US 10yr eyeing 3%. So now what?

Once we hit a 0% US real yield we adopted a "turning point watch" position. We don't think we've seen it yet, primarily as inflation expectations continue to trend higher. Containment of these is crucial, else we move into an explosive state where we trek in the direction of 4%. But contain them and we can top out with a low 3% handle, even on higher real rates

Source: Shutterstock

We've gone from 2% to almost 3% in a matter of months - are we done?

Back in February, the US 10yr broke above 2%, and we posed the question – now what? We noted at the time that "a tame 25bp hike (from the 16 March FOMC) with no bite could leave the market at least pondering a path towards 3% on the 10yr". Well here we are; now knocking on the door of a 3% 10yr yield as we face into the next FOMC meeting (set for 4 May).

So, we pose a similar question – what now?

We think there are two possible states ahead. One is for things to become more explosive. The other is for things to calm down. The latter is more probable, but the former is entirely possible, depending on a few important factors.

A 50bp hike is fully discounted, so is delivery inconsequential?

What the Federal Reserve does next is important for starters. A 50bp hike is fully discounted from the 4 May FOMC, but there is a mild discount brewing for a 75bp hike.

The minutes of the March FOMC meeting were remarkable in the sense that members noted that a 50bp hike could have been on the table had it not been for the Russian invasion of Ukraine. This is important as it is quite rare for the Fed to even consider delivering something that was not pre-discounted by the market (even if often pushed there by the Fed in the first place).

In consequence, the argument goes, could the Fed deliver 75bp in May as a catch-up? The argument against a 75bp hike is it could cause more consternation than comfort. We still think they do 50bp, but watch this space all the same.

The big question centres on inflation expectations - can they be contained?

In contrast, the argument in support of a 75bp hike centres on the containment of inflation expectations. Last week, we saw the US 10yr inflation breakeven briefly break above 3% (it's back below now). Psychologically it's important for the Fed to keep 10yr inflation expectations below 3%. Long-term inflation expectations are tolerable with practically any kind of 2% handle, but intolerable with a 3% one.

Remember, elevated 10yr inflation expectations are absolutely not about contemporaneous supply-chain bottlenecks or energy price spikes. Rather, it's about a failure to anchor long-term inflation dynamics, an area of central responsibility for the Federal Reserve.

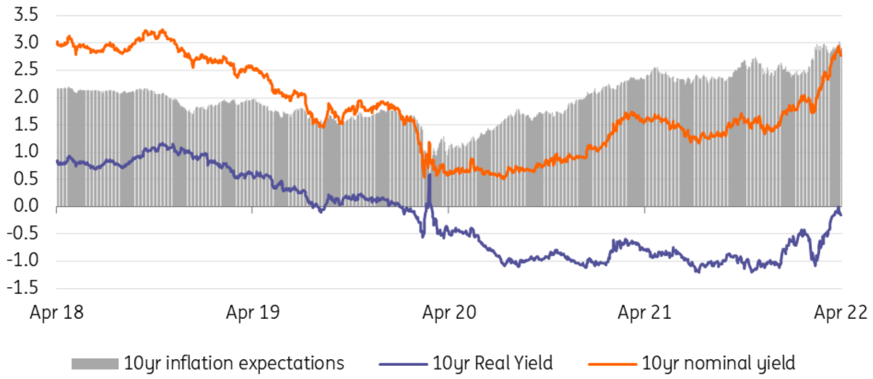
For as long as inflation expectations are testing the upside, it's hard to argue that we are at a turning point for market rates.

We are on turning point point watch - close but not there just yet

Typically, we know there has been a turning point in market rates when we see it in the rearview mirror.

We've argued that turning points typically occur when the 2/5yr spread is flattening with the 5yr yield falling. We'd add to that a requirement for inflation expectations to peak out and start to fall. That, together with a richening of the 5yr on the curve, would provide the key ingredients for market rates to top out. Right now, the 5yr is too cheap, and crucially inflation expectations are still heading in the wrong direction. So the pressure remains for market rates to head higher still.

Breakout of the US 10yr yield (bp) - Off the highs but still bubbling



Source: Macrobond, ING estimates

But, once the US 10yr real yield hit zero last week, we moved to "turning point watch", as a zero real yield was where we were pre-Covid. It could be argued that zero is still too low (and it is). Pressure for a higher real yield places more upward pressure on market rates. But even, say, a 50bp real yield does not mean that market rates need to be 50bp higher if inflation expectations were to fall by an equal and opposite 50bp.

An aggressive Fed could help here. It would accelerate an unwinding of 5yr cheapness to the curve, and would likely tame inflation expectations. And provided inflation expectations fall by more than real rates rise, then market rates can top out.

And then there is the explosive scenario where 4% is on the menu

However, if the Fed were to lose the long-run inflation expectations battle in the next couple of months, then we head into the explosive scenario where we start contemplating a 4% 10yr yield. Picture this as being primarily driven by a further elevation in inflation expectations, but bullied there also by higher real yields, for example, a 50bp real yield and 3.5% inflation expectation.

The most efficient means to containing the risk for a 4% 10yr yield would be to tame inflation expectations. Such expectations can be bullied by many factors that are outside the control of the Fed (e.g. price shocks from the war and/or the pandemic), but the Fed has no choice but to react to whatever the net impact is on US inflation expectations. Leave them untethered and risks elevate for a move toward 4%.

> We are on turning point watch as a central view, but we also maintain an apprehension that the risk for a further ramp higher in market rates has not yet been dealt with by suitable Fed policy. In consequence, we can see a break above 3% on the 10yr as likely from here, but the Fed would really have to lose the inflation expectation battle for us to be seriously considering a move to the next big figure at 4%.
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> And by the way, we've not complicated this by discussing the balance sheet roll-off saga. As

a stand-alone, this places upward pressure on market rates (as bonds roll off the Fed's balance sheet back onto the market). But this is not, in our view, a determining factor. Important for the collateral versus liquidity ratio and repo, but less important for mapping out where the 10yr market rate peaks.

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