

April 2023

Vanguard US Treasury Market Commentary

Recap:

Since the initial negative banking headlines in March, US Treasuries have rallied strongly. Bellwether 2y to 10y Treasuries have returned 2% to 4% in this time period on an unadjusted basis. The 60bp rally at the 5y tenor drove the 5s30s Treasury curve steeper by ~70bp over this period (Figure 1).

This price action has come amidst a sharp repricing of the Federal reserve hiking cycle. Hawkish Fed expectations have been pared back dramatically due to both adverse banking headlines as well as a decline in inflation. Figure 2 highlights that pre-SVB failure, markets were priced for the Fed to increase interest rates all the way to ~5.7% before cutting it to ~4.2% by the end of next year. Markets now expect that the Fed is done hiking and will cut rates to sub 3% by end of the next year. We expect the Fed “dots” to fall in the June FOMC meeting to from the ones that were indicated in March.

Figure 3 highlights market's expectation of inflation prints. CPI (inflation) fixings suggest further decline in core and headline CPI. Rent of shelter inflation, which has ~40% weight in CPI, declined in the March print and remained at that level April, suggesting a more sustained nature of inflation slowdown driven by housing. This has contributed to the pricing of the Fed on hold in the June meeting, and as lagged effects of previous hikes flow through the system, cut rates later in the year. We expect the Fed to show patience as they await further economic data.

Strategy/Outlook:

With the Fed on hold, markets are pricing in significant cuts over the next twelve months. We are neutral on duration as for the long view to be profitable, the Fed needs to deliver more than the substantial number of cuts that are in the price. Given the banking system stress and the gradual data weakening we have seen so far, while we don't believe Treasury markets are significantly mispriced, valuations are not compelling either. Markets seem convinced of an upcoming pivot from the Fed, but economic data does need to weaken further for market's view to be realized. Instead, we prefer to express our macro view that we are in late stage of the hiking cycle (if not at the end) via steepeners, which offer more protection than duration if the data holds up better than expected.

Figure 1: Treasuries have rallied substantially, and the curve has steepened, with the Fed potentially pausing the hiking cycle

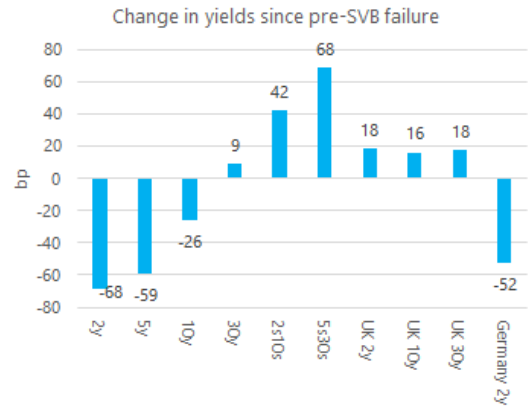


Figure 1: Fed hike expectations have been lowered amid weaker than expected inflation and banking system headlines

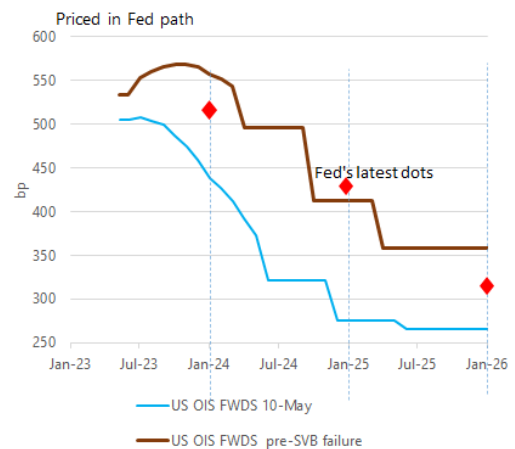
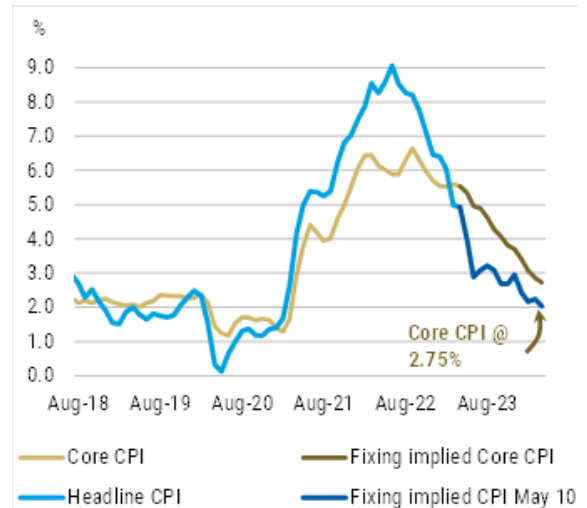


Figure 3: Inflation has moderated since the peak and markets are expecting the decline to continue in the medium term



Source for all charts: Dealers, Bloomberg

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