3 November 2023

Research US

Bond yields headed lower towards 2024

- **Bond market outlook remains blurred by high issuance, debt sustainability worries as well as uncertainty over economic outlook and inflation. We continue to forecast lower long-end yields, but less than previously.**
- **We see 10y UST yield at 4.20% in 12M horizon (from 3.70%). We also revise up our US GDP forecast to 2.4% for 2023 (from 2.1%) and 1.1% for 2024 (from 0.9%), reflecting stronger realized data but still weak outlook.**

10Y UST yields have generally traded in the 4.80-5.00% range over the past weeks, but broke below the recent range following the November FOMC Meeting. Yields remain caught in crosswinds stemming from data, market dynamics and monetary policy.

On the latter, Powell struck a rather balanced tone at the press conference following yesterday's FOMC meeting, emphasising that the committee sees progress on inflation/labour market data but is not yet convinced that financial conditions are sufficiently restrictive. Wage growth remains elevated, excess labour demand is still present and growth continues to surprise to the upside. The 'high for longer' narrative has clearly been adopted by markets, which is visible in the noticeable staple pricing of the SOFR forward curve to bottom at a level above 4% in 2025 (see right-hand chart).

Dire deficit outlook justifies a higher Term Premium

Apart from data and monetary policy, bond markets remain highly impacted by supply/demand dynamics encapsulated in the move up in the Term Premium since the summer (see right-hand chart). The US debt outlook is in centre of these discussions, after the Treasury's sizeable upward revision of expected issuance in August. However, recent announcements on issuance have brought some calm to markets.

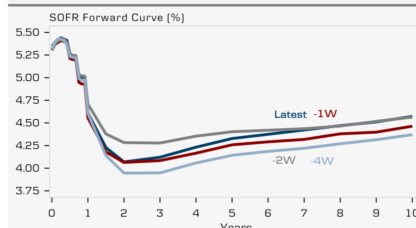
Earlier this week, the Treasury lowered its expected issuance for the remainder of the year, while signalling that the cash buffer (TGA) is now sufficiently refilled after being drained in the lead up to the debt ceiling resolution in June. According to the Quarterly Refunding Statement out Wednesday, issuance for the remainder of the year will mainly pick up at the belly of curve, while selling in the long-end will decline marginally in December and January. A continued high share of T-Bills in the issuance profile indicates, that the short end will continue to bear a significant share of US deficit burden. Markets had clearly feared a more significant amount of duration to accommodate in the short run.

On the demand side, investors still seems cautious to take on more duration risk in the current situation. Powell mentioned in his speech at The Economic Club of New York earlier this month that the FOMC is looking at the current positive bond/equity correlation as a potential driver of Term Premia. Bonds have become less useful for hedging risk. Bonds and equities share a common exposure to inflation, and historically the two have correlated positively in decades characterized by elevated price pressures as the 1970s and 1980s (see chart below on page 2). As economic growth slows and inflationary risks dampen, the positive correlation will likely recede gradually from here.

Our recent work discussing US yield outlook

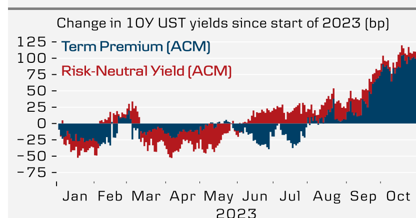
- November FOMC Meeting: *Fed review: Still on track*, 1 November.
- Term premium: *Research US - Yields not bound to remain high for long*, 5 October
- Neutral rate & Productivity: *Research US - Could investment boom pave the way for a soft landing?* 22 August

Forward curve remains quite staple



Source: Macrobond and Danske Bank

Term Premia have moved up strongly



Source: Macrobond and Danske Bank

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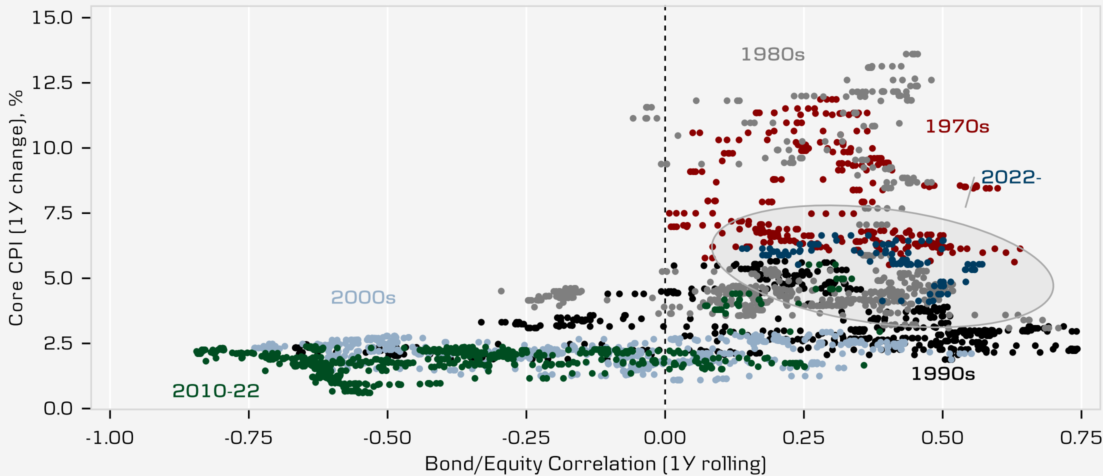
Bond/Equity correlation has typically been positive in periods characterized by high inflation



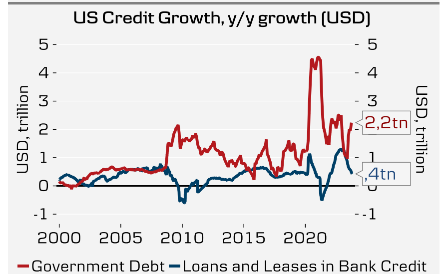
Note: Correlation is based on weekly return data

Source: Macrobond and Danske Bank

Balancing short-term policies with long-term risks

No matter if you see the latest rise in yields driven primarily by demand or supply factors, we like to emphasize that the two are closely interlinked. Stance of US fiscal policy remains relatively loose, which is likely counteracting some of the tightening impact of monetary policy. When looking at credit growth in USD terms, growth in public debt is more than compensating for the slowdown in private bank lending growth. Public investments have been a key component of GDP growth over the past year, while the IRA and the CHIPS & Science act have provided a significant boost to private investments.

Monetary policy has tightened, but fiscal policy is pulling the other way

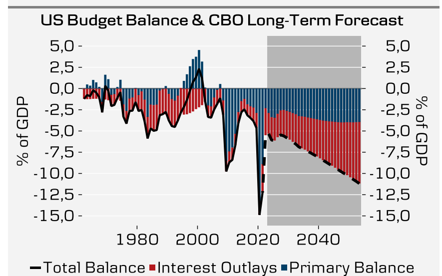


Sources: Macrobond, U. S. Treasury, The Fed

The Fed is facing a challenging balancing act, as fiscal policy is both supporting economy's resilience, but also fuelling debt sustainability concerns, which in turn are tightening financial conditions for the private sector.

Over the very long term, US debt-to-GDP is set to reach 180% by 2053 in the *CBO's latest long-term projections* and 566% by 2097 according to *the Treasury*. Compared to countries like Japan or Italy, which have much higher debt-to-GDP ratios today, the main challenge the US is facing relates to the high level of structural primary deficits.

Interest outlays are increasingly driving budget deficits



Sources: Macrobond, U. S. CBO

With market pricing positive real interest rates far into the foreseeable future, interest outlays are set to become the clear main driver of US deficits already over the next decade. Authorities are facing growing pressure to address rising health care and social security costs, which will be the main driver of the primary deficit, but the task will be politically difficult, especially if the economy returns to a weaker growth path over coming years.

This also means that higher interest rates have overtaken short-term fiscal policy as the main driver of the debt sustainability worries. We estimate that a 1%-point rise in financing costs over the CBO's baseline would lift the 2053 debt-to-GDP forecast to 210%. US Treasuries still enjoy a high level of structural demand, but the evident risk of higher yields becoming a self-fulfilling prophecy could explain some of the rise in term premium.

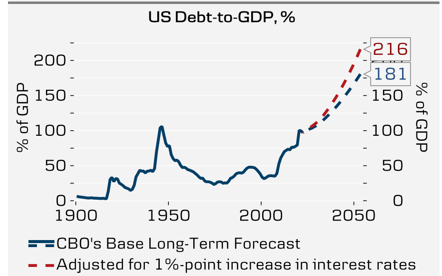
We expect long rates to decline, but less than previously

Powell mentioned on the meeting earlier this week, that the FOMC is closely watching the rise in long rates and the implications for financial conditions. To have an impact on monetary policy, the move needs to 1) be driven by a higher term premium (which it according to Powell seems to be) and 2) be persistent. Simply put, a persistently higher Term Premium should be countered by monetary policy, assuming that financial conditions are to remain unchanged. Nothing indicates an intention from the FOMC to achieve additional tightening, and as long as that is the case, the markedly higher Term Premium should eventually increase the probability of monetary policy turning softer in H1/2024.

Reflecting stronger-than-anticipated private consumption and ongoing lift from fiscal policies, **we revise up our US GDP forecasts to 2.4% for 2023 (from 2.1%) and 1.1% for 2024 (from 0.9%)**. But as we still expect consumption growth to cool towards winter and as tighter financial conditions gradually weigh on investment activity, the forecast profile still includes a clear slowdown towards H1 2024.

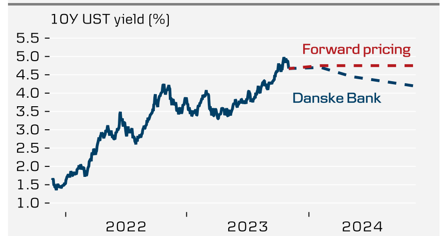
We still pencil in a downward trending profile for long UST yields over the coming year, though with a higher level expected on a 12M horizon compared to our September forecast. **We expect the 10Y UST yield to decline by 70bp to 4.20% (previously 3.70%),** as inflationary pressures soften and Fed initiates its cutting cycle. The upward revision is mainly an effect of a higher Term Premium, which we expect to prove stickier than the pricing of policy rates remaining 'high forever'.

US debt-to-GDP outlook highly sensitive to interest rate level



Sources: Macrobond, U. S. CBO

We expect long yields to decline gradually over the next 12M



Source: Macrobond and Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Frederik Romedahl Poulsen, Director and Antti Ilvonen, Analyst

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