

## Gauging Bond Market Potential: Is The Rally Fully Discounted?

The Fed has embarked on its long-awaited rate cut cycle as investors have increased their bond allocations and extended duration. A bull steepening of the yield curve has become the overwhelming consensus.

This view is well-supported by the experience of past interest rate cycles. Historically, every rate cut cycle since the 1980s has been accompanied by a bond rally (Chart 1). At the onset of each cycle, the bond market has consistently underestimated the extent of the easing that would eventually be delivered. Can this time be different?

It is always difficult to bet against history, but there are three reasons why the upside for bonds may already be fully priced in:

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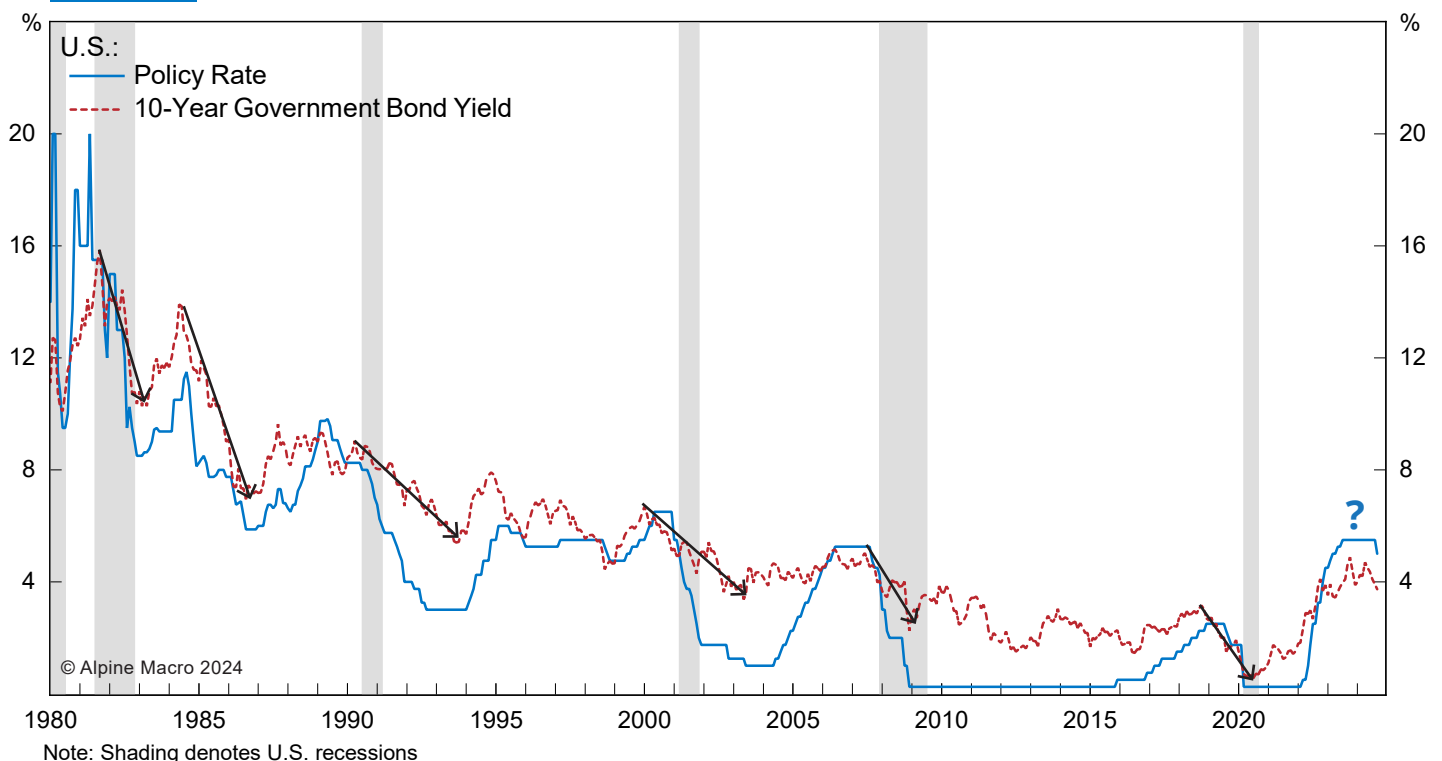
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**Chart 1** Bonds Have Rallied In Past Every Rate Cut Cycle



- (1) The number of rate cuts discounted is the highest on record.
- (2) The bond rally has already done much of the easing work for the Fed. Green shoots are visible in lending markets.
- (3) Markets are already pricing in an unusually flat terminal yield curve, whereas historically, the yield curve has been steeper after a rate cut cycle.

### The Most Anticipated Rate Cut Cycle Ever

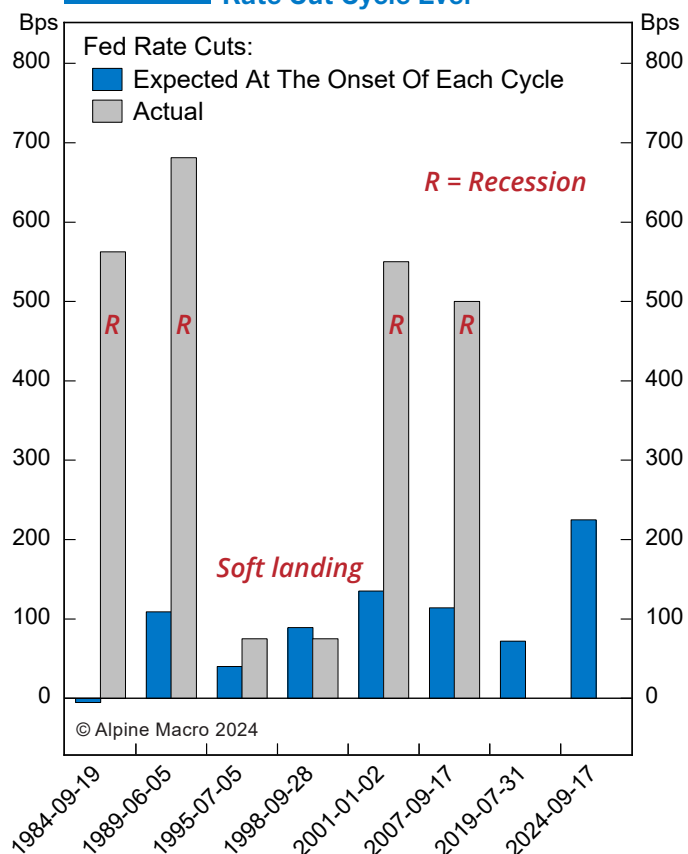
Money markets have already discounted 250 basis points of rate cuts for this cycle, most of which are front-loaded. **This is the most anticipated rate cut cycle in history.** The expected easing is double the historical average at the onset of previous cycles, as shown in [Chart 2](#).

Bond and money markets discount the same information. In a rate cut cycle, bond yield shifts are driven by policy rate adjustments not initially anticipated by the market. The magnitude of unanticipated rate cuts has varied across cycles. They were typically larger in the 1980s when rate cut cycles were deeper. The 2019 cycle, however, was short-circuited by the pandemic.

**As a rule of thumb, the 10-year yield moves by about half of the unexpected shift in policy rates.**

[Chart 3](#) illustrates a positive correlation between the change in long-term bond yields and the size of unanticipated rate cuts. For every 100 basis points of unanticipated cuts, 10-year Treasuries rallied by 58 basis points. **This statistic is skewed by the**

**Chart 2** Most Anticipated Rate Cut Cycle Ever

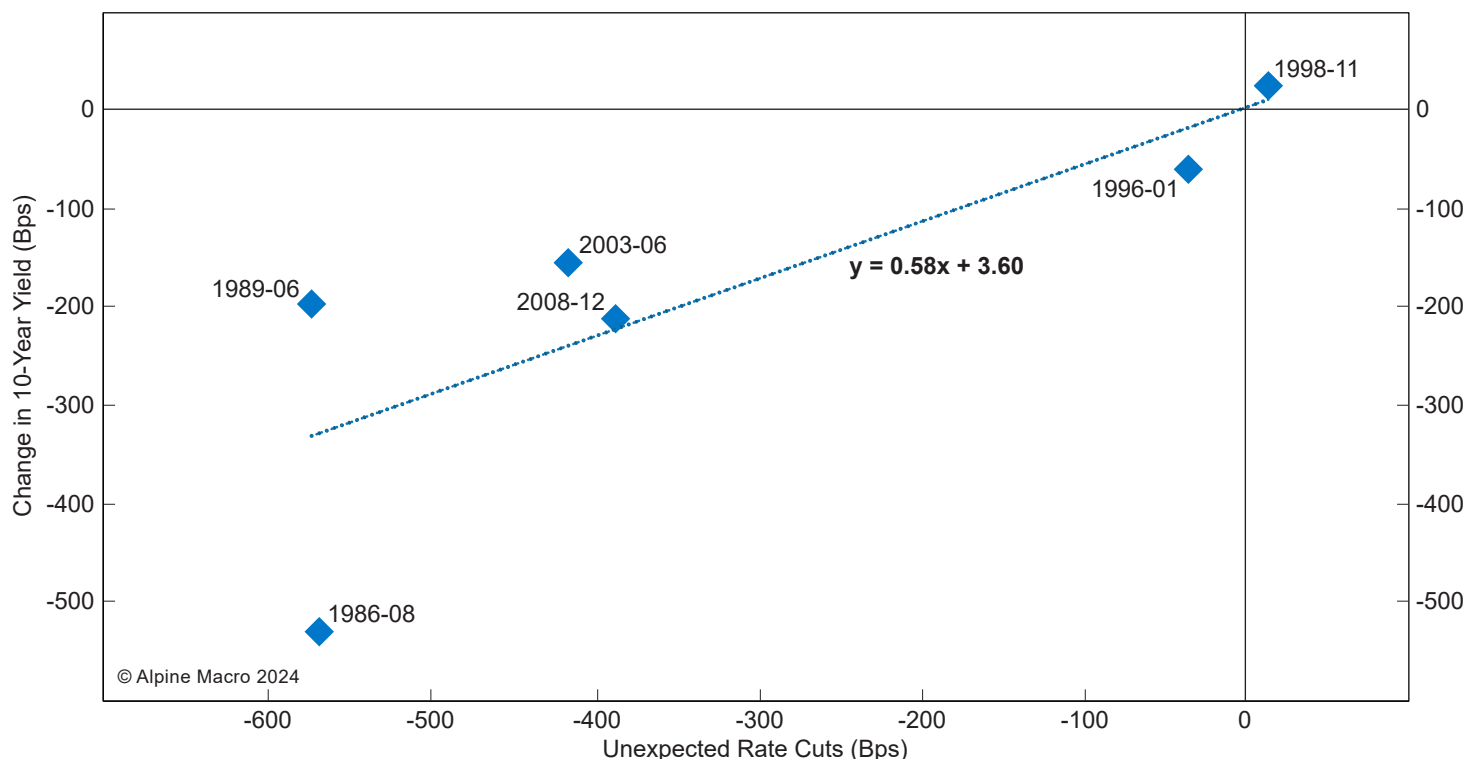


**1986 rate cut cycle, which, if excluded, implies an average 38-basis-point move in 10-year yields.**

Starting from today's pricing, [Table 1](#) offers a calculation of expected changes in 10-year yields for different policy rate endpoints. The current market expectation of a sub-3% terminal rate echoes a soft landing, with risks tilted to the downside.

It is difficult to see the Fed cutting rates significantly more than currently discounted unless there is a recession. Even if the Fed eases more than anticipated – say, to 2.5% – 10-year yields would have about 25 basis points of downside, significantly smaller than in previous cycles.



**Chart 3** 10-Year Bond Sensitivity To Unanticipated Rate Cuts**Table 1** Scenarios For Treasuries Yields If Terminal Policy Rate Changes

Changes to Market Discounted Rate (Bps)	Terminal SOFR Rate* (%)	Projected 10-Year Treasury Yield (%)
+100	3.89	4.33
+50	3.39	4.04
+25	3.14	3.895
0	2.89	3.75
-25	2.64	3.605
-50	2.39	3.46
-100	1.89	3.17

\*Terminal rate using 3-month SOFR

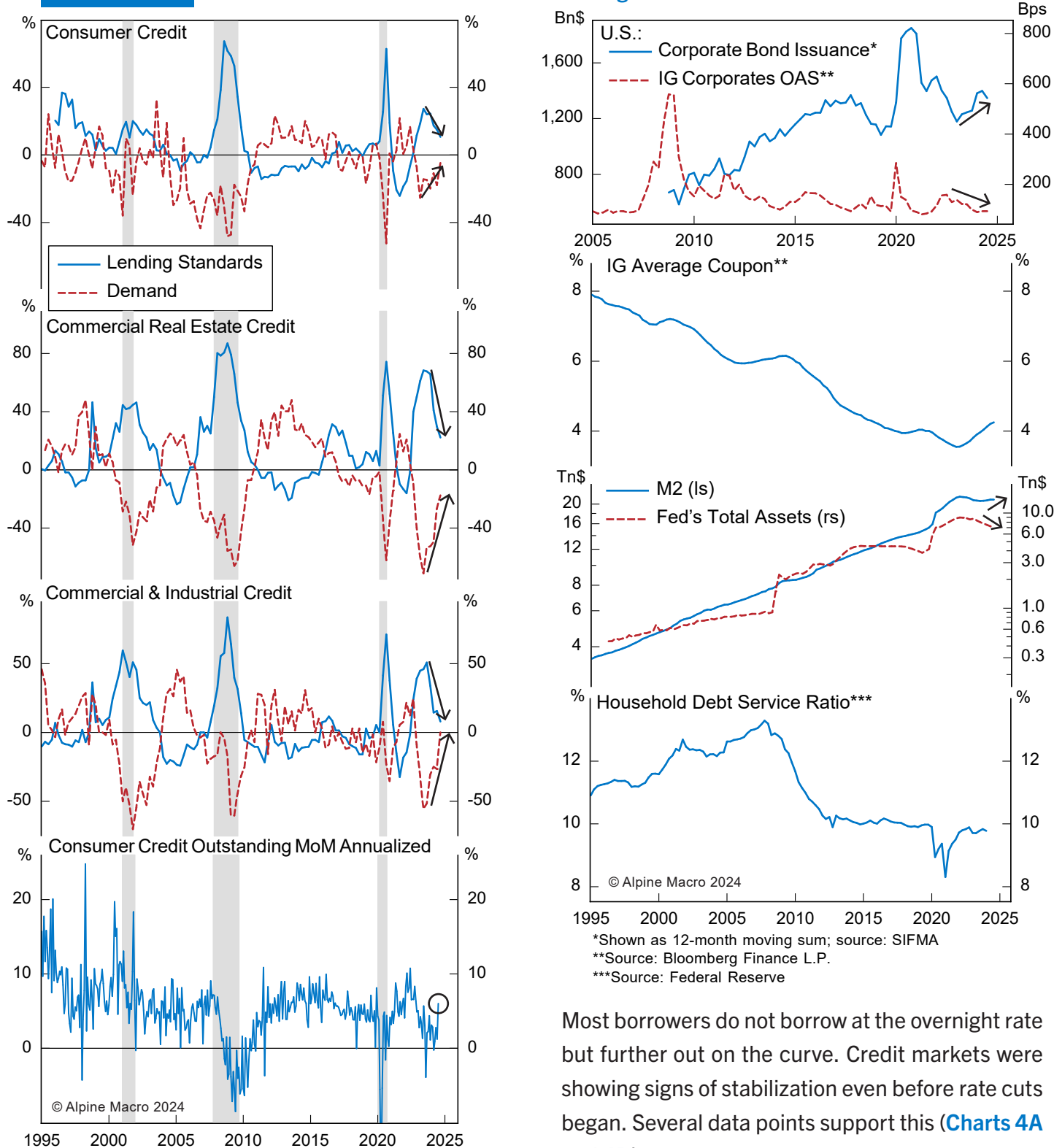
Note: Trade off ratio is 0.58 (100 bps rise in terminal rate increases 10-year yield by 58bps) using current 10-year yield of 3.75

Of course, this all changes if the economy ends up in a recession. We have written extensively about why a recession is not the most likely outcome. Please refer to our *Global Strategy report* titled “Why Are We Still Bullish?” from August 5<sup>th</sup> for a detailed discussion.<sup>1</sup>

### The Back End Of The Curve Has Already Rallied

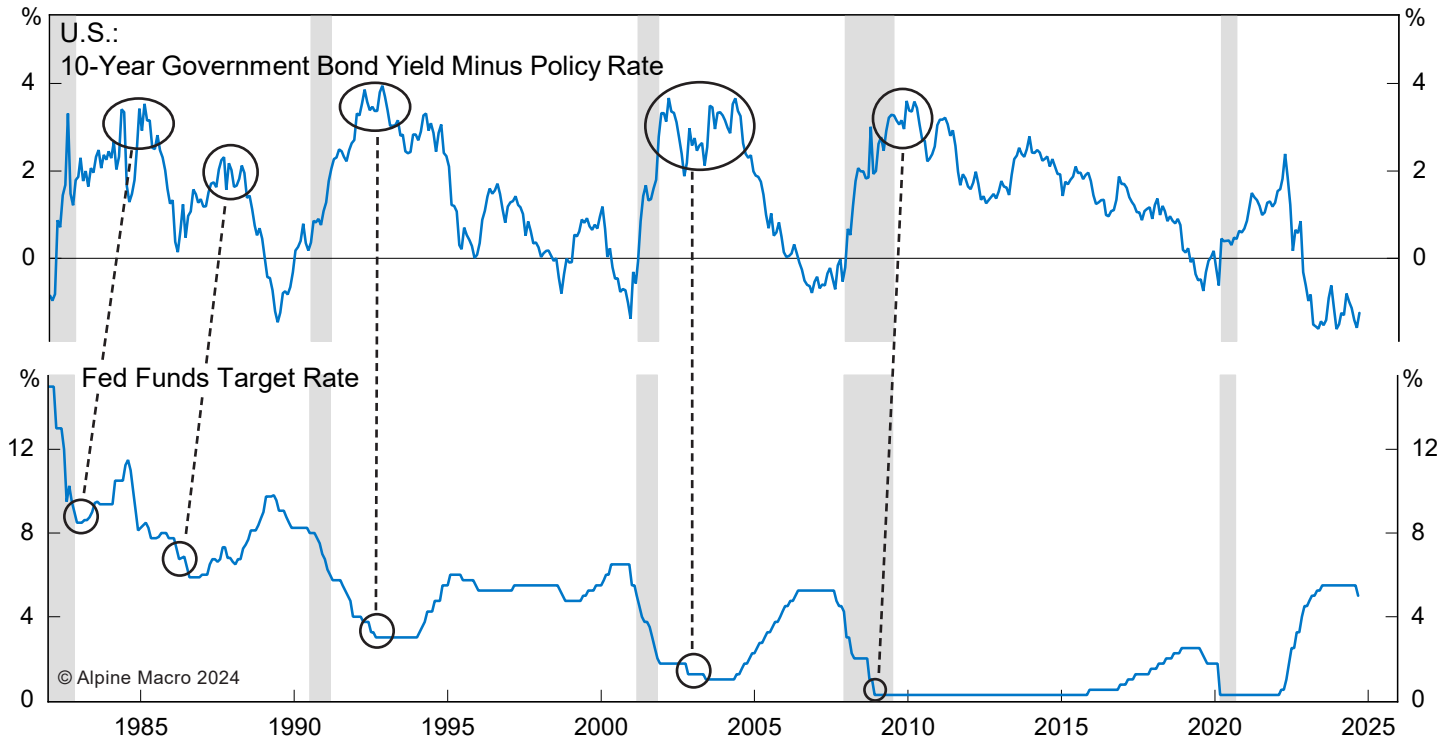
Although the uneven pace of disinflation has prevented the Fed from easing sooner, fixed income markets have already reversed a sizable portion of the post-pandemic tightening cycle. Ten-year Treasury yields peaked 11 months ago at 5% and have since fallen by 125 basis points. This may curtail the amount of Fed easing needed at the short end of the curve.

1 Alpine Macro *Global Strategy Special Report* “Why Are We Still Bullish” (August 5, 2024).

**Chart 4A & 4B Credit Markets Have Been Able To Handle Higher Rates**

Most borrowers do not borrow at the overnight rate but further out on the curve. Credit markets were showing signs of stabilization even before rate cuts began. Several data points support this ([Charts 4A](#) and [4B](#)):



**Chart 5** Yield Curves Are Typically Much Steeper After Rate Cuts

- The Senior Loan Officer Opinion Survey indicates stabilizing credit demand and a halt in the tightening of lending standards across various categories. This is consistent with conditions seen after recessions, not before.
- Higher-frequency consumer credit growth appears to be bottoming out.
- Corporate bond issuance has surged without a significant increase in spreads, suggesting borrowers find interest costs manageable.
- The average corporate bond coupon, a proxy for corporate interest expenses, has risen by only 70 basis points and remains very low relative to history.
- M2 is expanding despite the Fed's quantitative tightening and slowing inflation, indicating stronger real lending.

- The household debt service ratio remains below pre-pandemic levels.

That said, the loosening of financial conditions driven by the decline in long-term bond yields is contingent on the Fed delivering the rate cuts that markets have already priced in. If the Fed cuts less than anticipated, bond yields could rise, tightening financial conditions and potentially forcing policy-makers to deliver additional easing down the road.

### The Shape Of The Yield Curve After Rate Cuts

The yield curve has historically been steeper than currently discounted at the end of an easing cycle. The market expects the 10-year minus policy rate yield curve to be about 85 basis points after the Fed finishes cutting rates.



Our focus is on 10-year minus policy rate curve rather than the typical 2/10-year curve. This is because our analysis explores the impact of rate cuts on the long end of the curve. **The easing cycle is likely to be over in two years, limiting the impact of rate cuts on the 2/10-year curve.**

We provide three reference points suggesting that the terminal yield curve is unlikely to be flatter than already discounted, limiting further long-term bond rallies.

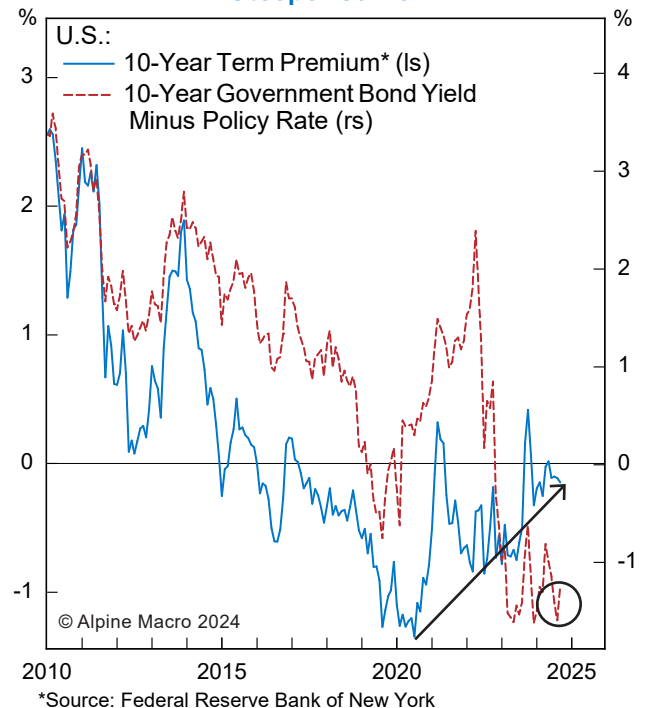
First, the yield curve typically steepens to 300-400 basis points at the end of easing cycles (**Chart 5**). Most of these easing cycles coincided with recessions, which required rates to be cut below neutral. If a recession is avoided, the Fed may only need to cut rates to around neutral or slightly below. In that case, the terminal yield curve could be closer to half the average of past cycles, or about 150 basis points.

Second, looking at monetary easing cycles without recessions offers some context. For example, at the end of the 1995 and 1998 cycles, the 10-year minus policy rate yield curves landed at 35 and 12 basis points, respectively. However, the Fed only eased by 75 basis points in both cases.

The 1986 cycle is a better comparison as it involved a more substantial number of rate cuts. The 10-year minus policy rate was 120 basis points steep after the last rate cut.

Third, the term premium, a key driver of the yield curve, is unlikely to fall below the levels that prevailed in the previous decade. **The term premium typically reflects longer-term growth and inflation risks, which can lead to greater bond yield volatility. It has been**

**Chart 6 The Term Premium Suggests A Steeper Curve**



**in decline over past the several decades.** The term premium hit historic lows – occasionally negative – between the Global Financial Crisis (GFC) and the pandemic, largely due to consumer deleveraging, the Fed’s forward guidance and restrictive fiscal policy.

Since the pandemic, consumer deleveraging has been replaced by stronger spending, and fiscal policy has become more expansionary. While we do not expect either to surge, **the term premium should be greater than in the previous decade on the back of higher upside uncertainty to growth and inflation.** Moreover, forward guidance on rates is over.

The estimated term premium is currently slightly below zero, near the range which prevailed between 2014 and 2018. During that time, the spread between 10-year bond yields and the policy rate fluctuated between 100 and 200 basis points. We previously



hypothesized that it could move into slightly positive territory once the economy returns to normal and settles into a new equilibrium ([Chart 6](#)).<sup>2</sup> If so, the risk is that Treasury yields may be skewed to the upside.

## Investment Conclusions

We expect that the Fed will deliver sufficient front-loaded rate cuts to guide the economy to a soft landing. That said, a lot of the easing we are expecting is now discounted and a more aggressive easing cycle would require growth to be weaker than consistent with a soft landing. Our main point is that the bond rally well advanced if our base case macro view proves to be correct.

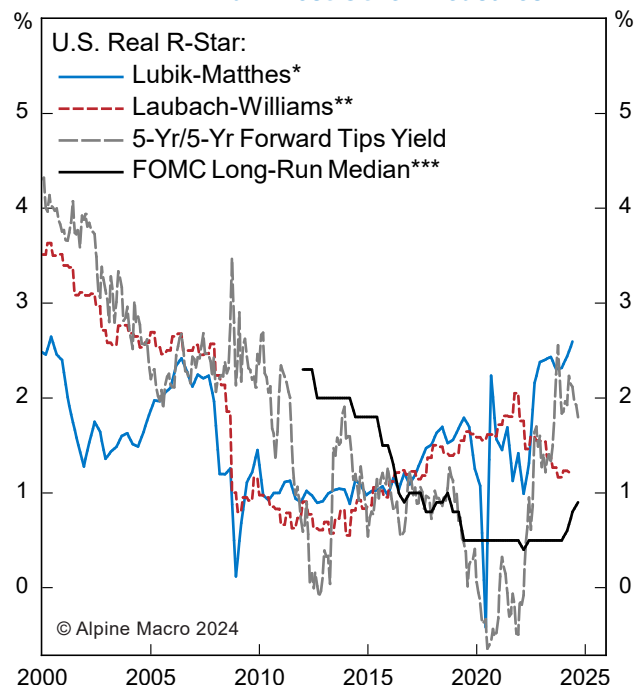
A key concern is that the equilibrium short-term interest rate (R-star) is higher than the Fed and even the market currently discounts. This risk was discussed in depth by a recent Alpine Macro *Global Strategy* report.<sup>3</sup>

**Chart 7** shows various measures of R-star. The Fed's summary of economic projections suggests that R-star is 0.9%, below econometric model estimates at 1.2-2.6%, and the market's proxy at 1.8%. The current path of projected easing would drop to about 100 basis points below the market's view of neutral.

If the Fed's current estimate of real R-star is correct, then the terminal fed funds rate may settle at 3% after adding a 2% steady-state inflation rate. Treasury yields could have limited downside potential if a mildly positive term premium is added to obtain a rough fair value for long-term yields.

However, if R-star ends up 100 basis points higher than the Fed originally thought, the FOMC will have to adjust its dot plot by a similar amount. Under this

**Chart 7** The FOMC Sees A Lower R-Star Than Most Other Measures



\*Source: Federal Reserve Bank of Richmond

\*\*Source: Federal Reserve Bank of New York

\*\*\*FOMC long-run summary of economic projections minus 2%; source: Federal Reserve Bank of St-Louis

condition, the 10-year Treasury yield could bounce back to above 4%.

Investors should consider trading 10-year Treasuries within a range of 3.5% to 4.25%, capitalizing on opportunities on both sides. We expect upcoming data releases to inject unusually high volatility into markets as the Fed remains intensely focused on individual data releases. We expect that these releases will test, but should not derail, a soft-landing scenario.

**Henry Wu**

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2 Alpine Macro *U.S. Bond Strategy Special Report* "Fiscal Stimulus And Bear Steepening" (November 2, 2023).

3 Alpine Macro *Global Strategy* "Debating Federal Reserve Policy" (September 16, 2024).





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