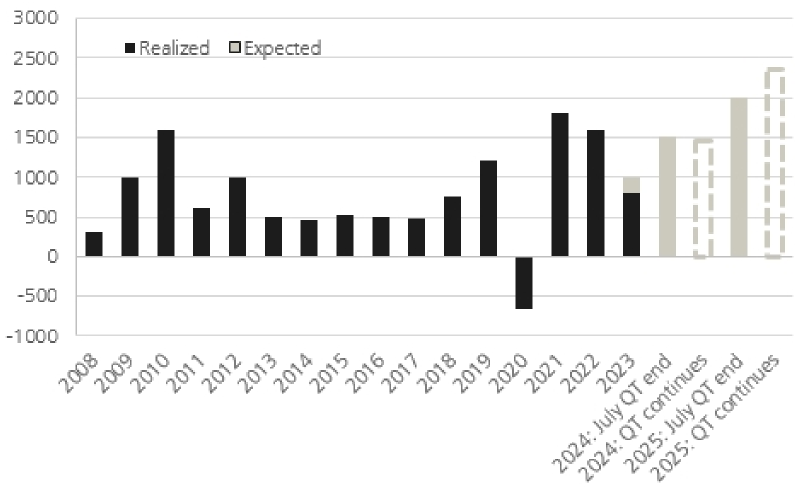
# Fixed income: Hard to handle

Blog

Leslie Falconio, Head of Taxable Fixed Income Strategy, CIO Americas, UBS Financial Services Inc. (UBS FS)
John Murtagh, Fixed Income Analyst, UBS Financial Services Inc. (UBS FS)

The 10-year US Treasury yield reached a new handle—it is now in the 5% area—having increased more than 125 basis points since the trough in July. Both the 10-year and 30-year have now surpassed 5% yield for the first time since 2007. We will be the first to admit that the velocity of this move was not in our expectation. While volatility within the rates market has spiked, thus widening the range of potential outcomes for the 10-year yield over the next year, the recent illiquidity and "catch a falling knife" market mentality may push the yield toward 5.15% during this week's auction, when the Treasury Department will issue 2-year, 5-year, and 7-year bonds worth a total of USD 141bn (Fig. 1).

Fig. 1: Net coupon supply will increase in the coming years, increasing if the Fed continues its policy of quantitative tightening



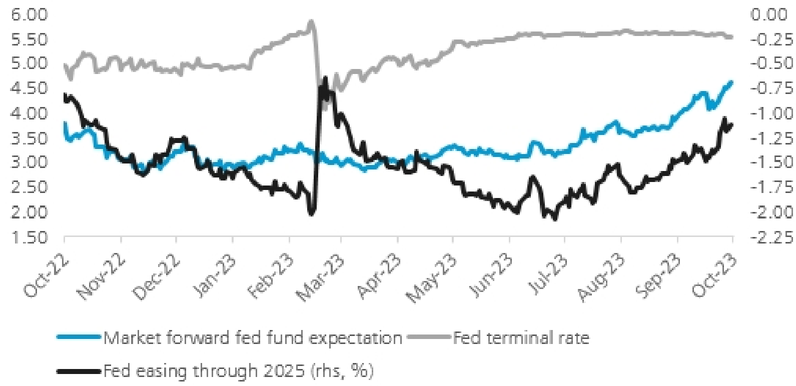

Source: ICE BofA, UBS, as of 12 October 2023

The negative market sentiment is currently in the driver's seat for yields. With the approaching pre-meeting blackout period for the Federal Reserve—and with no clear indication from the plethora of Fed chatter over the past few weeks—the market has guided toward no November rate hike, which we also view to be unlikely at the 1 November meeting. The market will now focus more on this week's Treasury supply and Thursday's third-quarter GDP release, which is anticipated to be a strong 4.5% growth.

While our forecast ranges for the 10-year yield through mid-July were nearly spot on, the last few months have proven challenging. This has occurred for two main reasons. First, growth and consumer resiliency have been much stronger than what we anticipated. Outside of the third-quarter GDP, last week's retail sales printed well above expectations, and the decline in jobless claims has reinforced the continued strength in the labor market. While it remains our view that third-quarter strength will be taken from the fourth-quarter growth—alongside our expectation that the Fed will likely not hike in December (although the data will ultimately dictate it) and thus our conclusion of lower US interest rates ahead—this is a "show me" market. The uncertainty has heightened volatility, and more importantly it has increased negative sentiment.

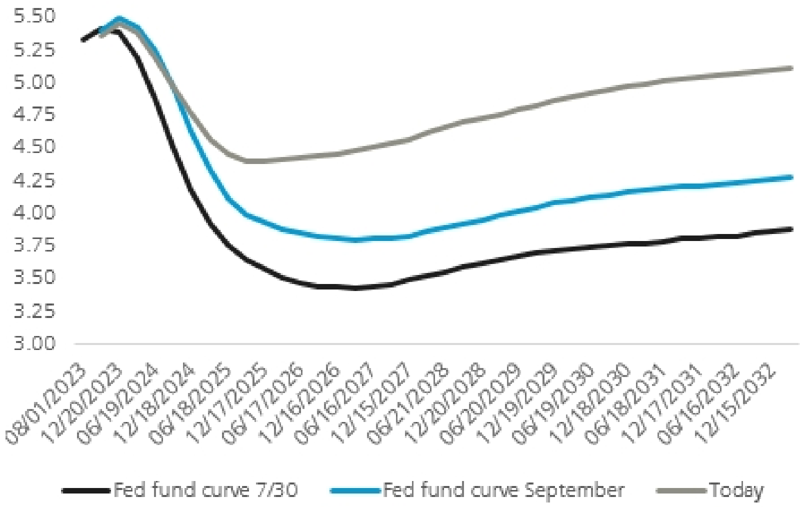
The second reason is that, although we pushed against Fed easing in 2023 and forecast nearly 200 basis points of easing in 2024 (the reason we waited before recommending to lock in at higher rates), the magnitude of the market's removal of Fed easing—to not only 50bps in 2024, but a now-combined mere 115bps through 2025—has given "higher for longer" an entirely new meaning (Figs. 2 and 3). These past few weeks, the market has witnessed a dramatic shift higher in the future federal funds rate curve.

Fig. 2: With the market pricing a mere ~115bps of easing for two years, the long-term fund rate remains high




Source: Bloomberg, UBS, as of 23 October 2023

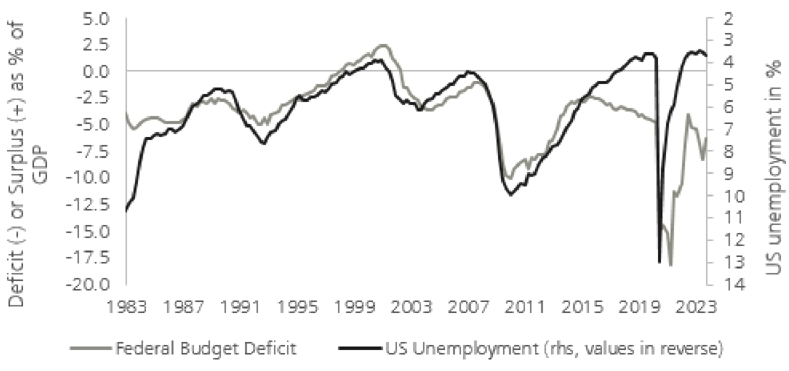
Fig. 3: The shift in the forward SOFR (fed funds) curve has been dramtically pushed higher in October




Source: Bloomberg, UBS as of 23 October 2023

These variables have been the driver of rising yields, and while we do not dismiss the headwinds of Treasury supply, quantitative tightening, or a dysfunctional government (which is impacting negative sentiment), it's the consistently above-consensus economic data releases coming out of a very difficult forecasting environment that has been the main driver. That said, what is priced in today may shift tomorrow, and as a result volatility may be here to stay until the Fed clearly states a pause, or until growth data (specifically payrolls) show they are continuing on a path lower (Fig. 4).

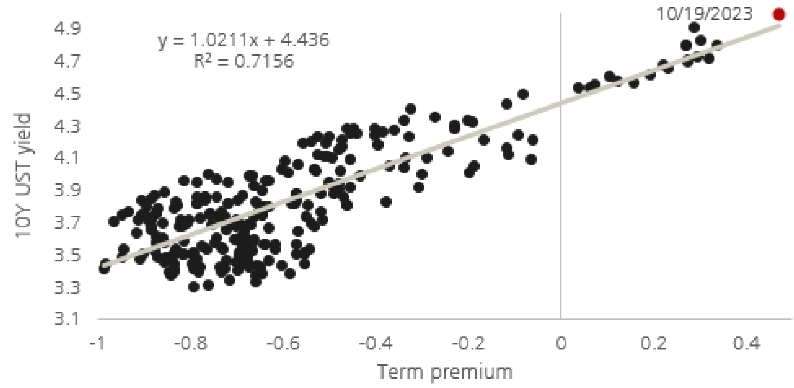
Fig. 4: Normally highly correlated, the deficit and unemployment diverged in 2022; higher-for-longer rates could force a correction




Source: Bloomberg, UBS, as of 19 October 2023

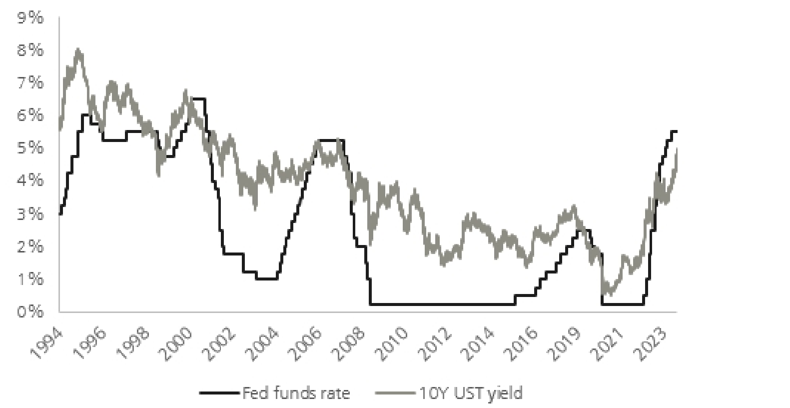
The term premium, which is a nebulous driver, has been rising as investors demand higher compensation for moving out the yield curve. It has reached 47bps, the highest since 2015, not a typical move this late in the cycle (Fig. 5). However, while "higher for longer" is not a new factor to the market, neither is supply; the inverted yield curve has fueled the term premium spotlight (Fig. 6). While we view the shape of the yield curve as a coincident, not a cause, of recession, the historic length of the inversion is being unwound given the strong economy, which is fueling the fear of future rising inflation.

Fig. 5: Price-sensitive buyers are seeking compensation for holding long-dated Treasuries, contributing to the rise in yields




Source: Bloomberg, UBS, as of 19 October 2023

Fig. 6: Historically, 10-year yields have not held below the federal funds rate; however, the US yield curve has been inverted for over 20 months




In 1994-1995, the 10-year peaked at 8.03%; the upper bound of the fed funds target peaked at 6% about two months later.
In 2000, the 10-year peaked at 6.79%; the fed funds peaked at 6.5% about three months later.
In 2006-2007, the 10-year had a double peak at around 5.29% over about 12 months that coincided almost perfectly with the peak in fed funds at about 5.25%.

Source: Bloomberg, UBS, as of 20 October 2023

However, this fear has not adjusted market expectations that the Fed will continue its hiking path beyond the potential of one more 25bps rate hike. In fact, market pricing of the Fed's terminal rate has stayed steady, while the amount of future easing has not—it has been materially removed.

Our expectation was for the yield curve to steepen in 2H23. Granted, at this late stage of the cycle we were in the camp of the bull steepeners, anticipating lower front-end yields as we near the plateau for the fed funds rate. The reason we believe 5.15–5.2% is a potential ceiling to 10-year yields is that the 2-year/10-year yield curve will be upward sloping (with the 2-year around 5%, and the 10-year at 5.15%). The more upward sloping the curve, the less of a headwind (i.e., lower negative carry) there will be to locking in at higher rates.

**Supply**

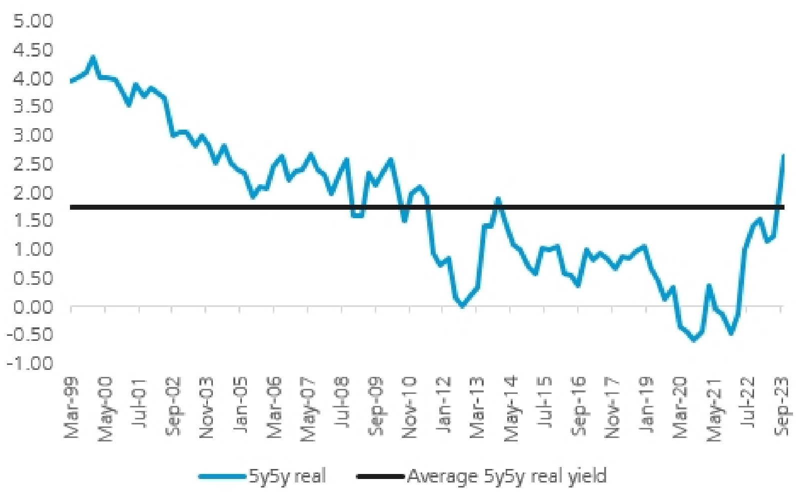
With the Fed keeping "mum's the word" and 3Q GDP expected to be strong, seeing the 10-year yield reach 5.15–5.2% as buyers remain on the sidelines and momentum remains negative is possible. Given the Fed's lack of affirmation of a hike on 1 November, the market that day will likely be more focused on the refunding announcement. While a pickup in supply is expected for the quarter—alongside the potential of USD 1tr in coupon supply in 2024—given the spotlight placed on supply, the refunding announcement may well trump the Fed's rate decision given that the market is already aware of the potential of a 25bps move come December.

The deficit is not new information to the marketplace, and neither is supply. The continued strength of the economy is. We have held the view that increasing Treasury supply while growth is slowing would still result in lower-trending yields, albeit at a slower pace than history dictates following a Fed pause. However, large supply alongside strong growth would not be a welcome combination for US Treasury yields, particularly when it starts while the Treasury curve is inverted.

**Going forward**

While reaching 5.15–5.2% amid market illiquidity is not out of the question, we continue to debate the sustainability of this range. It is easy to say that credit markets are holding up while 10-year yields breach these levels, but it would be for a short period of time. The forward real yields—alongside indications of tightening financial conditions and a restrictive economy—have reached levels not seen since before the global financial crisis (GFC), and they now rest well above their long-term averages (Fig. 7).

Fig. 7: Forward real yields have moved to post-GFC levels



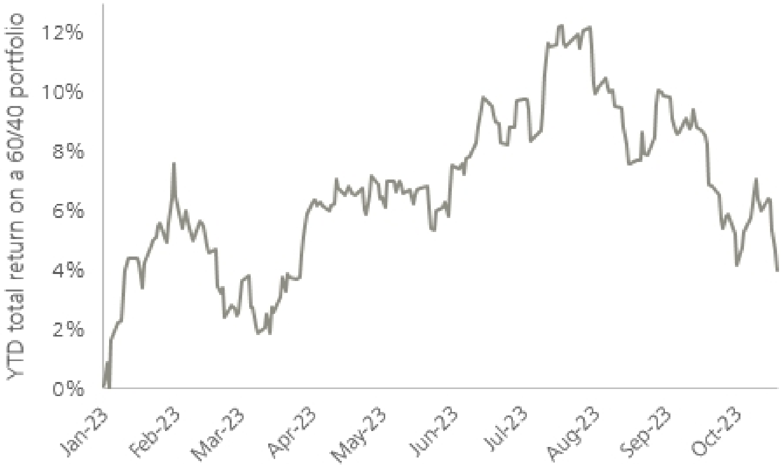

Source: Bloomberg, UBS, as of 23 October 2023

This has started to impact credit spreads. As of Friday's close, the year-to-date total return for the ICE high yield (HY) index was 3.95%. While positive, it is now lower than the year-to-date total return on cash (3.97%). This recent underperformance of HY—particularly versus its floating-rate counterpart, senior loans—has run its course, in our view, and we recently shifted to a least preferred stance in loans and most preferred in HY. We cannot overemphasize that this is a credit-to-credit allocation. Adding outright credit risk versus

Treasuries or higher-quality fixed income is not recommended at this late stage, also considering lower-quality credit's outperformance throughout the year.

While a higher 10-year yield is not out of the question given the negative momentum, we believe this will be short-lived. However, if growth reignites concerns of a reacceleration of inflation, then the Fed's terminal rate will move higher. This remains a risk to our outlook of yields trending lower. If this were to occur and the Fed continues to hike in 2024, then the market will initially push higher, but once again price in higher forward recession probabilities with greater duration and depth (i.e., when ultimately "something breaks"). The closely watched equity and fixed income correlation, which has recently proven a point of concern for fixed income buyers (Fig. 8), will mean-revert to historical norms given that Treasury yield levels have reached 2007 highs.

Fig. 8: Fixed income returns have weighed negatively on traditional 60/40 stock/bond allocation. We expect them to mean-revert at these levels




Source: Bloomberg, UBS, as of 23 October 2023

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