The Starting Line for the US Yield Curve

January 6, 2025

Two key components drive the shape of the yield curve: expectations for the short-term interest rate and expectations for the term premium. The market expects the fiscal deficit to continue growing and for the Fed to be all but done cutting rates. Given strong economic data and lack of details around Trump's economic policies, interest rates are near fair value; however, we see risks as skewed to the downside given current valuations.

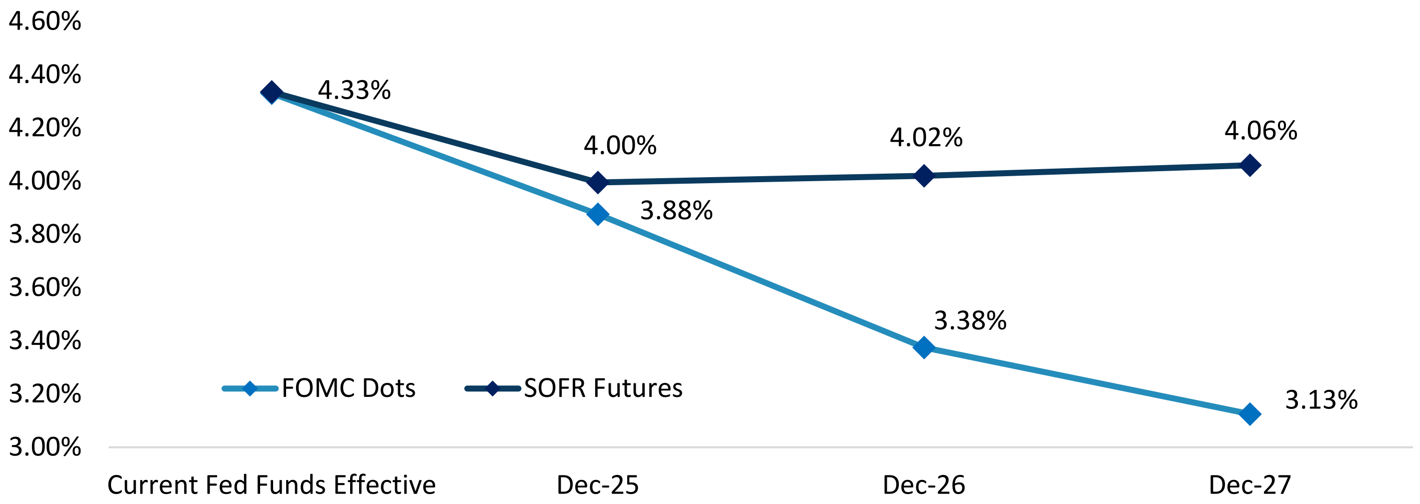
How Fed Expectations and Term Premium Shape Interest Rates

In the US, the short-term rate reflects market expectations about future interest rates set by the Federal Reserve, shaped by progress on its mandates of full employment, stable inflation, and financial stability. The term premium, on the other hand, compensates investors for the risks associated with holding longer-term bonds, such as policy and inflation uncertainty. Fed expectations have a larger effect on shorter-term interest rates, while changes in term premium influence the longer-term points on the yield curve. Together, these components determine the shape of the yield curve, which can slope upward (normal curve), flatten, or invert.

Fed Expectations: At the December FOMC meeting, the committee lowered its policy rate by 25 basis points to 4.5% and signaled two additional 25 bps rate cuts in each of 2025 and 2026. The markets responded to the Fed's acknowledgement of a resilient economic expansion and the potential for Trump economic policies to result in higher inflation by pricing in a hawkish path for rate cuts. The SOFR futures market is pricing in 33 bps of cuts in 2025 and none after that.

Fed Funds Projections and Market Pricing

Source: Federal Reserve, Bloomberg as of January 5, 2025

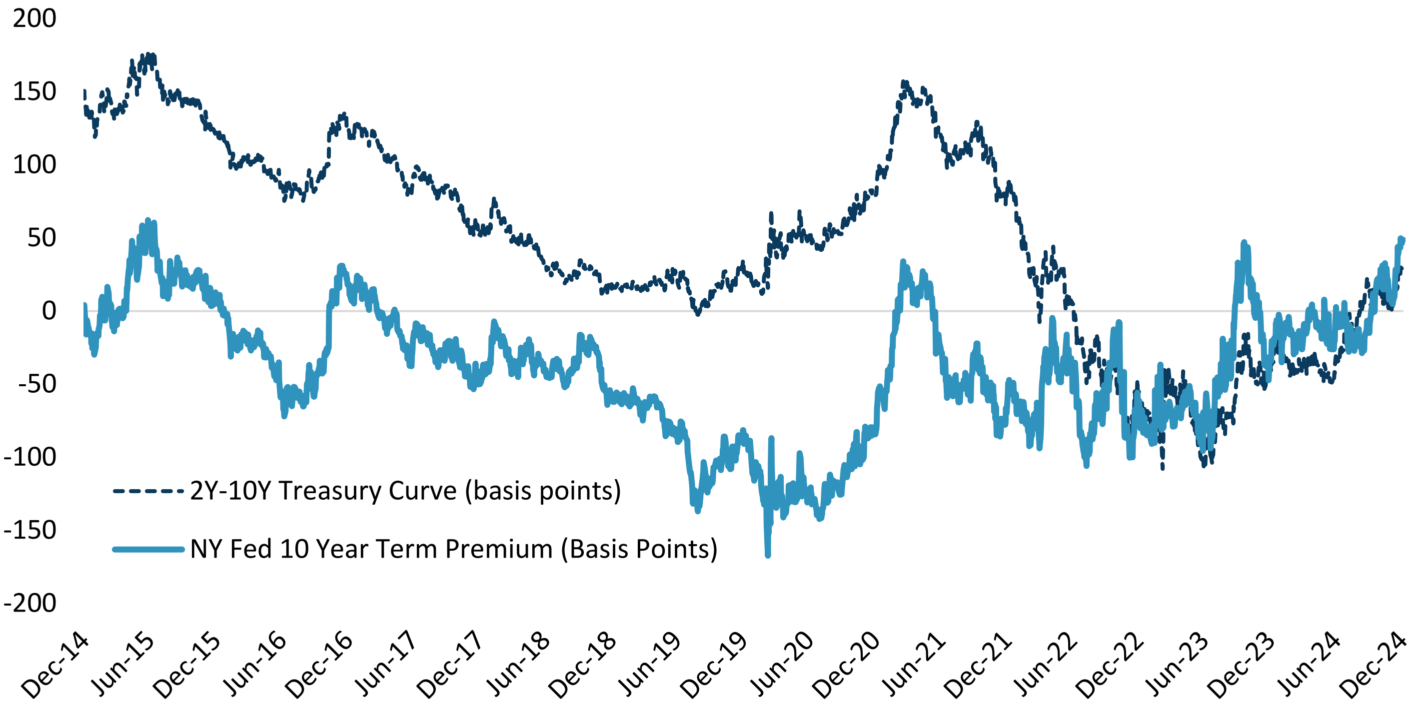


Term Premium: The United States has been running a fiscal deficit during an economic expansion, an uncommon occurrence. This has led to higher Treasuries issuance, which combined with elevated inflation expectations, has driven an increase in the term premium. The New York Federal Reserve defines its Treasury term premium measure as the extra compensation investors demand for holding long-term bonds instead of a series of short-term securities. The New York Fed's 10-year Treasury term premium estimate currently stands at +49 basis points, marking its highest level in a decade. This surpasses the peaks observed during the yield shock of late 2023 and the recent period of elevated inflation in 2021 and 2022, reflecting the impact of increased Treasury issuance.

The chart below shows the impact that changes in term premium have on the shape of the yield curve. While the steepness of the yield curve (10Y – 2Y Treasury yield) was driven by the Fed remaining near its zero-policy rate post-Great Financial Crisis, more recent years have seen the steepening of the yield curve driven by rising term premium, which makes sense given the dominance of fiscal stimulus on inflation post-Covid.

NY Fed 10Y Term Premium versus 10Y-2Y Treasury Spread

Source: Sage, New York Federal Reserve



Volatile Rate Expectations and Fiscal Challenges

The bar remains high for the FOMC to hike rates in response to strong economic data, while disappointments should result in more cuts being priced in. To that end, the possible paths of the federal funds rate are tilted to the downside; however, the path will be bumpy. Last year demonstrated the volatility of rate expectations: markets initially priced in nearly seven cuts by January, then reduced expectations to one by April, only to see five cuts anticipated by August before the Fed ultimately lowered rates by 100 basis points. This year appears poised for similarly significant swings in rate expectations.

One of the key questions will be whether higher fiscal deficits and increased Treasury issuance will materialize. If so, term premium could widen. We believe that given the current size of the interest expense (slated to be $1 trillion this year) and rhetoric around fiscal austerity from the incoming administration (e.g., DOGE), fiscal sustainability could be a larger concern for Washington in the near-term and will limit the scope to which term premium could increase this year.