Ahead of the Curve
The calm before the storm: The outlook for Treasury yields

From the Field
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Key Insights

- U.S. fiscal expansion and potential tax cuts, combined with a healthy economy, are likely to push Treasury yields higher.
- Decreasing foreign demand for U.S. Treasuries could further elevate yields, and potential tariffs and immigration policies would likely be inflationary.
- The transition period in U.S. politics is an opportunity to position for increasing longer-term Treasury yields and a steeper yield curve.

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Between the U.S. election and the presidential inauguration, markets are now in a "calm before the storm." Investors are working through the implications for U.S. Treasury yields. I continue to expect higher intermediate- and long-term Treasury yields, steepening the curve as Federal Reserve (Fed) rate cuts anchor short-term yields. As I outlined before the election in "Could a 5% 10-year Treasury yield be around the corner?," we could reach that level as soon as the first quarter of 2025.

I'm watching several key factors as we wait to see what campaign promises the Trump administration is able to implement. Some support my thesis of higher yields and a steeper yield curve, while others work against it. On balance, I think the former outweigh the latter.

The new U.S. administration represents meaningful new information, and at a minimum, it creates uncertainty and a broader set of outcomes. Is a 6% 10-year Treasury yield possible? Why not? But we can consider that when we move through 5%.

Factors in favor of higher longer-term Treasury yields

1. U.S. fiscal expansion persists

The U.S. budget deficit for fiscal 2024 is 7.0% of gross domestic product (GDP), according to the Congressional Budget Office. With the Trump administration promising to cut taxes, there is little chance that the deficit will meaningfully decrease. The Treasury Department will need to continue to flood the market with new debt issuance to fund the budget deficit, pressuring yields higher.

Also, keep in mind that most other governments around the world are doing the same thing, forcing global yields higher as they compete for demand. Often, the U.S. fiscal situation is thought of in isolation. Given the bloated post-COVID state of many government balance sheets globally, this is possibly the biggest mistake one can make.

2. The U.S. economy remains healthy

It appears that the Fed has successfully guided the economy into an elusive soft landing. I see little chance of a recession on the horizon, especially if the expected postelection pent-up demand scenario plays out. The Fed also seems determined to continue to ease monetary policy—even if markets and policymakers have quickly moderated the number of expected rate cuts in the next 12 months—raising the prospect of an inflation resurgence. It appears that the route to an economic recession would be through a financial market breakage.

3. **Foreign demand for Treasuries has been falling**

   There is evidence that foreign demand for U.S. Treasuries has been decreasing. Japanese holdings of Treasuries dropped to about USD 1.1 trillion as of September 2024 from a peak of USD 1.3 trillion in 2021. With the Bank of Japan preparing to raise rates again in 2025, more Japanese investors could leave U.S. Treasuries for their domestic market. China's U.S. Treasury holdings have steadily decreased to about USD 770 billion in September 2024 from around USD 1.1 trillion in 2021.[1]

   Anecdotally, Treasuries have become more volatile than other high-quality developed market government bonds—and even some emerging market sovereigns—potentially steering some investors away.

4. **Make Inflation Great Again**

   Inflation has been moderating recently, but it appears that many policy initiatives are pro-inflation as well as pro-growth. To that end, I think it will be interesting to see where the policy "red lines" sit when it comes to actual implementation. It seems abundantly clear that inflation is a career limiter for many elected officials, but we also know there can be some meaningful lags between policy change and any subsequent economic response.

   As has already been written many times over, tariffs are likely inflationary. But of all the campaign promises of the new U.S. administration, the prospective immigration policy changes would likely be the biggest driver of inflation. The counter-argument is that, in President-elect Trump's previous term, inflation remained becalmed as companies swallowed price changes. Has the pandemic experience changed the ability to pass on price increases to customers? What seems clear, however, is that without help from the Middle East, it will be hard for U.S. oil suppliers to create an offsetting deflationary impulse through the energy channel.

Factors against higher longer-term Treasury yields:

1. **Regulatory changes may boost U.S. bank demand for Treasuries**

   Recent bank regulation guidance from the Fed that clarifies the scenarios in which banks can convert Treasuries into liquidity through the Fed's discount window may encourage banks to hold more Treasuries instead of reserves. Banks that need liquidity under stress (as was the case during the regional banking turmoil of March 2023) can now receive credit in liquidity stress tests for borrowing reserves using Treasury holdings at the discount window. The Fed is attempting to reduce the long-held market stigma that borrowing at the discount window is a last resort for troubled banks.

2. **Fears of deteriorating Fed independence could influence quantitative tightening (QT)**

   Rumblings about the Fed becoming less independent and increasingly subject to political pressure have been working through the U.S. rates market as the president-elect has mused about exerting more influence over the central bank. Political forces could encourage the Fed to slow or stop QT sooner than would be prudent—or even restart bond purchases. Even mere rumors about deteriorating Fed independence could cause markets to price in more Treasury demand.

Limited market reactions don't make sense

Following an immediate postelection jump to nearly 4.50%, the 10-year Treasury yield in early December was about 10 basis points (bps) *lower* than on November 4, when it was 4.29%. The difference between the two-year and 10-year Treasury yields was 7 bps in early December versus 10 bps the day before the election.[2]

Do these yield movements make sense? In short, no. Even keeping in mind that it will take time for the new U.S. administration to implement any of its agenda, the preelection U.S. political uncertainty has cleared. Longer-term Treasury yields should be increasing, steepening the yield curve. I see this transition period in U.S. politics as an opportunity to position for these outcomes before we return to the noisy, more volatile environment of social media posts moving markets. I'll be watching interest rate volatility measures very closely for warning signs.

[1] Source for Treasury holdings data: Bloomberg Finance L.P.
[2] Source for yield data: Bloomberg Finance L.P.

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