by 50bp), the 10yr will then trade some 30bp through the funds rate. This is not unusual at this phase of the rate hiking cycle. History shows that the 10yr can trade dramatically through the funds rate. In fact back in the heady 1970's and 1980's it managed to trade some 4-8% through. But that was when rates were up at 10-15%.

Taking a more modern period, back to the 1990's, we find that the 10yr in the extreme has managed to trade 150bp through the funds rate (apart from a few one-off spikes). That, as a stand-alone fact, would suggest that there is no real issue with the Fed continuing to hike the funds rate as market rates fall. For example, it suggests that the US 10yr yield could fall towards 2% while the Fed hikes to above 3.5%, resulting in a repeat extreme spread of 150bp.

The 10yr is on the verge of breaking below the Fed funds rate



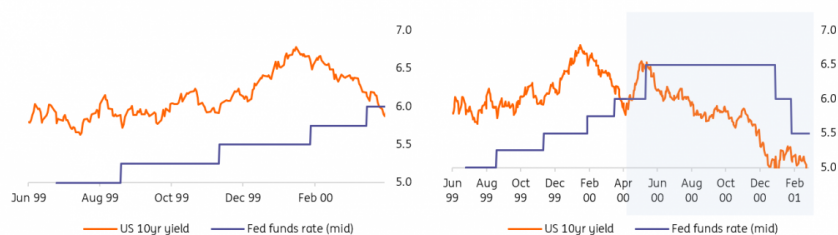
Source: Macrobond, ING estimates

But when such a gap opens up, it is usually coming from the 10yr

However there is one important nuance here. When the 10yr breaks below the funds rate, the funds rate itself tends to have peaked, or at least be very close to one. It can be just about to peak, or can actually have peaked. But there is no example in modern times of a large negative gap opening up between the 10yr yield and the funds rate that has been led by the funds rate. It is always led by the 10yr yield.

To crystallize this point, take a look at the scene below; back at the bursting of the dot-com bubble, a period that has many similarities to the current phase (albeit with just as many differences). The chart on the left shows the moment that the 10yr broke below the fed funds rate, and the chart on the right then shows the follow-through where the 10yr continues to trade further and further through the fed funds rate. There was one further hike, but that was then the peak, the 10yr traded 25bp through fed funds before the peak, but no more. After the peak was in, the 10yr really pushed through the funds rate (to 150bp in the extreme), and culminated in rate cuts down the line.

This is what happened during the dot.com rate cycle change



Source: Macrobond, ING estimates

Granted this is just one cycle example, but if you whip out your magnifying glass and apply it to the larger graph above you will find that this is pretty typical of what has happened at virtually every cycle change.

The Fed does not tend to hike when the 10yr is through the funds rate

Furthermore, there is no modern example of getting to these extremes where the Fed has pushed against the market and gone ahead and hiked as market rates are falling, in particular when the 10yr is actually through the funds rate. There are some examples of the Fed getting one more hike in as the 10yr trades through the funds rate, but that is 50bp through at the very extreme (and even that is unusual). The other 100bp is coming from falls in the 10yr yield (not from follow-through rate hikes).

This suggests that it would be unprecedented for the Fed to continue to hike the funds rate should market rates continue to fall from here. So something must give. Either market rates have overdone it to the downside and need to back up, or the Fed needs to start winding lower rate hike ambitions.

Or there is another option, where the Fed chooses to outright sell bonds to the market in an acceleration of its quantitative tightening agenda. An extreme option, but one that is there. Let's park that for now, but watch it come on to the table should the Fed really believe it needs to do more as market rates fall.

So, either market rates back away from 2.5% and head toward 3%, or the Fed faces a real dilemma

Our view? We think the Fed still has a rate hiking job to do. Moreover, we think the Fed thinks the Fed has a rate hiking job to do. Chair Powell termed the current funds rate at just short of 2.5% as being the "neutral" rate. That alone suggests there is a job to be done, with we think at least another 1% is needed on top of that. For that to happen, the US 10yr needs to steer clear of a break below 2.5%. In fact, the Fed might be happier if it managed to claw it's way back up towards a 3% handle again.

The counter argument is the market has this right and the Fed can only move mildly north of their neutral rate (say just one more hike in September). Not our preferred view, but one

that also paints a poor picture ahead. The collapse in the US 10yr real yield from 90bp in single digits earlier this week pushes on a similar worry – the dawn of resumed negative real yields.

Far better, and we think more likely, for market rates to back away from a break below 2.5% and for the Fed to have the room to deliver the hikes deemed to be required. Should the 10yr break below 2.5% we are in to a whole new set of circumstances should the Fed want to go ahead and deliver a series of rate hikes from here.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@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 <http://www.ing.com>.