Bank of Melbourne

Monday, 9 October 2023

Taking Higher For Longer More Seriously

The sell off in US treasuries has intensified since the end of August. The US 10-year treasury yield jumped from a close of 4.11% on August 31 to a 16-year high of 4.89% on Friday night, a whopping 78 basis points. Over the same period, the US 2-year treasury yield has risen from 4.86% to an intra-day high of 5.15% on Friday night, representing a move of 29 basis points. The relatively sharper increase in yields at the longer end of the yield curve has led the yield curve to steepen dramatically.

Australian bond yields have mirrored the moves in US yields, but to a lesser extent.

The spike in global bond yields has been driven by three evolving forces, which are interest rate expectations, changing risk premia and the supply and demand of treasuries.

Interest rate expectations

Way back in June last year when the US rate hiking cycle was in its infancy, US Federal Reserve Chair Jerome Powell made the first mention of interest rates remaining 'higher-for-longer' during a question-and-answer session. Since then, this mantra has increasingly grown central to the Fed Chair's forward guidance. A chorus of central bankers have echoed this message.

But up until recently, markets were sceptical, pricing in interest rate cuts very shortly after they expected rates to peak. However, it's starting to look like markets are taking the higher-for-longer message a little more seriously. At the end of August, the market was pricing a near 45% chance of another hike in the fed funds rate by November and rate cuts were almost fully priced by May 2024. Fast forward to today, the implied odds of another rate hike in the US by year's end is little changed, but rate cuts have been pushed out to July 2024.

Another dimension of interest-rate expectations to consider is the neutral level of interest rates. The neutral real interest rate (i.e. interest rates adjusted for inflation) provides a broad indication of the level of real interest rates where monetary policy is neither contractionary nor expansionary. There is a growing discussion that the neutral rate may be higher than previously expected, at least in the US. So, longer-term interest rate expectations may be reflecting this view. Pricing in the swap market currently suggests the fed funds rate will settle at around 4.10% in three years' time. At the end of August, this rate was lower, at 3.50%.

Expectations that rate cuts may come later and that the easing cycle may be smaller than previously anticipated (i.e. higher for longer rates) is likely a driving force behind the recent steepening in the US yield curve. However, it is also not the only force at play.

Risk Premium

The risk premium is an important component of government bond prices and can reflect many different types of risk, credit risk (usually very low on US treasuries), liquidity risk, inflation risk, and more. The risk premium and its components are notoriously difficult to measure and observe. However, if markets were to perceive the future as more uncertain or more volatile, this could increase the risk premium demanded by investors, hurting bond prices and increasing bond yields.

The current economic landscape is highly uncertain, not only because the combination of shocks from the pandemic were largely unprecedented, but also because there are an increasing number of risks that could knock the global economy from its current trajectory. These risks include those coming from geopolitical tensions. Investors may demand more compensation for taking on risk in this environment (an increase in the risk premium), driving down bond prices and pushing up yields.

Supply and demand of treasuries

One of the final pieces of the puzzle is the supply and demand of treasury securities. While this will be partly influenced by the factors above, markets can sometimes behave in ways that do not perfectly align with economic theory. We may be experiencing one of these episodes now.

A sharp increase in the relative supply of US treasuries has put downward pressure on bond prices and upward pressure on yields. This has been a key driver behind the current surge in longer-dated treasury yields.

The US Federal government continues to run large budget deficits. So far during the 2023 US fiscal year (October 2022 to August 2023), the US government has recorded a deficit of US$1.52 trillion (equivalent to 5.7% of GDP). This is contributing to a large increase in the issuance of treasuries (i.e. new supply). The unwind of the Fed's quantitative easing programme (dubbed 'quantitative tightening') is also adding around US$60 billion in treasuries to the market each month.

The biggest holders of US treasuries are global central banks. They hold these instruments as part of their currency reserves. The dominant players are the Bank of Japan (BoJ) and the People's Bank of China (PBoC). There is growing speculation that one or both of these central banks have been intervening in the FX market to defend their currencies. This would see these parties liquidate their treasury holdings to enter the FX market.

On the demand side, growing political fragmentation and the rising public debt burden are weighing on demand for US treasuries at the margin. Greater uncertainty and rising rates have also seen investors shun duration risk (which is higher for longer-dated maturities), weighing on demand for treasuries with longer maturities. The escalation of the conflict between Israel and the Hamas militant group over the weekend has the potential to act in the opposite direction, supporting safe-haven demand for US treasuries in the near term. During Asian trade today, longer-dated US bond yields fell. This could be in response to US government bonds being bid up due to safe-haven flows.

What are the implications?

All else equal, the run up in longer-dated yields in the US and Australia should make the job of central bankers a bit easier. A steeper yield curve means financial conditions are tighter, as borrowing over the longer term becomes more expensive. In fact, this is a key reason behind the higher-for-longer guidance issued by the US Fed, so it would be reassuring to the Fed that market pricing is moving more into line with this messaging. Central bankers could ultimately deliver less tightening than otherwise might be the case because the movement in the yield curve has helped make conditions more restrictive.

Weekly data calendar

Domestic data is light this week meaning the direction of local markets will be determined heavily by offshore influences.

Tomorrow, we receive an update on business and consumer sentiment. The mood among businesses has stabilised in recent months alongside resilient demand. This is despite recession-like pessimism among consumers. We are unlikely to see a sharp turnaround in consumer sentiment given the headwinds facing households from elevated inflation and higher interest rates. The interest will, therefore, remain on businesses. In particular, the tenacity of demand and the outlook for inflation from the business survey's price indicators. Over recent months price measures in the business survey suggest some potential for inflation to prove sticky. However, there are also some early signs that businesses are finding it more difficult to pass on cost increases as demand softens. Updated price measures will provide a timely update on the current inflation pulse.

Turning offshore, the US September inflation report is due to be released on Thursday night. An upside surprise for US non-farm payrolls data late last week bolstered interest rate expectations. Fresh inflation data will be another key to the interest rate story. The US consumer price index (CPI) rose 0.6% in August, accelerating on the back of rising oil and fuel prices. This pushed annual headline inflation to 3.7%, from 3.4% in the previous month. However, core inflation, which excludes food and energy, continued to moderate in annual terms. Core inflation slowed to 4.3% over the year to August, from 4.7% the month prior. Progress on core inflation remains constructive, however, there is still some way to go before the Fed's inflation target is met.

Jameson Coombs, Economist
Ph: +61 401 102 789

Group Forecasts

		2023	2024				2025
End Period:	**Close (6 Oct)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.13	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.23	4.10	4.00	3.90	3.80	3.70	3.50
10 Year Bond, %	4.54	4.45	4.50	4.40	4.30	4.20	4.00
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.80	4.45	4.50	4.40	4.30	4.20	4.00
USD Exchange Rates:							
AUD-USD	0.6386	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	149.32	147	145	143	141	138	135
EUR-USD	1.0586	1.08	1.09	1.11	1.13	1.14	1.15
GBP-USD	1.2237	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.5990	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6386	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.6032	0.61	0.61	0.61	0.61	0.61	0.62
AUD-JPY	95.34	97.0	97.2	97.2	97.3	96.6	95.9
AUD-GBP	0.5218	0.54	0.54	0.54	0.55	0.55	0.55
AUD-NZD	1.0660	1.08	1.10	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	4.3	3.2
CPI (Trimmed mean), %	2.6	6.9	4.1	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

Contact Listing

Chief Economist
Besa Deda
dedab@bankofmelbourne.com.au
+61 404 844 817

Senior Economist
Pat Bustamante
pat.bustamante@bankofmelbourne.com.au
+61 468 571 786

Senior Economist
Jarek Kowcza
jarek.kowcza@bankofmelbourne.com.au
+61 481 476 436

Economist
Jameson Coombs
jameson.cooombs@bankofmelbourne.com.au
+61 401 102 789

The Detail

The information contained in this report ("the Information") is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom Bank of Melbourne has a contract to supply Information, the supply of the Information is made under that contract and Bank of Melbourne's agreed terms of supply apply. Bank of Melbourne does not represent or guarantee that the Information is accurate or free from errors or omissions and Bank of Melbourne disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to Bank of Melbourne products and details are available. Bank of Melbourne or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. Bank of Melbourne owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of Bank of Melbourne.

Any unauthorised use or dissemination is prohibited. Neither Bank of Melbourne- A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.