GLOBAL MARKETS UPDATE

The Treasury yield curve could "disinvert" next year

- **We expect the Treasury yield curve to "disinvert" in 2024, as we think the Fed will cut rates by more than investors expect and term premia will remain at least as high as they are now.**
- **The spread between the yields of 10-year and 2-year Treasuries has become notably less negative over recent days, as short-dated yields have fallen vis-à-vis long-dated ones**. That reflects a significant paring-back of investors' expectations for the federal funds rate after Fed governor Christopher Waller, who'd previously taken a hawkish stance, signalled last Tuesday that he thought it had peaked.
- **That shift in the spread marks not only a reversal from its earlier downward trend, but also a change in its main driver**. Between July and November, moves in that spread were driven by changes in 10-year yields outweighing those in 2-year ones. That was unusual: typically, the 10-year/2-year spread fell during tightening cycles as short-dated yields rose vis-à-vis long-dated ones (indeed this was the case in the first half of this year and for most of 2022) – and vice-versa during easing cycles. (See Charts 1 & 2.)

Chart 1: Year-To-Date Changes In Treasury Yields And Spread & US 2-Year OIS Rate (bp)

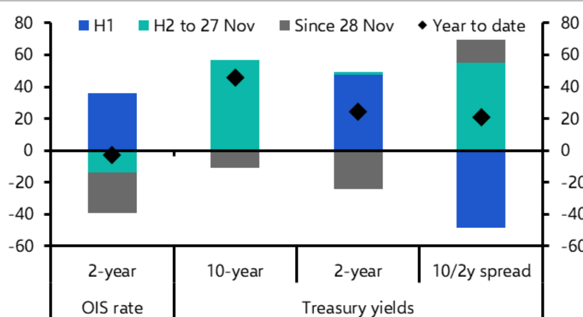
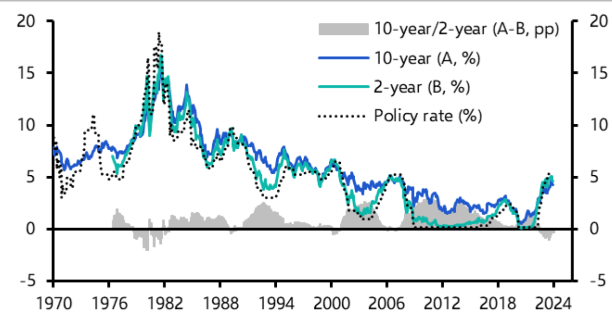


Chart 2: 10-Year/2-Year Treasury Yields And Spread & US Policy Rate



Sources: Refinitiv, Capital Economics.

- **One explanation for that unusual pattern is that, until last week, the 10-year yield had been affected by factors other than near-term policy rate expectations.** For one, investors seem to have revised up their expectations for interest rates in the longer run. Second, there was an increase in term premia during most of the summer and autumn (at least according to some commonly used estimates). And although some of that rise has partially unwound more recently, the 10-year term premium is still ~70bp higher than its average since 2020. (See Chart 3.)
- **But, as investors have seemingly begun to abandon the "higher-for-longer" narrative** (money markets now price in the first Fed rate cut in Q1, which has been our long-held forecast)**, it looks like their expectations for near-term policy rates have become the main driver of long-dated yields again**. (See Chart 1 again.)
- **We think this will continue, for two reasons**. **First, we expect investors to pare back their expectations for near-term interest rates further, but that expectations for long-term rates won't change much.** That's because we see sharply falling core inflation to allow the Fed to deliver 225bp of rate cuts over the easing cycle as a whole, compared to the 150-175bp of cuts currently priced in money markets. But the longer-run policy rates already priced in are broadly in line with our own view. **If we are right, then (at least) *risk-neutral* short-dated yields will fall vis-à-vis long-dated ones.**
- **Second, we doubt that the surge in the 10-year term premium this year will unwind further in the near term.** After all, that premium was in part pushed up by growing worries around the net supply of Treasuries which the private sector will need to absorb over coming months and years. And if US fiscal policy stays on its current track, it will probably remain higher than it has been over the past decade as markets adjust to a new era of fiscal uncertainty. Meanwhile, term premia on long-dated bonds have typically been higher

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than those on short-dated ones: accordingly**, we expect the 10-year/2-year *term premium* spread to stay positive going forward. That means that, at any given level of relative rate expectations, the Treasury yield curve is likely to be steeper than it was in recent years**. (See Chart 4.)

- **The upshot is that we expect the Treasury yield curve to become upward sloping in 2024, as short-dated yields fall vis-à-vis long-dated ones. We project the 10-year/2-year yield spread to be roughly +50bp by the end of 2024, compared to –35bp at present.**

Chart 3: ACM Estimates Of Treasury Term Premia & Federal Funds Rate

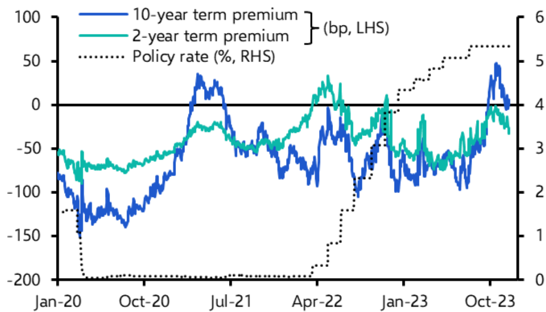
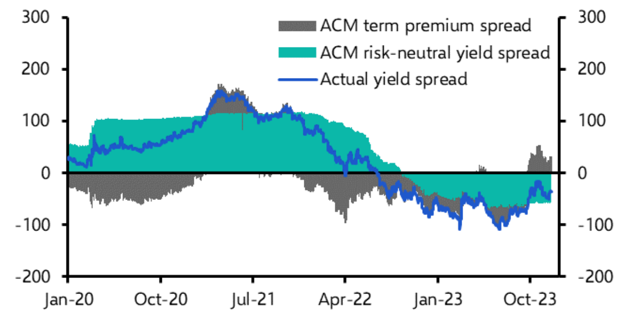


Chart 4: 10-Year/2-Year Spreads Of ACM Treasury Yield Components & Actual Treasury Yields (bp)



Sources: ACM, Refinitiv, Capital Economics.

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