

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.

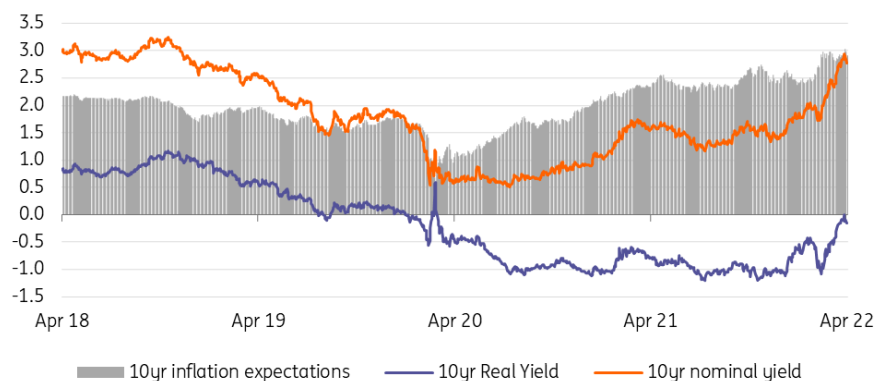
For as long as inflation expectations are testing the upside, it's hard to argue that we are at a turning point for market rates.

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%.

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.

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>.