

August 2023

Vanguard US Treasury Market Commentary

Recap:

Since the end of July, US Treasuries have sold off strongly, led by the longer end of the yield curve. Specifically, 2y, 10y and 30y yields have risen ~10bp, 30bp and 35bp respectively. At the belly and long end, the entire sell-off has been driven by a rise in real yields.

Three factors have contributed this long-end led selloff. First, the US Treasury announced issuance forecasts that were well in excess of market expectations. This was due to deficits printing larger than expected on both lower revenue and higher outlays. Second, the BoJ introduced flexibility for its Yield Curve Control (YCC) policy, and third, economic data continued to surprise to the upside, with the economy remaining resilient despite aggressive rates from the Federal Reserve. Figure 1 shows that 5y Treasury yields have moved largely in tandem with the US economic data surprise index. The first two factors have contributed to a rise in term premium and contributed to the long end driven sell-off.

With the Fed's hiking cycle near completion, focus is increasingly on the Fed's anticipated path in 2024. Figure 2 shows that Z3-Z4 spread (roughly a proxy for market's pricing for hikes in 2024), is approaching -100bp (~4cuts of 25bp each) after pricing in as much as 6 cuts earlier in the year. Meanwhile, Z4-Z5 (roughly a proxy for market pricing of hikes in 2025) has remained sideways at ~2cuts. Combined this indicates that market has reduced the cumulative number of cuts by ~2 and this has driven yields higher.

Whether Z3-Z4 spread compresses further remains a strong function of incoming economic data. Over the past few months, data have lent credence to the soft-landing narrative. Figure 3 shows that even as the Atlanta Fed Core Sticky CPI ex-shelter has declined meaningfully, and as have wages, the former has still outpaced the latter. Labor markets are now more in balance but are still resilient and economic growth is tracking well above potential in Q3.

Strategy/Outlook:

As the end of the Fed hiking cycle comes into view, we find valuations attractive at the longer end of the Treasury curve and are biased long. We prefer to trade this tactically as the sensitivity to economic data surprises remains high. We have turned neutral on our curve positions. We continue to monetize relative value and systematic trading opportunities.

Figure 1: US Treasury yields have risen in tandem with economic data surprising to the upside

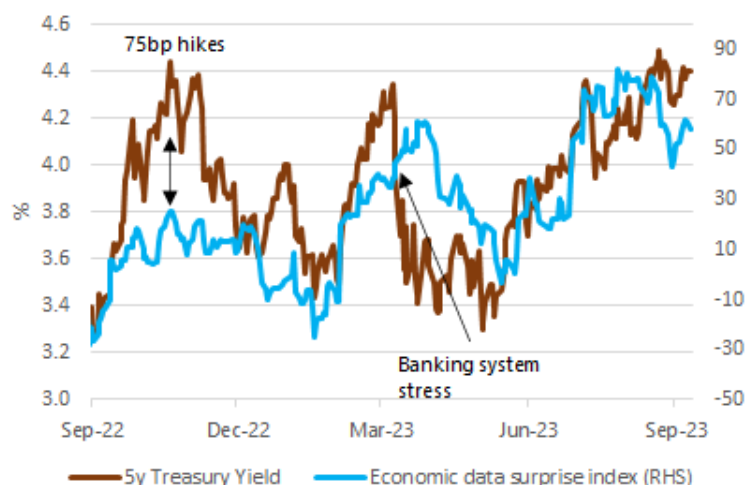


Figure 2: Strong economic data has driven the markets to reduce its pricing of cuts in Fed funds rate next year

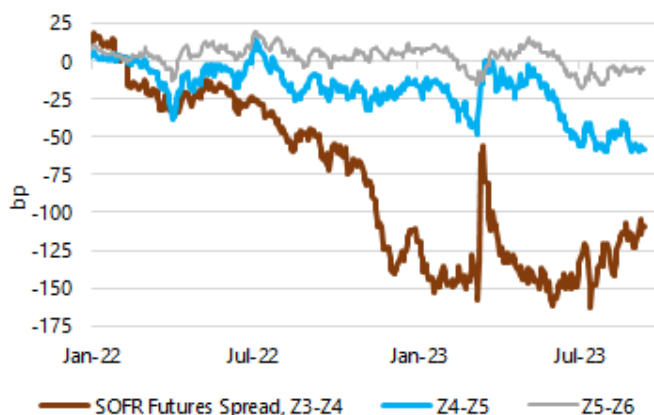
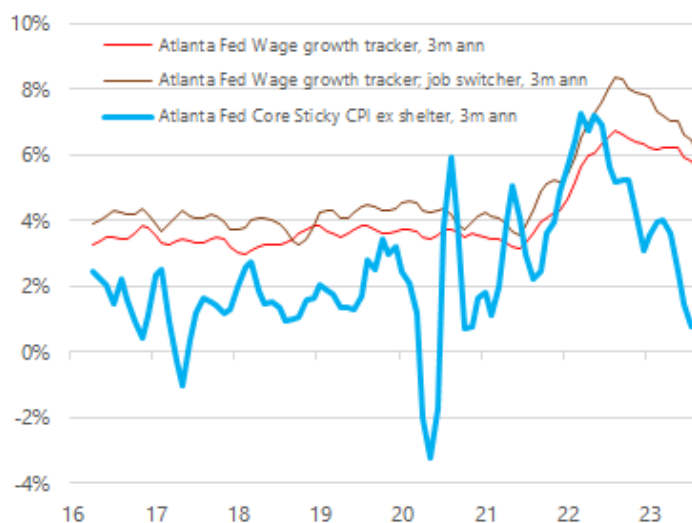


Figure 3: Soft landing narrative has been bolstered by declining inflation amid reasonably resilient labor markets



Source for all charts: Bloomberg

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