

April 9, 2024

What's Causing The Rise In US Yields?

Oil prices, policy expectations

- We investigate this year's increase in 10y bond yields
- Combination of higher oil prices and slower rate-cut expectations seems the driver
- Waning T-bill supply buoying RRP balances

Decomposing the rise in yields

US 10y bond yields have topped 4.4% in recent days, reaching their highest levels this calendar year. Multiple hypotheses have been advanced for the steady move higher, including stickier and higher inflation readings, expectations that the Federal Reserve will be much slower to cut rates this year (if at all), US fiscal deterioration, higher natural rates of interest (i.e., higher r^*), and stronger US growth in 2024 than was initially expected.

Some of these explanations are overlapping or mutually reinforcing. Stronger growth due to a productivity boom may have raised the equilibrium rate of interest, as would structurally higher inflation (by requiring tighter monetary policy in equilibrium), for example.

Inflation expectations in the short term may be playing a role. However, survey data (including the Consumer Expectations Survey from the New York Fed, released on Monday) show little movement in inflation forecasts made by consumers. Likewise, economist surveys. The 5y5y inflation swap has risen a mere 10 basis points since the beginning of the year. Where we really see movement in market-based measures of inflation expectations, however, is in breakeven rates, inferred from comparing the 10y nominal yield to the 10y TIPS yield. That has risen 23bp since Dec. 29, 2023. Much of that move is due to rising oil prices, a factor to which the breakevens are particularly responsive. See the chart below.

Oil Prices Drive Breakevens

Breakeven inflation and oil



Source: BNY Mellon Markets, Bloomberg

Other suggestions, such as protracted and worsening fiscal conditions, don't strike us as having an impact yet, although we do think there will eventually be further upside risk to yields in the second half of the year. We would argue that if fiscal deterioration were responsible, we'd see a rising term premium, reflecting increased credit concerns for long-dated US debt. As the chart below shows, however, we see no material increase in the NY Fed's estimate of the premium – it's currently slightly negative.

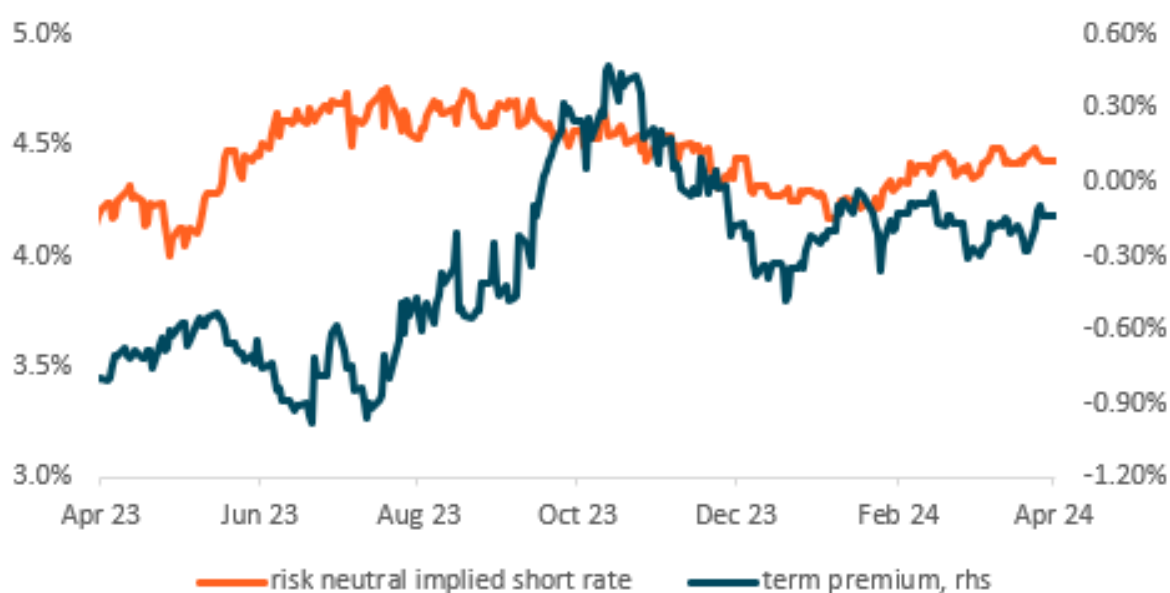
What about higher short-term rates, either driven by the notion of a higher r^* or that the Fed will be slower to cut rates this year, and those rate cuts will be fewer and slower over time?

In many ways those two debates are the same – they center on what the appropriate interest rate will be when all is said and done in this cycle. We note that the terminal fed-funds rate, 2.6% 'long run' in the March Summary of Economic Projections, was up slightly from 2.5% in December. As Cleveland Fed President Loretta Mester mused recently, r^* could be even higher. In general, we view the Fed as rethinking the neutral rate, an exercise we'd agree with. In the chart below we include the so-called risk-free neutral rate associated with current bond prices, a proxy for short rates in ten years. It's barely budged.

We also note that the 10y-2y yield spread has held steady around -35bp to -40bp since 10y yields began rising. Essentially, the 2y yield, which should summarize medium-term expectations for monetary policy, has risen by roughly the same amount as the 10y yield. In other words, to the degree the 2y rate is sensitive to Fed policy expectations, the 10y yield has moved with it. The above discussion leads us to conclude that it's a combination of higher oil prices and higher expectations for the eventual policy rate that's driving the move higher in yields.

Term Premium And Implied Short Rates Contained

NY Fed 10y bond yield decomposition



Source: BNY Mellon Markets, Federal Reserve of New York

Developments at the very front end of the curve

Take-up of the Fed's reverse repo facility (RRP) is not declining inexorably as it had in the recent past. After reaching a low of \$414bn in mid-March, current usage of the facility is just under \$450bn. In the first six days of April, the RRP averaged \$442bn. At the same time, T-bill issuance has been cut back in recent weeks. Treasury has cut auction sizes, and since March 15, net bill issuance has declined by \$3.8bn. This is – not coincidentally, in our view – the same date that RRP usage hit the low point mentioned above.

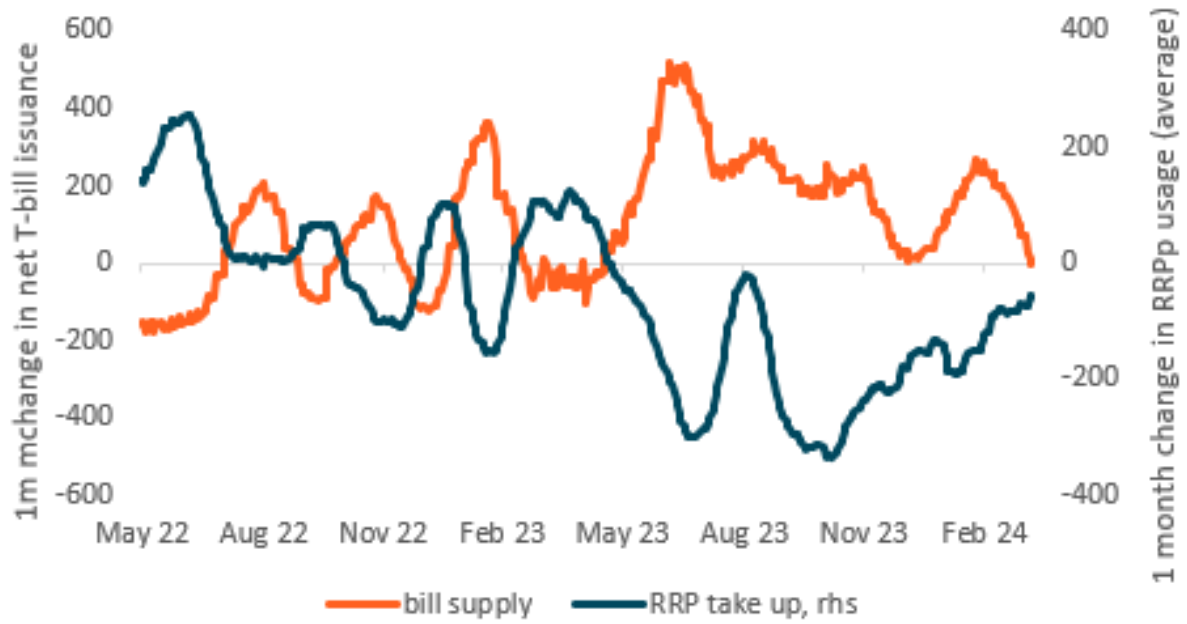
The chart below illustrates a strong relationship between bill issuance and RRP usage. The more T-bills out there, the faster the RRP drain. We show the one-month increase or decrease in RRP usage (blue line), versus the one-month change in net bill supply (orange line). The almost-mirror-like relationship between the two series shows this dynamic clearly.

We expect T-bill supply to be restrained in coming weeks, thanks to both robust tax receipts this month paid into the Treasury (see [here](#)) as well as a Treasury General Account that – at around \$800bn – is above the \$750bn target set forth by the Treasury.

This is good news, as we have been arguing that payments this tax season would be large on the whole, approaching the \$600bn taken in by Treasury during April 2022. At that time, all-system reserves fell by nearly \$500bn. If that were to happen this time around, and with bill supply restricted, we could see reserves become uncomfortably low. However, with RRP still holding steady above \$400bn, reserve scarcity might not become an issue this month.

RRP Usage & T-Bill Issuance

Bill supply and RRP



Source: BNY Mellon Markets, Federal Reserve Board of Governors, Bloomberg

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNYMellon.com



John Velis
AMERICAS MACRO STRATEGIST

CONTACT JOHN

