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SHORT THOUGHTS

December 10, 2024

Yields Settle Down, Brokers Flush with Bills

Term Premium Comes Back In, but Should Rise in 2025

- After moving higher immediately after the election, 10y yields have come back lower
- Fluctuations in the term premium have moved the yield around, and we expect it to move higher in 2025
- T-bill holdings at dealers are near record highs, iFlow shows adequate real money demand as bill supply declines this month

Ever since the election, we have been of the view that the US Treasury curve would eventually steepen. We explained our reasoning in a Macro Morning Briefing a few weeks ago (see here). A combination of likely fiscal expansion, tariffs, and immigration reform will conspire to push long rates up, and result in a bear steepening of the curve. In the week or two after the election, US 10y yields rose to approximately 4.45%, continuing a move higher that began in mid-September when yields were as low as 3.62% on September 16. Since then, the 10y note has richened, driving the yield down to around 4.2%, roughly where it trades today.

We're not surprised by the evolution of 10y yields, and we're not backing off our steepener call for 2025 either. We still think the conditions are in place for yields to rise in 2025 due to the same drivers we cite above. In addition, we think terminal rates for this easing cycle will end higher, probably between 3.5 and 4.0% when all is said and done, eventually providing a floor for rates across the curve.

Recent pre- and post-election moves in the 10y yield have mainly come about due to fluctuations in the term premium, or the additional rate of compensation required by investors to lend to the government at long-term horizons. Exhibit #1 plots the evolution of the 10y note yield, the term premium, and market-implied inflation expectations. For this last value, we plot the simple breakeven inflation rate computed from the TIPS market. We could have used the 5y5y inflation swaps instead, but the contours of the two series are similar, even if the levels are somewhat different. For example, the current 10y implied inflation breakeven is currently 2.26%, while the 5y5y swap is 2.45%. Nevertheless, their fluctuations match each other quite tightly.

From the chart we can see an increase in the term premium (as calculated by the Federal Reserve Bank of New York) from a low of –2bp in mid-September to +33bp on November 13, a week after the election. It has since retreated to just 5bp as of last Thursday. This wide

swing in a short period of time likely reflects prolonged uncertainty about the parameters, timing of, and likelihood of implementation. In addition, a run of modest macroeconomic data has solidified expectations of an FOMC rate cut in December and has pushed the curve lower. We don't know how policy will evolve in 2025 – especially later in the year – as that same policy uncertainty clouds the macro outlook.

Inflation expectations have mostly stood still in the last few months, and frankly, they have been steady for most of the last two years. Coming in at a high of just around 3% in early 2022 and a low of about 2% this past September, the stability of these breakeven inflation rates has been impressive over that time. These expectations are important to the Fed, because if they risk becoming de-anchored, we would expect the central bank to turn hawkish. In such a case the bear steepening would have two drivers – higher Fed rates than previously foreseen, and rising inflation expectations.

As we get closer to the new administration taking office, we expect more certainty to emerge on the above-discussed drivers of the steepener trade, and the term premium to begin to register concern over fiscal policy and inflation, as well as a lack of demand by cross-border investors into USTs, something we have documented frequently (see here, for example).

Exhibit #1: Steepeners on Hold (for now) ... Watch the Term Premium

Source: BNY Markets, Federal Reserve Bank of New York, Bloomberg

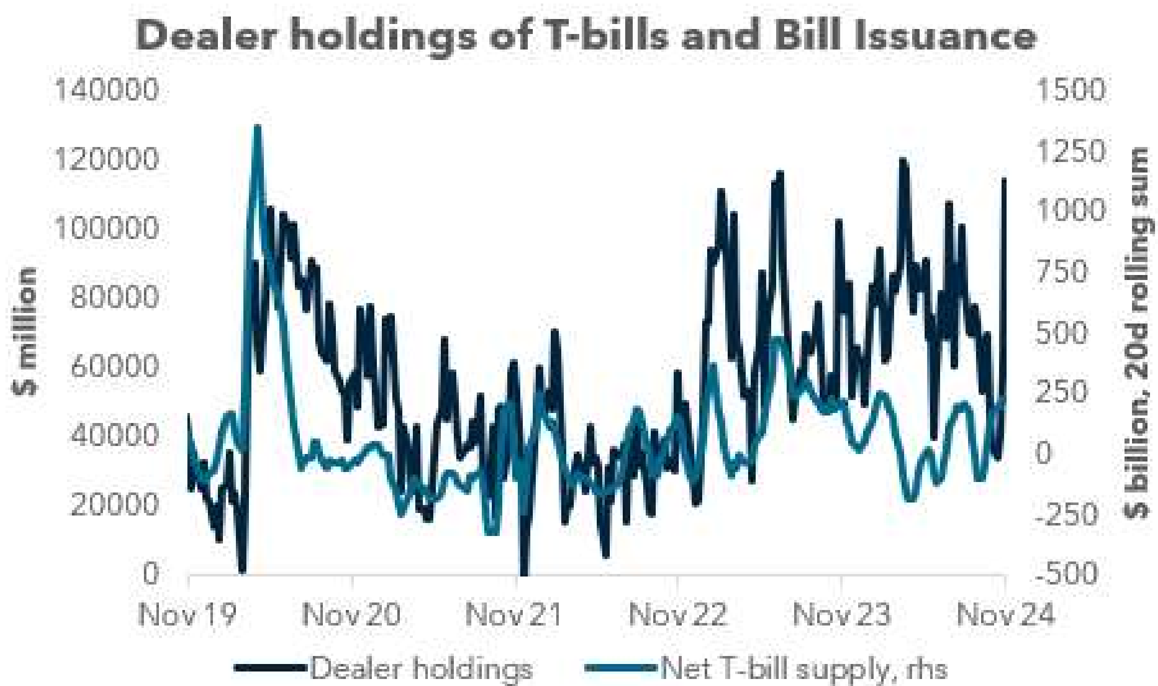
Bill supply is slowing. But through the end of November, broker dealers' balance sheets are getting longer and longer in their holdings of T-bills. The week from November 20 through 27 saw a $55bn increase in these positions, and an absolute level ($113bn) of holdings which rivals a record $117bn achieved around this year's April tax deadline on the 17th of that month.

The bills curve is relatively flat out past the end of Q125, with rates out to April 8 at around 4.4% depending on the exact maturity. Scarcer bill supply (the Treasury's General Account going into year-end is a rather flush $800bn) into the rest of the year, and expectations for a rate cut next week – although they are murkier into 2025 – will keep likely keep T-bill rates under wraps.

Nevertheless, the growing holdings of bills at dealers suggests that demand is still strong. Exhibit #2 shows an updated version of a chart we have shown before. It uses iFlow to show that T-bill demand (as shown by flows into the 0-1y portion of the UST curve) continues to keep pace with bill supply, while Exhibit #3 shows the relationship between dealer holdings and T-bill supply is somewhat less close, although there is some relationship with supply.

With supply to shrink modestly, some of this balance sheet pressure could be alleviated toward the end of the year as we await likely increases again in early 2025. Fewer bill settlements this month could further alleviate some of the pressure on funding markets expected at year-end, but we don't think this will be massively important as we approach December 31.

Exhibit #2: Dealers' T-bill Holdings Very High



Source: BNY Markets, Federal Reserve Board of Governors, US Treasury

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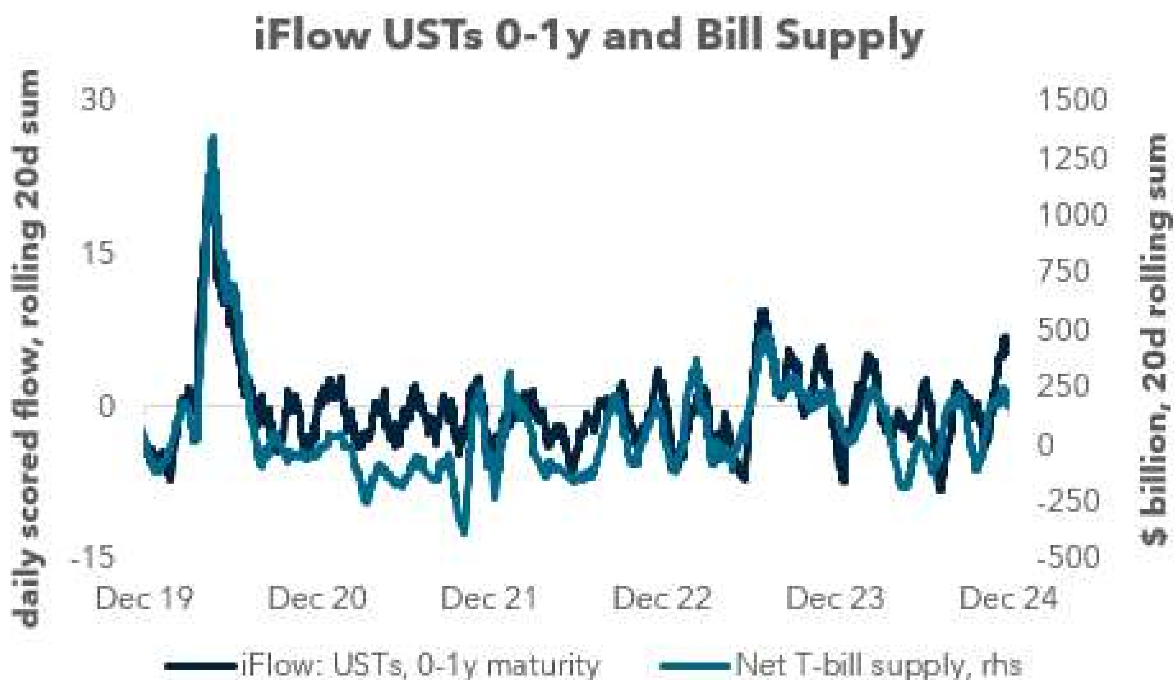
Exhibit #3: T-bill Supply Meets Adequate Real Money Demand



Source: BNY Markets, US Treasury, iFlow

Please direct questions or comments to: iFlow@bny.com

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John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN

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