US 10yr bond yield at 2%. So now what?

The US 10yr bond yield has hit 2%. It's been a heavy lift, and took a 7.5% inflation reading to get us here. We may well pause here in a narrow range around 2% for a bit, but beyond that we view a rise to the 2.25% area as likely, as the real rate journeys out of deep negative territory. From there the debate really begins, and what the Fed does in March matters hugely

What the Fed does in March matters hugely to 10yr bond yield

OK we hit 2%, but the 7.5% print leaves a whopping negative real yield in its wake

It took an inflation reading of 7.5% to finally take the US 10yr bond yield above 2%. The implied negative real yield is staggering; it's -5.5%. What does this mean in plain terms? Well, if you went to your bank and posted a tin of beans as security for a loan to buy the tin of beans, you would get your tin of beans back at the end of the year with an effective 5.5% return on the trade. Basically, completely unproductive activity can yield a positive abnormal return.

Market rates should be above consumer price inflation. But they are not. The question is why not? And more pertinently, where are they heading to next?

The 10yr yield is now in the 2% area. It struggled to get above 2% last year due to Federal Reserve bond buying, foreign demand (US yields are high in a relative sense) and captive audiences like banks and pension funds (regulatory pressure). This year there has been something of a capitulation, partly as the mounting weight of macro evidence has pivoted the thematic underpinning from one of a pandemic recovery to an economic boom. But even there, the 10yr yield in absolute terms is not exactly off the charts. Remember the US 10yr got to 3% in 2018, with US consumer price inflation barely topping 3%. And now inflation is at over 7%.

The US 10yr may well pause here at 2% for a bit (%)

Source: Macrobond, ING estimates

In the 10yr, look for the -50bp real yield to journey towards zero

When we look at the 10yr, the relevant inflation rate is the path it takes from now into the future. The 10yr average inflation rate can be gleaned from market breakevens and is currently pitched at just under 2.5%. So there is a clear expectation that US inflation slows. In fact, the market profile has average inflation at 3% over the coming three years, and then it falls further. If we take the 10yr inflation expectation of 2.5% and confront it with the 10yr Treasury yield of 2%, we derive a negative real yield of -50bp. Not quite as dramatic as the aforementioned -5.5%, but it is still anomalous.

At the very least, the 10yr real yield should journey from -50bp to zero, pressuring the 10yr Treasury yield higher from 2% to 2.5% (the full 50bp). This can be muted to the extent that inflation expectations fall. Let's suppose 10yr inflation expectations fall from 2.5% to 2.25%, which is entirely possible (as the Fed actually beings to tighten policy). That would pull the 10yr Treasury yield back to the 2.25% area. That level represents neutrality. It is neither rich nor cheap. It's well up from where it was, but from an ultra-low starting point.

We target the 10yr to hit 2.25%. From there the debate really begins

Once we get to 2.25% (assuming we do), there is an asymmetrical profile ahead spanning from 2% to 3% (75bp to the upside vs 25bp to the downside). It is entirely possible that the 10yr could spike to 3%. The market could, for example, pay proper attention to the fact that the Fed will move some US$2-3tr from its balance sheet to the open market in the coming few years, implicating a big net rise in available bonds.

But the journey to 3% would also pressure the economy, which has re-calibrated to much lower rates. Bond re-financing by both government and corporates would also become that bit more painful. There are natural constraints there to help prevent an exaggerated move to the upside.

On the other side of the debate is the notion that an undramatic balance sheet roll-off, slowing inflation, and ongoing foreign and captive demand for core bonds, is a rationale for the 10yr Treasury yield to slip from 2.25% back down to 2%. Or even lower should long-term demographic and/or nearer-term sub-trend growth concerns rear their respective heads.

In fact, should the 10yr inflation expectation converge lower to 2.25%, and the 10yr trades flat to this, that would imply a zero 10yr real yield. That could prove a tolerable equilibrium if the Fed is doing their tightening thing in an effective way on the front end.

> As a short-term guide we need to watch the March FOMC meeting carefully. Prompt and timely rate rises from March onwards should begin the work of taking steam from the economy. In fact if these are perceived to be aggressive enough, the curve can seesaw with back end rates easing lower, as we have seen in previous rate cycles. This is more applicable to the 30yr, but can filter down to the 10yr.
>
> As a call we think the US 10yr heads for 2.25% regardless. Then, a Fed that delivers 50bp in March is more likely to be getting ahead of the curve which would help contain the 10yr cycle peak to the 2.25% area. A decisively hawkish 25bp hike might have a similar effect. But a tame 25bp hike with no bite could leave the market at least pondering a path towards 3% on the 10yr. We may not even get close, but on the table it is.

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 www.ing.com.