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# UNPACKING THE US BOND SELL-OFF

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Since late April 2023, global developed bond markets have sold off conspicuously. In recent weeks, the yield on 30-year US Treasuries hit a 16-year high reaching 4.95 per cent for the first time since 2007 - before the Great Financial Crisis. In a sign of the pervasive impact of the sell-off, German and Italian borrowing costs also hit their highest levels for more than a decade.

Bond yields contain a wealth of forward-looking assessments regarding the real economy. Very often, it is only when disaggregating overall yields into sub-component parts that one gains “line of sight” with regards to these embedded assessments of economic prospects.

Before we delve into the changes in the underlying components of the benchmark 10-year US bond yield, recall that at the start of the year, there was a widely held view among market participants that US real growth would fall well below potential in 2023; a product of significant tightening in both fiscal and monetary conditions in an environment of broader global tightening. The key assumption embedded in this view is that although financial conditions adjust immediately to reflect expected and actual changes in monetary policy, the full adjustment in output, employment, and inflation occurs with a considerable lag.

In contradistinction to this, there was a second camp who believed instead that recent empirical experience as well as econometric modelling reveals that the peak drag on economic growth from a tightening in financial conditions occurs *without considerable lags* - after a mere two or three quarters, on average. Given that the most significant tightening in financial conditions occurred in the middle of 2022, when the Federal Reserve pivoted sharply toward more aggressive rate hikes, they contend that the maximum drag on growth may have already occurred quite early on, and most headwinds were now “in the rear-view” mirror.

What has occurred factually over the course of the year 2023 has in fact been a situation very close to the latter of the camps described above - i.e., that US aggregate demand and consumption has in fact remained robust and resilient, and if anything continues to surprise to the upside with regards to its contributions to the real economy.

Turning now to a decomposition of the US 10-year bond yield (the bars indicate changes in the variable concerned, from end April to early October 2023), we can make the following assertions:

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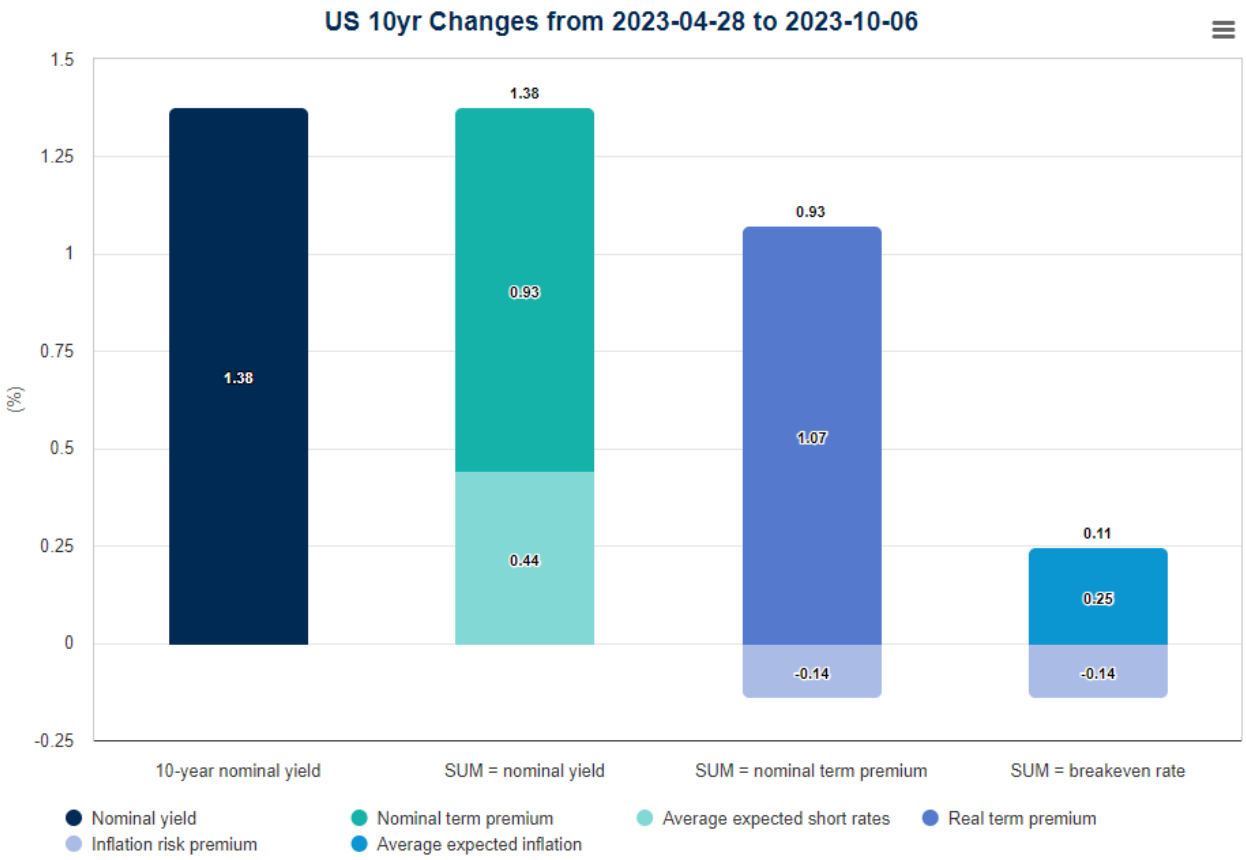


| Date | US 10 yr nominal yield | US 10 yr nominal term premium | US 10 yr breakeven | US 10 yr inflation risk premium | US 10 yr real yield | US 10 yr real term premium | US average expected short rates | US average expected inflation | US average expected real short rates |
|---|---|---|---|---|---|---|---|---|---|
| 2023-04-28 | 3.42 | -0.67 | 2.21 | 0.50 | 1.21 | -1.17 | 4.09 | 1.71 | 2.38 |
| 2023-10-06 | 4.80 | 0.27 | 2.32 | 0.37 | 2.48 | -0.10 | 4.53 | 1.95 | 2.58 |
| change | 1.38 | 0.93 | 0.11 | -0.14 | 1.27 | 1.07 | 0.44 | 0.25 | 0.20 |

**Sources: Prescient Investment Management, Bloomberg October 2023**

- Overall, the 10-year US bond yield is 1.4%% weaker since end of April 2023 (navy bar, chart above, remembering that bars represent changes)
- This increase in the overall 10-year bond yield is chiefly driven by a 0.93% or 93 bps increase in the *nominal term premium* (darker green bar) – this means that the market has re-assessed the compensation it requires for taking duration risk, or in

other words the market now requires a greater “lock-up” premium to invest in longer dated bonds as opposed to rolling over a series of shorter dated bonds.

- Decomposing the *nominal term premium* increase of 93 bps, we find that this in turn is driven largely by as significant 107 bps increase in the *real term premium* (purple bar), or the term premium embedded in the inflation-linked (real yield) bond market.
- Proximate reasons for this material increase in *real term premia* are likely due to the US labour market proving much more resilient than initially estimated. Fiscal transfers during COVID bolstered household incomes in the US and created savings stockpiles which were able to guide and buffer consumers through what would otherwise have been a very brutal and punitive hiking cycle.
- Prospects for economic growth have therefore been revised to the upside to such an extent that real yields have had to adjust upwards to reflect an increased opportunity cost for locking capital away instead of employing it in the real economy.
- What is also clear is that there has been an upward revision of 44 bps in *average expected short-rates* (lighter green bar). This revision occurs largely when average policy rates (in this case the Federal Funds rate) have been re-assessed by the bond market to remain “higher for longer”.
- Since the increase in real yields in the US have largely repriced due to a revision in growth prospects and resilient consumption, this would ordinarily be met by US and foreign capital “seeking out” risk-assets in pro-cyclical destinations like emerging markets.
- However, to date this has not happened, because the stronger US labour market has in some sense “cross-subsidised” the FOMC’s resolve to keep policy rates “higher for longer” and in so doing, led to a re-pricing of the front-end of the US term structure – making it a very attractive investment destination.
- Therefore, the stronger US economy grinds on, the longer the risk-free front-end of the US yield curve can afford to remain elevated, which in turn creates a high hurdle to scale before global capital will look for yield elsewhere. (The opportunity cost of moving away from the US is simply too high at present)
- The *inflation risk premium* (light purple bar) has decreased by 14 bps because now, with a very likely disinflationary trend gaining traction, the risk of inflation surprises (as assessed by the bond market) has reduced, with investors accepting lower compensation for bearing this risk.

Given the decomposition above, it is clear then that US bond yields have become weaker largely on account of re-pricing of real yields, which, in turn, occurs when the market requires additional compensation for parting with capital and delaying consumption in an environment where the real economy is able to offer viable alternatives.

Importantly, the observed weakness in US bond yields has not been driven by a material re-pricing of *breakeven inflation.* This means that the traded markets assessment of future average inflation has not been at the heart of the recent sell-off at all. This should be a positive signal for the Federal Reserve, who have previously expressed concerns around the resilience of the labour market possibly leading to an upward revision of consumption-driven inflation-expectations once more.

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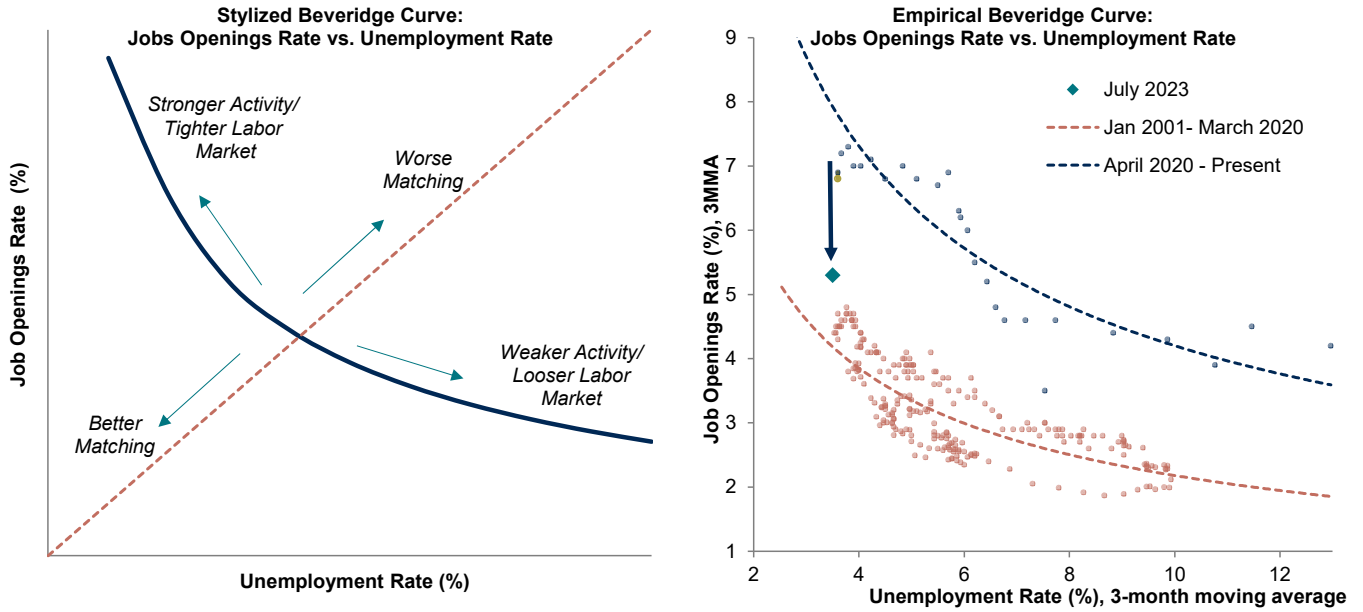
An illuminating way of tracking the US consumer's resilience over the post-Covid period is the Beveridge curve - a visual representation of the empirical relationship between job openings and unemployment rates. The underlying intuition behind the curve is that as vacancies (job openings) increase, capacity utilization increases and the number of unemployed declines, entailing a negative slope for the Beveridge curve.

The Beveridge curve is at the heart of the debate around the re-balancing of the US labour market, and consequently the evolution of the inflation process. There had been some market participants and economic commentators who felt that the movement of the Beveridge curve outwards from the origin of the axes since the pandemic was a permanent structural feature of the labour market, and therefore that any movement that reduced job openings (and concomitantly brought some degree of balance to the labour market) would necessarily mean a painful increase in the unemployment rate.




**Sources: Prescient Investment Management, Bloomberg, October 2023**

Others differed, offering views to suggest that it may well be possible to restore balance to the labour market via a relatively painless decrease in postings for available jobs, and so de-necessitate the need for material increases in the unemployment rate. Recent evidence seems to support the case for the latter of these views, with the job-openings rate decreasing without any increase in the unemployment rate at all.

This is consequential because a key part of the case for bringing forward policy rate cuts by the Federal Reserve (so the theory went) would be a large-scale capitulation of the labour market into significantly higher unemployment and ultimately deep recession, which would necessitate a policy-pivot and usher in the start of a rate-cutting cycle. Since this has not occurred, as we describe above, the strong labour market has in some sense "cross-subsidised" the higher policy stance in the US (affecting front-end yields) and also has had ramifications for real yields further out on the yield curve.

**ENDS**

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