

Flash Note

Ten-year US Treasury yield – Update

Ten-year Treasury yield has further to rise

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We outlined previously that if the Trump administration were to deliver fiscal reforms that stimulated growth, the 10-year yield could rise to about 3%. Taking into account last December's fiscal reforms, **we have indeed revised our end-of-the year target for the 10-year Treasury yield up from 2.6% to 3.0%.**

Higher US economic growth (up from 2% to 3%), a more hawkish Fed (we now expect four hikes this year rather than two) and core inflation closing in on the Fed's target of 2% are likely to put further upwards pressure on the 10-year Treasury yield this year.

In this flash note, we review our baseline scenario for the 10-year Treasury yield in 2018, which we originally set out in October last year (see [Flash note on core sovereign yields](#)). We outlined previously that if the Trump administration were to deliver fiscal reforms that stimulated growth, the 10-year yield could rise to about 3%. Indeed, taking into account the fiscal reforms enacted in December and our economist's upwards revision of estimated real 2018 US GDP growth from 2% to 3% (see [Flash note on US forecast update](#)), we have now revised our end-of-the-year target for the 10-year Treasury yield up from 2.6% to 3.0%.

Ten-year core sovereign yields - PWM forecasts as of 29 January 2018

	29.01.2018	2017		2018 Old		2018 New
US Treasury	2.69%	2.50%	↓	2.60%	↑	3.00%
German Bund	0.69%	0.70%	=	0.90%	=	0.90%
UK Gilt	1.45%	1.40%	↓	1.70%	=	1.70%
Japanese JGBs	0.09%	0.00%	↑	0.25%	↓	0.10%

Source: Pictet WM - AA&MR, Bloomberg

In our previous note, we pointed out that the long-term government bond yield can be calculated by combining the policy rate and a risk premium that reflects the bond's term (time to maturity) plus inflation. Forecasting core sovereign bond yields involves setting out predictions for the macroeconomic factors influencing short-term rates and the risk premium. Taking all this into account, we have built a fair-value model (see [Flash note on US monetary policy](#)) for the 10-year Treasury yield based on:

1. **The neutral interest rate**, which incorporates most macroeconomic variables, as it represents the real policy rate consistent with trend economic growth, stable prices and full employment.
2. **Long-term inflation expectations**, represented by the 10-year inflation breakeven yield.
3. **The size of the US Federal Reserve's (Fed) balance sheet**, as the Fed has bought a lot of US Treasuries, compressing the term premium.

Building on this fair-value model, in our initial scenario for 2018 we identified three macroeconomic factors that would help us forecast core sovereign bond yields—inflation, business cycle and monetary policy.

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As it turned out, the tax cuts enacted by the US Congress in late 2017 revived hopes that fiscal stimulus would spark animal spirits in the US in the form of increased capital investments. For this reason, we anticipate that fiscal policy more than the business cycle will become a relevant factor in 2018, such that we now expect the following three macroeconomic factors:

- **Inflation**
- *Fiscal policy*
- **Monetary policy**

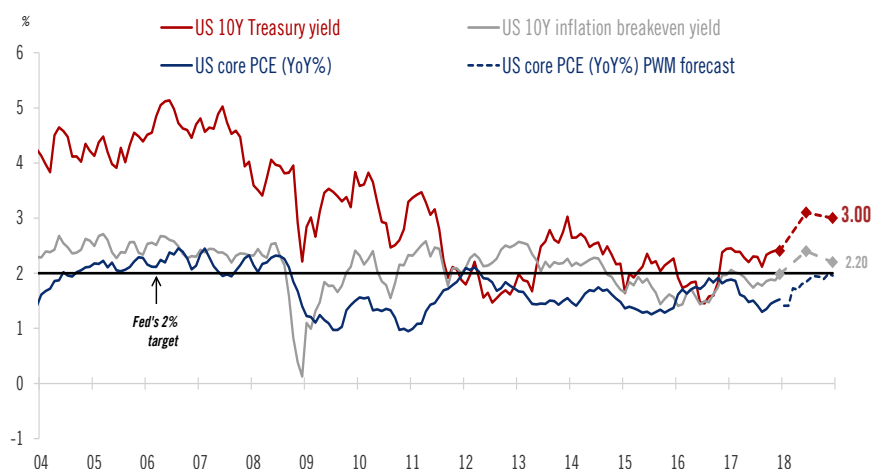
The revision in our year-end target for the 10-year US Treasury yield up from 2.6% to 3.0% (within a range of 2.9–3.1%) is due to higher expected growth over the coming two years and tighter monetary policy from the Fed. By contrast, our initial forecast for the Bund yield remains unchanged at 0.90% as the euro area economy has been performing broadly in line with our expectations. We also maintain our 10-year UK gilt yield target at 1.7%. However, as we still expect the Bank of Japan (BoJ) to hold its yield target at around 0%, we are revising our forecast for 10-year Japanese government bond (JGB) yields down from 0.25% to 0.10% (see [Flash note on Japan](#)).

Core US inflation to accelerate to reach the Fed's target of 2%

Core US inflation should accelerate during the year, but we expect it to remain slightly below the Fed's target of 2.0% for 2018 as a whole (1.9%). Our economist only expects US core inflation to reach the Fed's target during the second half of 2018 as improving economic growth and full employment are likely to take time to feed through into higher wages and then higher core inflation.

So far this year, the rise in the 10-year Treasury yield has been partly due to a rebound in inflation expectations thanks to higher oil prices and expectations of rising wages resulting from tax cuts. We expect this upward trend in inflation expectations will continue, with the inflation breakeven yield moving up from 2.1% at 29 January to 2.2% by the end of the year (see Chart 1).

Chart 1: Ten-year US Treasury and inflation breakeven yield with US core PCE



Source: Pictet WM - AA&MR, Bloomberg

US economic growth to be boosted by tax cuts

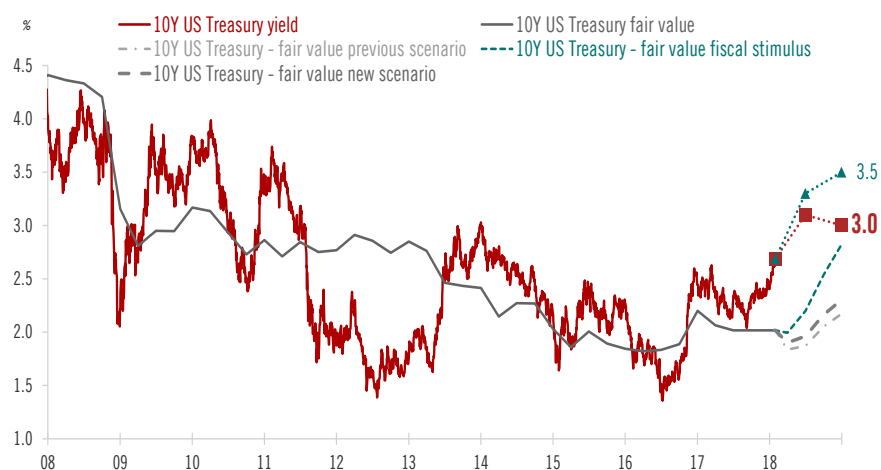
US growth was solid in the US in 2017, with the economy expanding by 2.3% over the year, up from a low of 1.5% in 2016. Thanks to fiscal reforms, we expect growth to accelerate further, with the US economy rising by 3.0% this year and another 2.4% in 2019. Quicker growth should push the 10-year Treasury yield higher. **This means that the 10-year US Treasury yield's 29 bps rise so far this year (as of 29 January) should have further to run, such that it could reach 3.0% by the end of the year. Our fair-value model has been working as an attractor for the US 10-year Treasury yield around which it gravitates. Taking into account the recent fiscal stimulus measures, it calculates that the Treasury yield will rise this year 20bp higher than in our previous scenario (see Chart 2).**

Main risk lies in core inflation rising durably above 2%

Should core PCE pick up durably above 2%—fuelling fears that the Fed is “behind the curve”, i.e. that monetary tightening is too slow to dampen inflationary pressures—the US yield curve could steepen again, as the bar is high for the Fed to hike more than once each quarter. **We attribute a 25% risk to this alternative scenario (highlighted in green in Chart 2), which could see the 10-year Treasury yield rise to 3.5% on the back of the strong inflationary pressures caused by the fiscal stimulus.** In this case, the fair value moves up to 2.8%.

There is also a chance (we estimate the probability at about 10%) that politics derails the current positive economic momentum (eg. the collapse of the NAFTA agreement) or that investments do not pick-up as we expect, thereby failing to revive US economic growth. This could cause equity markets to tumble: as we consider US Treasuries a safe-haven asset (and negatively correlated to equity markets), the US yield curve could flatten much more than it already has, with the 10-year US Treasury falling to 2.3% by end-2018.

Chart 2: Ten-year US Treasury yield fair value and forecasts



Source: Pictet WM - AA&MR, BEA, Eurostat, Thomson Reuters, Bloomberg

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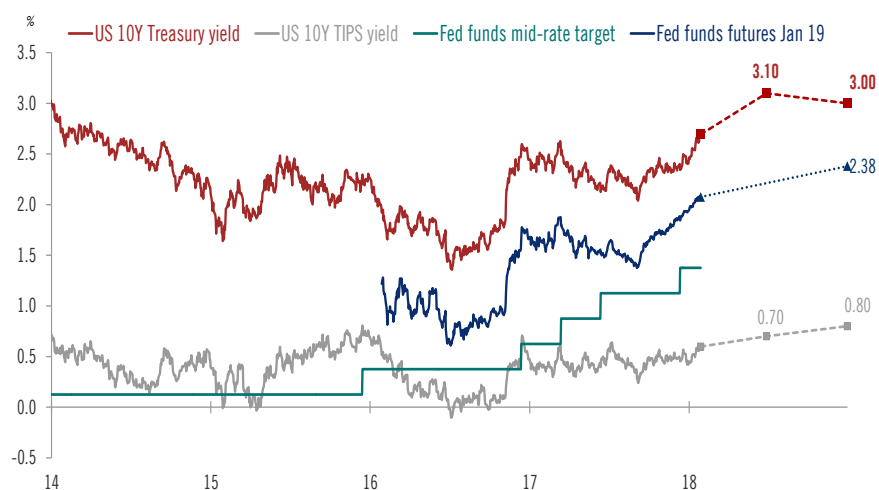
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The Fed to turn even more hawkish

As we discussed above, with core inflation likely to reach the Fed's target late this year and with US economic growth set to accelerate, we expect the Fed to become more hawkish, raising rates four times in 2018 – one hike more than it currently anticipates in its dot plots. With a rate hike every quarter, this means the Fed could settle the Fed funds rate at 2.38% this year. This level is above market expectations, as measured by Fed funds futures, which currently (29 January) stand at 2.1% for the January 2019 future. Moreover, the Fed is likely to continue with the balance-sheet reduction it began in October last year, gradually accelerating the reduction of its reinvestments in US Treasuries to USD 50bn a month. **This reduction of the size of its balance sheet should raise the term premium, adding around 15bp to the 10-year US Treasury yield by the end of 2018, according to our estimates.**

All in all, a more hawkish Fed than the market currently expects and an increased net supply of US Treasuries due to a larger fiscal deficit, combined with the Fed's reduction of reinvestments, should push the 10-year Treasury inflation-linked (TIPS) yield up from 0.6% as of 29 January to 0.8% by the end of the year.

Chart 3: Ten-year Treasury and TIPS yield with Fed funds target and futures



Source: Pictet WM - AA&MR, Bloomberg

In summary, given our expectations of a rebound in core inflation, accelerating growth and a faster rise in the Fed funds rate this year, we now expect the 10-year US Treasury yield to rise from 2.7% as of 29 January to 3.0% by the end of 2018. This rise is likely to be driven by both inflation expectations and TIPS yields creeping higher. In this central scenario of ours, the US yield curve (10-year – 2-year Treasury yield) would continue to flatten, as we saw in 2017, but at a slower pace.