What is the Fair Value of the 10-Year Yield?

Treasuries are selling off in further bearish fashion. This is in response to lower-than-expected jobless claims and better than previously reported Q1 real GDP and consumer spending growth. For now, the economy is not breaking. Some economists may even be considering revising upwards their current quarter and beyond GDP growth forecasts. Considering this recent data strength, investors will continue to grapple with what they think is the fair value of market rates.

**There are two primary determinants of long-term rates.** The first factor is the terminal *fed funds rate* or the projected path of monetary policy. After all, the yield on the 10-year notes is simply the overnight borrowing rate plus a series of forward rate contracts that extend out 10 years. The Fed determines the level of short rates from which point investors add a risk premium thereafter. This is where the second factor comes into play — inflation expectations.

The **breakeven rate of inflation** captures the market’s expectation of what inflation will average over the next 10 years. When we combine this with the expected trajectory of the fed funds rate, which we proxy with a series of rolling 12-month forward fed funds contracts, we can explain 90% of the yield on the 10-year Treasury note, and the standard error on the model is a relatively small 20 basis points (bps). The actual and predicted values of the model are shown in the chart below.

Right now, the futures market one year from now is discounting a fed funds rate around 4.85%. Assuming that breakeven inflation is steady at around 2.20%, **the present fair value on the 10-year note is 3.60%**. However, if the economy goes into recession and the Fed cuts rates as much as we think next year, then current fair value is closer to 3%, which is essentially our yearend forecast.

If we plug the Fed’s projections into our model — we assume that half of the 100 bps of easing is done in the next 12 months — then fair value is 3.70%. Interestingly, all these estimates — ours, the market’s and the FOMC projections — predict readings on the 10-year that are below current levels.

The reason for this is the current slope of the yield curve. **The deep and historic inversion of 2- and 10-year treasury notes means that it may be difficult for the 10-year to sell-off meaningfully from here.** For that to happen, inflation would have to reaccelerate, which is doubtful in our view.

![](chart.png)

**10-Year Treasury Fair Value Model**

Sources: FRB, Bloomberg, SMBC Nikko
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