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Ahead of the Curve
Could a 5% 10-year Treasury yield be around the corner?

From the Field
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Key Insights

- The Fed's rate cuts may keep short-term Treasury yields low, but fiscal spending and rising inflation expectations should likely push long-term yields higher.
- Government deficit spending forces the Treasury to issue more debt even as the Fed's quantitative tightening has reduced demand, driving yields up.
- An uptick in long-term inflation expectations is also contributing to a higher U.S. Treasury term premium.

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Market consensus expects the yield on the 10-year U.S. Treasury note to decrease with the Federal Reserve (Fed) kicking off a rate-cutting cycle. But could a combination of factors—not least fiscal largesse in a U.S. election year—push the 10-year Treasury yield up from its near 3.80% level in early October?

I think that the 10-year Treasury yield will test the 5.0% threshold in the next six months, steepening the yield curve. There are three dynamics at play:

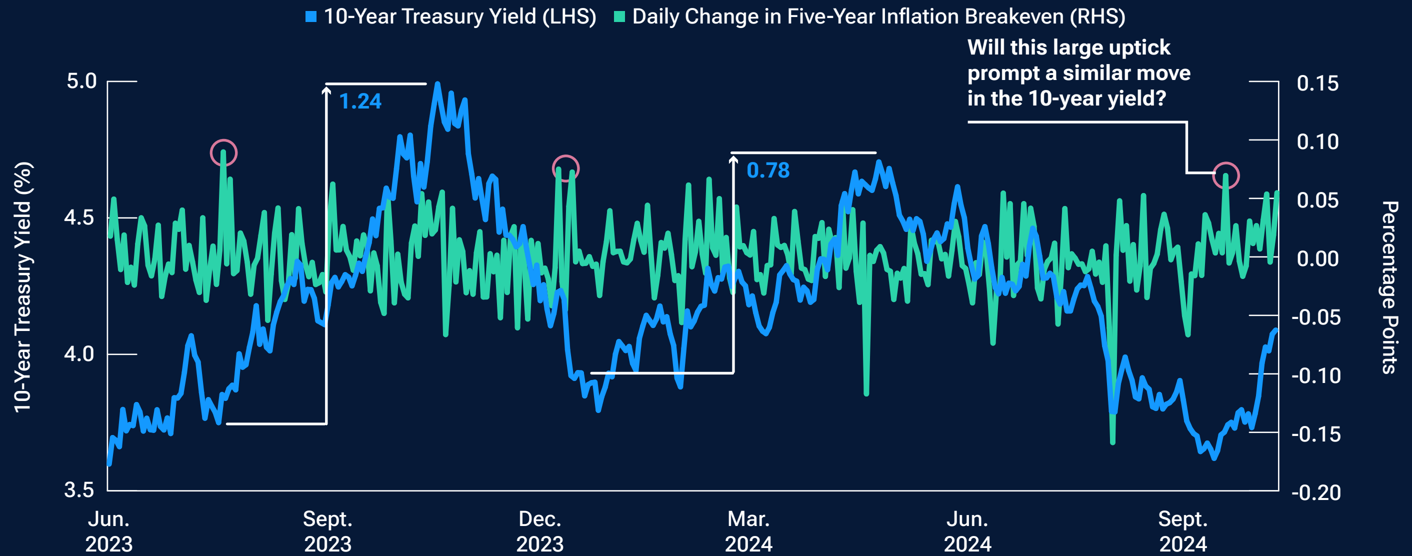
1. Fed rate cuts could limit yield increases on short-maturity Treasury bills.
2. Ongoing issuance by the Treasury to fund the government's deficit spending is flooding the market with new supply.
3. The Fed's quantitative tightening has taken a large, reliable buyer of Treasuries out of the market, further skewing the balance of supply and demand in favor of higher yields.

Term premium moving higher

The term premium, which measures the amount by which the yield on a longer-dated Treasury note exceeds the expected average yield on a series of Treasury bills rolled over at maturity, has been moving higher. The growing imbalance between Treasury supply and demand is contributing to a higher term premium on 10-year notes. Long-term inflation expectations are beginning to increase, which is also helping to push term premiums higher.

Inflation outlook could lead 10-year yield up

(Fig. 1) Daily change in five-year breakevens and 10-year yields



Past performance is not a reliable indicator of future performance.
As of October 10, 2024.
Source: Bloomberg Finance L.P.

Breakeven inflation rates[1] are the best measure of market-implied inflation forecasts. On September 20, the day after the Fed's rate cut, 10-year inflation breakevens jumped around seven to eight basis points[2] higher, likely in response to the size of the rate cut. After the previous two inflation breakeven moves of that magnitude, the nominal[3] 10-year Treasury yield increased by about 100 basis points within three months. This pattern indicates that inflation expectations could likely contribute to a higher 10-year term premium over the next few months.

Three scenarios for the U.S. economy and the Fed

I see three possible scenarios for the U.S. economy and the Fed over the next 12 months. There is some overlap between these and what I outlined in "Three Fed scenarios, same result: higher yields, steeper curves" in May, though I've replaced the "no Fed rate cuts" outcome with a recession scenario.

1. **Midcycle adjustment**

   China injects more stimulus into its economy, providing a boost to global growth. The cloud of uncertainty around the U.S. election clears up quickly, allowing the Fed to make its rate cuts relatively shallow (like the 1995–1998 midcycle adjustment). I believe this is the highest-probability scenario of the three.

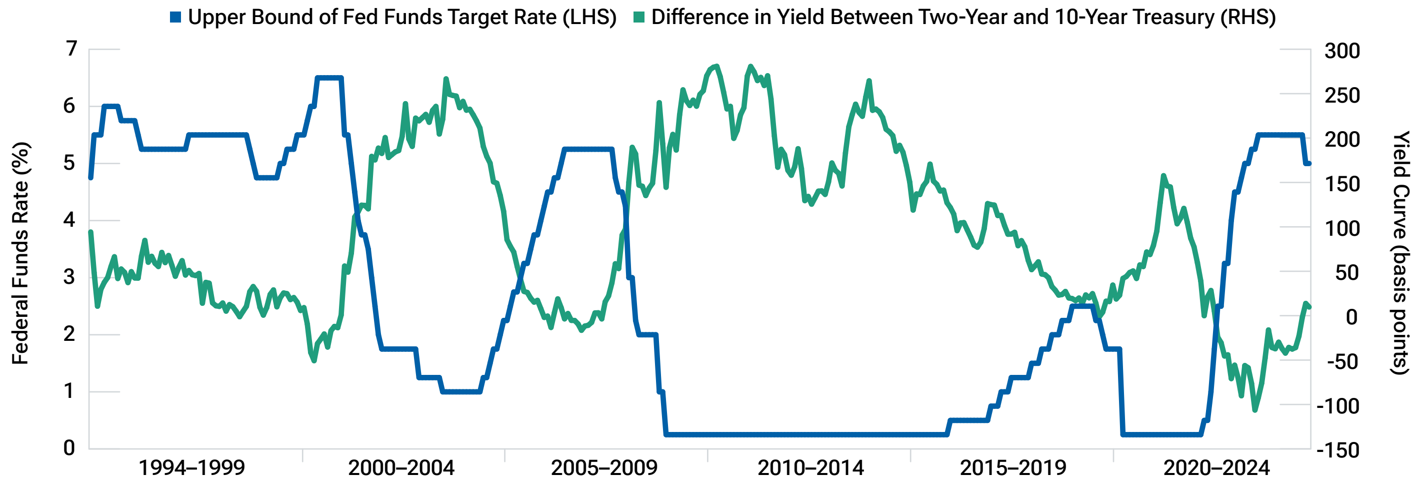
2. **Normal easing cycle**

   The Fed reduces rates to near neutral, which is probably around 3%. This would steepen the two-year to 10-year Treasury yield curve, driving it to a positive slope[4] of an estimated 100 basis points that would be more in line with historical norms.

[1] The difference in yield between a nominal Treasury issue and a Treasury inflation protected security (TIPS) with the same maturity.
[2] A basis point is 0.01 percentage point.
[3] Not adjusted for inflation.
[4] The difference in yield between the 10-year Treasury and the 2-year Treasury.

Lower fed funds to steepen yield curve

(Fig. 2) Fed rate cuts have led to steeper two-year versus 10-year yield



As of October 10, 2024.
Source: Bloomberg Finance L.P.

3. Recession

The U.S. economy enters a recession. This environment would force the Fed to aggressively ease monetary policy, possibly cutting rates back to the near-zero levels that followed the global financial crisis of 2008–2009 and the onset of the pandemic in 2020.

I believe the second and third scenarios have approximately equal probabilities, with both less likely than the midcycle adjustment.

Midcycle adjustment would get 10-year Treasury yield to 5% the fastest

The 10-year Treasury yield's fastest path to 5% would be in the scenario that features shallow Fed rate cuts. My forecast could also pan out in an environment where the Fed eases enough to get the federal funds rate close to neutral, though in that scenario it might take longer for the 10-year yield to hit the 5% level. However, if the U.S. economy descends into a recession, a 5% 10-year Treasury note would be completely off the table as the Fed would need to aggressively ease policy.

Investors sharing my view that a near-term recession is unlikely should consider positioning for higher long-term Treasury yields.

Is the Fed making a policy error?

So does the combination of low recession probability and my outlook for a meaningful increase in the 10-year yield mean that the Fed's 50-basis-point cut in September was the start of a policy error? Not exactly. Even if there was 75 basis points of easing before the end of 2024, the fed funds rate would still be well above the neutral rate. The Fed's reaction to slowing inflation and a gradually weakening labor market has been on target so far, but it will need to stay nimble and not ease too much in 2025.

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