Macro Comment US

Fed models support the case that the "bond vigilantes" are back

US long government bond yields have soared over the past two months and analysts are grappling with a range of potential drivers. Is surprisingly strong macro data increasing the likelihood of a "no-landing" rather than a soft-landing scenario? Is the rising oil price driving inflation compensation in markets? Have markets only just got the message from central bankers, that policy rates will be higher for longer? Or are markets driving up yields because of worries that US public finances are unsustainable? In other words, are the "bond vigilantes" back? In our view, the Federal Reserve's models for yield curve analysis support the latter, and imply a possibly bigger need for upward revision of our interest rate forecasts, as well as an increased risk to the economic outlook.

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US long rates surges on, despite stable policy rate expectations

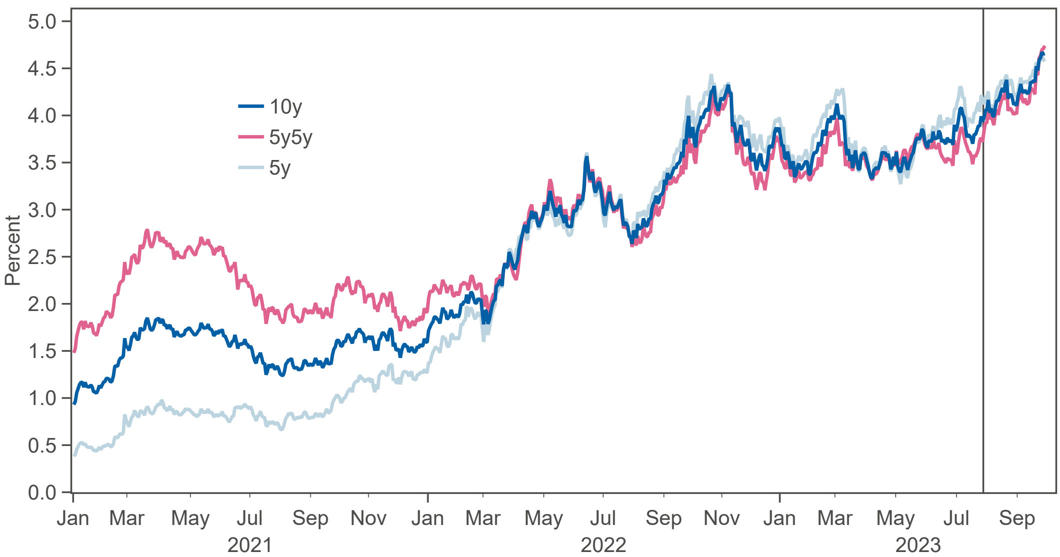
Market expectations on Fed policy cannot explain the bond yield rise, but r* may be an accomplice

From the end of July until the end of September, the US ten-year government bond yield surged above 70bp. Breaking down the yield curve, it is clear that the longer-term segment lies behind the bulk of the long rate rise, with the five-year/five-year forward (5y/5y) yield soaring 100bp, while the shorter- to medium-term five-year segment shows a yield rise of about 40bp (see graph). Using the Federal Reserve's model for yield-curve term structure, we find that the real expected short rate has picked up somewhat.

So, does that mean market participants are only now getting the message from the Fed, that the policy rate will be higher for longer? In our view, this is not what is happening. Firstly, market pricing on the policy rate has not changed very much lately, with the big repricing having taken place during spring and early summer. So why is the Fed model showing a rise in the real expected future short rate? Indeed, for the five-year segment, short-rate expectations have hardly moved, and instead it is in the 5y/5y segment that about a quarter of the yield surge has come from this source. Thus we judge that the explanation could be due to higher expectations on the neutral rate (r*) following the intensified debate on this topic, particularly at the Jackson Hole central bankers symposium in late August and around the time of the September Fed policy decision.

In the past two months, the longer-term 5y5y segment of the curve has been rising much more than short- to medium-term yields

US nominal bond yields



Sources: Macrobond, Federal Reserve and Handelsbanken

Note: Term structure calculated with the Fed's DKW-model.

The real term premium is the dominant factor behind surge in long rates

Fed models support the case that the "bond vigilantes" are back, as worries about US fiscal sustainability mounts

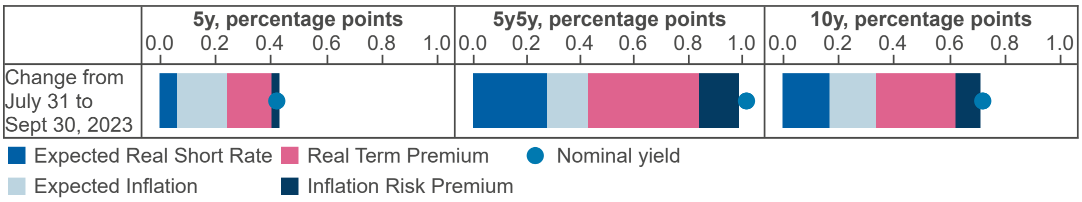
The main driver of the long rate rise is actually a pickup in the real-term premium, especially in the 5y5y segment, where it has driven 40bp of 100bp yield rise (see graphs below). We view it as likely that this is related to the increased uncertainty about the US fiscal outlook. Why? Because if the term premium surge was instead due to rising uncertainty about the economic outlook, we should expect to see more of the term premium rise in the short- to medium-term yields, but it is not the main driver in the five-year segment yield rise. So the Fed model results are not consistent with recent analyst proposals that the yield rise is due to a switch from this summer's soft landing narrative to more of a focus on the 'no-landing scenario' - something that increases the economic uncertainty.

Our main candidate factor, which we believe is driving up the real-term premium is uncertainty about the fiscal outlook. In the longer run, the US public finances may be on an unsustainable path. This year's surprising deepening of the US budget deficit is one signal. There should be no acute risk of a US default, but the question has come into focus with potential rating downgrades and the on-going impasse in US politics, which threatens to cause a government shutdown in November. The result is the claim that the "bond vigilantes" are back, i.e. the view that the bond market will ultimately halt any unsustainable policy implicitly, via higher yields as market participants require higher and higher risk premia (see e.g. Financial Times, October 4, 2023). We judge that the Fed model supports the "bond vigilante" view, by showing longer-term real term premia rising fast. The fact that the longer-term premium is indeed rising the most is supported by both the Federal Reserve Board of Governors' model we use here, and the term structure model of the New York Fed.

Note also that the long rate surge has been focused on the US bond market, signaling that it relates to a US-specific issue rather than e.g. Fed monetary policy which has a tendency to spill over into bond markets around the globe. Someone may wonder if the Fed's on-going quantitative tightening (the reduction of its asset portfolio, "QT") could be to blame for the rising term premium? While we view that as a driver for the overall term premium rise in 2023, we have had no significant news about QT lately, making it an unlikely source of the recent long rate rise. Finally, the oil price surge is unlikely to be the main bond yield driver now, as it is the real yields (TIPS yields) not market breakeven inflation that has soared lately. Indeed, the Fed model decomposition tells the same story, attributing a limited weight to expected inflation.

The term premium appears to have been the main driver in the recent long rate surge

US bond yield rise decomposed with the Fed's model



Sources: Macrobond, Federal Reserve and Handelsbanken

Note: Federal Reserve's DKW-model.

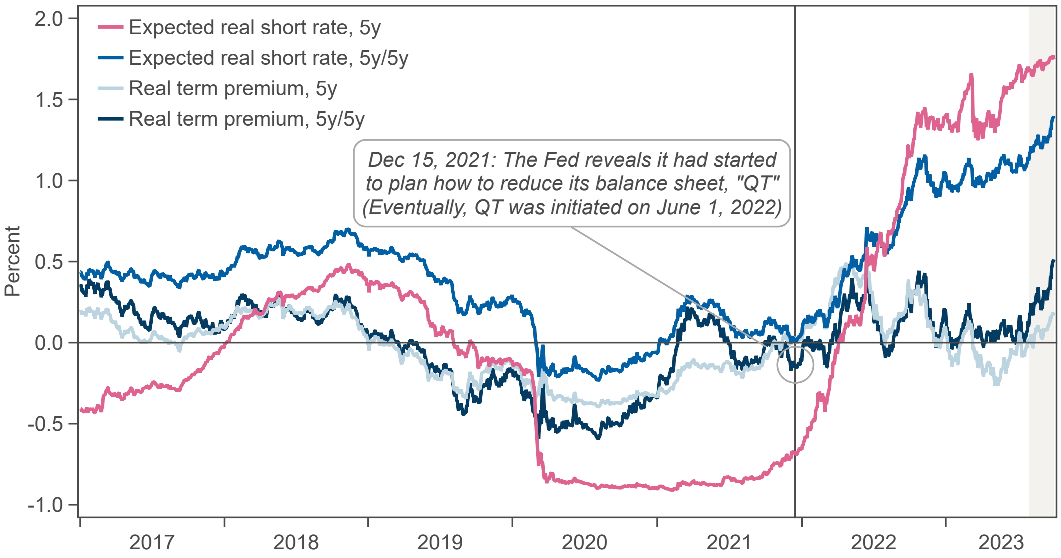
Upward revision of our interest rate forecasts on the cards

The conclusion about long rate drivers impacts how large the forecast changes will be. We await some key macro data before finalising.

The large moves in long rates mean we will likely need to revise our market interest rate forecasts upwards, at least for the shorter term. However, depending on the final conclusion as to which factors actually lie behind the long rate rise, the revisions may be very different in scope, potentially also raising the need to revise other parts of our macro outlook. We will await some key macro data such as the September inflation prints, while also gauging the continued bond market developments before finalising our coming revisions. Stay tuned.

A pickup in the real-term premium, especially in the 5y5y segment, is driving long rates

US government bond yields: Select drivers



Sources: Macrobond, Federal Reserve and Handelsbanken Capital Markets

Note: Nominal yield decomposed with the DKW-model, Board of Governors of the Federal Reserve System.

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