BNY MELLON

iFlow

SHORT THOUGHTS

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Behind The Rise In Treasury Yields

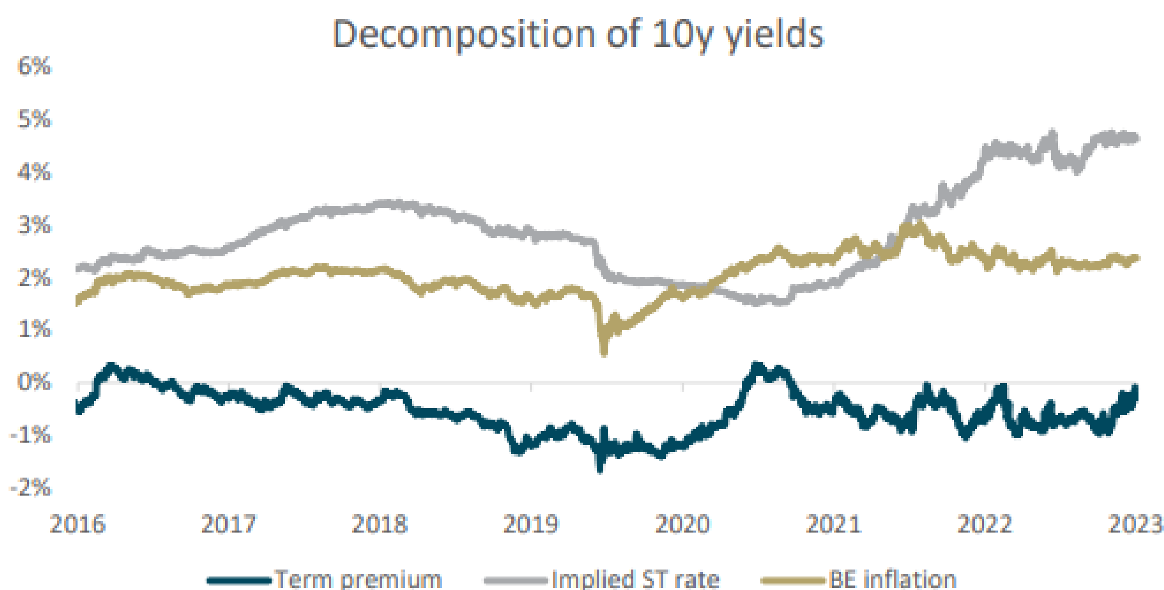
A Quick Decomposition Of Yields

The recent move higher in US bond yields has made for a significant bear steepening in the Treasury curve, in line with a call we made back in June. For example, the 2y10y yield spread has gone from roughly -150bp since end-June to around -60bp as of this writing.

Our bear-steepening call was based on several factors, one the view that the Fed would eventually be seen to be done – or very close to it – raising policy rates, thus anchoring the 2y yield at around 5%; it's 5.12% now. We were also concerned about fiscal dynamics in the US, as well as the requirement – since realized – for a significant increase in coupon supply. Finally, we were unsure of how a variety of players in the Treasury market would participate in this issuance. All of these developments have come to pass. An additional driver was the threat of a move to tighten policy by the Bank of Japan. An actual move would serve as an interest-rate shock to global bond markets, likely driving yields higher across developed markets. While the BoJ has been reticent to really alter its yield curve control policy, the threat is still on bond markets' radar, implying a discount to bond pricing.

In this note, we look at the drivers of the move higher in the 10y Treasury yield from around 3.3% in April and May this year to over 4.5% presently; it took just two months, since mid-July, for the 10y yield to run up 75bp from 3.75%. It would be tempting to argue that sticky inflation and the consensus view – as well as the Fed's – that inflation would persist have driven up nominal yields. However, in the chart below we can see that inflation expectations as implied by breakeven rates (amber line) have not moved materially higher during 2023. Indeed, breakevens have declined subtly in the last few months, so it would appear that inflation expectations are not driving this move higher.

Higher Short Rates = Higher Yields



Source: BNY Mellon, Federal Reserve Bank of New York, Bloomberg
Note: The term premium and implied short term rate are from the NY Fed's Adrian, Crump, and Moench term premium model.

Higher Yields And Less Dealer Inventory

We include on the chart a widely followed estimate of the 10y Treasury term premium, or the extra compensation required to hold a long-term bond (blue line), along with a related estimate of the market's expectation for short-term policy rates in ten years' time (gray line). Both the term premium and the estimated policy rate have moved significantly higher in recent months. The former, which had been negative and falling for most of the post-GFC/pre-pandemic period, is now nearly positive. The move lower in the term premium during the decade before COVID reflects the impact of central bank purchases of bonds during the post-GFC QE era. Furthermore, a prevalent belief in "secular stagnation" after the GFC implied lower equilibrium interest rates and hence bond yields. Those days are now behind as we move forward in the post-COVID world.

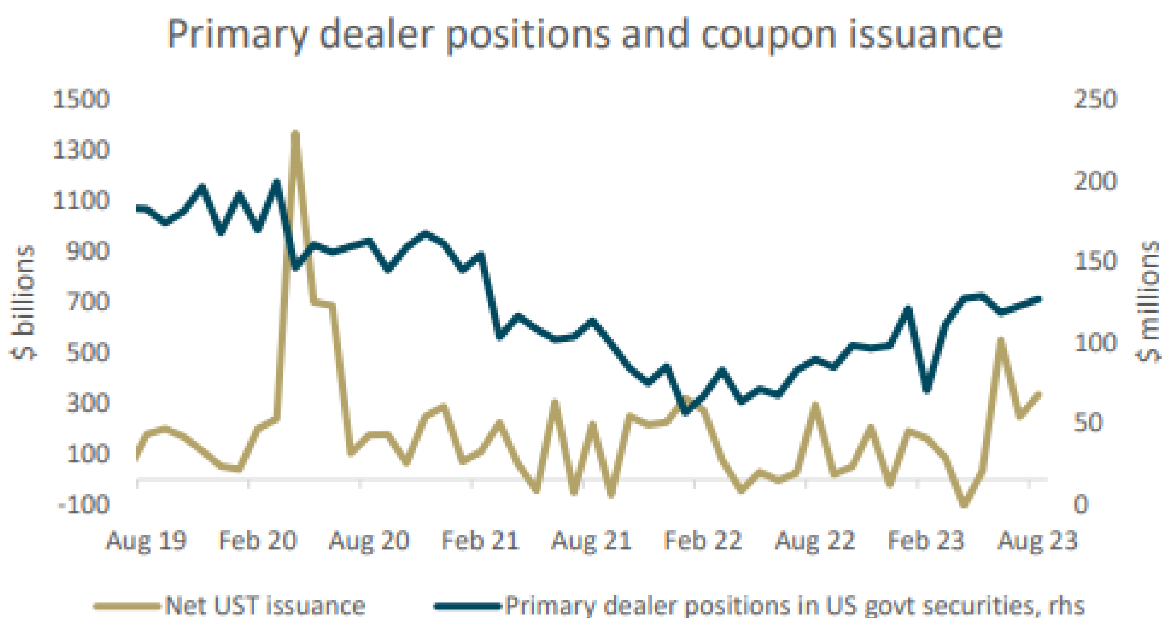
This change in view, from secular stagnation to a world with higher interest rates, is also reflected in the estimate of the expected short rate ten years hence. Note the move higher in the amber line since 2020. Markets have become increasingly of the view – and the Fed more strident – that policy rates will stay high for many years as the central bank aims to crush inflation, something Fed officials think will take a long time. The updated Summary of Economic Projections from last week's FOMC meeting shows that in its collective wisdom, the Fed sees policy rates all the way out to 2026 that are higher than its own projection for the neutral policy rate, or r-star (see here for our take on this concept). This means that for five years, if we include 2022's realized policy rates, the Fed expects that the nominal funds

rate will be higher than 2.5%, which the Fed still pegs as the neutral rate of interest.

The amber line rejects that view and presumes that in a decade hence, the neutral short rate will be on the order of 4.5%. This means that 10y bond yields will have risen to incorporate a much higher neutral policy rate, anchoring yields higher. The bottom line is that term premia are returning to more reasonable levels and expected short rates to much higher values. This is a real rate move, not necessarily a nominal (i.e., with inflation expectations) move.

In the next chart below we show primary dealers' outright holdings of all US Treasuries and net coupon issuance. The former have increased as issuance has taken off post-debt ceiling resolution this summer, but remain well below levels seen, for example, during the period of COVID spending by the government. Primary dealers are balance-sheet constrained and appear unwilling to keep excessive inventory. This is a significant portion of the market which does not appear to be growing rapidly as issuance proceeds apace.

Dealer Inventories Not Keeping Up With Issuance



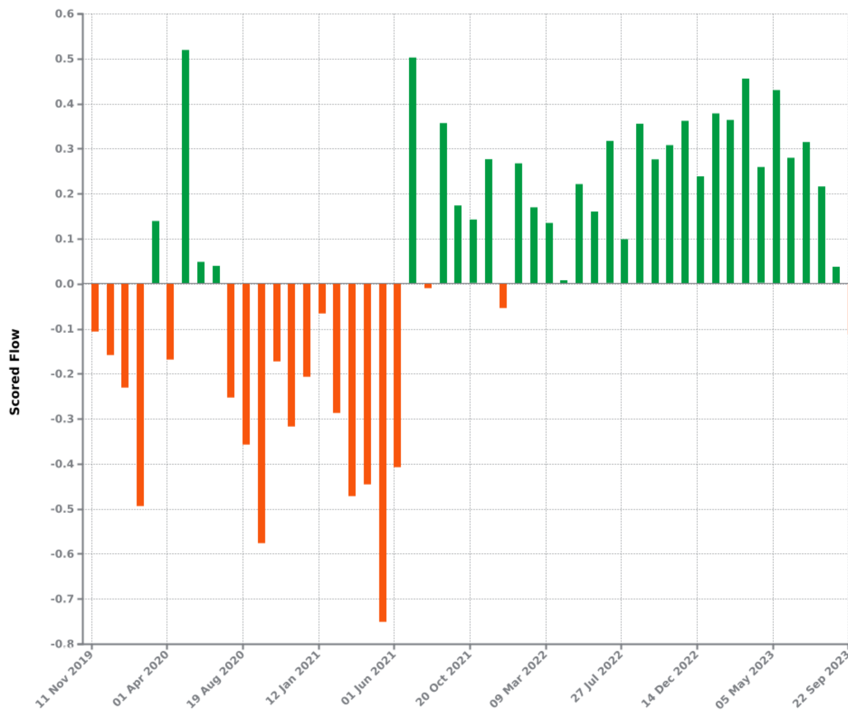
Source: BNY Mellon Markets, Bloomberg, SIFMA

Waning Real Money Demand

Finally, below we show our iFlow data for UST flows over the last three years. Interestingly, until very recently – when we have seen demand wane – for most of the post-lockdown period real money flows had been quite robust and implacable. That has changed: as yields have risen in the last few months, we see net selling for the first time since the summer of 2021. Investors had been content to buy into rising yields (falling prices) for most of the year until August, which of course, coincides with the onset of bear steepening. Supply and

demand fundamentals continue to auger for higher yields, in our view. We expect the 10y Treasury yield to move towards 5% by the end of the year.

Recent Change in Investor Demand



FI

SUBCLASS
GOVERNMENT BONDS

Scored Flow

INVESTOR BASE
ALL

United States

Monthly
AVERAGED

DATE RANGE:
09.30.2019 — 09.22.2023

MEAN +0.04

STANDARD DEVIATION +0.31

Source: BNY Mellon Markets, iFlow

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

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CONTACT JOHN

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