FED FOCUS

Treasury bond yields near peak as Fed hikes rates, recession fears grow

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By Brian Scheid
Market Intelligence

The growing likelihood of a recession has paused the monthslong selloff in U.S. government bonds. Whether that pause represents a peak in Treasury yields, though, will depend on the future path of inflation.

The benchmark U.S. Treasury 10-year bond yield rose 197 basis points from 1.52% to 3.49% from January 1 to June 14, surging as the Federal Reserve ended its pandemic-era monetary policy, hiking rates and stopping buying $120 billion in bonds every month. The two-year yield rose 272 basis points over that same period, from 0.73% to 3.45%.

Since the Federal Reserve hiked rates in mid-June, however, bond yields have retreated. The 10-year fell 36 basis points and the two-year fell 41 basis points from June 14 to June 24.

"There is a good chance that the peak in yields has been reached," said Kathy Jones, managing director and chief fixed-income strategist with the Schwab Center for Financial Research.

Inflation fears ease

Yields move inversely to prices, falling as the demand for Treasurys rises. When investor confidence falls, demand for relatively safe government bonds tends to rise, resulting in a decline in bond yields. Yields have fallen on expectations for slower growth and the rising risk of recession, Jones said. A dip in inflation expectations has also put pressure on yields, Jones said.

The University of Michigan reported June 24 that consumers expected inflation to rise at a 5.3% annualized rate as of the end of June, lower than its preliminary expectation released earlier this month of 5.4%.

At the same time, the rally in commodity prices appears to have moderated.

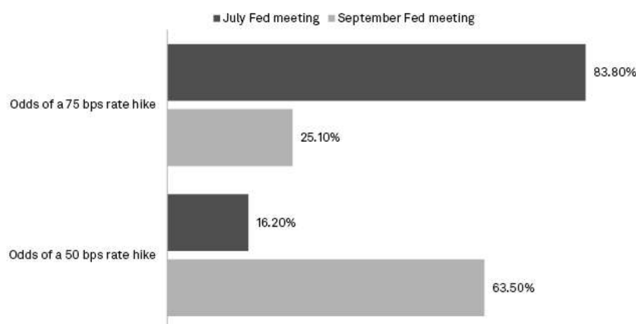
Since reaching its peak June 8, the S&P GSCI Index, a composite index of commodities, has fallen by 10.2%. Of the index's 24 constituents, 18 have lost ground in June, including natural gas, which has fallen nearly 23% so far this month, according to S&P Dow Jones Indices.

Market leads

The decline in Treasury yields indicates that the Fed's push to raise rates to combat inflation has begun to take effect.

As bond yields soared, the Fed raised its benchmark federal funds rate by 75 basis points on June 15, the largest hike since 1994, due to surging commodity prices and falling consumer sentiment. Bond yields, which surged in anticipation of the Fed's aggressive moves, are now reacting to the possibility that interest rate hikes will ease in the fall.

"The market has been leading the Fed this entire time," said Patrick Leary, a senior trader with Loop Capital Markets. "The bond market knew all along where we needed to be."



Most market watchers expect another big rate hike, with the odds of a 75-basis-point hike at the Fed's July meeting at nearly 84% as of June 24, according to the CME FedWatch Tool, which measures investor sentiment in the Fed funds futures market.

But odds of a rate hike that large drop substantially by September, when just 25% of the surveyed investors expect a raise of 75 basis points. The largest rate increases in decades have reduced the sense that the Fed is "behind the curve" in shifting policy in response to the state of the economy, said Antione Bouvet, a senior rates strategist with ING.

"This has brought inflation swaps down and made long-term Treasurys more attractive to investors," Bouvet said.

Whether bond yields will continue to moderate will largely depend on whether inflation worsens, forcing the Fed to raise rates even more aggressively, said Leary with Loop Capital Markets.

"So much hinges on inflationary pressures," Leary added.

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