

Ahead of the Curve

Three Fed scenarios, same result: higher yields, steeper curves

From the Field
May 2024

During a discussion in a recent monthly policy week, when our portfolio managers meet to discuss outlook and positioning, someone asked, “Can anyone see the 10-year U.S. Treasury yield at either 4% or 5%?” The answer was a resounding “Yes—we can see both happening.”

Over the last couple of months, the market consensus has moved entirely from one side of the boat to the other, and then seemingly back again. The 10-year Treasury yield has followed, moving down, then up, and then back down again, demonstrating that pendulums never stop in the middle.

Despite the noise, little has changed

But really, what has changed? At the risk of data mining, the core U.S. consumer price index (CPI) has increased either 0.3% or 0.4% month over month for every 2024 data release through April. My main point here is that, while volatility will remain a constant and consensus whips around, it is important to remain focused on what you think will actually happen over time and have a plan for how to handle it.

Looking back at my views published over the last several months, many have either become consensus or reality. As anticipated in February’s “*Central bank rate-cut pricing is eye-catching but deceiving*,” markets have meaningfully dialed back expectations for rate cuts from developed market central banks since the beginning of the year. Much of this shift is due to the consensus expecting a resurgence in inflation—while actual U.S. inflation readings for the first quarter have been steady, they were higher than expected—as predicted in last month’s “*Current market inflation expectations are ridiculous*.”

But some haven’t fully worked out. In last summer’s “*The fairy tale of a soft landing*,” I made the case that “no landing”—an uninterrupted upward growth trend—followed by a global recession was a more likely outcome than the consensus of a brief slowdown and no recession. We’re currently experiencing the no-landing scenario, but a recession looks to be off the table.

Higher yields and steeper curves

What’s next for rates? With the 10-year U.S. Treasury yield at 4.35% in mid-May¹



Arif Husain
Head of Fixed Income and
Chief Investment Officer,
Fixed Income

¹ Source for all U.S. Treasury yield data: Bloomberg Finance LP as of May 15, 2024

and heading lower, I view this as an opportunity to reduce duration exposure. I see yields moving substantially higher and yield curves steepening as longer-term rates increase. As stated before, we may not have seen the highs in yields.

I think there are three possible primary scenarios for the Federal Reserve, all of which would result in higher yields and steeper curves.

1. The Fed admits that it won't cut rates.
2. The Fed reduces rates because it desperately wants to (possibly referring to them as preemptive or insurance cuts), not because of major labor market cracks or deterioration in economic data. Inflation expectations rise.
3. The effects of looser financial conditions experienced from late 2023 through early 2024 dissipate, leading to rate cuts—and higher inflation expectations. The increase in yields that we've seen over the last couple of months could be part of this tightening of financial conditions, although equities and credit have held up relatively well.

Short-term U.S. Treasury yields near attractive levels

Of course, you're probably wondering when it would make sense to add any duration to a portfolio. I think we're at least approaching that level—a two-year U.S. Treasury yield in the high 4% range is certainly in the right ZIP code. The two-year yield briefly broke through 5% at the end of April, after increasing from 4.15% in mid-January, before its upward momentum paused.

What's your hedge?

While I don't think yields have quite peaked, it's a good idea to have at least

some duration exposure at these levels. I still believe that duration will be the most effective hedge against a dramatic sell-off in risk assets, such as equities and corporate bonds, like what we experienced in early 2020 at the onset of the pandemic. With that said, I don't see any evidence that I can rely on the negative return correlation between duration and risk assets returning in the near future.

I think that exposure to the U.S. dollar is a way to hedge against a more minor downturn in risk assets that could be triggered by heightened anxiety related to the Middle East or any number of current geopolitical hot spots. The U.S. dollar tends to function as a safe-haven asset and benefit in these types of risk-off situations. I anticipate that this will still be the case even after the dollar's remarkable run of strength as investors have rapidly scaled back their Fed rate cut forecasts, preserving the relatively attractive interest rates available in the U.S.

Pairing both of these hedges—duration exposure and a long U.S. dollar position—could make sense for construction of an international portfolio. If the market narrative shifts toward a more dovish Fed outlook featuring additional rate cuts, the duration exposure would benefit while the U.S. dollar position would likely decline. If the consensus shifts toward a more hawkish Fed, duration would sell off, but the dollar would probably appreciate.

My only caveat, however, is to watch the fiscal and political situation in the U.S. carefully. While muscle memory is strong relative to Treasuries and the U.S. dollar, the next few months may present a break in that paradigm if U.S. fiscal spending looks to spiral out of control.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from historical performance. The information presented herein is shown for illustrative, informational purposes only. Any historical data used as a basis for analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been verified. Forecasts are based on subjective estimates about market environments that may never occur. Any forward-looking statements speak only as of the date they are made. T. Rowe Price assumes no duty to, and does not undertake to, update forward-looking statements.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

Colombia, Chile, Mexico, Perú, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.