GENERALI ASSET MANAGEMENT

FOCAL POINT

US: a higher neutral rate may limit the fall in long yields

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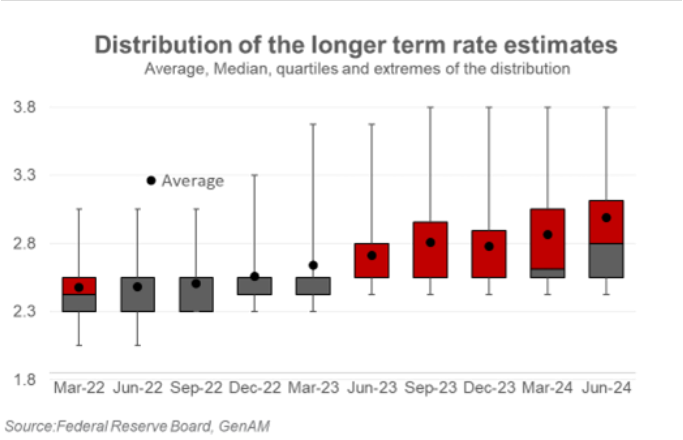
Our Focal Point series explores topical issues on macro, markets and investment

- **The most hawkish message delivered by the Fed at the June meeting was the upward revision of the longer-term policy rate, from 2.6% to 2.8%. With that the FOMC signals that, after the easing cycle, rates are very unlikely to go back down to the very low levels prevailing before the pandemic.**
- **Indeed, we now expect the Fed to bring the policy rate down to the 3.25%-3.5% range by mid-2026. This is 25pp *higher* than the corresponding median 'dot', and 50bps higher than the current FOMC median estimate of the neutral rate *yet* still *some 50 bps below market pricing*.**
- **Our estimate of the longer term, neutral rate is around 3.1%. This is due to a combination of a temporarily higher trend growth of the economy and the projected higher net supply of Treasuries. This puts a higher floor to the descent of the long-term rates.**

At the June meeting, the Fed disappointed markets by signalling only one rate cut in 2024 in its median projections by FOMC members. However, the disappointment was mild as it left the door open to two cuts, which remains our baseline. The most hawkish message, and the one with a potentially stronger bearing for Treasury yields, was the upward revision of the neutral, longer-term, rate, from 2.6% to 2.8%. This was the continuation of a trend already visible since late 2022 (see chart), which indicates an important shift in the FOMC thinking about the long-term outlook for monetary policy.

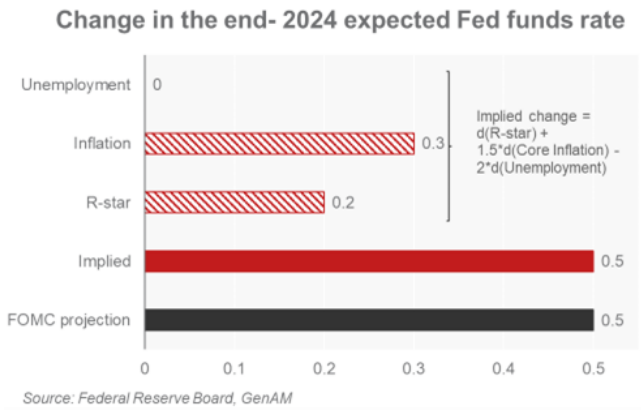


Source:Federal Reserve Board, GenAM

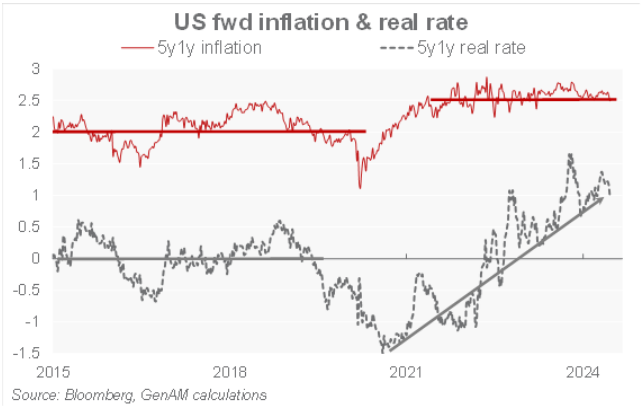
Higher neutral rate impacts yields at short horizons

During the press conference, Chair Powell was careful in saying that the Q1 inflation overshoot led the Fed to conservatively raise the inflation forecast, but that the beginning of the easing cycle is just delayed. Indeed, the appropriate rate for year end-2026 remains in the 3% to 3.25% range. However, given that by that time the FOMC sees core inflation at target and the unemployment rate 0.1 pp below the natural rate, the rate is still 10 bps higher than

what a popular policy rule[1] would require and 30 bps higher than neutral. More importantly, we think that the upward revision of implicit R-star had an important role also in the decision to reduce the number of appropriate cuts for this year from three in March to just one. The policy rule can also be used to gauge what motivates the policy shift[2], by considering the variation of the drivers of the policy decision (neutral rate and expected core inflation and unemployment) and deriving the implied change. This exercise shows that the actual revision is in line with that implied by the policy rule and, importantly, nearly one half of that is due to a higher estimated neutral rate (see chart).



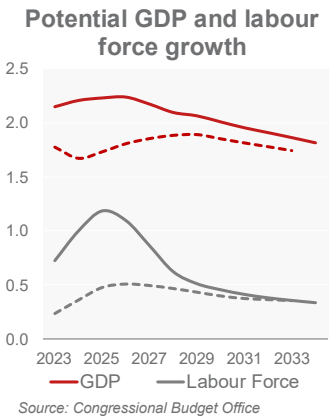
Chair Powell has repeatedly downplayed the importance of the neutral rate, yet it appears to matter for even short-term monetary policy. Market based estimates of R-star are strongly correlated with the 10-year UST.

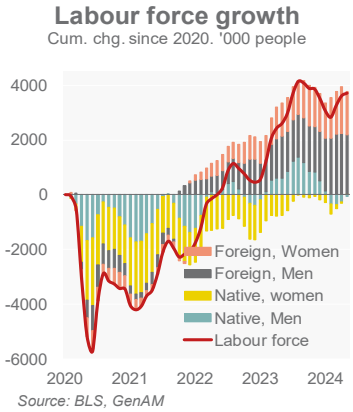


Before the pandemic these estimates were relatively stable around zero and have soared over the last couple of years. A one-to one comparison with the 0.8% real neutral rate implicit in the FOMC dots is not entirely accurate, as market-based measures contain risk and liquidity premia. But the widening of the gap since 2023 indicates the expectations that, faced with some structural (or at least long-lasting) changes in the economy, the Fed will be forced in the medium term to keep the policy rates at a higher level than in the past. We think that this view has its merits and expect the Fed to bring the policy rate down to the 3.25%-3.5% range by H1 2026, well below current market pricing of 3.9% but higher than what the FOMC deems appropriate. We also raised our estimates of the long term (neutral) policy rate, to 3.1%, some 30 bps higher than the current FOMC estimates. We think there are good and bad reason for that. First, a persistently higher trend growth raises the Fed funds level at which the forthcoming easing cycle will end. But, more structurally, a higher net supply of Treasuries will increase the longer-term neutral rate.

Stronger growth lifts the (short term) landing rates

Stronger trend growth, especially if due to higher working age population growth and productivity, is normally associated with a higher neutral rate as the economy can tolerate a higher level of policy rate without harm to domestic demand. In February the Congressional Budget Office (CBO) revised upwards its projected trend growth over the next four years. The key driver is the surge in the labour force as the pandemic era immigration restrictions were lifted in 2022. Indeed, immigrants accounted for most of the increase in the labour force during the post-pandemic recovery. This pace of growth is unlikely to continue in the coming years, especially if the Republicans are strong enough after the November election to implement their very restrictive immigration policy plans[3], and given also the relatively low appetite Democrats have for mass immigration. Therefore, its contribution may be long lived but not structural.





Another important uplift to trend growth is the rise in labour productivity observed since 2023. We think that this is linked

[1] Rate = Neutral Rate + 1.5*(Inflation – 2%) – 2*(Unemployment – NAIRU), see Yellen (2016)
[2] For a more detailed explanation, see this 2016 paper from the San Francisco Fed
[3] The CBO labour force projections are based on the current legislation.

to firms' reaction to a tight labour market and is likely to fade once demand and supply for labour go back into balance.

Longer term, AI could provide a strong and more durable contribution, which has yet to show up in the numbers: surveys show that a very limited number of firms (less than 10%) use or plan to adopt AI in the short term. In the mid-1990, the late 1980s mass PC adoption eventually boosted total factor productivity and lifted persistently trend growth, allowing the Fed to keep the short-term rate higher than nominal growth for a prolonged period without crushing demand.

Higher net supply of Treasuries drives up R-star…

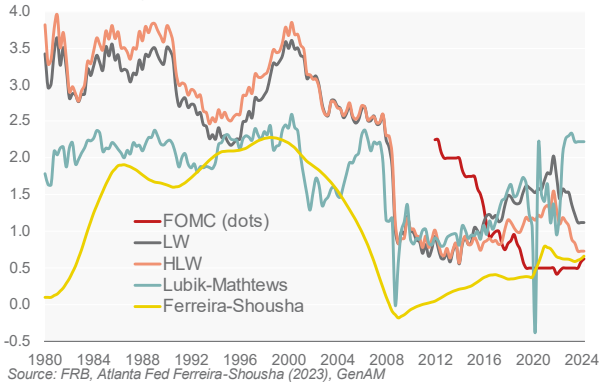
We think that the neutral rate (a longer-term gauge) will go up too, due to less benign factors. It is worth recalling that the neutral rate is not only linked to the steady state growth of the economy. Being defined as the equilibrium, risk-free short-term real rate, it also reflects the balance between demand and supply of safe assets, like US Treasuries. This is in turn linked to the balance between domestic saving and investment (for the public sector, the budget balance) and to the foreign investors' propensity to hold US safe assets. The most popular estimates of R-star are derived from theory-heavy macroeconomic models, whose baseline assumptions may be questionable and may not work properly when the economy is hit by very large shocks like COVID.

…but model-based measures are very volatile

This delivers a very wide dispersion in the point estimates: looking at the most widely diffused models as of Q1 2024, the neutral rate for the US can be anywhere between 0.6% and 2.2%, too wide a range to provide a useful guidance. Moreover, post-2020 readings from the most popular structural models[4] show extreme volatility (hard to explain for a supposedly steady-state variable) and some counterintuitive behaviour, such as the sharp decrease in some measures, which is hard to reconcile with the strength of the economy[5].

Still, having a view on the neutral rate dynamics is useful as it drives long term rates. In what follows we update the work we presented last year on what drives the neutral rate and what is a realistic medium-term path given a set of macro assumptions[6]. As our econometric estimates show[7], a lot of the drop in the neutral rate can be explained by the sharp increase in demand for Treasuries by interest-insensitive investors, namely EM countries willing to prop up FX reserves after the mid-1990s Asian crises and the Fed during the several rounds of QE. Moreover, bouts of volatility increased private sector risk aversion, contributing to the demand for safe assets. All this has created an excess demand for Treasuries that lowered the rate required to balance demand and supply.

Model/survey based measures of the real neutral rate



Source: FRB, Atlanta Fed Ferreira-Shousha (2023), GenAM

Going forward, according to the projections from our updated econometric model we expect a moderate increase in the US neutral level, of about 40 bps over the next five years to around 3.1% (corresponding to a 1.1% real rate), slightly higher that our 0.9% previous estimate. This will be the result of two opposing trends. On the one side, after the bump due to higher labour supply and productivity, trend growth is set to weaken as bad demographics kicks in. This brings down the long-term rate of return of the economy, and the neutral rate with it. Yet, this downward pressure is not enough to offset the upward push from the increase in the net supply of US safe assets. This results from the increase in US debt pushing up Treasuries issuance, which is not matched by and adequate increase in interest-insensitive demand. First, Fed's holdings of Treasuries are set to decrease until mid-2025 and then will restart rising but at a slower pace than issuance. Therefore, markets will have to absorb an increasingly high net supply. Second, holdings from foreign central banks are expected to stabilize and being diversified away from the USD, in large part due to less reliance on trade for growth and, more broadly geoeconomics splits.

An increased floor for long-dated yields

The real neutral rate and long-term inflation expectations in combination with the term premium explain to a large extent

[4] We add the results of a very recent methodology developed by Ferreira and Shousha (Journal of Monetary Economics, 2023), which unlike the other models explicitly considers the role of the net supply of safe assets.

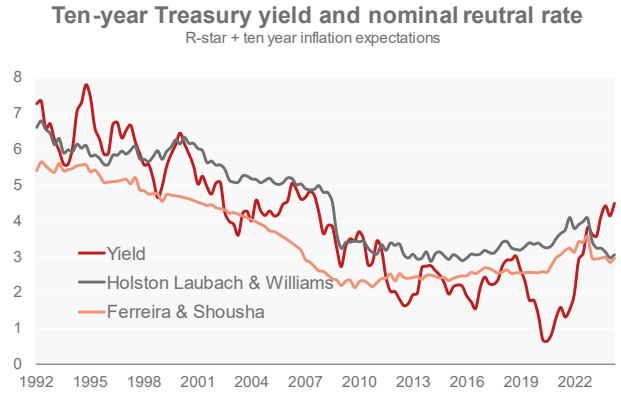
[5] Like the Laubach and Williams and Holston-Laubach and Williams measures

[6] A detailed description of the conceptual framework we use for R-star can be found in a Core Matter published last year, which also considers the interaction between the neutral rate and financial stability.

[7] The updated results and the detailed projections are explained in the Appendix.

the long-term trend of US Treasury rates yields. Therefore, the evolution of R-Star is a key driver of their medium-term dynamics.

Assuming that the 10 year ahead inflation expectations from the survey of professional forecasters remains at the Q2 2024 level (2.3% consistent with the 2% PCE inflation targeted by the Fed) and using our projections for the neutral rate and adding a term premium we get a long term value for the 10yr UST of around 3.5% (against the current 4.3%). This is moderately lower than the levels seen just before the Great Financial Crisis but some 100bps higher than what prevailed in the pre-Covid Period. The materialization of such a scenario will give rise to some sort of "new old normal", characterised by real yields back up to more than 1% to be set against a lower trend growth rate and a strongly upward path for government debt.



Source: NY, Fed, Ferraira Shousha (2023), Philadelphia Fed, GenAM

APPENDIX – The Neutral rate and the net supply of safe assets

The first quantitative models used to compute the neutral level of the short-term interest rate were based on a very simplified description of the economy, which just included an equation for aggregate demand and one for inflation. Over time, more sophisticated models emerged, which also consider the equilibrium on the market for safe assets. The most recent example of this kind of models is the one recently published by Ferreira and Shousha. They posit that the neutral interest rate depends on:

- the net supply of sovereign debt, assumed to be a safe asset: we defined it as the difference between the outstanding stock of Treasury and the Fed's holding.

- demand for safe assets which is not very sensitive to yields: this is in turn split in demand from the domestic and Foreign central banks and safe-haven purchases by the private sector. For the former we adjusted the data on global reserves for the share of US$ holdings provided by the IMF. Private market risk aversion is proxied by the spread between US AA corporate rates and that of Treasuries (convenience yield)

- trends in productivity growth, demographic changes, and global spillovers in productivity, all affecting the trend growth rate of GDP.

Data for the neutral are available at the half yearly frequency for the US and several other developed economies[8]. To project the neutral rate, we interpolated the estimate for the US to get a quarterly series and regress it to a set of variables approximating the factors listed above. We use an estimation technique that accounts for the non-stationarity of the series (see table).

Model for the Ferreira - Shousha R- Star

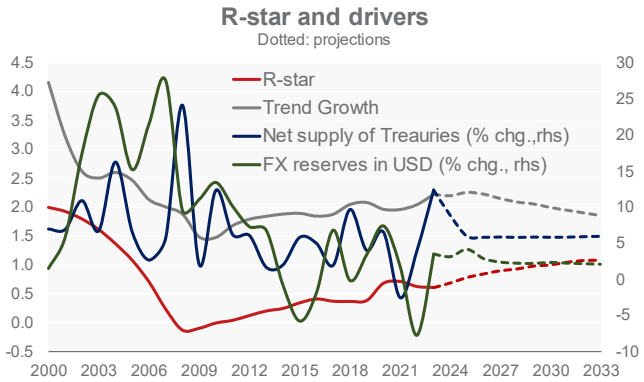
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Outstanding Treasuries - Fed holdin	1.41	0.21	6.61	0.00
Potential Growth	0.16	0.07	2.41	0.02
Global Fx reseves in USD (log)	-1.67	0.18	-9.05	0.00
AA spread	-0.26	0.04	-6.95	0.00
Constant	13.32	1.33	10.02	0.00
R-squared	0.97	Mean dependent var		0.83
Adjusted R-squared	0.97	S.D. dependent var		0.80
S.E. of regression	0.13	Sum squared resid		1.75
Long-run variance	0.05	FOMLS Estimates		

To use this equation to project the neutral rate we use:

- our projections on US Federal debt and the Fed's balance sheet,

- the CBO estimates of potential growth

- the Oxford Economics projections for global reserves and assume that the share invested in Dollars decline from the 58% at the end of 2023 to 45% (the early-2000 level) by 2033



Source: CBO, OxfordEconmics, FRB, IMF, GenAM

[8] The paper and the data can be found here.

Imprint

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