SMBC Group

US Macroeconomics

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What Next for the 10-year Treasury Note?

On a closing day basis, the yield on 10-year Treasury notes this year traded as low as 3.37% in January and as high as 4.06% earlier this month. This wide range reflects investors' ever-changing view on the economic and financial outlook. Given where we are in the business cycle, it has been our view for some time that last October's 4.24% high in yields would not be breached. But now that the Fed's next move could be an interest rate cut, some market participants are left wondering how low 10-year yields can go.

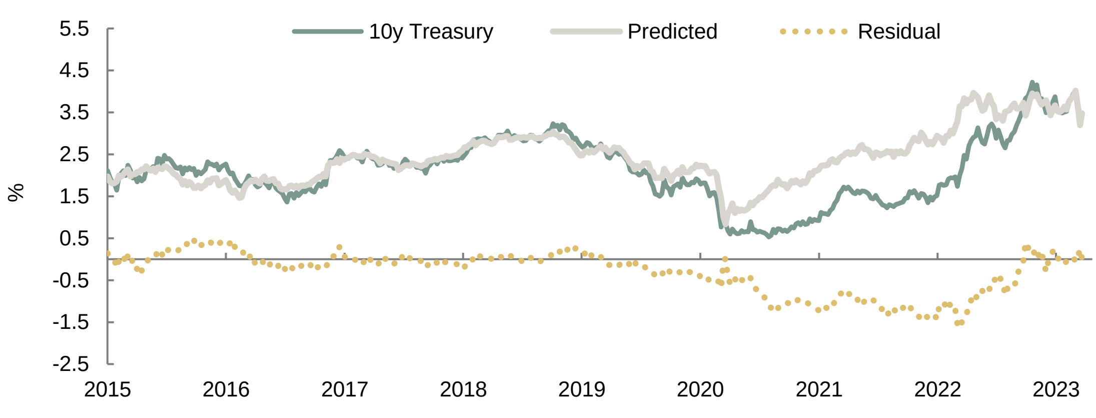
There are two primary determinants of long-term rates. The first factor is the terminal fed funds rate or the projected path of monetary policy. This makes sense when one considers that the yield on the 10-year yields is simply the overnight borrowing rate plus a series of forward rate contracts that 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 markets' expectation of what inflation will average over the next 10 years. When we combine this with the expected trajectory of the 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**. Additionally, the standard errors on this two-variable model, a measure of model uncertainty, is only 20 basis points (bps). Moreover, we can see in the chart below that residuals have been close to zero for the past seven months. Bottom line: the model does a good job predicting yields.

Where is fair value now? At present, the futures market is discounting 100 bps of cuts over the next year. At the same time, breakeven inflation is hovering around 2.30%. This implies, according to our calculations, **a fair value on long-term treasuries of around 3.45%**, which is close to where the 10-year note is trading right now. But if the Fed cuts rates more than what the market is expecting, long-term yields should fall further breakeven inflation aside.

Assuming inflation expectations remain anchored, a reduction in the funds rate back to its equilibrium nominal level of 2.5% implies 10-year treasury fair value at 3.10%. However, if there is a deep recession, which is a risk, breakeven inflation would likely fall significantly as it has in the past. In this case, fair value on 10-year notes would be well under 3%. Consequently, there is plenty of room for long-term yields to fall further if our projections come to pass.

10-Year Treasury Fair Value Model



Sources: FRB, Bloomberg, SMBC Nikko

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