

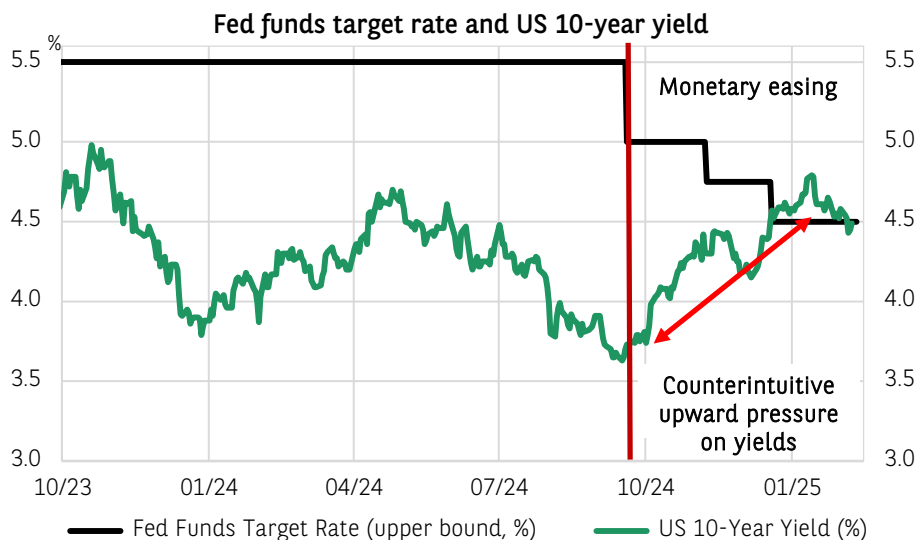
CHART OF THE WEEK



10 February 2025

UNITED STATES: WHAT'S UP WITH LONG-TERM RATES?

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Source: Macrobond, BNP Paribas

While the Fed lowered its target rate by 100 bps from 18 September 2024, bond yields rose by around 80 bps¹. This rare divergence is reminiscent of an inverse version of the 'Greenspan conundrum' (2004–2005)²: during this episode, which spread to Europe, the rise in short-term rates had little effect on long-term rates. What are the reasons for these contrary movements between short- and long-term rates, and what might the implications be? The implications, moreover, go beyond the US case, given the central role of US Treasury bonds for other sovereigns.

An initial reason is the reduced anticipation of rate cuts on the markets. On 19 September, Fed Funds Futures implied a 2.85% effective rate at the end of 2025, a figure that stands at 3.77% today¹. These movements are linked, in part, to the dynamic US economy, as illustrated by the rise in the real 10-year interest rate from 1.6% to 1.8% between September 2024 and January 2025. Sell-off episodes (e.g. when nonfarm payrolls were stronger than expected) illustrated the sensitivity of the markets to the strength of the economy. One notable consequence of the differing trends in 2-year and 10-year rates is that it puts an end to more than two years of inverted yield curve, traditionally considered a leading indicator of recession. From this perspective, the steepening of the curve is a positive sign. A further explanation for the divergence is the expected rise in inflation, as evidenced by the 30 bps rise in the 10-year breakeven inflation rate between September and January. In this sense, increased uncertainty, which could affect growth, is seemingly playing a role.

Fed Chair Jerome Powell puts forward a technical explanation for this divergence, namely an increase in the term premium. Nevertheless, this increase is similar to a normalisation in relation to its pre-pandemic level and the argument seems simplistic in view of the aforementioned factors. Furthermore, the federal government's fiscal situation cannot be ignored, namely the scale of the financing requirements and the resulting appeal to the markets. The calculations of the Cleveland Fed, which show relative stability in risk premiums on inflation and real rates, are indicative of the importance of this factor. And the rise in long-term rates further complicates the US budget equation, through the increased interest burden and their negative impact on growth, particularly through the real estate channel.

The divergence of long- and short-term rates also raises questions about the effectiveness of monetary policy transmission, a point of concern per se and detrimental to growth. Ultimately, the central question is whether long-term rates are rising for good reasons, such as strong growth, or bad ones, such as more inflation, the prospect of significant financing needs and more uncertainties. At this stage, in view of changes in real rates, breakeven rates and the term premium, the latter is seemingly exceeding the former.

¹ Data as at 7 February 2025

² Ahmed Rashad and Alessandro Rebucci, A 'reverse conundrum' and foreign official demand for US Treasuries, CEPR, 15 Jan 2025 - Link

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