US Macroeconomics

June 29, 2023

Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

What is the Fair Value of the 10-Year Yield?

Treasuries are selling off in further bearish fashion. This is in response to lower-than-expected jobless claims and better than previously reported Q1 real GDP and consumer spending growth. For now, the economy is not breaking. Some economists may even be considering revising upwards their current quarter and beyond GDP growth forecasts. Considering this recent data strength, investors will continue to grapple with what they think is the fair value of market rates.

There are two primary determinants of long-term rates. The first factor is the terminal **fed funds rate** or the projected path of monetary policy. After all, the yield on the 10-year notes is simply the overnight borrowing rate plus a series of forward rate contracts that extend out 10 years. The Fed determines the level of short rates from which point investors add a risk premium thereafter. This is where the second factor comes into play — inflation expectations.

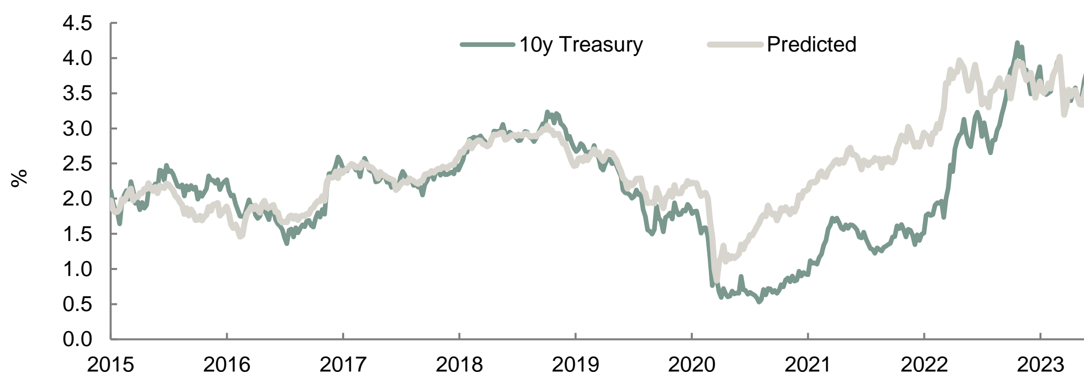
The **breakeven rate of inflation** captures the market's expectation of what inflation will average over the next 10 years. When we combine this with the expected trajectory of the fed funds rate, which we proxy with a series of rolling 12-month forward fed funds contracts, we can explain 90% of the yield on the 10-year Treasury note, and the standard error on the model is a relatively small 20 basis points (bps). The actual and predicted values of the model are shown in the chart below.

Right now, the futures market one year from now is discounting a fed funds rate around 4.85%. Assuming that breakeven inflation is steady at around 2.20%, **the present fair value on the 10-year note is 3.60%**. However, if the economy goes into recession and the Fed cuts rates as much as we think next year, then current fair value is closer to 3%, which is essentially our yearend forecast.

If we plug the Fed's projections into our model — we assume that half of the 100 bps of easing is done in the next 12 months — then fair value is 3.70%. Interestingly, all these estimates — ours, the market's and the FOMC projections — predict readings on the 10-year that are below current levels.

The reason for this is the current slope of the yield curve. **The deep and historic inversion of 2- and 10-year treasury notes means that it may be difficult for the 10-year to sell-off meaningfully from here**. For that to happen, inflation would have to reaccelerate, which is doubtful in our view.

10-Year Treasury Fair Value Model



Sources: FRB, Bloomberg, SMBC Nikko

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. ("SMBC Nikko"), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko's economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.