

Ep. 197 - Swings in U.S. interest rates

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**ATTENDEES**

**Michael Konidaris**

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**Kristen Hallam**

Financial conditions in the U.S. have tightened significantly of late, with a rapid jump in yields on longer-term treasury securities, a material rise in the dollar, slowing in bank lending and continued weakness in equities. This argues for a slowing in growth of demand and GDP in coming quarters. In this episode of the Economics and Country Risk podcast, Michael Konidaris, an Associate Director in our U.S. economics team discusses the sharp fluctuations in interest rates over the last month or two.

**Michael Konidaris**

Let's recap the recent moves in financial conditions. The last few months have been interesting for financial markets from late July and through just prior to the FMC meeting that ended on November 1, their interest rates rose sharper. The yield on the 10-year treasury note rose 100 basis points, briefly exceeding 5% in mid-October, while the conventional mortgage rate flirted with 8%.

We can think of the yield on the 10-year treasury as a sum of 2 distinct components: the expectations of short-term interest rates and the term premium. Expectations of short-term interest rates are driven by expectations regarding the Feds decisions of a monetary policy. But what about the term premium? The term premium can be defined as a portion of the yield, not explained by expectations of short-term yields.

This unexplained measure acts as compensation for interest rate risk and other types of risks that investors incur for holding longer-dated securities. In other words, if we are set to hold long-term bonds, we have to be compensated for the risk that they will lose value if interest rates rise. That compensation is captured by the term premium.

Based on the data, we can observe that the rise in the long-term yields was disproportionately more than the rise in the shorter-term yields. This led us to believe that the major culprit for the sharp rise was not upwardly revised expectations of future monetize policy of the term premium itself. More on this later. Since early November though, the yield on the 10-year treasury has fallen by more than 50 basis points, the mortgage rate behaved in a similar manner, rising sharply since late July and reversing some of those increases over the last 3 weeks.

Let's take a deeper dive into the term premium. Term premia are not observed directly, but they're estimated. One such estimate from the New York Fed shows a term premium for the 10-year treasury note. The credit level is by no means unprecedented, but it is undeniable. But the rise that occurred since early August has been particularly sharp.

However, following the most recent FOMC meeting, the term premium has some work retreated, but it still remains elevated. This offers the question as to what drove both the rise and the recent decline. We list the factors that can affect the term premium, either increasing it or decreasing it, so let's go down this list.

Number one, there has been an increase in the issuance of new treasuries after the debt ceiling situation was resolved and the treasury was once again able to issue debt, including some additional issuance to compensate for months of not issuing any. This has greatly increased the supply of treasuries in the market, a development that would be expected to drive term premia higher.

The treasury issuance report published on November 1 stated that the issuance over the next 3 months would be less than previously expected, which helped alleviate some of the upward pressure as of late. Number two, we keep hearing that the banks are lightening up on treasuries to raise liquidity, but we do not see this in the data. So it is questionable how much this factor has affected the term premium, more on this later.

Number three, there is an appreciation in the dollar led some foreign central banks sell treasuries to defend their own currencies, contributing to the upward movement in the term premia, more on this also later. Number four, private investors already have portfolios with long duration and their unwillingness to further increase the duration may also be pushing the term premium high.

Number five, concerns over the large fiscal deficits and their expected rise over time, which will lead to further debt issuance is making investors wary. On top of that, the episodes of this function in Congress are also perceived as a risky factor for the U.S. debt going forward, pushing term premia higher.

Number six, if the FOMC statement is judged by market participants to be on the dollar side, it will also put term premium lower. Finally, if the peak in the policy rate has indeed already been reached, then the term interest rate risk is falling because rates can only go one way from here. These are in a nutshell; the factors explain the rise of the term premium from early August to late October and the reversal from early November.

Now we're examining more closely 2 of those factors pertaining to the domestic banking industry and the foreign investors. The amount of cash on bank's balance sheets has been drifting upwards since the SBB incident in March as banks are trying to raise their liquidity measure. Even though we are hearing the banks are lightening up on treasury though the holdings of treasuries have been fairly flat over the last few months.

On the contrary, banks continue to shed all other securities from their balance sheet to raise liquidity and reduce interest rate risk. It is possible that banks are shedding riskier assets in favor of the safer U.S. treasuries to fortify their balance sheets. It is also possible that as rates have been rising and are nearing their peak, treasuries have become cheaper, so banks have been adding more of them to exploit that.

Private sector holdings have been on the rise for some time. On the contrary, historically, Central Bank holdings have been in decline, especially in time periods when the dollar is appreciating like the spring of 2020 and throughout 2022. Even though it might not be evident from the scale, holdings of central banks have turned down in August, and we expect to see the downward trend continue. The dollar has already appreciated somewhat, and we expect foreign central banks to sell U.S. treasuries to defend their own currencies, pushing long-term U.S. rates higher.

The foreign private sector will probably continue to add U.S. treasuries to their balance sheet. As we mentioned before, we believe financial conditions have tightened enough through late October. But after the recent rally in the market, they do not see tighten up anymore. Now the big question is whether the increase in yields following the recent plans is enough for the Fed to achieve its goals.

To the extent that the rise was due to a rise in term premia, then this effect is a substitute for further Fed tightening, if that was due to a rise in monotype policy expectations, then the Fed should tighten to validate those expectations. Finally, it could also be due to a fundamental reassessment of the level of equilibrium real rates.

As mentioned earlier, the majority of the move in rates happened on the long end of the curve, which shows evidence that it was not because of a rise in the expected funds rate, but because of a higher term premium. Recent good news on the inflation and labor market front led to a downward revised expected policy path as market participants may not consider, but the current tightening cycle is over.

As a reference point, the probability for a Fed high in December currently stands at essentially 0% according to data on Fed funds futures from the CME Group. At this point, it is worth reiterating that growth has been quite resilient through Q3. Inflation is retreating but is still unsustainably high. Labor markets are still extremely tight.

So we believe that financial conditions need to tighten more to achieve the slowing in growth and inflation, but we believe the Fed would be comfortable with. As a result, we expect that more policy tightening is the answer, and we're anticipating one more rate hike of 25 basis points in the December meeting, bringing the funds rate at its peak at 5.5% to 5.75%.

Now the rate hike in December will encode financial conditions to tighten more over the next few weeks. We expect the 10-year treasury to finish the year at around 4.73% on a quarterly average basis and the mortgage rate at 7.64%. A gradual retreat will follow thereafter as the Fed begins its easing cycle in June. The BWA corporate bond yield will also rise through the end of the year in line with long-term risk-free rates.

The dollar strength will persist through early 2024 as interest rate differentials continue to widen between U.S. treasuries and bonds priced in other major currencies. Thereafter, we expect the dollar to trend downwards as those interest rate differentials way. Right now, this is an out-of-consensus call and of the Fed speakers to condition market expectations for a December timing to become a reality. That may be held by another inflation report and report for November.

**Unknown Attendee**

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