US Macroeconomics

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What is Our Fair Value Model Telling Us Now?

There are two variables that explain 90% of 10-year Treasury yields. They are the one-year forward expected fed funds rate and the 10-year breakeven inflation rate. The remaining 10% that is unexplained can be chalked up to term premium. The standard error on the model is a relatively low 20 basis points (bps).

The coefficient on the funds rate is 0.25, which means that for every 1 bp change in Fed policy expectations, the yield on the 10-year note moves by one-quarter of that amount. The coefficient on breakeven rate is 1, which means 10-year note moves one-for-one with inflation expectations.

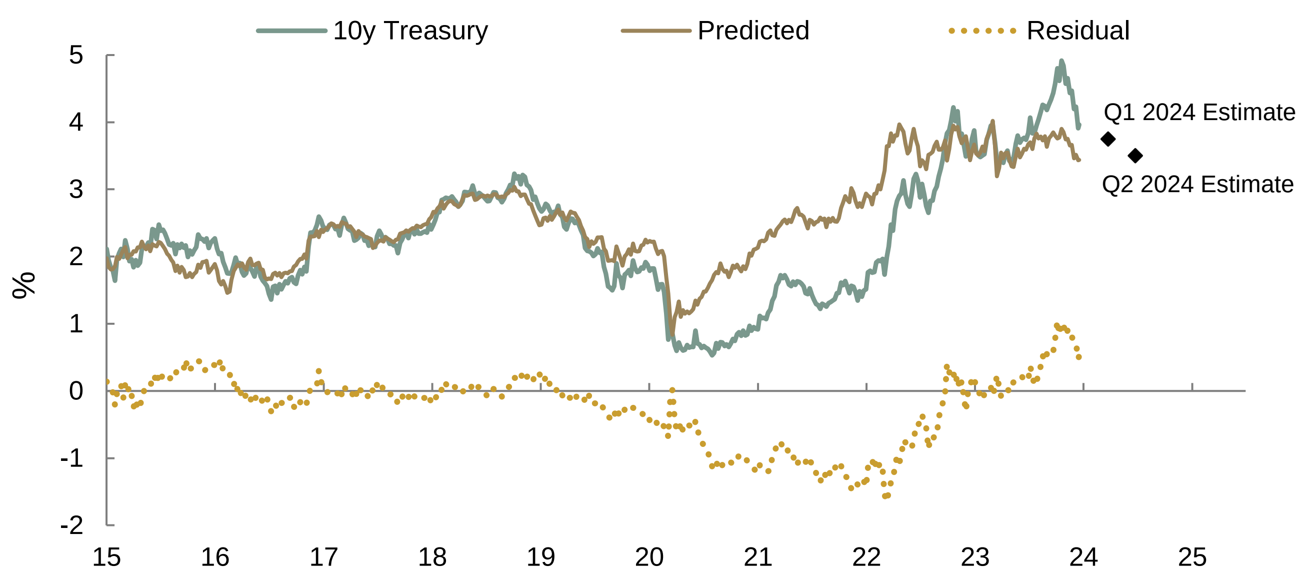
The model was run using weekly data from 2015 to 2019, and fair value estimates are then run out of sample. **Unsurprisingly, the model's estimates broke down during covid with fair value consistently estimated to be much higher than what turned out to be the case**. In other words, rates were exceedingly low, lower than warranted by fundamentals. This is evident from the plotted residuals in the bottom dashed line of the chart below.

But as the economy normalized, the accuracy of the model improved. From late 2022 until mid-2023, the model was a good predictor of 10-year yields, meaning the predicted values were generally within the range of statistical error. This, too, can be gleaned from the chart with the residuals closely clustered around zero.

From July 2023 to October 2023, interest rates were much higher than what our model implied. Most analysts determined this was due to rising term premium, but our work showed it was more likely the result of foreign-related selling. Recently, the residuals have been declining. What is the model telling us now?

If the futures market is correct in its view the Fed lowers rates by roughly 150 bps in the next 12 months and the breakeven inflation rate remains steady at around 2.25%, then **fair value on the 10-year Treasury note is approximately 3.5%** plus or minus 20 bps. If the economy goes into recession, then breakeven inflation is likely to fall sharply, pushing 10-year yields down toward 3%.

While we show point forecasts of the 10-year note below, whether we get there next quarter or later cannot be known a priori with certainty. But if we are generally correct on the direction of Fed policy and inflation, then yields should trend even lower over time.



Sources: FRB, Bloomberg, SMBC Nikko

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