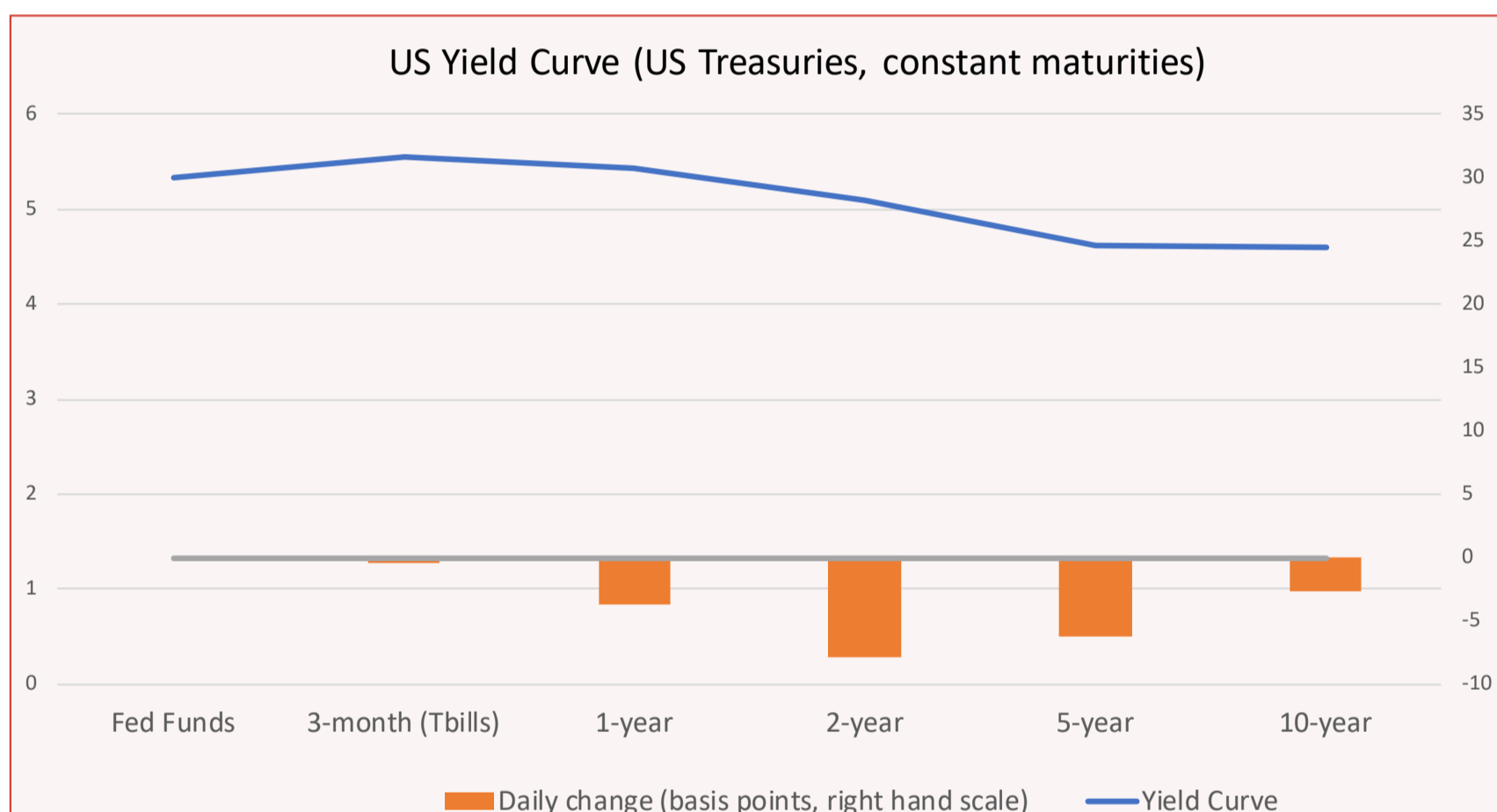


RISK PREMIUM INVEST

Daily analysis of the US Treasuries Market

28 September 2023

	Fed Funds	3-month (Tbills)	1-year	2-year	5-year	10-year
Rates	5.33	5.56	5.43	5.09	4.62	4.59
Daily changes (bp)	0	0	-4	-8	-6	-3



Source: Federal Reserve, H15. (with small tweaks to smooth out the impact of benchmarks changes).

Highlights:

- At the end of a volatile day, US Treasuries yields finally fell slightly on Thursday.
- This volatility and choppy trading result from the large uncertainties concerning the economic outlook and the right level of risk premia.

PART I : Changes in expected Fed Funds.

PART II : Risk premia contributions.

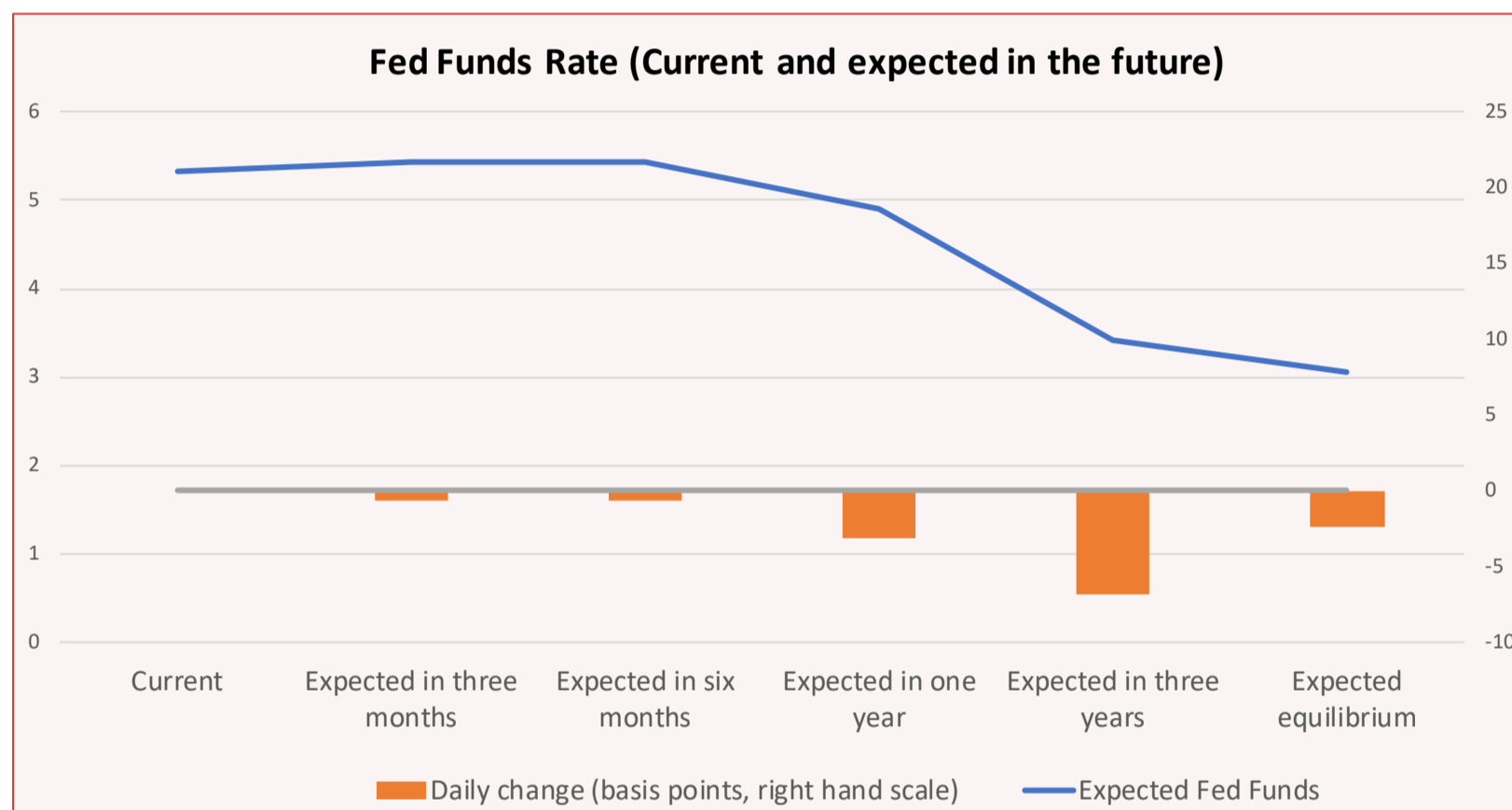
PART III : Methodological annex.

PART I : CHANGES IN EXPECTED FED FUNDS

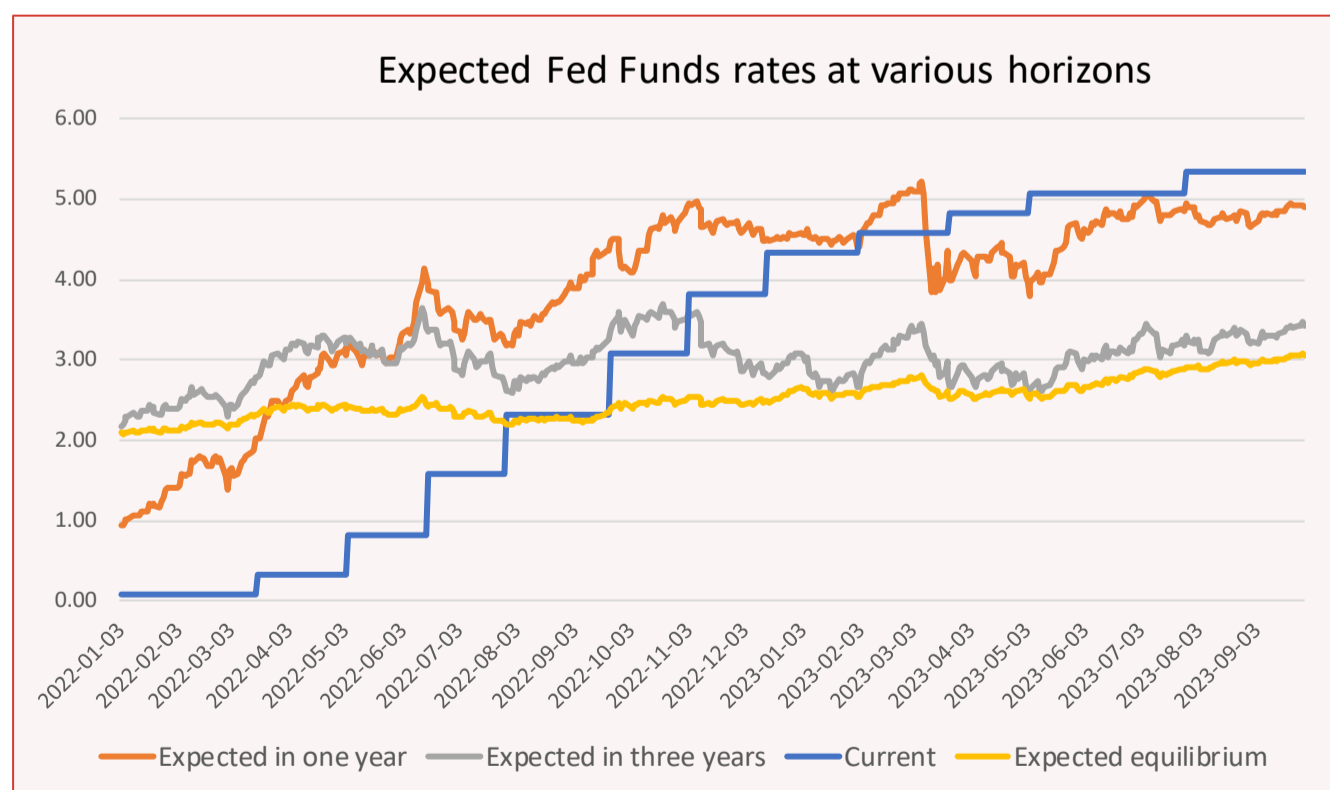
Fed funds futures provide a biased estimate of investors' true expectations, as they are influenced by varying risk premia. The Fed Funds rates expected by investors are here estimated by our proprietary model using both different surveys (the monthly "Consensus Economics" survey and the quarterly "Survey of Professional Forecasters") and the rich information contained in the yield curve (see the methodological annex). Estimates are revised when more recent surveys become available (on September 18, the September "Consensus Forecast" was introduced).

For the second day in a row, rates varied significantly throughout the day with no clear triggers. The economic outlook is highly uncertain due to the difficulty of assessing the extent to which past interest rate increases still have the potential to reduce demand. Additionally, these uncertainties are amplified by the recent sharp rise in oil prices, the impact of strikes in the car industry and the looming federal government shutdown. The labor market is very tight – with initial jobless claims surprising again on the downside – but the current uncertainties were also highlighted on Thursday by the unexpected sharp drop in pending home sales. In a way, Chicago Fed President Austan Goolsbee underscored these uncertainties by saying that the Fed may be on the cusp of "something rare" by lowering inflation without a major blow to jobs and growth. Shifts in the yield curve at the end of a volatile day showed that investors slightly reduced their estimates for Fed funds rates at medium-term horizons.

	Current	Expected in three months	Expected in six months	Expected in one year	Expected in three years	Expected equilibrium
Fed Funds	5.33	5.43	5.44	4.90	3.42	3.06
Daily changes (bp)	0	-1	-1	-3	-7	-2



Even if a majority of FOMC members expect another rate hike before the end of the year, risks seem asymmetric with very little chance of two rate hikes and a significant probability of no hike if core inflation continues to improve despite higher energy prices. As a result, the average expected Fed funds rates at the end of the year is significantly lower than 5.58%. According to our estimates, investors have also in mind a different profile for future rate cuts. They still forecast slightly larger rate cuts in 2024 than expected by the "median" FOMC member, but after that they expect Fed funds rates to plateau at a higher level. Investors facing a very resilient economy have gradually become more pessimistic and have raised their average estimates for the long-term neutral rate from 2% at the start of 2022 to more than 3% currently (against 2.5% in the Fed's dot plots).



Main market-moving news: 28 September 2023

US Macroeconomics

Initial jobless claims at 204,000 (Expected 215,000; Prior 201,000 revised at 202,000).

Pending home sales for Aug at -7.1% MoM (Expected -0.8%; Prior 0.9% revised at 0.5%).

Others

Chicago Fed President Austan Goolsbee said the Fed may be on the cusp of "something rare" by lowering inflation without a major blow to jobs and growth.

European bonds hit by Italy's deficit amid fears of 'higher for longer' rates.

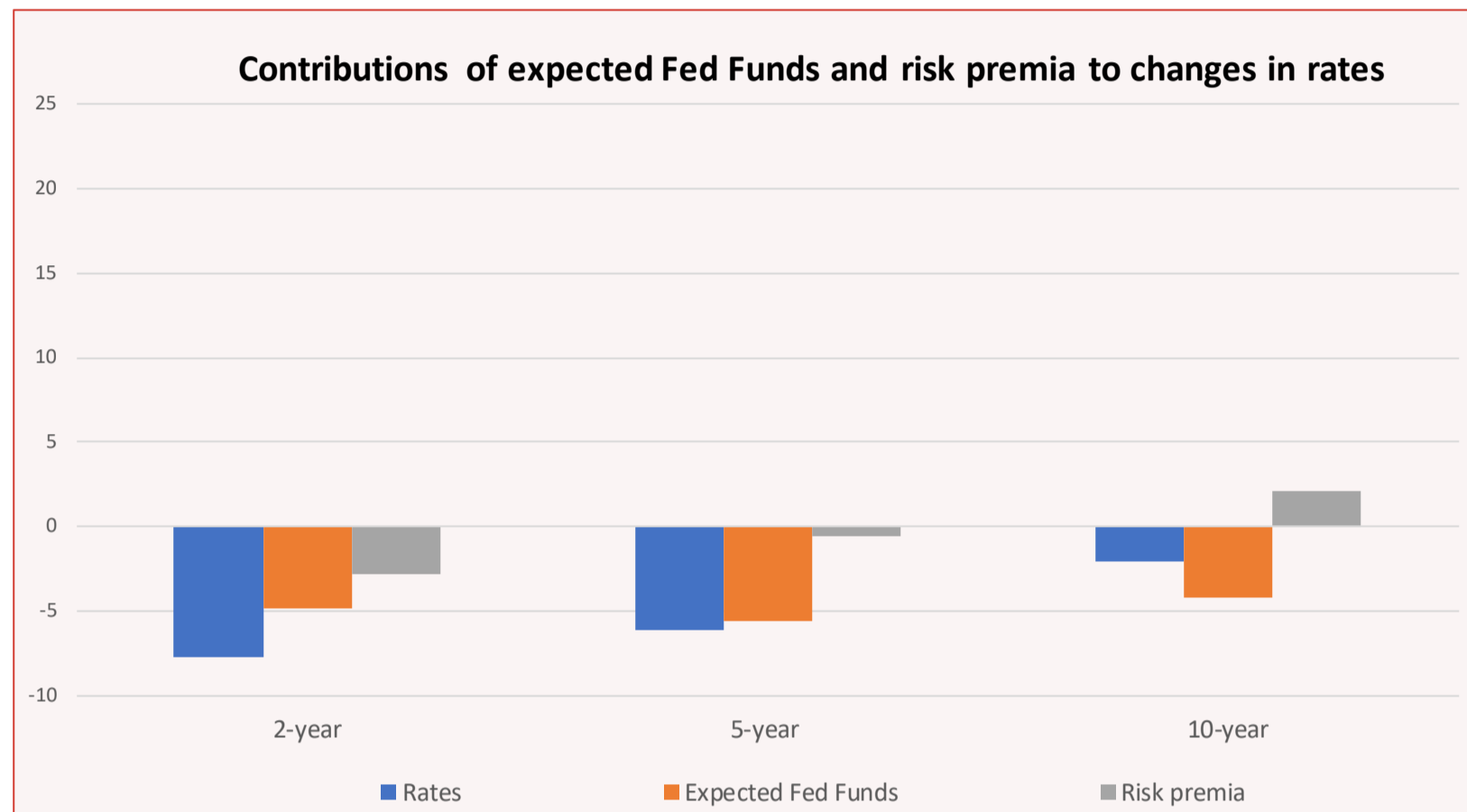
PART II : RISK PREMIA ANALYSIS

For US Treasuries, as for all financial assets, there are two key different types of risk premia:

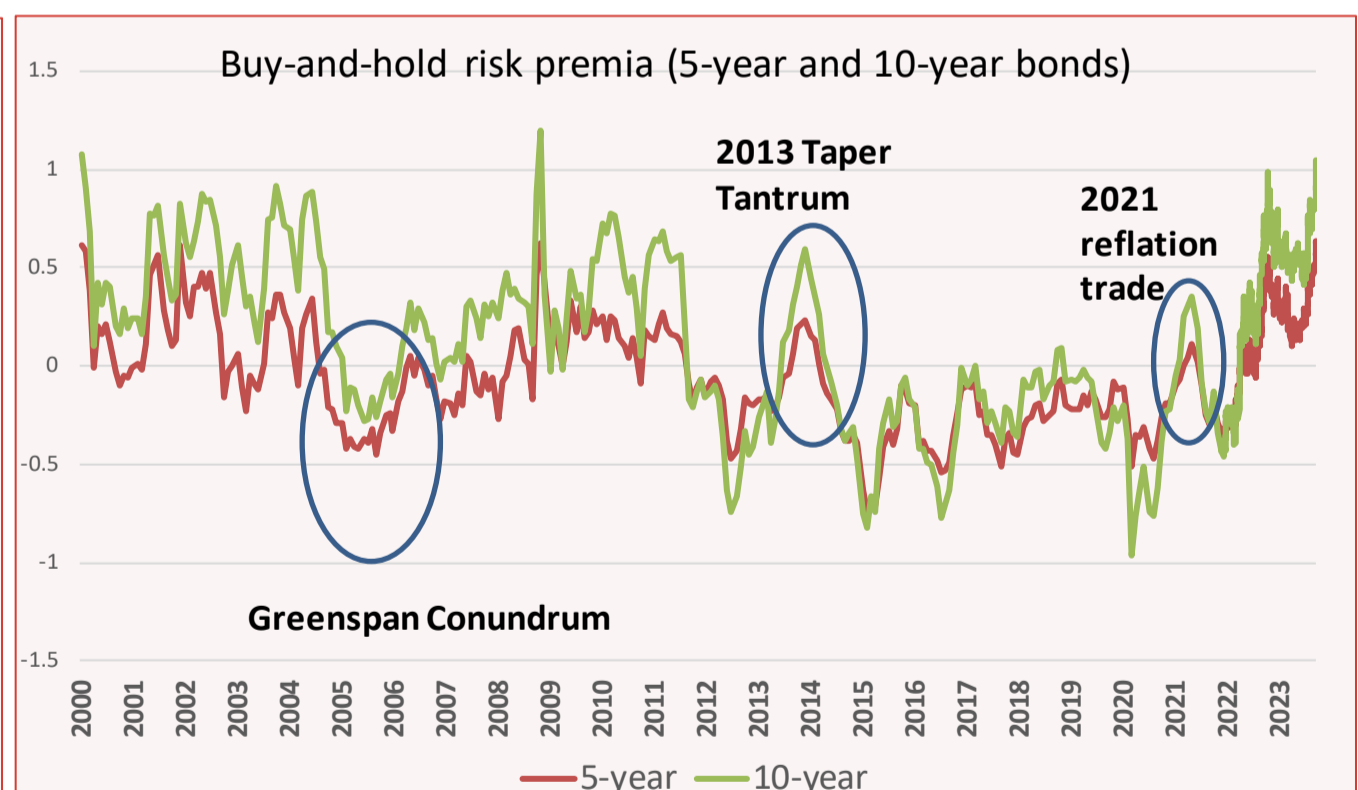
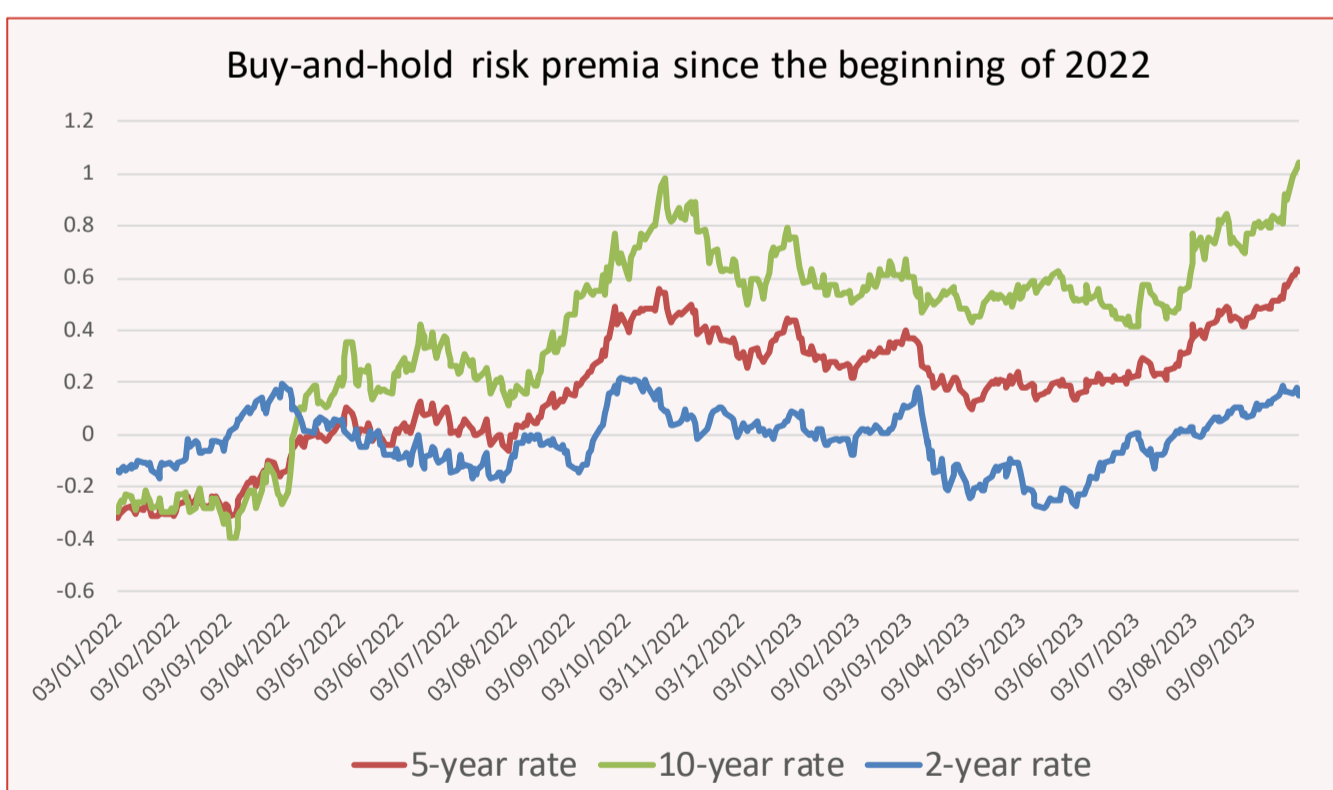
- The short-term **tactical risk premia**: How much excess returns investors require to hold various risky assets at their tactical horizon (which depends on investors, but is often around 3 months)? The tactical positions taken by investors relative to their benchmarks (“neutral”, “short”, “long”) depend on these tactical risk premia.
- The **“buy-and-hold” or “embedded” risk premia**. How much excess return **long-term investors** expect if they hold risky assets over an extended horizon? In the case of US Treasuries, the buy-and-hold risk premia are the differences between the zero-coupon rates of various maturities and the (annualized) expected return on a fund invested in Fed Funds over the same period.

We estimate both types of risk premia (see the methodological annex and our excel file) but we discuss here only the buy-and-hold risk premia.

Recently, risk premia have been volatile due to large macroeconomic uncertainties, but also growing concerns about the strong upcoming supply of US Treasuries. This volatility also manifested itself on Thursday, with at the end of the day, according to our estimates, slightly higher risk premia on long-term bonds and lower risk premia at the short-end of the curve.



	2-year	5-year	10-year
Buy-and-hold risk premia	0.15	0.63	1.04
Daily changes (bp)	-3	-1	2



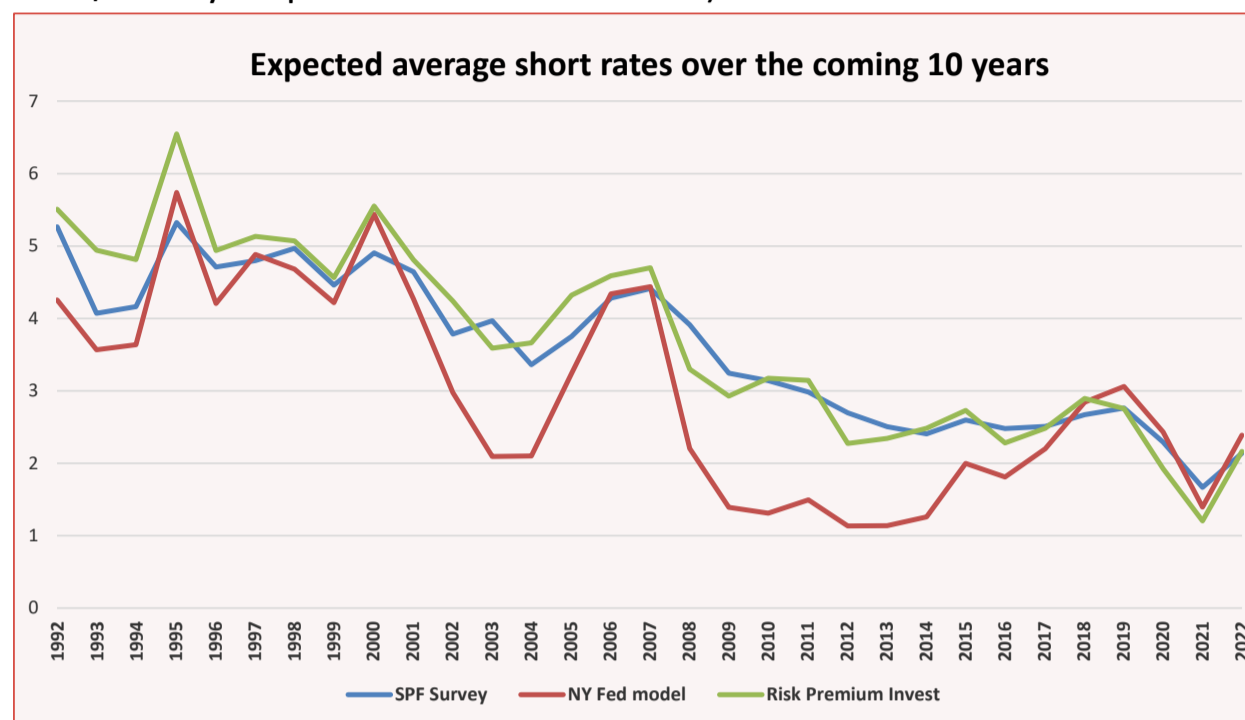
With a long-term perspective, it appears that the buy-and-hold risk premia on long-term Treasuries are now very high (see the right-hand side graph). This may not come as a surprise with some inflationary risks remaining and often – but not always - a positive correlation between the price of long-term bonds and equities. Moreover, very high short-term rates may encourage investors to buy short durations bonds rather than long-term bonds. Yet, since the beginning of Fed’s Quantitative Easing in 2010 and until 2022, there has been only two episodes where the buy-and-hold risk premia on 10-year US Treasuries have been significantly positive: the 2013 “taper tantrum” and the 2021 “reflation trade” episodes where investors introduced large short positions in Treasuries. Both time, these relatively high short positions and positive risk premia proved unsustainable and risk premia came back later on negative territory.

Looking forward, changing buy-and-hold risk premia could continue to introduce a lot of volatility in the US Treasuries markets. On the one hand, the lessons of the last 10 years should not be forgotten. There may be a tendency for risk premia to go back on negative territory as soon as inflationary risks recede (with at some stage lower short-term rates and the return of negative betas). On the other hand, the market will have in the future to absorb a larger supply with a large deficit to finance and the Fed cutting its holding of bonds (“Quantitative Tightening”). This may push many investors to introduce again large short positions in the belief that long-term rates are now on a structural upward trend.

PART III : METHODOLOGICAL ANNEX

There is an abundant academic literature trying to extract from the yield curve the monetary policy path expected by investors and the risk premia embedded in the observed US Treasuries rates.

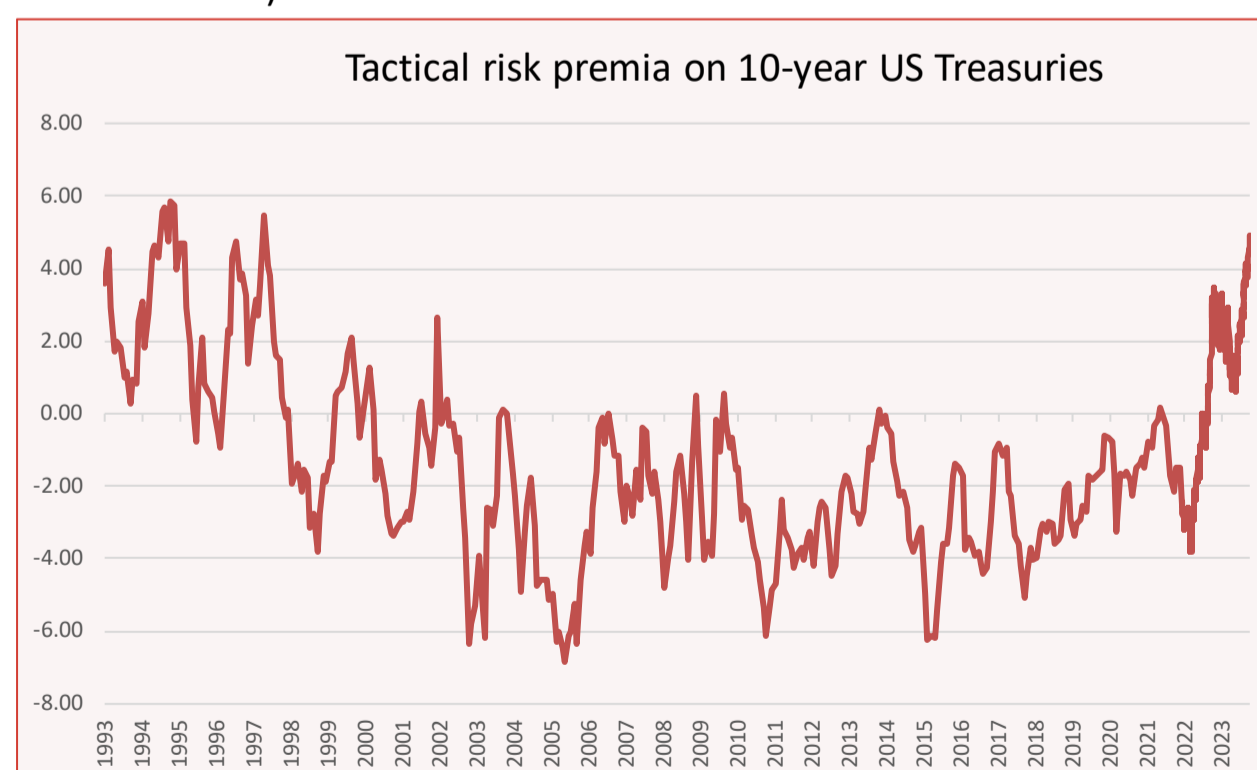
One of the best-known statistical models is the model developed by the Federal Reserve Bank of New-York. Their estimates are published daily on the NY Fed website (see www.newyorkfed.org/research/data_indicators/term-premia-tabs#/overview). Strangely enough, these estimates don't seem to be used by many markets practitioners when they discuss the shape of the yield curve and how it can be explained by short-rates expectations and risk premia. One of the reasons is that the results of the model are often quite unrealistic. To illustrate that observation, we can compare the average short rates expected by investors over the next 10 years according to this model with what professional forecasters expect (answers, once a year in February, to the well-regarded survey managed by the Federal Reserve Bank of Philadelphia. See www.philadelphiafed.org/surveys-and-data/real-time-data-research/survey-of-professional-forecasters).



There are many reasons why the average investor's view priced into the market may differ somewhat from the answer given by professional forecasters, but the difference is often much too large to be realistic.

The truth is that the estimates published on the NY Fed website are rather imprecise. There is indeed a large academic literature stressing that the yield curve alone does not contain enough information to extract the investors' underlying views and that the results of surveys should be incorporated in the extraction process (see Kim, Don H., and Athanasios Orphanides, 2012, Term structure estimation with survey data on interest rate forecasts, *Journal of Financial and Quantitative Analysis* 47).

Our model belongs to this class of models that combine information coming from well-regarded surveys with the observed yield curve. But its key originality is elsewhere. Our model does not extract only the buy-and-hold risk premia, but it also extracts the important short-term tactical risk premia required by investors on bonds of various maturities. These tactical risk premia are very important to understand the shape of the yield curve (see the references at the end of this page). One very important result of our work is that until the recent inflationary fears and the sharp increase in short-term rates these tactical risk premia have been on average negative since the end 90s (the following graph represents the annualized excess return expected by investors on 10-year Treasuries at the 3-month horizon).



That means that a long time before the Fed introduced QE there was already an insufficient supply of risk-free Treasuries: tactical positions were on average structurally short in this key market. To keep it simple, this rich information about tactical risk premia is not discussed in this daily comment, but an excel file with the full information is available on our website (see the link on the homepage of www.riskpremium.com)

To know more about our modelling of the yield curve, and the key insights it provides on how markets price risks:

For a short presentation of the indicators we publish and how they can be used to understand the US yield curve, see <https://riskpremium.com/wp-content/uploads/2022/07/RiskPremia-UST-guide-en.pdf>

For a non-academic description of our modelling, see <https://riskpremium.com/wp-content/uploads/2022/06/USTreasuries-Model-Guide.pdf>