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MARKET SIGHT *LINES*

A New Market Rate Regime? Data and Sentiment Say Yes.

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Through much of 2022 and 2023, we've focused on inflation and Federal Reserve (Fed) monetary policy, which has led to higher market rates last seen before the Great Recession. The Fed has pushed rates higher to slow the economy and cool inflation. And as we look forward, market participants have accepted we should expect a higher rate regime, with market rates settling above the pre-pandemic levels, perhaps with a "neutral" 10-year Treasury rate of about 3.5%. But lately market participants are signaling the 10-year rate may stay above 4% for much longer, implying a higher "neutral" rate.

In this Sight|Lines, we discuss the potential for a higher market rate regime, considering both market data and investor sentiment in our discussion.

THE TAKEAWAY: A HIGHER RATE REGIME APPEARS POSSIBLE.

Based on a review of market data and the sentiment implied in that market data, a higher rate regime going forward seems quite possible. In summary:

- The 10-year Treasury yield has risen above 4%, levels not seen since before the Great Recession.
- Forward rates are signaling market participants believe the 10-year yield will remain above 4% for decades.
- While some point to the potential for higher future inflation for this elevated level, the breakeven rates signal inflation will fall back close to the Fed's 2% target.
- A recent downgrade in U.S. Treasury debt may be one explanation for higher rates, as investors demand higher rates for taking on higher credit risk.
- Another possible catalyst is the increased debt issuance by the Treasury to fund higher deficits, which means market forces may drive yields higher to attract enough investors to purchase the debt.
- Higher rates mean higher debt costs for consumers, businesses, and the government.
- Positive implications include the potential for higher growth rates longer term from better fiscal management.

IN-DEPTH: MARKET DATA AND SENTIMENT ARE SIGNALING A HIGHER RATE REGIME IS POSSIBLE, WITH BOTH NEGATIVE AND POSITIVE IMPLICATIONS LONG TERM.

Through much of 2022 and 2023, we've had a focus on inflation and Fed monetary policy, with the benchmark fed funds rate now at 5.25%-5.50%. The Fed has raised rates to increase the cost of borrowing and slow the economy, all to cool inflation. Looking forward, we may well be entering a higher rate regime. Going deeper:

- Market rates are currently high:
  - The 3-month Treasury bill yield is currently around 5.5%, aligned with the funds rate, and the 10-year Treasury yield is roughly 4.2%.

    - Many say that an inverted yield curve, with short rates higher than long rates, are a precursor to recession, and the yield curve will "normalize" by falling back to normal levels – positively sloped, with longer rates exceeding short ones.
    - Such a rate decline is often triggered by a Fed rate cut cycle, which is why Fed policy and the prospect of rate cuts in 2024 have been in focus.
- The current yield curve reflects forward rates signaling market participants believe the 10-year yield will remain above 4% for decades.
    - For the decade prior to the pandemic, the 10-year Treasury rate averaged 2.0%. And for the decade prior to the Great Recession, the 10-year Treasury rate averaged 5.0% from 1997 through 2006.
    - Market participants have accepted we're headed into a new normal for the 10-year Treasury rate, with much talk that 3.5% may be the neutral market rate going forward.
    - But the 10-year Treasury forward rate in 10 years and 20 years are 4.1% and 4.5%, respectively, signaling a higher market rate regime.
- While some blame future inflation for this higher level, the breakeven rates signal inflation will fall back close to the Fed's 2% target.
    - The 10-year inflation breakeven rate is currently 2.3%.
- The recent downgrade in U.S. Treasury debt may be one explanation for higher rates, as investors demand such higher rates for taking on higher credit risk.
    - The 10-year Treasury yield rose from 4.0% to 4.3% after the downgrade.
- Increased Treasury debt issuance to fund higher deficits means more supply:
    - The CBO forecasts Treasury debt will grow by $20 trillion over the next 10 years.
    - Market forces may drive yields higher to attract enough investors to purchase the debt, especially since the Fed is no longer buying Treasury bonds to implement quantitative easing.
- Negative implications include higher debt costs for consumers, businesses, and the government.
    - The CBO forecasts debt service will represent 20% of the federal revenue in 2033.
- Higher cost of debt may mean better fiscal management, which could lead to higher growth:
    - Management may be more discerning when investing in projects, which could lead to better returns.
    - Investors and voters may call for better fiscal management from the U.S. government, making lower spending and/or higher taxes more palatable politically.

CONCLUSION

Since the beginning of last year we've been focused on inflation and Fed monetary policy, which has led to higher market rates. As we look forward, market participants are expecting a higher rate regime, which means higher debt costs for consumers, businesses, and governments, and slower growth in the near term, but with the potential for higher growth in the future as better fiscal management is implemented to deal with higher debt costs.

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