Here's why US market rates should not really collapse from here

Inflation is convincingly lower and falling. And, at the very least, we're heading into a growth recession. So, shouldn't market yields be collapsing? They could. But, then again not necessarily. There are technical factors pushing in the other direction, ones that can in fact pressure longer-dated market yields higher, or at least mute any fall

The US 10yr yield looks one-way biased to fall for macro reasons, but the absolute level is already quite low

Here are four factors to consider:

1. History shows that the 10yr yield trades below the funds rate as the rate hiking cycle peaks. Typically it would get to 75bp through. It has been 150bp through in the past (e.g. dotcom bust), but not till just before the Fed cut. Recently it's been some 150bp through the likely peak in the funds rate. So, right here at 3.5%, the 10yr is not that cheap.

2. There is better risk / reward from ultra-front end positions, where handles of 4% + are attainable. The price risk here is minimal (to zero). The only risk is the Fed starts to cut rates, which would

adjust down the yield on roll-overs. This trade, by definition, means lower buying of duration. Recent flows into money market funds suggest this is happening.

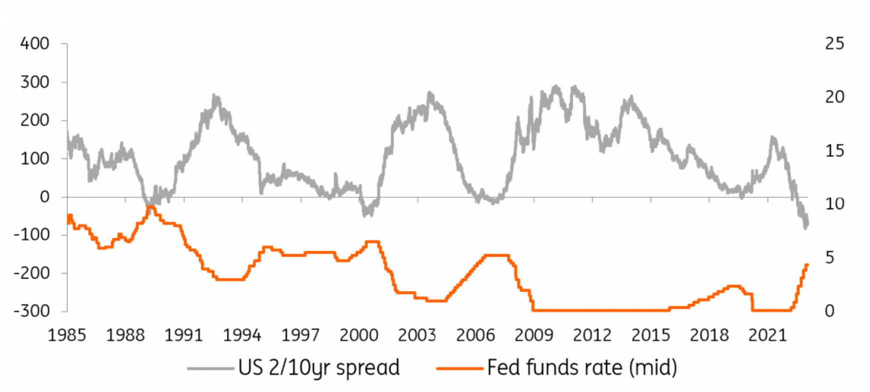
3. While US Treasury yields offer a generous yield for influential Japanese-based players, that's not the case for hedged positions. The cost of a 3mth hedge back into the Japanese yen is 4.9%, well in excess of any running yield along the Treasury curve. With hedged positions yielding a negative yield, this important rump will not play in Treasuries.

4. Importantly, the monetary tightening story is not just a US one. Ultra-low rate economies like the eurozone and Japan are also tightening policy. Indeed, more tightening is likely from the ECB than from the Fed in the coming months. So even unhedged longs will see attainable spreads becoming less attractive as we progress through 2023.

Bottom line, we're suggesting that the US 10yr yield is in fact not that high, we identify better risk/return on the ultra-front end, and suggest that external demand can become more fickle from a relative value sense.

This is further amplified should the US dollar maintain a weakening trend, and bond markets that are inversely related to the USD start to perform better (e.g. some emerging markets).

Future Fed cuts must mean room is made for a much steeper curve



Source: Macrobond, Federal Reserve, ING estimates

Also, to end up with a proper upward sloping curve there needs to be room made by the 10yr yield

There is another important technical factor to consider too, centered on finding room for the curve to steepen out appropriately.

Typically, as the cycle morphs from Fed hiking to cutting we evolve towards an upward sloping curve. At the very minimum the 2/10yr should get to 50bp, and even that is very conservative, as it more often than not gets to 100-200bp. The evolution from dis-inversion to a positively sloped curve limits the room for the 10yr yield to fall. The 2yr yield can fall by lots. The 10yr too, but it depends on what's feasible.

So what is feasible? Let's take our relatively aggressive view for the funds rate – as we see the Fed cutting later in 2023, and getting the funds rate down towards 2.5%. That's the starting point for the curve. When the funds rate gets there, it has bottomed, and the 2-10yr yield curve should be positively sloped. Let's pitch the 2yr at flat to the funds rate, at 2.5% in 2024.

Given that, the 10yr yield really has no business getting below 3%, as at 3% that's only a 50bp curve. It should in fact be a 100bp curve, which would bring us all the way back to 3.5%, where we currently are. In fact, if the 10yr were at 4% while the funds rate targetted 2.5%, that would not be an unusual combination.

The target for the 10yr is 3% and no lower, but don't be surprised if it reverts to 4%

So as a call for 2023, we are looking for the 10yr to rally down to 3%, mostly as the Treasury market can get all excited as the Federal Reserve winds up for rate hikes. But that should in fact prove to be an overshoot to the downside.

The 10yr really has no business getting to below 3%, unless there is the emergence of some (unknown at this point) crisis. In fact, a fairer level is 3.5%. Moreover, if the market gets its head around this, there is a neat route back to 4%. Now that would be a more credible curve, and one more consistent with the renewed ability for economies to generate inflation in the future. We could even skip the 3% and go for straight to 4%.

We understand that the average US 10yr yield over the past decade is 2.15%, and indeed the 2% area has been crossed on a frequent basis over that period; a mean-reversion tendency. Fine, but that does not mean we are heading back down there. There is simply neither room nor logic for that to happen, apart from an anchoring to the recent past when 2% seemed normal.

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