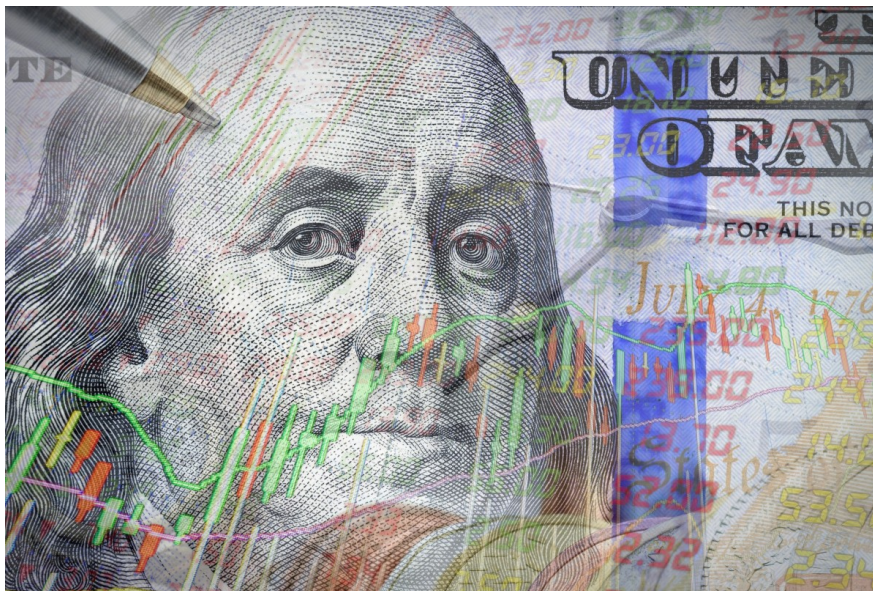


Prepare for some whipsaw in US Treasuries

We can see the 10yr Treasury yield targetting still lower as an attack on 4% is successful. But that's likely an overshoot to the downside. Higher inflation prints in the coming months will likely cause long end yields some issues, requiring a significant backup. And we've seen this before. The last time the Fed cut, the 10yr yield rose (Sep-Dec 2024)



We think the UST 10yr yield can get down to 3.75% but then back up to 4.50% on Fed rate cuts and higher inflation

There is a path for a lower 10yr rate in the lead up to the first Fed rate cut, but that could be it

Following a week of poor labour market data, we're facing into an inevitable rate cut on 17 September. The only debate is whether it will be 25bp or 50bp. We've been here before. In September 2024 the funds rate ceiling was at 5.5%, and it was cut by 50bp. Two more 25bp cuts followed in consecutive meetings, and then there was the pause (we're still on it).

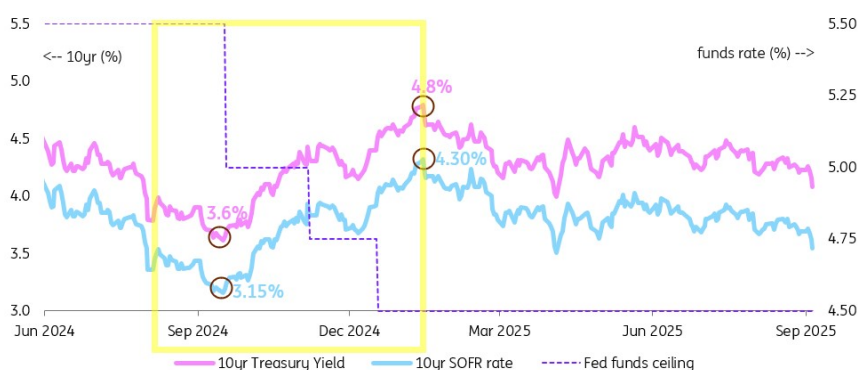
One of the issues of contention through September - December 2024 was the rise in the 10yr yield as the Fed cut rates. There were material falls in the lead up to the first cut. But after that, the 10yr yield ratcheted higher, by some 120bp on aggregate. Hindsight shows there was an overshoot to the downside in the 10yr yield ahead of the first cut.

This is best encapsulated by the 10yr SOFR rate which bottomed at a lowly 3.15%. That's quite a level when we consider it's not far from the bottom being discounting for the *funds rate* in the upcoming rate-cutting phase. Roll on then through December 2024, and that 10yr rate was heading to a new peak of 4.3% (or 4.8% for the 10yr Treasury yield).

We sense that something similar can occur in the coming months.

When the Fed cut last time, the 10yr rate commenced a ratchet higher process

The chart shows the 10yr and funds rate through the cut cycle through Sep - Dec 2024



Source: Macrobond, ING estimates

A rising inflation environment in the coming months is a reason for long rates to ultimately back up again

Why the 10yr yield rose from September through December 2024 is open to interpretation, but there was an underpinning of macro resilience, sticky-ish inflation and lots of talk on fiscal largesse as a medium-term risk. This time around, granted, worries on the economy are more intense. But offsetting this are ongoing fiscal concerns, and quite a different inflation dynamic.

When the Fed cut in September 2024, US inflation had eased to the 2.5% area, and had realistic ambitions to continue to edge lower. Fast forward to today, and US inflation is running at around 3%, and likely heading higher in the coming months on account of the tariff impact. On top of that is the meddling with the Federal Reserve coming from the Trump administration, which is problematic when viewed through the prism of perhaps rates being cut by too much ahead. And, the fiscal situation has not improved. Tariff revenue is underwhelming, tax cuts costs are coming in 2026, and spending remains broadly unconstrained.

These issues paint a risk for subsequent upward pressure on longer tenor yields.

Here's how the 10yr yield can get down to 3.75% and then back up to 4.5%

Currently the 10yr SOFR rate is 3.55%, and it is highly probable that US inflation trends up to the 3.5% area in the coming months. That implies a zero real rate, or the prospect of a negative real rate should the 10yr SOFR rate trend lower from here. Given the market mood,

it likely will, partly as the inflation ahead has yet to be proven.

The absolute limit for the 10yr SOFR rate should be the bottom of the rate cut cycle, discounted now at 2.75% - 3.00%. Realistically, a 50bp spread to that is a fair value floor for the 10yr SOFR rate. That churns out 3.25% as an absolute low. And equates to a 3.75% 10yr Treasury yield (given the 50bp swap spread).

But these are not sustainable levels. It is quite probable that the market begins to run scared of upcoming inflation prints. We agree that the tariff effect is a higher price rather than a sustained higher inflation one. But that too still has to be proven. If inflation prints in the 3.5% area, we'd suggest its quite conceivable that the 10yr SOFR rate would have to find some comfort at above this level. A backup to the 4% area is quite probable (or 4.5% for the 10yr Treasury yield).

This backs out a 100bp curve from the funds rate to 10yr SOFR or a 150bp curve to the 10yr Treasury yield as a call over the coming months. That's not aggressive for the curve. History shows that a 10yr term premium average of between 150-200bp is about right as a tendency to aim for.

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