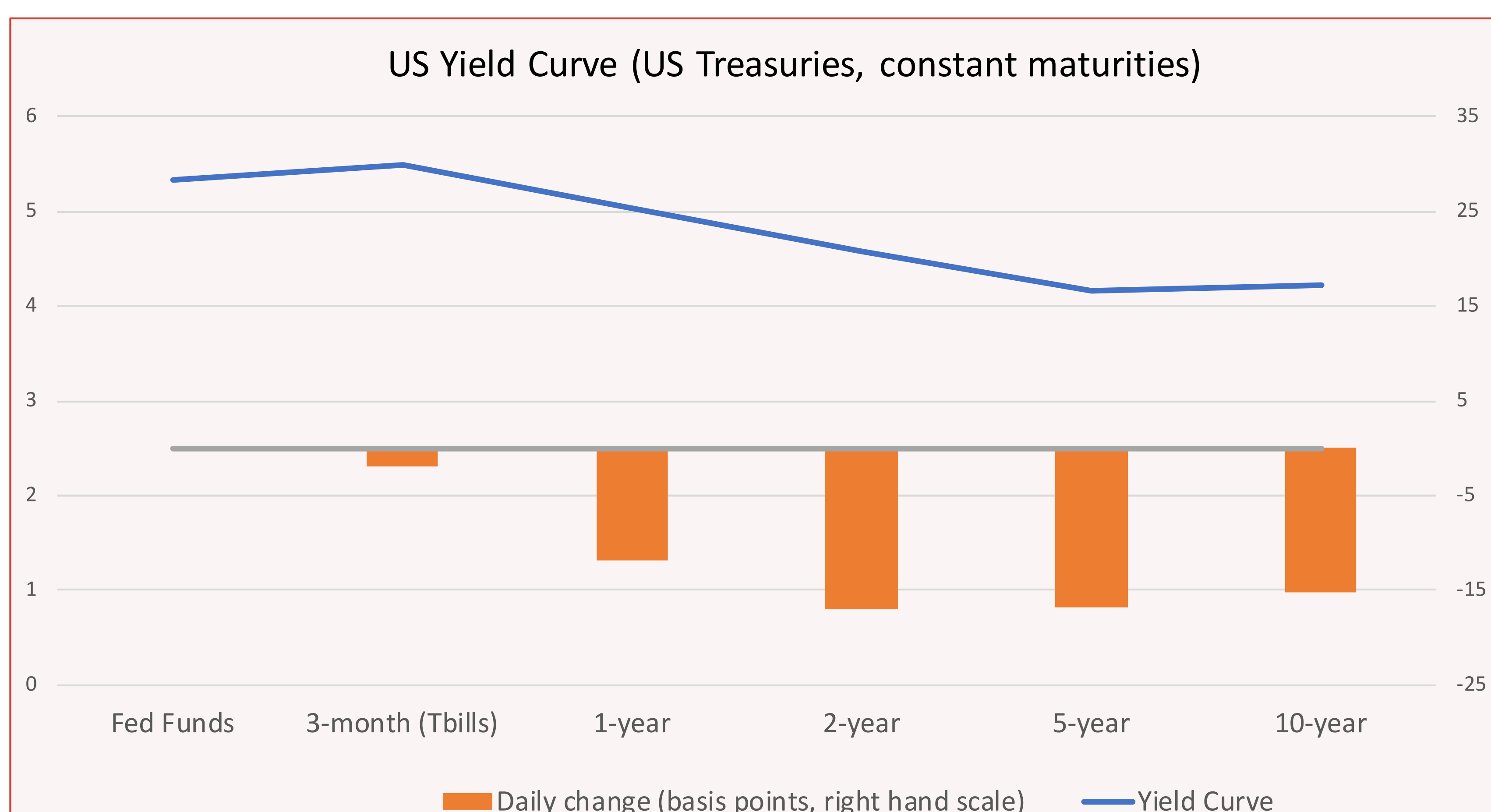
RISK PREMIUM INVEST

Daily analysis of the US Treasuries Market

1 December 2023

	Fed Funds	3-month (Tbills)	1-year	2-year	5-year	10-year
Rates	5.33	5.49	5.03	4.57	4.16	4.22
Daily changes (bp)	0	-2	-12	-17	-17	-15



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

Highlights:

- *US Treasuries yields fell sharply on Friday.*
- *The influential ISM manufacturing PMI was weaker than expected and in his much-anticipated speech, Fed Chairman Jerome Powell did nothing to combat the notion that with the economy slowing, rates could be reduced in 2024.*

PART I : Changes in expected Fed Funds Rates.

PART II : Risk premia contributions.

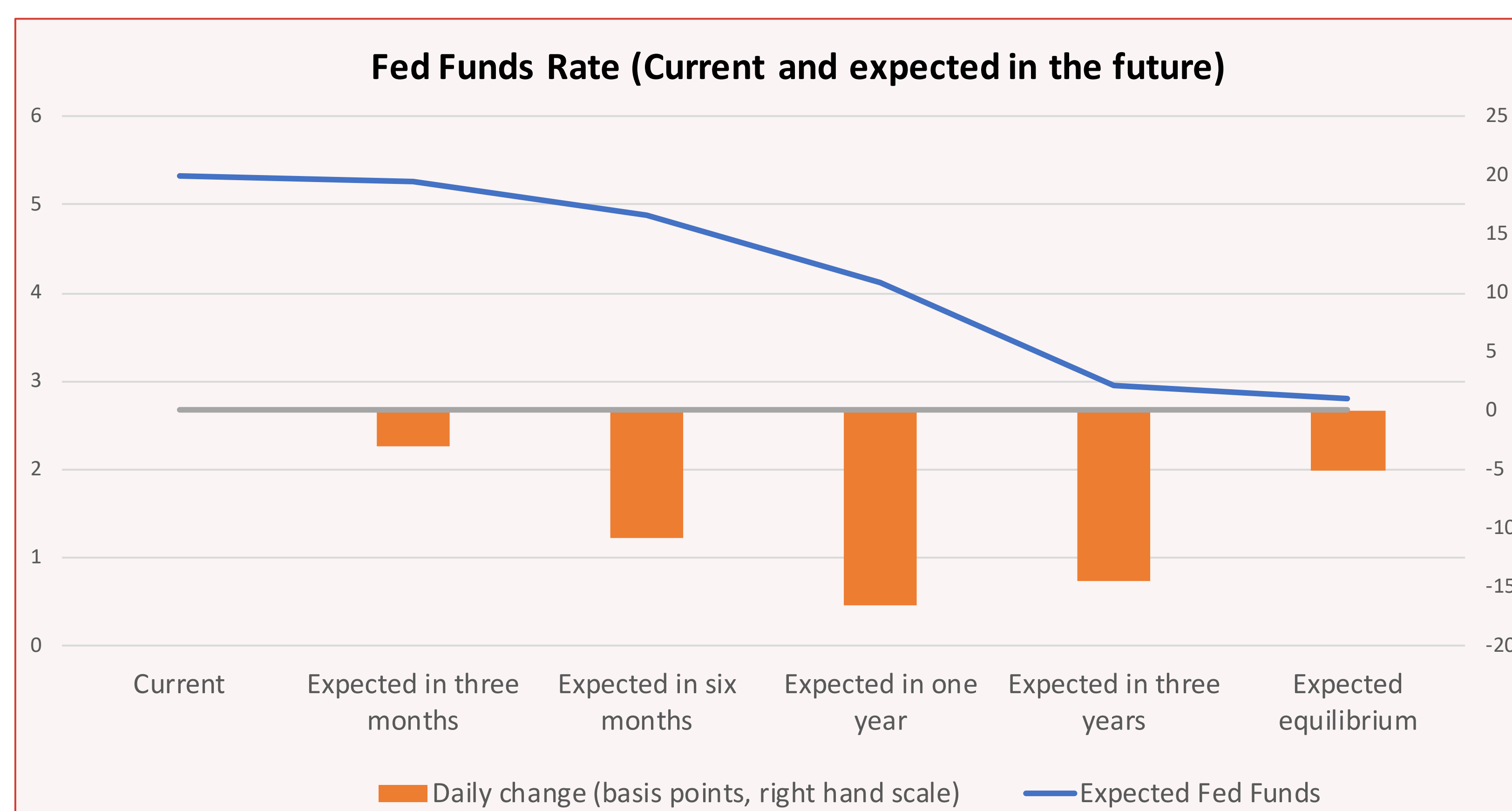
PART III : Methodological annex.

PART I : CHANGES IN EXPECTED FED FUNDS RATES

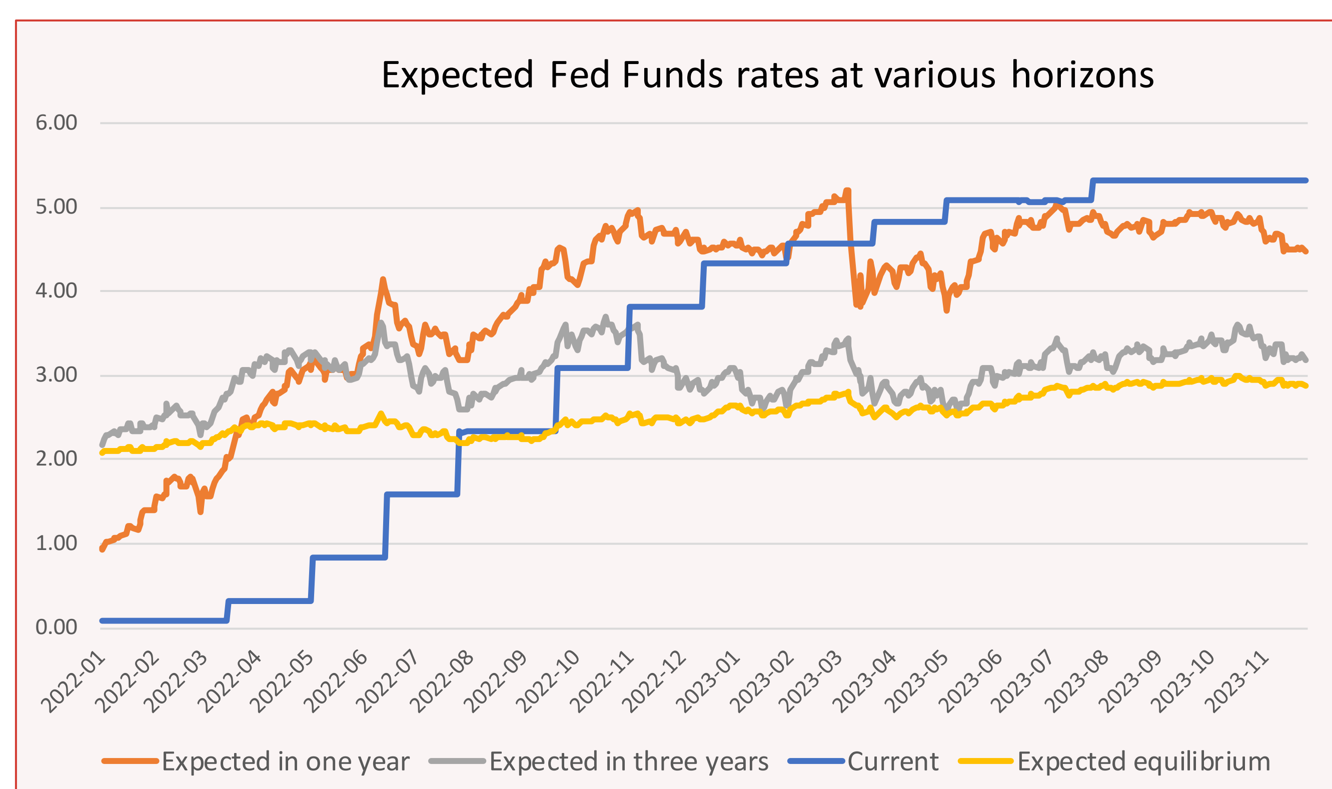
Fed funds futures provide a biased estimate of investors' true expectations, as they are influenced by varying risk premia. The Fed Funds rates expected by investors are here estimated by our proprietary model using both different surveys (the monthly "Consensus Economics" survey and the quarterly "Survey 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 November 13, the November "Survey of Professional Forecasters" was introduced).

The ISM Manufacturing PMI was weaker than expected in November, staying at a rather depressed level. This fitted well with Jerome Powell's much-anticipated speech later in the day, in which he stressed that "the full effects of our tightening have likely not yet been felt" and that he "anticipates that growth in spending and output will slow over the next year". Unsurprisingly, he reiterated that it was still too early to declare the Fed's inflation fight finished, but he also noted that a key measure of inflation averaged 2.5% over the six months ending in October, near the Fed's 2% target. He said that "It would be premature to speculate on when policy might ease", but he did nothing to stop investors from "speculating". And this is the important point, and a clear change in posture. Overall, expectations for future Fed funds rates fell significantly on Friday.

	Current	Expected in three months	Expected in six months	Expected in one year	Expected in three years	Expected equilibrium
Fed Funds Rates	5.33	5.27	4.87	4.13	2.96	2.81
Daily changes (bp)	0	-3	-11	-17	-14	-5



Even though the Fed keeps open the possibility of further monetary policy tightening, investors believe that Fed funds rates have probably reached their peak. According to our estimates, compared to the latest "dot plots" released in September by the Fed, investors have also in mind a different profile for future rate cuts. They forecast on average much more rate cuts in 2024 than the "median" FOMC member predicted (before the recent release of encouraging figures). At around 4.10% in one year, expected Fed funds rates are significantly lower than the 5.1% the Fed forecasted in September for the end of 2024. But at longer horizons, investors appear to expect that Fed funds will stabilize at a higher level. Investors have gradually become more pessimistic in 2022 and 2023 and have raised their average estimates for the long-term neutral rate from 2% at the start of 2022 to around 2.8% currently (against 2.5% in the Fed's dot plots).



Main market-moving news: 1 December 2023

US Macroeconomics
ISM Manufacturing PMI for Nov at 46.7 (Expected 47.6; Prior 46.7).
Construction spending for Oct at +0.6% MoM (Expected 0.4%; Prior 0.4% revised at 0.2%).

Others
Unsurprisingly, Fed Chair Jerome Powell reiterated that it was still too early to declare the Fed's inflation fight finished…
… but he also noted that a key measure of inflation averaged 2.5% over the six months ending in October, near the Fed's 2% target.

PART II : RISK PREMIA ANALYSIS

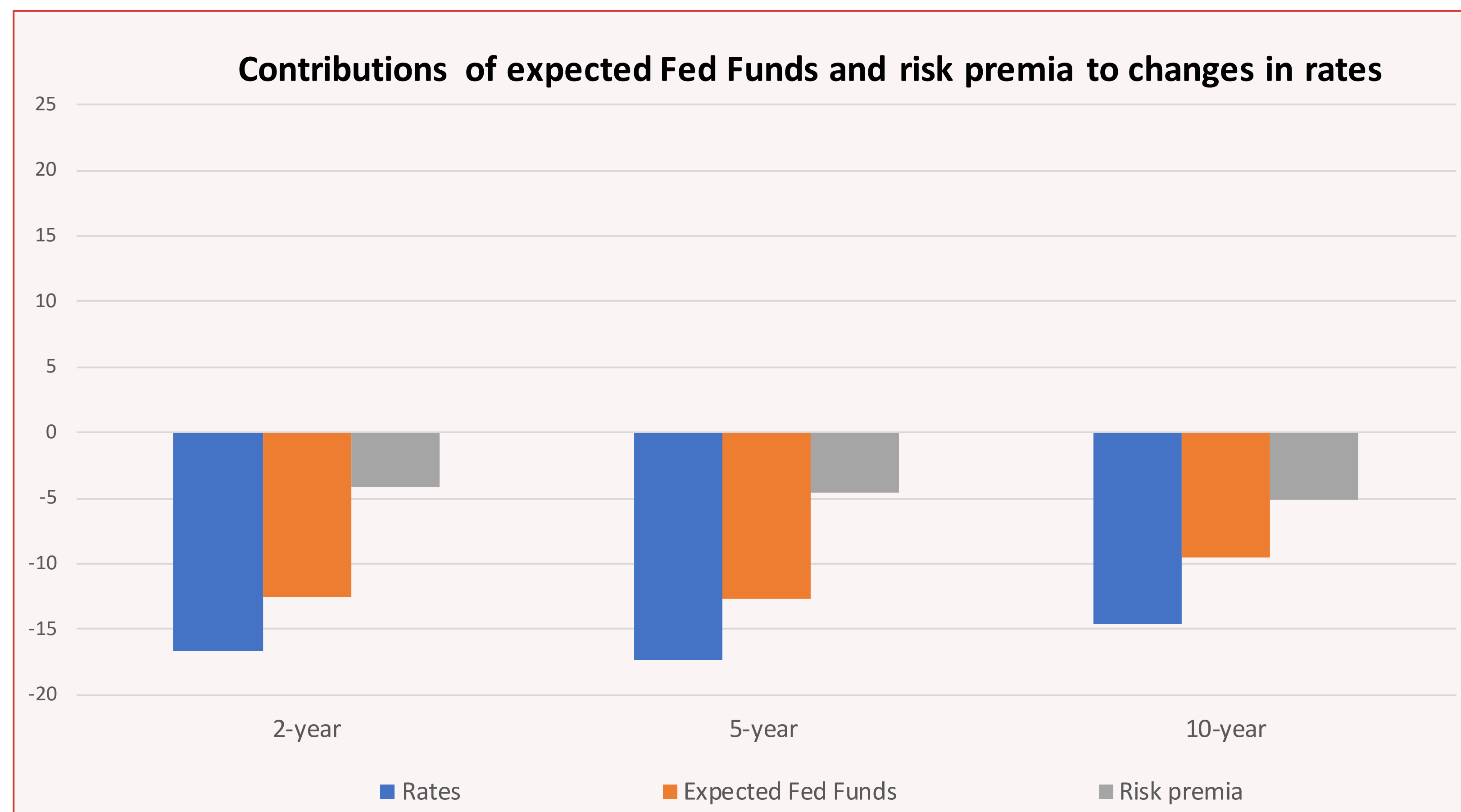
For US Treasuries, as for all financial assets, there are two key different types of risk premia:

- 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.

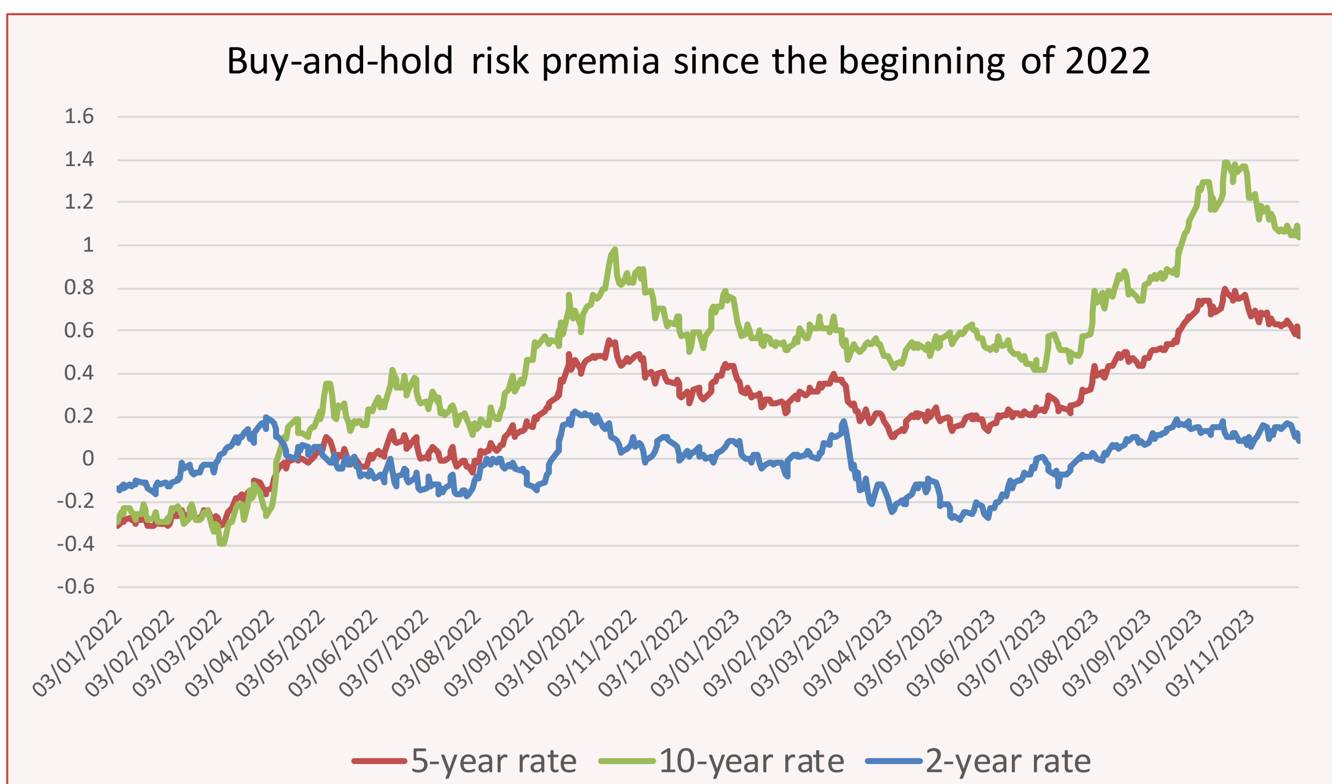
- The **"buy-and-hold" risk premia**. They are also called "term premium" in the academic literature. How much excess return **long-term investors** expect if they hold risky assets over an extended horizon? In the case of US Treasuries, the buy-and-hold risk premia are the differences between the zero-coupon rates of various maturities and the (annualized) expected return on a fund invested in Fed Funds over the same period.

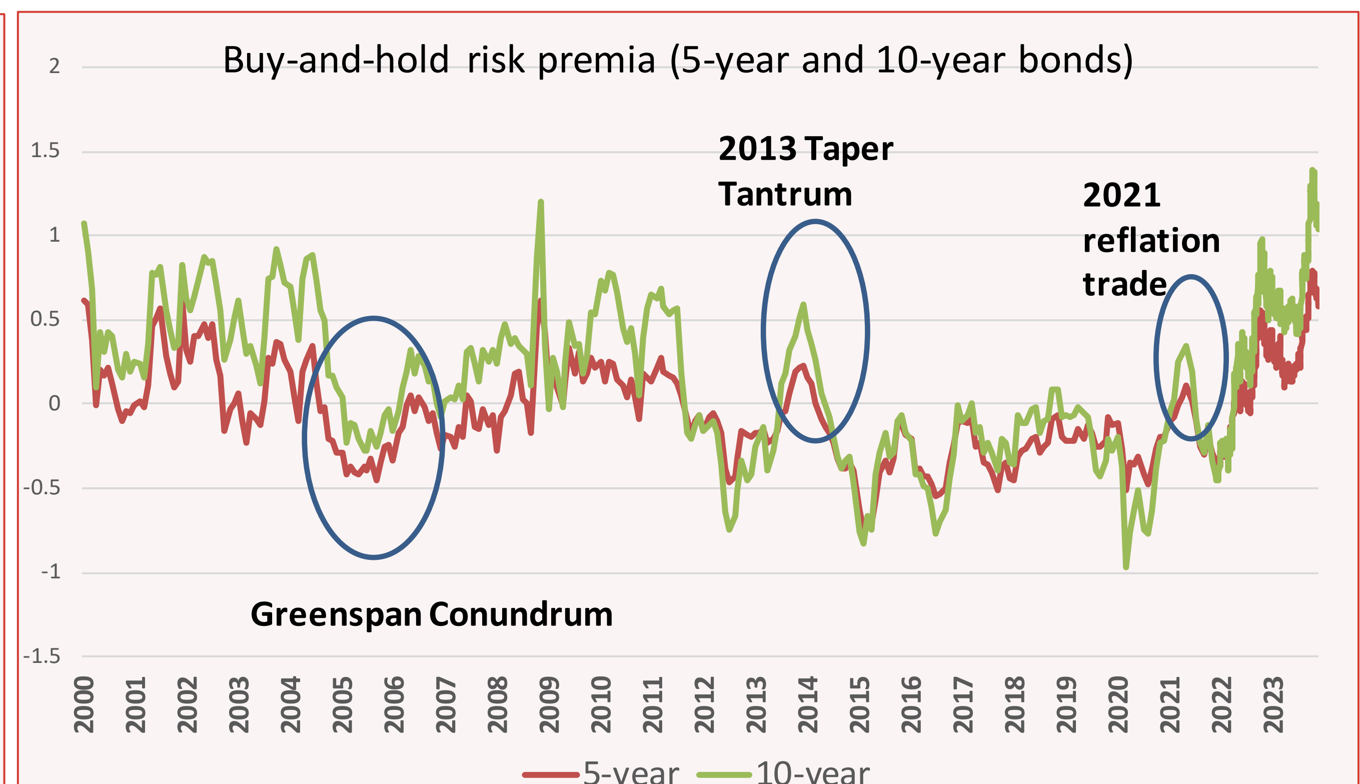
We estimate both types of risk premia (see the methodological annex and our excel file) but we discuss here only the buy-and-hold risk premia.

Friday's news (namely a weak ISM manufacturing PMI and a slightly dovish speech from Jerome Powell) naturally pushed down risk premia on US Treasuries. But the decline was relatively modest, and most of the decline in rates came from lower expectations for future Fed funds rates.



	2-year	5-year	10-year
Buy-and-hold risk premia	0.09	0.57	1.04
Daily changes (bp)	-4	-5	-5





From a long-term perspective, it appears that the buy-and-hold risk premia on long-term Treasuries are still quite high (see the two graphs above), although around 35 basis point lower than their peak on October 20. This is also true for the short-term tactical risk premia that few people discuss, but play an important role in our analysis of the market (see the annex and last month's analysis of the reasons why long-term rates rose sharply in October in www.riskpremium.com/wp-content/uploads/2023/10/10YT.pdf)

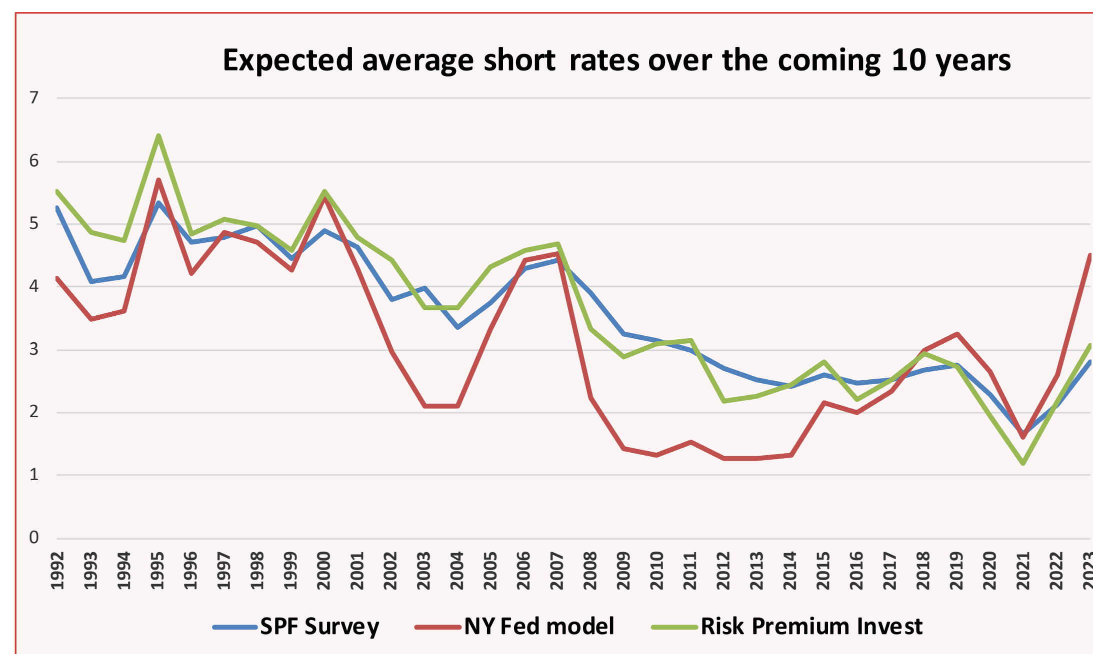
These very high risk premia may not come as a surprise with some inflationary risks remaining, a rising public debt and often – but not always - a positive correlation between the price of long-term bonds and equities (i.e. a positive "beta"). Additionally, very high short-term rates may encourage investors to buy short durations bonds rather than long-term bonds. Yet, since the start of Fed's Quantitative Easing in 2010 and until 2022, there have been few episodes where the buy-and-hold risk premia on 10-year US Treasuries were significantly positive. Generally, 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 market. On the one hand, the lessons of the last 10 years on US Treasuries as "safe haven" securities should not be forgotten. There may be a tendency for risk premia to decline sharply when 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.

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.

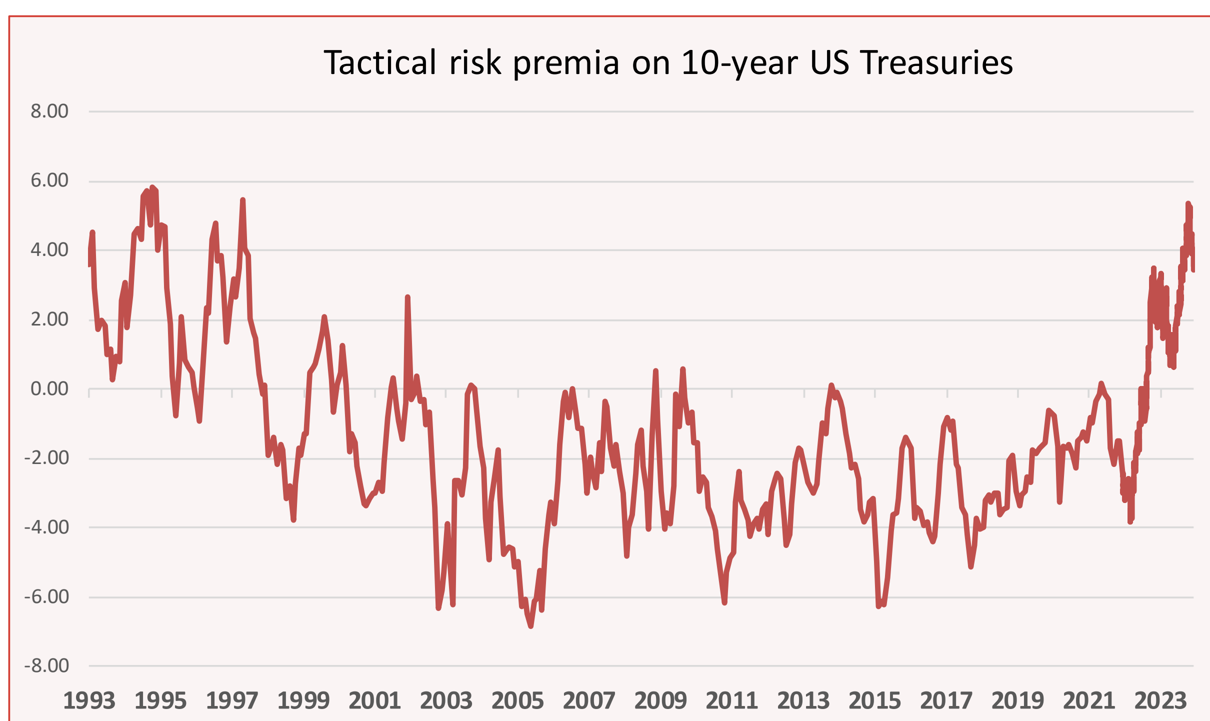
One of the best-known statistical models is the model developed by the Federal Reserve Bank of New-York. Their estimates are published daily on the NY Fed website (see www.newyorkfed.org/research/data_indicators/term-premia-tabs#/overview) and often discussed in newspapers. However, strangely enough, 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).

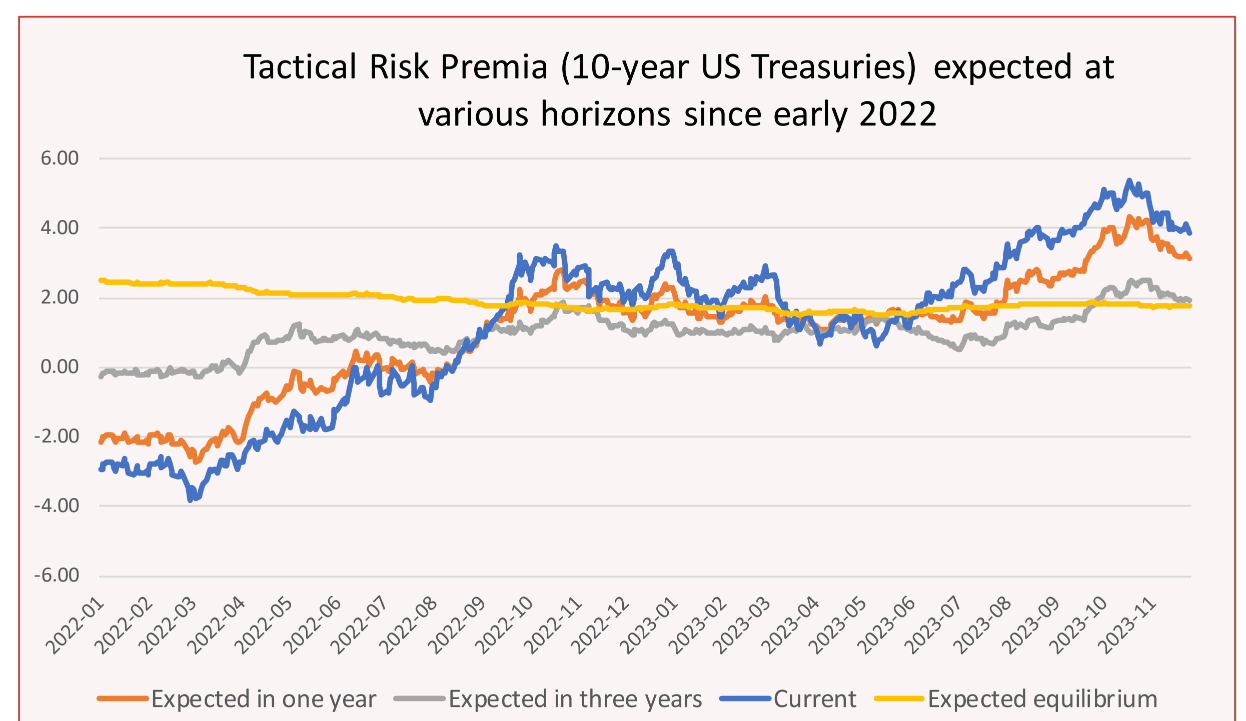


There are many reasons why the average investor's view priced into the market may differ somewhat from the answer given by professional forecasters, but the difference is often much too large to be realistic.

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 – current and expected in the future - 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 graph on the left represents the annualized excess return expected by investors on 10-year Treasuries over 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. These tactical risk premia have increased massively since fall 2022, and their future is very uncertain. To keep it simple, this rich information about tactical risk premia – current and expected in the future - is not discussed in this daily comment, but an excel file with the full information is available on our website.

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

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

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