

## Ahead of the Curve

### Three Fed scenarios, same result: higher yields, steeper curves

From the Field  
May 2024

During a discussion in a recent monthly policy week, when our portfolio managers meet to discuss outlook and positioning, someone asked, “Can anyone see the 10-year U.S. Treasury yield at either 4% or 5%?” The answer was a resounding “Yes—we can see both happening.”

Over the last couple of months, the market consensus has moved entirely from one side of the boat to the other, and then seemingly back again. The 10-year Treasury yield has followed, moving down, then up, and then back down again, demonstrating that pendulums never stop in the middle.

#### Despite the noise, little has changed

But really, what has changed? At the risk of data mining, the core U.S. consumer price index (CPI) has increased either 0.3% or 0.4% month over month for every 2024 data release through April. My main point here is that, while volatility will remain a constant and consensus whips around, it is important to remain focused on what you think will actually happen over time and have a plan for how to handle it.

Looking back at my views published over the last several months, many have either become consensus or reality. As anticipated in February’s “*Central bank rate-cut pricing is eye-catching but deceiving*,” markets have meaningfully dialed back expectations for rate cuts from developed market central banks since the beginning of the year. Much of this shift is due to the consensus expecting a resurgence in inflation—while actual U.S. inflation readings for the first quarter have been steady, they were higher than expected—as predicted in last month’s “*Current market inflation expectations are ridiculous*.”

But some haven’t fully worked out. In last summer’s “*The fairy tale of a soft landing*,” I made the case that “no landing”—an uninterrupted upward growth trend—followed by a global recession was a more likely outcome than the consensus of a brief slowdown and no recession. We’re currently experiencing the no-landing scenario, but a recession looks to be off the table.

#### Higher yields and steeper curves

What’s next for rates? With the 10-year U.S. Treasury yield at 4.35% in mid-May<sup>1</sup> and heading lower, I view this as an



**Arif Husain**

Head of Fixed Income and  
Chief Investment Officer,  
Fixed Income

<sup>1</sup> Source for all U.S. Treasury yield data: Bloomberg Finance LP as of May 15, 2024

opportunity to reduce duration<sup>2</sup> exposure. I see yields moving substantially higher and yield curves steepening as longer-term rates increase. As stated before, we may not have seen the highs in yields.

I think there are three possible primary scenarios for the Federal Reserve, all of which would result in higher yields and steeper curves.

1. The Fed admits that it won't cut rates.
2. The Fed reduces rates because it desperately wants to (possibly referring to them as preemptive or insurance cuts), not because of major labor market cracks or deterioration in economic data. Inflation expectations rise.
3. The effects of looser financial conditions experienced from late 2023 through early 2024 dissipate, leading to rate cuts—and higher inflation expectations. The increase in yields that we've seen over the last couple of months could be part of this tightening of financial conditions, although equities and credit have held up relatively well.

### **Short-term U.S. Treasury yields near attractive levels**

Of course, you're probably wondering when it would make sense to add any duration to a portfolio. I think we're at least approaching that level—a two-year U.S. Treasury yield in the high 4% range is certainly in the right ZIP code. The two-year yield briefly broke through 5% at the end of April, after increasing from 4.15% in mid-January, before its upward momentum paused.

### **What's your hedge?**

While I don't think yields have quite peaked, it's a good idea to have at least some duration exposure at these levels. I still believe that duration will be the most effective hedge against a dramatic sell-off in risk assets, such as equities and corporate bonds, like what we experienced in early 2020 at the onset of the pandemic. With that said, I don't see any evidence that I can rely on the negative return correlation<sup>3</sup> between duration and risk assets returning in the near future.

I think that exposure to the U.S. dollar is a way to hedge against a more minor downturn in risk assets that could be

triggered by heightened anxiety related to the Middle East or any number of current geopolitical hot spots. The U.S. dollar tends to function as a safe-haven asset and benefit in these types of risk-off situations. I anticipate that this will still be the case even after the dollar's remarkable run of strength as investors have rapidly scaled back their Fed rate cut forecasts, preserving the relatively attractive interest rates available in the U.S.

Pairing both of these hedges—duration exposure and a long U.S. dollar position—could make sense for construction of an international portfolio. If the market narrative shifts toward a more dovish Fed outlook featuring additional rate cuts, the duration exposure would benefit while the U.S. dollar position would likely decline. If the consensus shifts toward a more hawkish Fed, duration would sell off, but the dollar would probably appreciate.

My only caveat, however, is to watch the fiscal and political situation in the U.S. carefully. While muscle memory is strong relative to Treasuries and the U.S. dollar, the next few months may present a break in that paradigm if U.S. fiscal spending looks to spiral out of control.

<sup>2</sup> Duration measures a bond's sensitivity to changes in interest rates.

<sup>3</sup> Correlation measures how one asset class, style or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from historical performance. The information presented herein is shown for illustrative, informational purposes only. Any historical data used as a basis for analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been verified. Forecasts are based on subjective estimates about market environments that may never occur. Any forward-looking statements speak only as of the date they are made. T. Rowe Price assumes no duty to, and does not undertake to, update forward-looking statements.

#### INVEST WITH CONFIDENCE®

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

---

#### Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of May 2024 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

**Past performance is not a reliable indicator of future performance.** All investments are subject to market risk, including the possible loss of principal. Derivatives that may be used for currency hedging may be riskier or more volatile than other types of investments because they are generally more sensitive to changes in market or economic conditions; risks include currency risk. They may be subject to higher fees and a perfect hedge may not be achieved. Diversification cannot assure a profit or protect against loss in a declining market. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc., distributor. T. Rowe Price Associates, Inc., investment adviser.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.