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Marketing material

What interest rate will bring fiscal discipline to Washington?

David Bianco
Americas Chief Investment Officer

IN A NUTSHELL

- 10yr Treasury bond yields are at 15yr highs. The deficit could push them higher
- Treasury yields may be affected by fiscal conditions and thus overnight rates too
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10yr Treasury bond yields are at 15yr highs. The deficit could push them higher

Provided inflation doesn’t reaccelerate and the The U.S. Federal Reserve (Fed) doesn’t cut interest rates for about a year, we think 10yr Treasury yields are unlikely to climb higher than the current 4.65%. DWS expects 10yr yields to fall to 4.2% by Sept 2024, as economic growth slows to a crawl and unemployment climbs by near half a percent. But absent such economic softening and/or monetary policy discipline, 10yr Treasury yields might be settling into a roughly 4.5% or higher mid-cycle norm. We view the firmness in 10yr yields at 4.5%+ despite the dip in stocks as an indication that the September climb in yields is secular and mostly related to a higher real interest rate seen as required to keep inflation close to a 2% long-term target.

Fixed income markets now appear to expect long-term inflation of nearly 2.5% and a 3.5% neutral nominal Fed Funds rate (r*=1%), while demanding an about 1% 10yr term premium to account for greater expected inflation and r* uncertainty. This is a big shift in expectations and risk premiums since 2007, but in-line with 1990-2007 norms. While inflation is coming down, it’s still uncertain if it will be ≥3% like 1960-1990 or ≤3% like 1990-2020. The Fed has tools to achieve the latter and is sticking to that objective, but the real rate required to achieve low inflation is uncertain. The Fed will look to longer-term bond yields for guidance.

Treasury yields may be affected by fiscal conditions and thus overnight rates too

In addition to heightened uncertainty about the real interest rate required to achieve a 2.0% inflation target for the rest of this decade, against today’s US and global macroeconomic supply-side (productivity) and demand-side (change in savings) conditions, the US deficit and debt/GDP (gross domestic product) are well above 1990-2020 or peacetime norms. If the deficit as a % of GDP remains above the real GDP growth rate plus the 2% inflation target, thus causing debt to GDP to climb further or inflation to exceed target, then it’s likely that 10yr Treasury yields will climb to about 5% in 2024, absent a recession, in our opinion.

If 10yr Treasury yields climb to 5%, we think it very unlikely the Fed cuts below 4% in 2024 or 2025 outside a recession. The Fed won’t discipline fiscal policy, it takes whatever fiscal choices Congress makes. However, the longer-term bond market will discipline Congress. And if 10yr Treasury yields settle into higher new normal levels for fiscal or other reasons, then so does the neutral overnight rate, at probably roughly 100bp (basis point) lower, which is a fairly normal term premium. This is because the Fed evaluates whether its overnight rate is restrictive or accommodative in part by comparing it to market set longer-term yields.

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R^ or "R hat": An uncertain addition to R* that considers longer-term fiscal risks

We call the interaction between an uncertain R* and 10yr Treasury yields that are settling into a new normal mid-cycle range with consideration of longer-term fiscal risks R^. For Treasury bonds, longer-term fiscal risk is longer-term inflation risk. The US Treasury wouldn't rationally default, but the risks of emergency circumstances pressuring the Fed to monetize debt or raise its inflation target, or tolerate inflation above target, to accommodate fiscal policy from having to make politically unpalatable choices are risks around any inflation expectation and its accompanying expected R*. R^ is this fiscal uncertainty to R*.

Note: In statistics, a circumflex (ˆ), called a "hat", is used to denote an estimated value. In the context of errors and residuals, the "hat" over the letter indicates an observable estimate (the residuals) of unknown quantities or statistical errors.

What 10yr Treasury yield causes fiscal policy makers to correct course?

Saturday night, Congress passed a continuing resolution to fund the federal government for 45 days ending November 17th. While this averted a government shutdown, we think the ongoing battle to pass a full fiscal year budget will keep the bond market's attention on the fiscal challenges that lie ahead. We do not expect a budget with significant reductions to emerge over the next 45 days, however we think the negotiations will surface some of the difficult issues that are likely to become of greater policy, political and electorate importance as we enter a general election year. It might be that the bond market needs to demand the attention of these often disinterested groups with a 5% 10yr yield. At that rate, we think the high deficit and debt/GDP levels will become a key election year topic.

The S&P PE is very heavy at current Treasury yields: A fair PE is now under 20

In our intrinsic valuation models for the S&P 500 and its sectors, if we assume 1.6% 10yr Treasury Inflation-Protected Securities (TIPS) yield (now 2.25%) and a 400bp Equity risk premium (ERP), then the fair steady-state trailing S&P price-to-earnings (P/E) ratio is near 18, which supports a fair S&P value of near 4000 at 2023 end. We find a 5-10% premium to steady-state fair value for long-term economic profit growth to be reasonable for the S&P 500, but 10% or more is difficult to justify. If we raise our 10yr TIPS yield assumption to 2.0%, the fair steady-state PE drops to a bit under 17. Moreover, such higher real yields will likely weigh on economic profit growth potential.

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Glossary

Equity risk premium is an excess return earned by an investor when they invest in the stock markt over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

The term federal funds rate refers to the target interest rate range set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

R^ or “R hat”: An uncertain addition to R* that considers longer-term fiscal risks. We call the interaction between an uncertain R* and 10yr Treasury yields that are settling into a new normal mid-cycle range with consideration of longer-term fiscal risks R^.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The neutral federal funds rate (r* or R*) is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. It is the short-term real interest rate consistent with the economy maintaining full employment with associated price stability.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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