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Long-End Selloff Could be Overdone

Last year we showcased a bivariate interest rates model to assign fundamental fair value on the yield of the 10-year Treasury note. **Our work showed that two components explain 90% of long-term nominal yields**—one is the projected change in the fed funds rate over the next 12 months and the other is the 10-year breakeven inflation rate. Moreover, the standard error on the model is a low 20 basis points (bps).

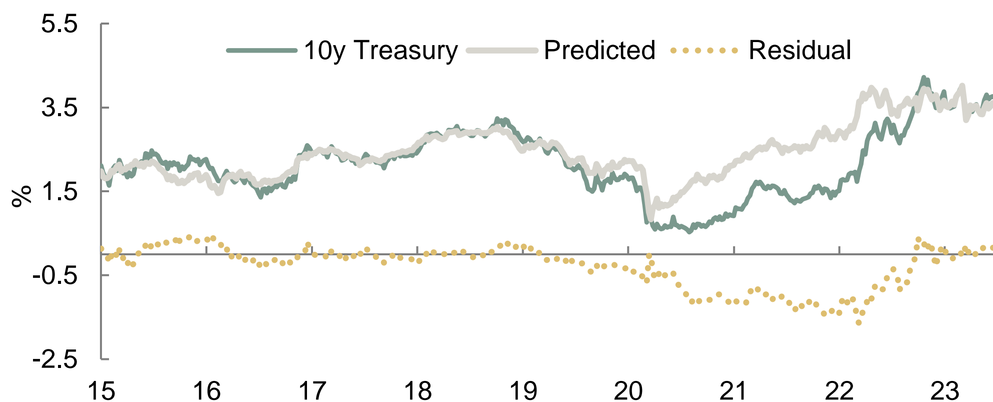
To be sure, there are other more sophisticated (perhaps over-engineered) models, but the advantage of ours is its simplicity. All one must do is plug in their estimate of 12-month forward fed funds and 10-year breakeven inflation. Since the latter is determined largely by food and energy prices, we make separate assumptions of these two variables to come arrive at a breakeven forecast. Together, expectations on fed funds and inflation allow us to ascribe fair value on the 10-year note.

Now the details. The model is estimated using weekly data for the five years ending 2019. To evaluate its performance, we show out-of-sample projections thereafter. As demonstrated in the chart below, the yield on the 10-year treasury was well below the predicted fair value for 2020 and 2021 and most of 2022. This is evident from the persistence of negative residuals.

These forecast misses were the result of the pandemic and its aftermath. By 2022 when the economy returned closer to normal, the residuals were no longer biased downward. The model has been a good predictor of the 10-year yield since then.

What is the model saying now? **The model is telling us that the 33 bp sell-off in the 10-year note in the last four weeks to 4.07% may be overdone**. We calculate that 10 bps of the increase is due to a modest shift in Fed expectations. The market is looking for a bit less cutting today than in early June. Another 6 bps is due to slightly higher breakeven inflation, the result of moderately higher oil prices. Consequently, this leaves an "unexplained" 17 bps to account for. Since this is still less than one standard error, yields may still grind a bit higher.

Going forward, Wednesday's June consumer price index (CPI) has the potential to be a big bond market mover. If the CPI is in line with expectations—0.3% headline and core, it could steady inflation worries. However, if yields were to push higher still, then the model would likely begin to send a strong signal that the sell-off in rates is truly overdone.



Sources: FRB, Haver, SMBC Nikko

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