Focal Point

Inflation woes and a dovish Fed drive long rates up

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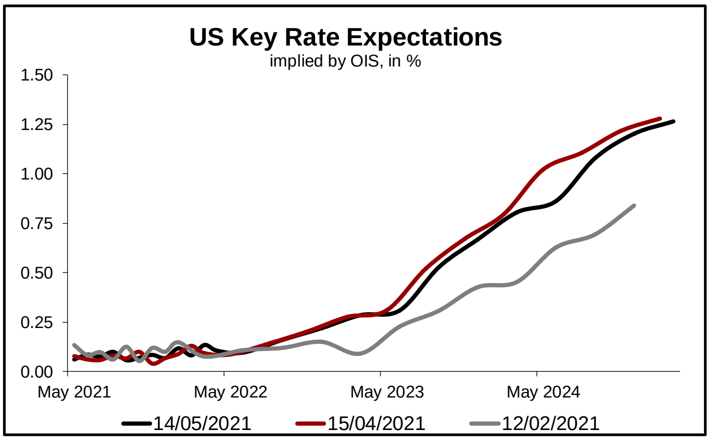
- Markets price the first US rate hike as early as in H1 2023, mainly reflecting a higher risk premium on inflation fears. These worries are unlikely to ease in the short term given the volatility in inflation and employment.
- In contrast, our estimate of the new Fed reaction function predicts a rate lift-off no earlier than in Q4 2023. Markets seem to have mixed views on the Fed's stated higher tolerance towards inflation, requiring the Fed to improve its communication.
- Expectations of an early liftoff strongly affect the short end of the curve. The currently priced strong increase in short-dated yields appears overdone. While not immune to the economic recovery and slowly approaching key rate hikes, short-dated US Treasuries are seen to hold up relatively well.
- In contrast, long-dated US Treasuries remain vulnerable to a rise in real yields and a delayed lift-off. The USD yield curve is then set to steepen further.

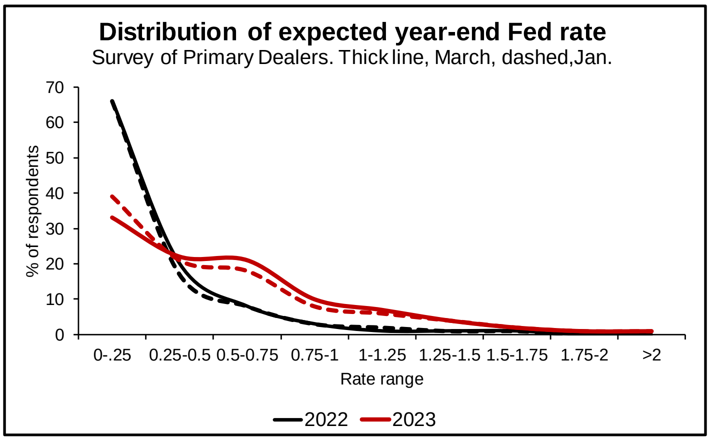
Despite the latest strong economic rebound of the US economy and increasing worries about a surge in inflation, the Fed is tirelessly underlining that the conditions for withdrawing monetary support are still far from being met. Moreover, it has made clear that that first it will reduce and stop accommodation via asset purchases tapering and only afterwards it will directly start to tighten monetary conditions by raising the Fed funds rate. According to the FOMC projections presented in March, such a move is not deemed appropriate before the end of 2023.

Yet, markets do not seem fully convinced: forward rates point indeed to a lift-off as early as in H1 2023. The wide gap between expectations and the Fed's stated intentions has a nonnegligible impact for the short end of the US yield curve. In this paper we investigate the reasons of this disconnect, its likely evolution and the implications for fixed income investment.



Inflation fears drive expected policy tightening

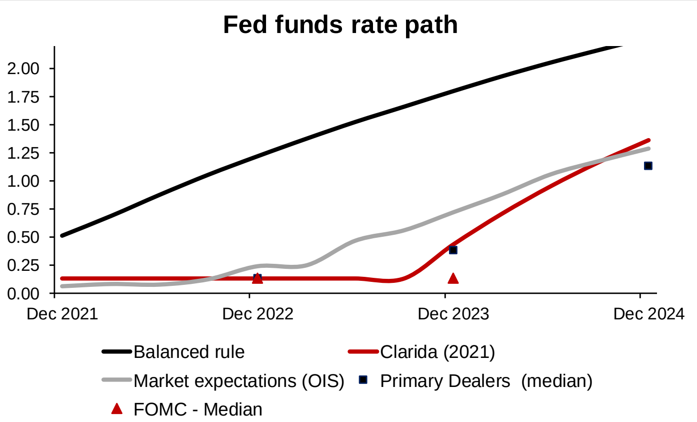
Price-based measures like forwards rates can be distorted by risk premia, but overall, they convey similar information as investor surveys, in particular, the widely watched New York Fed's Survey of Primary Dealers (SPD). It shows that the path presented by the Fed in March (no rate hikes before YE 2023) remains the most held view. Yet a strong and increasing share of respondents expects two or three rate hikes in 2023. As market rates are the average of the operator views, this helps to explain the rather aggressive pricing seen in the OIS curve.



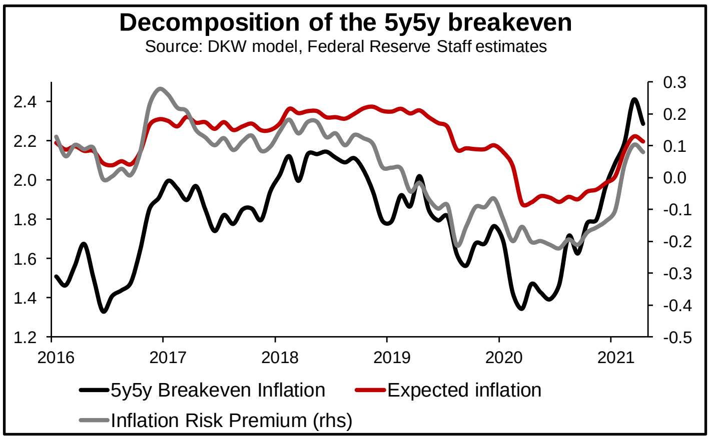
This stark divergence between the Fed announcement and market expectations does not seem driven by a rosier forecast of the evolution of the labour market, which would allow the Fed to speed up tapering, leading to an earlier rate hike. In March, primary dealers expected the unemployment rate to reach 3.75% by the end of 2023, slightly less optimistic than the median FOMC forecast of 3.5%, which is for the Fed consistent for stable rates according to the March projections. The fact that market participants, asked directly in the survey, set the level of unemployment that will trigger a rate increase at 3.8% suggests a rather aggressive interpretation of the new Fed reaction function. Indeed, the shift to the new policy framework has been accompanied by a deliberate ambiguity about the intermediate targets (i.e. the values of unemployment and inflation that would warrant a policy shift). Yet, the Fed is progressively adding information. In April it started publishing a regularly updated measure of broad inflation expectations, which will inevitably become a benchmark for gauging future policy actions. Moreover, in a speech in mid-April, vice president Clarida came very close to describe in full detail the new policy rule:

“Consistent with our new framework, the relevant policy rule benchmark I will consult once the conditions for lift-off have been met is a […] Taylor-type rule with a coefficient of zero on the unemployment gap, a coefficient of 1.5 on the gap between core PCE inflation and the 2 percent longer-run goal, and a neutral real policy rate equal to my SEP projection of long-run R-star”.

We tried to operationalize this interpretation by assuming that lift-off occurs when the unemployment rate falls to 3.5% (the level reached in January and February 2020) and core inflation is above 2.1% for four consecutive quarters. We take the latest FOMC estimate of the neutral policy rate (2.5%), plug in our forecast for unemployment and core PCE inflation and compare the outcome with that of a standard Taylor rule (fed funds rate depending on the deviation of inflation and unemployment from target). In particular we applied the “balance rule” described by then governor Yellen in 2017, which gives a 0.5 weigh on the inflation target and a unitary weigh on the employment target. The chart below shows that, by and large, the median expectation by primary dealers is consistent with this new “rule”. The implied OIS path is also much closer to the new rule than the old one, though the market’s pricing of the first hike appears very premature.



This leaves us with another possible explanation: worries that an outburst of inflation will in the end force the Fed to raise rates regardless of the evolution of the labour market. Worries linger despite the repeated remarks that the inflation target will really matter for monetary policy only when full employment is reached. This may reflect mixed views about the Fed’s pledge to act on realised value rather than expectations, which means remaining deliberately behind the curve in terms of inflation. Market-based measures show indeed that it is not just the baseline inflation forecast that is rising, but also the uncertainty. Looking at derivatives, markets price a 30% probability of inflation exceeding 3% in five years: in the last years that measure peaked at 20% in 2015 and stood at just 5% at the end of 2019. Moreover, and most importantly for Treasury yields, according to an analysis by Fed economists, the bulk of the increase in breakeven rates seen since H2 2020 is due to the spike in the inflation risk premium. Genuine inflation expectations are merely back to the end-2019 level.



The recent data and the short-term outlook will not do much to reduce uncertainty. April CPI inflation (4.2%yoy) was much above expectations (3.6%). While this reflects to a large extent the impact of a quick ramp up in demand, it adds to evidence of inflationary pressures from commodities prices and business and consumer surveys.

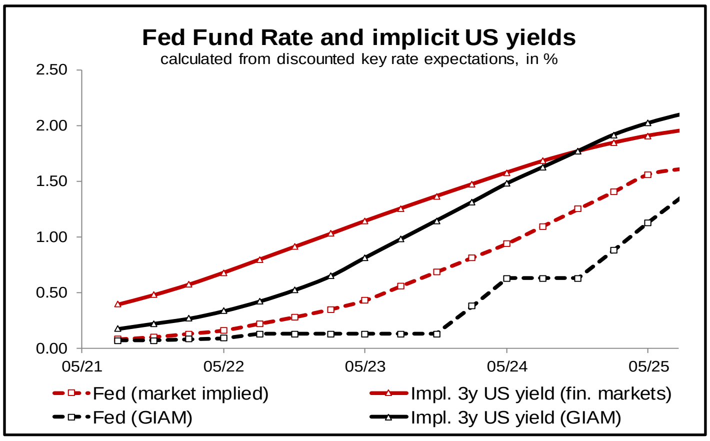
Our baseline view remains that upward price pressures are mostly temporary and due to the fast restarting of the economy. However, the impact of dislocations on prices may last longer than expected, fuelling further worries about inflation, and there is a risk that they may get so some extent ingrained in expectations. Markets will test the Fed’s resolve to tolerate higher expected and realised inflation coupled with a slower and less smooth than expected labour market recovery The April employment report, and especially its disappointingly low pace of job creation, vindicated the Fed’s patience. However, it showed at the same time that, due to still extremely weak labour market participation, there are increasingly signs of strengthening wage inflation. This too is likely to prove temporary and due to the lagged effect of Covid-19-related restrictions. But at the moment it is not possible to fully rule out but the possibility that longer lasting scars reduce participation, making wages more sensitive to the increase in employment.

If the Fed succeeds in fully convincing markets that it really focuses on addressing first the labour market, and sticks to a late lift-off, this will peg the short end of the curve, but may also fuel inflation expectations, affecting the longer end.

Short-dated US Treasuries to do rather well, but …

The currently priced key rate hikes as well as the uncertainty about the future path of inflation and how the Fed will deal with it has important implications for the US yield outlook.

As we show in the following, short-dated US yields (e.g. 3-year yields up 15 bps year-to-date) are trading above their fair value and the risk of a further strong increase appears rather limited. Moreover, the consolidation at the long end of the curve over recent weeks has hardly impacted short-dated yields.

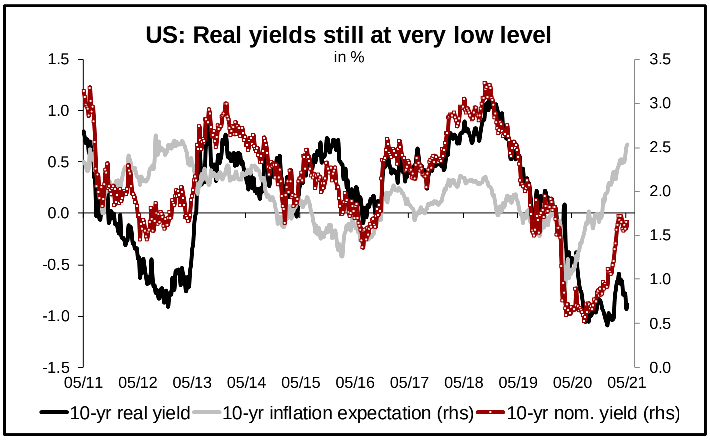


Using the currently priced key rate expectations one can calculate the future path of short-dated US yields. The chart above signals that the priced early lift-off will drive 3-year US yields up in the months to come (roll-up). Assuming key rate expectations do not change going forward, the 3-year US yield would rise above 0.5% by year-end and to almost 0.7% in twelve months (from a current level of 0.3%). This is also reflected in forwards which imply a rise of 3-year yields above 0.6% by yearend and 0.8% by May 2022.

While short-dated US yields will inch up on the economic recovery and the slowly approaching Fed hike, they will be capped by already aggressively priced rate hikes. Assuming the lift-off will be around the turn of the year 2023/2024, we would see fair value of 3-year US yields to rise not more than 10 bps by year-end. Over the next two years we would expect a level to be reached that forwards are already pricing for May 2022.

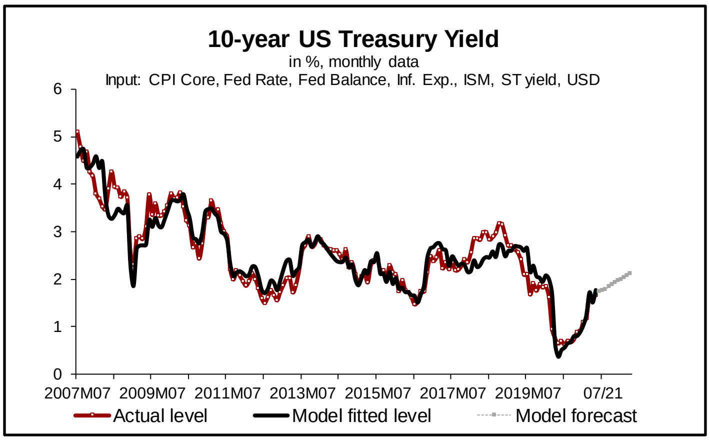
… long-dated US Treasuries remain vulnerable

After the worst first quarter in decades, long-dated US Treasuries have consolidated over recent weeks despite an overall strong data flow, with 10-year yields down by around 10 bps from the peak. However, we do not regard this as a change in trend and expect long-dated US yields to rise further in the months to come for several reasons.



First, the bulk of the nominal yield increase since summer 2020 has been driven by the inflation component and in particular by the risk premium (see above). However, the risk premium is still not at excessive levels. There is also some more leeway to the upside, as the uncertainty is unusually high after the most recent inflation and unemployment data. Moreover, as financial markets adjust expectations, acknowledging the Fed will rather err on the side of caution and prefer a more lasting overshooting of inflation rather than risk a too early lift-off, the premium at the long end of the curve is likely to rise further.

Second, genuine inflation expectations (in distinction to the risk premium) have risen only slightly over recent months and are still close to the historical average (see also above). Considering the changed fiscal outlook and the new monetary policy strategy, a rise of this genuine inflation component above the levels of 2018 appears reasonable. While the changing inflation environment has already been largely priced in at the short end of the inflation curve (2-year inflation swaps above 3% at the highest level since 2008), the long end is lagging.



Third, the real component of long-dated US yields does not look sustainable either. After the sell-off in February long-dated real yields have fallen sharply again – a success of the Fed's strong communication efforts. At current levels of -0.9% the 10-year real yield is only 20 bps above the historical trough. This is at odds with a fast recovering economy. Moreover, the infrastructure plans by the Biden administration may eventually also boost the growth potential (which in and of itself justifies a higher real yield). At the same time, the high fiscal deficits lead to a persistently high supply in US Treasuries in the years to come. This is happening in an environment in which the Fed will be withdrawing from the US Treasury market.

Overall, we expect long-dated US yields to rise going forward. Our model indicates an increase above 2.1% on a one-year horizon. In combination with a rather muted increase at the short end of the curve this implies a further considerable steepening of the US yield curve.

Accordingly, we recommend investors to avoid long-dated maturities as they are most exposed to the forecast yield increase. In contrast, short-dated US Treasuries appear relatively attractive thanks to overpriced rate hike expectations.

Imprint

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