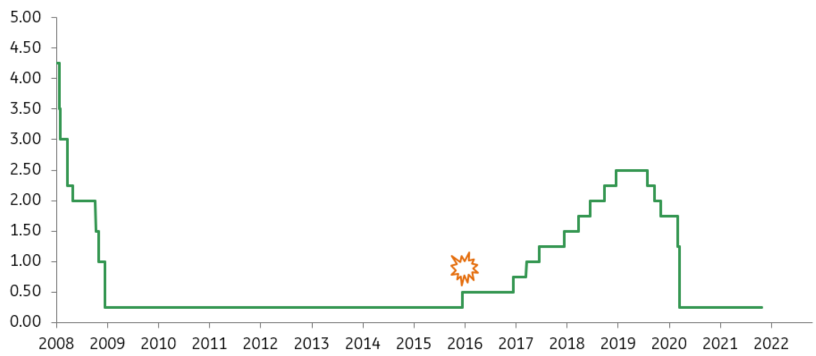
Where now for US rates

At the end of 2015, the Federal Reserve hiked the Fed funds rate by 25 basis points to take it off zero, after practically seven years. It took that long for the economy and system, in the wake of the financial crisis, to be able to take a first hike. We are now looking into a lift-off phase again. Here we examine what's discounted and what happens next

The Fed funds rate is waiting for lift-off again (%)

Calculated at the ceiling where there is a range (e.g. now at zero to 25bp)



Source: ING estimates, Macrobond

The first port of call is the shape of the curve. The curve naturally steepens when the Fed cuts. We've been through that phase. Phase two of the steepening is where longer tenor rates begin to fret about an uplift in inflation. We've had a bit of this, but we feel there is more ahead, partly as the inflation worries are becoming more ingrained, contrasting with the prior dominant notion of a transitory inflation spike. The quantitative easing-impacted excess of demand over supply of government bonds has muted the degree of steepening.

Probable is upward pressure on longer tenor rates, led by the belly

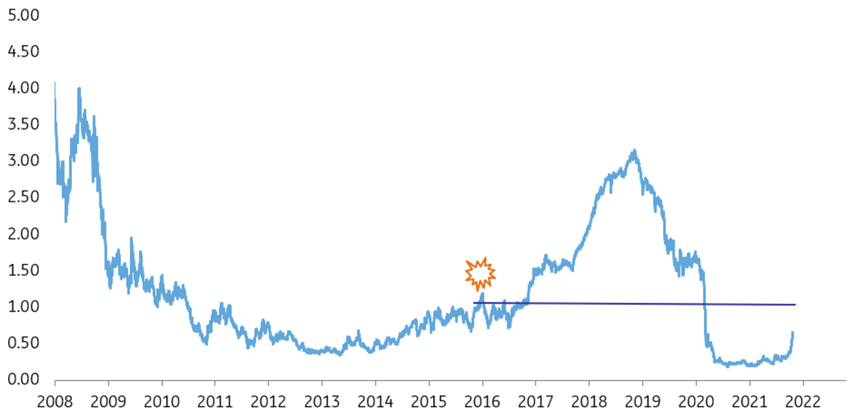
But what remains probable is upward pressure on longer tenor rates. The bulk of this upward pressure is centred on the belly of the curve, identified as the 5-10yr area. This manifests in flattening pressure on the 10/30yr segment and steepening pressure on the 2/5yr segment. Both of these are ongoing. The difference is the 10/30yr flattening process is a structural one that is already underway, and could ultimately end up in a medium-term inversion.

The belly has a nose for where rates might settle in a few years

The steepening on the 2/5yr segment is more tactical. It's being driven by upward pressure on the 3/5yr area. This has a nose for where front end rates might settle a few years down the line. So for example, the 5yr rate today at 1.25% is telling us that in all probability the Federal Reserve manages to get the funds rate up to the 1% area at the very least. The 2yr is less responsive right now as a rate hike is not seen as imminent. At the same time, there has been a clear move higher in recent weeks; it's now approaching 50bp.

The 2yr yield is popping higher; much more to go (%)

The last rate hike process started at end-2015



Source: ING estimates, Macrobond

Before the first Fed hike at the end of 2015, the 2yr had shot up to the 1% area. A year before, it was in the 60bp area, but trading in a range between 40bp to 80bp. And two years before, it was in the sub-40bp area. Based off that, we are currently entering what could be described as the one year countdown to a first hike. A structural move to above 50bp would imply that the one year countdown has officially begun. A move above 75bp would bring that down to a three-month window, where we are on imminent rate hike alert.

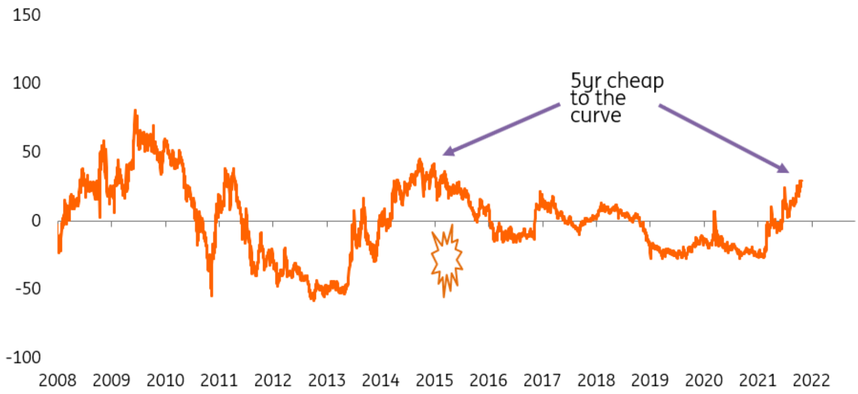
> *Over time, the 5yr will overshoot and undershoot versus its fair value position on the curve*

Another way to look at market preparedness could be through the prism of the curvature of the curve, and specifically the positioning of the very sensitive 5yr on the curve. Where the 5yr sits between the 2yr and 10yr tells us a lot. The 2yr stares down the barrel of imminent central bank policy and reacts directly to that, whereas the 5yr sits between the jumpy 2yr versus the more measured long term inflation expectations rudder as set by the 10yr.

Over time, the 5yr will overshoot and undershoot versus its fair value position on the curve. When it's trading cheap (sitting above the curve) it typically means that either we are in a bear market for bonds and market rates are rising and/or we should brace ourselves for a change in the cycle where the Fed is thinking about interest rate hikes.

The belly of the curve is getting cheaper and cheaper (bp)

Calculated as the 5yr versus a straight line between the 2yr and 10yr



Source: ING estimates, Macrobond

A glance at the current positioning of the 5yr on the curve confirms that it is quite cheap, having been on a definite cheapening trend since February this year. It is now at valuations that are in line with what we saw in 2015 (the year that saw the Fed's first hike at the start of the previous hiking cycle). The chart also shows that the 5yr became even cheaper in 2014, and history shows that the 5yr has in fact been much cheaper in previous cycles. Usually it tops out in the 25bp area (versus 15bp currently); or 50bp in gross terms (as some prefer to use this).

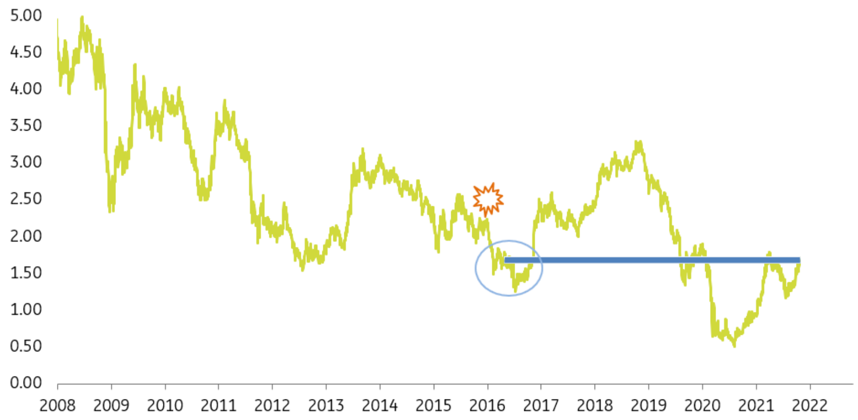
> *The 10yr in the 1.7% area is neither comfortable on the macro prognosis nor frantically worried*

Typically, as the 5yr goes on a cheapening trend we are in a bear market and market rates are rising. As the Fed gears up for an actual hike, the 5yr will decompress and begin to richen, but mostly as the 2yr rate rises in relative terms. So during this important phase of the cycle, the 2/5yr segment is flattening quite dramatically, driven by the rise in the 2yr yield. Splicing that on to current circumstances would suggest that a big 2/5yr flattening is coming, likely really by the beginning of 2022.

With respect to the level of rates, the benchmark guide here comes from the 10yr. It's now at just under 1.7%, back to where it was in March this year as it gapped higher on reopening optimism, but also back to where it was in the second half of 2019 (pre-Covid) when the markets were beginning to fret about an imminent recession. So the 1.7% area valuation is not a decisive level; it's neither comfortable on the macro prognosis nor frantically worried.

The 10yr yield is getting nearer to a nod towards rate hikes (%)

Ideally needs to be at or above 2% for comfort



Source: ING estimates, Macrobond

When the Fed hiked at the end of 2015, the 10yr was at 2.25%. Even though it slipped lower in the wake of that hike, subsequent years saw it ratchet up to 2.5% in 2017 and 3.0% in 2018. So, as the Fed delivered a series of 25bp hikes during this period, it was endorsed by an ongoing elevation in the 10yr rate. Back to today. At just under 1.7%, there is only a mild nod coming from the markets that the Fed can engage on the delivery of a series of hikes. Realistically, the 10yr should trade at a handle of 2% before a first hike, providing the Fed with room for a confident delivery.

> *Realistically, the 10yr should trade at a handle of 2% before a first hike*

And that's what we expect. The 10yr should edge up to the 2% area. As it does, the 5yr should cheapen further on the curve. Alongside that, the 10/30yr is on a structural flattening process, likely heading towards zero (now 43bp). By early 2022, the 2yr should be on the rise, breaking above 60bp, ultimately on the way to 90bp. That should flatten the 2/5yr segment, which should have peaked out in the 100bp area (currently 75bp). As the Fed delivers hikes in the second half of 2022, that 2/5yr segment follows the 10/30yr towards zero, while the 5yr is on a structural richening process to the curve.

What could muddy the waters? Lots

What could muddy the waters? Lots. But a failure of the 10yr to get to 2% would make the prognosis far more wobbly. Worse, a fall in the 10yr yield (some are talking about 1%) would make the runway that the Fed needs for a series of hikes much shorter, lowering the terminal rate. A fall in the 10yr rate, as the Fed (eventually) hikes, would have a similar effect, as the Fed will not want to invert the curve. The signalling coming from the 10yr real rate at -100bp ensures that such scare stories are not without merit. But all things considered, every base case has its shadow risk case, and our base case sees a 2% handle on the 10yr. At least we get there first, and we'll see then.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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