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Fixed Income Strategy | Capital Markets Chronicle

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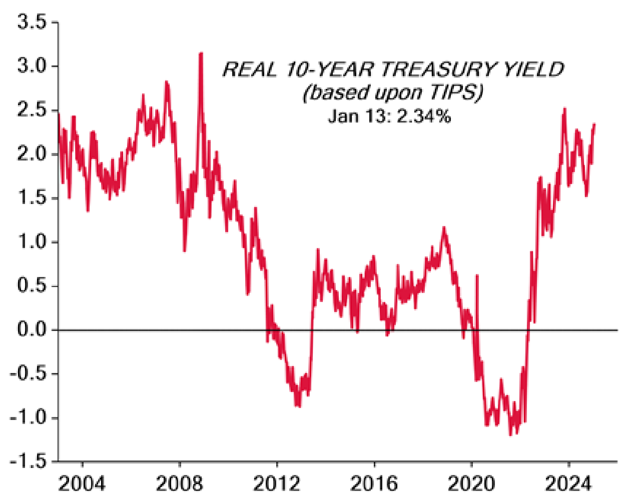
Normalization, Seasonal Factors and Uncertainty

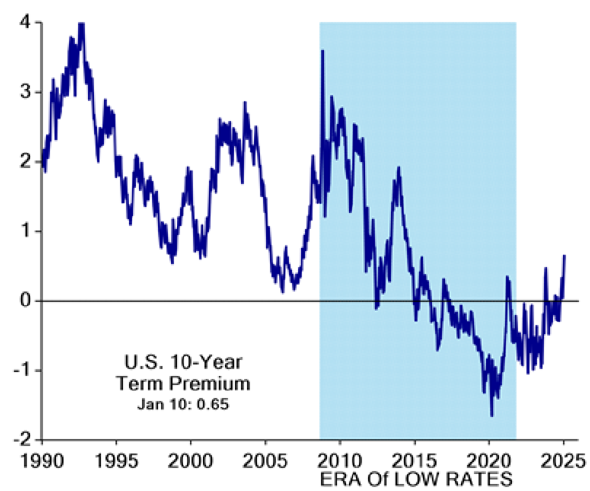
Thought of the Day

Fixed income investors continue to insist on a higher yield / return than has been the case since 2010. Term-premiums are back in positive territory and the 'real' 10-year yields are back to an average real rate prior to the Great Recession. Consensus is uncomfortable with the current nominal rate with inflation still elevated and overall U.S. economic growth solid. Furthermore, the budget outlook suggests Treasury auctions will stay quite high. The probability of a soft landing or 'no' landing is no longer significant. Both suggest higher yields. The chatter that the 'era of low interest rates' is over is becoming more prevalent. Despite high economic policy uncertainty as details of Trump's economic policy agenda have not been released, macro fundamentals are more than offsetting that uncertainty.

The charts below tell the story. From 2009 to 2021, term premiums, and the nominal and real 10-year Treasury yield were low as Fed policy was skewed to keeping growth positive and trying to push inflation up towards its target. The neutral 10-year yield had a '1' or '2' handle except for a brief period in 2019.

Real 10-year Treasury Yield Is Back to a 'Normal' Pre-Great Recession Reading. But While The 10-Year Term Premium Has Jumped , It is Still Materially Lower Than the Average Pre–Great Recession Reading.

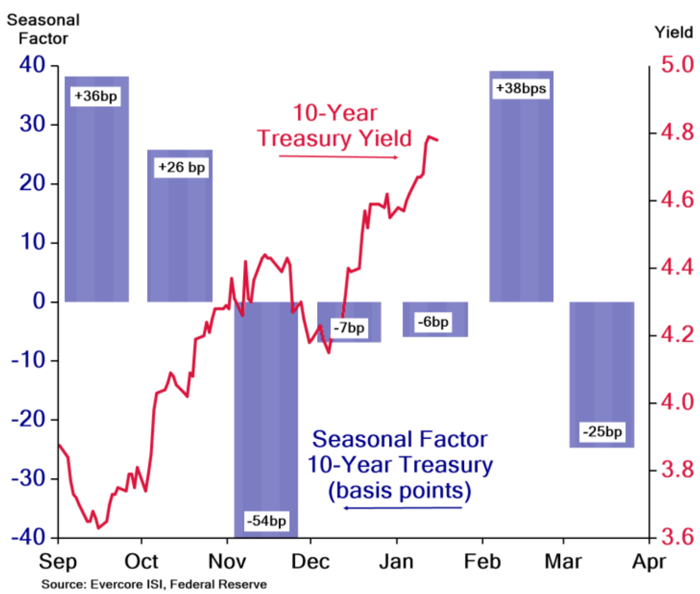




But the normalization of Treasury yields is restoring historic relationships. Using TIPS (yes, the history is not long), real rates should average about 2% and long-term inflation expectations at 2.5% are consistent with the Fed target. That would put the nominal 10-year yield at 4.5%. Term premium models suggest the nominal 10-year should have a '5'% handle.

The normalization of the 10-year term premium is not so clear. The 10-year term premium is still over 100bps below a rate associated current fundamentals and readings pre-Great Recession. There are many paths to restore those term premiums. But the most likely is for the front end of the yield curve to fall further, which is consistent with Krishna Guha's fed funds outlook in 2025.

Fundamentals Are Overwhelming The Influence of Seasonal Factors On the 10-Year Treasury Yield.



While seasonal factors for the 10-year Treasury yield have been a significant source of its return for the past 20 years, the 60bps rise in the 10-year yield since early December is against modest seasonal headwinds in Dec and Jan. That means changing expectations about growth, inflation and Fed policy have been more important than seasonal factors. However, February's seasonal factor for the 10-year yield jumps 38bps higher. Will changing fundamental expectations offset that seasonal boost? Historically, Seasonal Factors Account For 38% of the Change in the 10-Year Yield.

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