Alert: US bonds in turmoil what's really at play?

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The U.S. bond market is experiencing heightened volatility, driven by a 60-basis-point surge in 10-year Treasury yields following the recent FOMC meeting on September 18, 2024. This upward pressure, alongside a jump in interest rate volatility and a shift to positive term premiums, signals significant shifts in market dynamics. This analysis explores the key factors behind these developments and considers what may unfold ahead of the U.S. elections in just one week.

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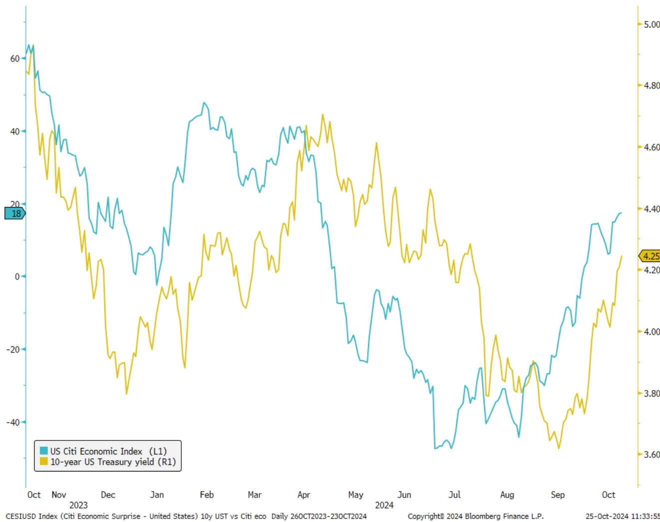
The bond market shake-up: what's fueling it?

Since the Federal Reserve's September meeting, 10-year Treasury yields have spiked nearly 60 basis points. This increase reflects multiple forces at play: stronger-than-expected U.S. macroeconomic data (Chart 1), commodity price inflation fueled by Chinese stimulus measures, and recent statements by Fed policymakers advocating a higher terminal rate, as seen with central bank officials Neel Kashkari and Christopher Waller.

Chart 1

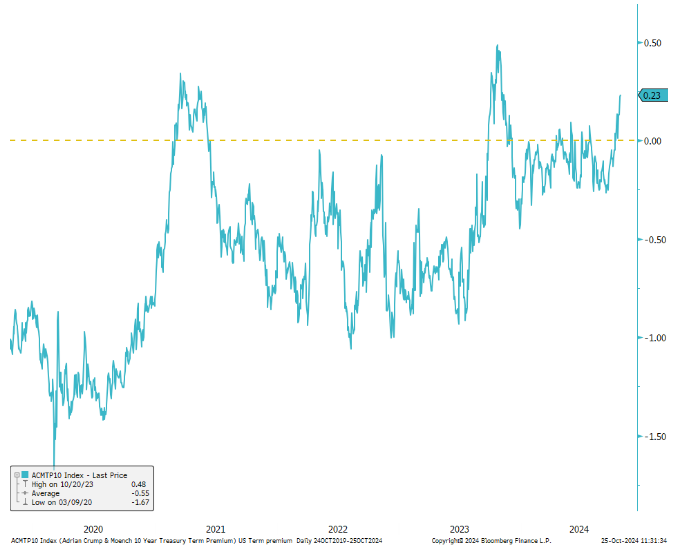
Stronger-than-expected macroeconomic data continue to drive rate pressures



Rising political uncertainties add pressure, particularly the increasing probability of a Republican "sweep" (presidency, Senate, and House), that could accompany a potential Trump victory. This political backdrop has fueled market anxieties, as investors brace for the prospect of new tax cuts and potentially a ballooning federal deficit – both factors that historically contribute to upward pressure on bond yields and in particular the Term Premium (Chart 2).

Chart 2

Adrian Crump and Moench 10-year US Treasury term premium



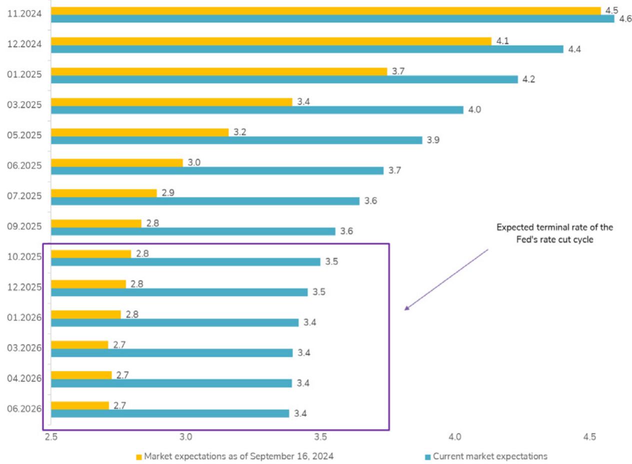
Positive term premiums and bond market tensions

Several key factors are driving the surge in Treasury yields, which we dissect below:

→ **Revaluation of the terminal rate:** A higher terminal rate—essentially the bottom rate expected in the Fed's current rate cut cycle—has been priced in, influenced by data suggesting the U.S. economy remains resilient. A "soft landing" scenario appears increasingly likely, implying a higher "neutral rate" (the rate at which the economy neither accelerates nor decelerates). This revaluation has moved the expected terminal rate from 2.7% to 3.4% within a month (Chart 3), aligning with recent comments from Atlanta Fed President Raphael Bostic, who estimates a neutral rate of 3.0–3.5%.

Chart 3

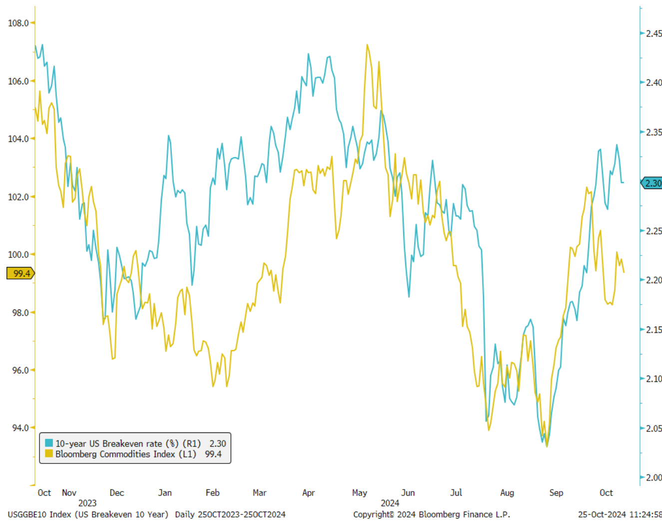
Expected Fed terminal rate, September 16, 2024, vs. today.



➔ Pressure on breakeven rates: Breakeven rates, which represent the difference between nominal and real yields and serve as a proxy for inflation expectations, have been influenced by rising geopolitical tensions and Chinese stimulus. The 10-year breakeven rate jumped from 2.05% to 2.32% over the past month (chart 4), nearing 2024 highs (2.4%). Although oil prices have eased with diminishing risks in the Middle East, breakeven rates remain elevated.

Chart 4

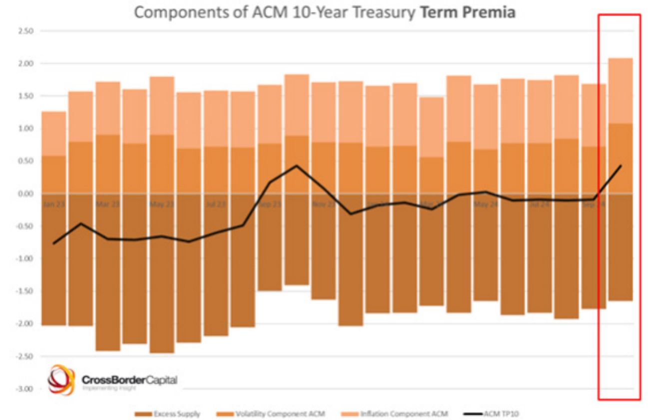
10-year U.S. breakeven rate vs. Bloomberg Commodity Index.



➔ Rising term premiums: The term premium, or the extra yield investors require to hold longer-term Treasuries, has turned positive, reaching a high for 2024. Typically, low since the 2008 financial crisis due to liquidity injections, the term premium has risen by 50 basis points, with Cross Border Capital attributing 70% of this to bond volatility, 10% to inflation risk shifts, and the rest to changes in supply and demand dynamics.

Chart 5

Components of ACM 10-year Treasury Term Premium

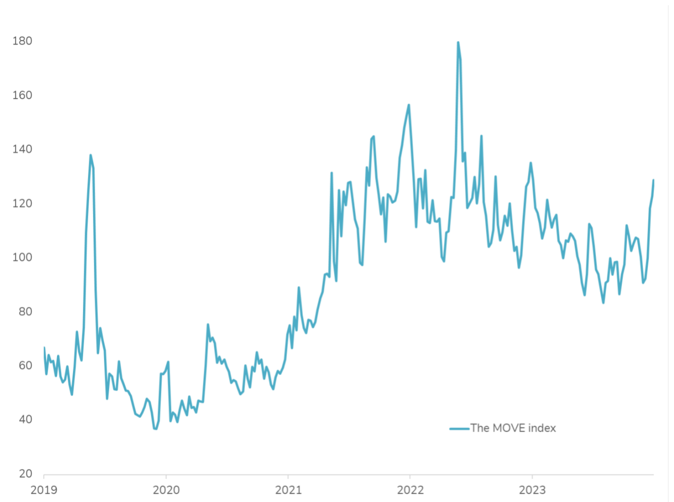


Source: CrossBorder Capital

➔ Spike in interest rate volatility: The MOVE index, a barometer for bond market volatility, hit a one-year high on October 7, surpassing levels seen during the Silicon Valley Bank collapse and the Fed's 75-basis-point rate hike in June 2022. According to MOVE creator Harley Bassman, this marked the first time that one-month options extended beyond the election date, reflecting heightened political anxiety around future yields.

Chart 6

MOVE index spikes to new 2024 highs!



What do these valuations reflect?

If the Federal Reserve proceeds with two additional 25-basis-point rate cuts by the end of 2024, as the market anticipates, we could see a yield curve steepening of approximately 70 basis points. This would align with the current 10-year U.S. Treasury yield of around 4.2%, close to the historical average of 80 basis points. Notably, the 10-year U.S. yield has surged by 60 basis points in recent weeks, as markets increasingly expect a Trump victory with a Republican majority across the presidency, Senate, and House.

Unlike in 2016—when Trump's election was a surprise that drove the 10-year yield up by 80 basis points—this time, markets are more prepared, and the adjustments are less abrupt but still impactful.

From a valuation perspective, and given the current economic cycle, a 10-year yield at 4.2% approximates its fair value within a context where a Republican victory is plausible. The recent repricing pressure on the terminal rate seems to be reaching its peak, and breakeven rates have decoupled from oil prices, which have recently softened. This divergence is unusual, as break evens typically mirror movements in commodity prices like oil.

In our recent report on the implications of the U.S. elections on the bond market, we highlighted that a Trump presidency would likely involve more aggressive fiscal expansion through significant tax cuts, increased defense spending, and potentially new tariffs. Such policies could increase inflationary risks, which would limit the Federal Reserve's capacity for deep rate cuts. In this scenario, the yield curve could steepen further, with long-term yields rising more sharply due to heightened inflation expectations and a higher term premium. Fiscal expansion and potential trade disruptions from tariffs could further accelerate inflation, driving yields higher as investors demand additional compensation for heightened risks.

At this level, additional basis points could still be added, justified by the compounded uncertainties surrounding future U.S. Treasury supply and the anticipated expansionary fiscal policies. The combination of elevated fiscal spending and potential supply-driven inflation risks could lead to further upward pressures on long-term yields in the bond market.

Conclusion

The recent bond market volatility appears to have already factored in the expected outcomes and policy implications of the upcoming U.S. election., This suggests that any potential post-election yield spikes may be restrained, unlikely to match the intensity of the 80-basis-point surge seen after Trump's 2016 victory. Nonetheless, further yield increases remain possible, particularly if unanticipated fiscal or economic developments arise.

Two key factors could help stabilise or slightly reduce yields. First, a divided government would constrain fiscal expansion, complicating the passage of significant spending measures. Second, weaker-than-expected macroeconomic data could prompt a more cautious policy response, potentially delaying or scaling back anticipated fiscal changes, which would alleviate upward pressure on yields.

In the absence of these stabilising elements, we expect the bond market to remain steady, albeit fragile, around current levels. We remain vigilant regarding "tail risks" that could disrupt this balance, particularly on the long end of the yield curve. A major policy shift or economic surprise could drive renewed upward pressure on yields. Given this potential volatility, we maintain a cautious stance on long-term rates and are prepared to respond to any unexpected market developments.

For further information

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