Mizuho Brief: Steeper Curve & Risks

MIZUHO

Economics & Strategy | Asia ex-Japan

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Bracing for Steeper Curves & Loftier Term Premium

In a Nutshell: A **steeper UST yield** curve is **widely understood** (based on greater front-end sensitivity to policy rates) to be **a given** *as the Fed embarks on a rate cutting cycle*. ***But*** the **case for a steeper curve is even more compelling**. Partly because of the ***coincidence of US elections*** and the Fed rate cut cycle; given the experience of higher long-end yields in 2016 and 2020. But crucially, this is **due to structural geo-economic forces**. Notably, *structurally higher and more upwardly volatile inflation* as **geo-political tensions and "green-flation" conspire to overwhelm China's massive overcapacity** is one reason for steeper rates priced further out. What's more, ***significantly increased global bond issuances likely to be termed out*** amid ramped up *military spending and social spending pressures*. This, in a **splintering global order marked by rolling conflicts, displacement, diminished deterrence** and a **more isolationist US.** Most poignantly, *mounting discomfort with USD hegemony* and its *value retention over time,* but with no immediate alternative, suggests ***non-linear USD debasement risks*** (growing disproportionately with time) are ***priced as UST term premium***. This steeper curve will likely **rub-off on EM Asia yield curves** too. But price discovery ***may entail risk-re-pricing*** and bouts of capital flow volatility. ***Higher-yielding EM Asia FX may be relatively more compromised*** (vs. lower-yielding EM Asia FX).

"The lower you fall, the higher you fly." – **Fight Club**

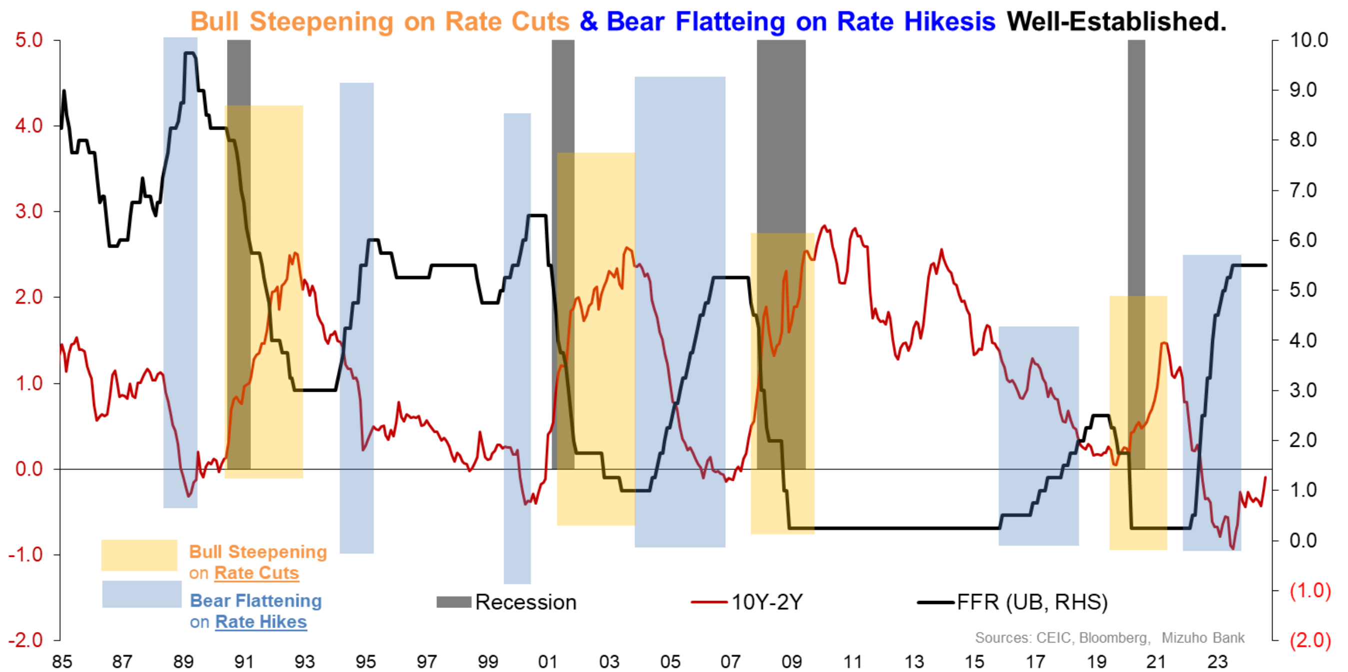
A Compelling Cyclical-Structural Proposition

- **Steeper yield curves** globally, associated with a **pronounced pick-up in term premium^**, is *not just reasonable conjecture,* but **a seriously compelling proposition**.
- Especially considering that the case for a steeper yield curve goes **beyond monetary policy and political cycles**, instead **conspiring with arguably more *durable geo-economic structural forces*** at work.

^ Strictly speaking, term premium is the **unobservable component of long-end yields over and above short-rate expectations**.
As such, it is not synonymous the steepness of the yield curve (approximated by 10Y-2Y spreads), but 10Y-2Y spreads provide a reasonable approximation, and more importantly, cues n direction of travel. As such, we have by and large represented the points using 10Y-2Y spread.

The Fed-Cycle & Reversion

- To be sure, the **low-hanging fruit for higher long-end yields** is **simply** a **reversion** (*from rate hike "inversion"*) **to an upward sloping curve, *coinciding with policy inflection to a rate cut cycle***.
- The dynamic is intuitive. A "bull steepening*" resulting from sharp Fed pivot to rate cuts may be reasonably assumed.
- Notably, this *reverses out the earlier "bear flattening**" from the preceding rate hike cycle*, which had ultimately "inverted" the yield curve.
- So, nothing controversial here. In fact, it (**re-steepening**) is the (**policy-driven**) **path of least resistance**.

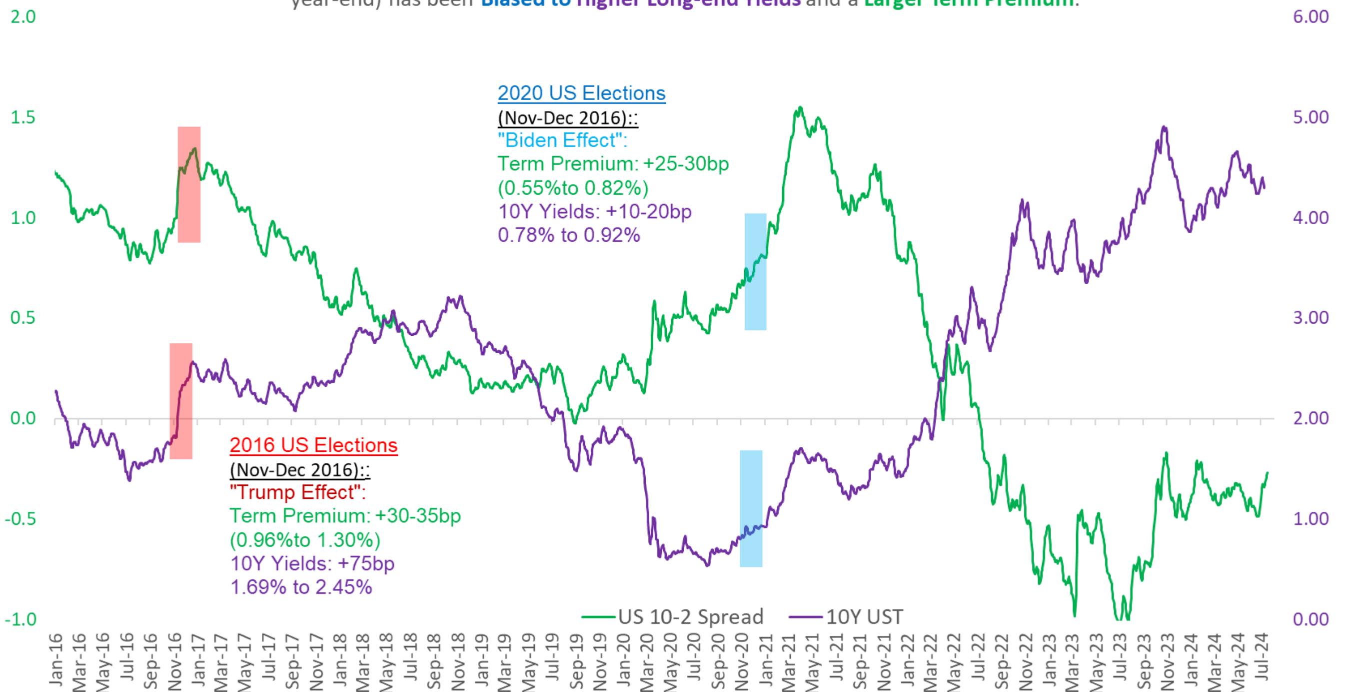


* Policy-sensitive front-end yields falling more sharply than long-end yields.
** Policy-sensitive front-end yields rise much faster than longer-end yields.

US Elections: A Blip Coinciding with Policy & Geo-economic Tailwinds

- In addition, **UST yield curve steepening as a by-product of US elections** is arguably a factor to consider, being **the lived, relatable recent experience**. Not just of "Trump 1.0" in 2016 as well as the Biden win in 2020.

Term Premium (2Y-10Y Spread): Details Vary, but the **Initial Election Response** (over ~2month from Nov to year-end) has been **Biased to Higher Long-end Yields** and a **Larger Term Premium**.



- Admittedly, the enduring **US elections effects on the yield curve may be overstated** *given coincident shift in monetary policy* (out of ZIRP), *geo-politics* and the *pandemic could conceivably have had far greater sway.*
- Nonetheless, **expectations tied to US elections** are not just **understandable given extrapolation of fiscal/geo-political/inflation risks**, but arguably (**at least temporarily**) self-fulling.

Enduring Geo-Economic Structural Forces

- But above all, a **significant** and **structural lift in term premium**, *accentuating the policy cycle buoyancy expected in longer-end yields* (in re-steepening), **a key macro risk** that is worth highlighting.
- Which is to say, is that this restoration of term premium is ***agnostic to Presidential election outcome*** [See Box 1 below].
- And instead has a **stronger structural element**.

i. Inflation Expectations – Up & Uncertain?

- First, **structurally higher inflation**, associated with *de-globalization threats that feature antagonistic US-China geo-politics**** colliding with *"green-flation"*.
- What this does, is that it introduces **greater *upside tendency*** alongside ***uncertainty*** to **inflation** (and attendant rate) **expectations** further out.
- The former is it is captured in *rising rate expectations* further out while the latter is subsumed as *increased term premium*. Either way, the **curve steepens**.

*** This entails an entire suite of cost-push layers associated with sanctions/tariffs, the higher-cost alternatives to circumvent barriers, strategic loss of economies of scale/comparative advantages from hedged manufacturing/production, "security stock-piling" and competitive technology acquisition costs.

ii. Geo-Political & Social Costs Termed Out

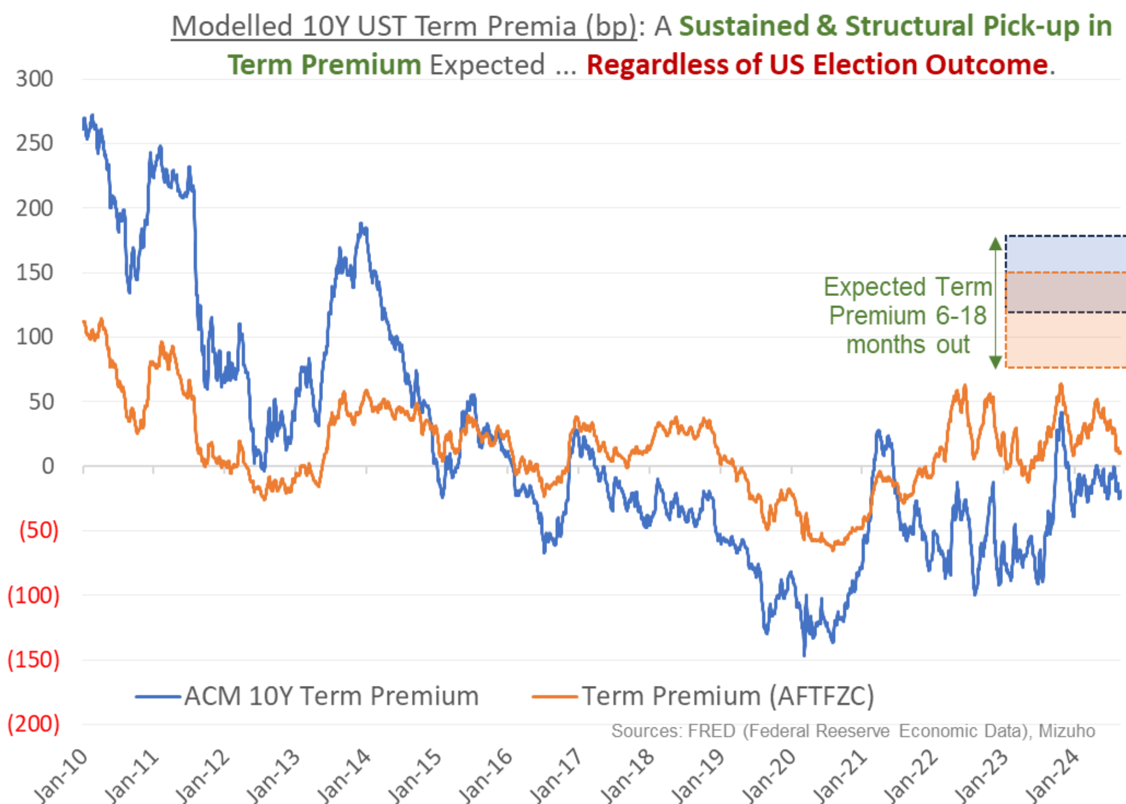
- Moreover, ***conflict/geo-political tensions raising longer-end bond supply globally***, *exacerbated by a more isolationist and less predictable US,* **feature in the term structure via higher volatility expectations**.
- Specifically, as ramped-up debt issuances globally given the need for; i) increased military spending as the deterrence effects of US-NATO diminishes, as well as; ii) greater social spending to tackle inequality/immigration issues.
- From which, **increasingly burdensome debt servicing**, exacerbated by elevated post-pandemic debt levels, **will incentivize terming our public debt**.
- Consequently, **resulting in a steepening of the yield curve**; *as ascending rate expectations, increased supply and greater fiscal uncertainty conspire.*

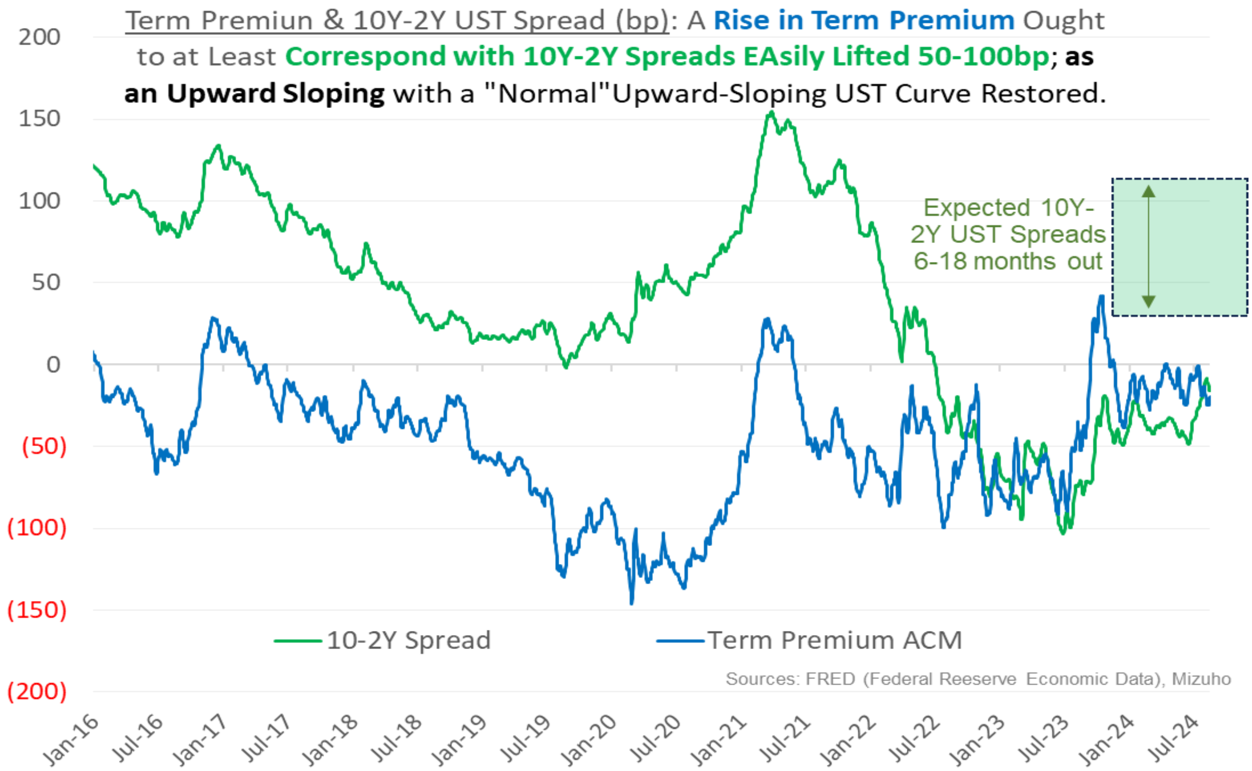
iii. Debt, Debasement & Dollar

- ***Most importantly*****, dramatically increased, but harder-to-time, USD debasement risks** *from burgeoning, debt,* will need to be expressed as **pronounced UST term premium.**
- Reason being, currency (USD) risks linked to USTs are, by definition, not expressed as credit/FX risk premium the means that.
- But is merely a quirk of convention owing to *peculiarities of reserve currency status* and *associated "risk-free" benchmark for rates/yields.*
- Whereas the growing "tipping point" **risks associated with the USD**, and *by extension UST value preservation,* will **demand disproportionately higher compensation for longer-dated bonds**.

Steeper Curve & Higher Term Premium

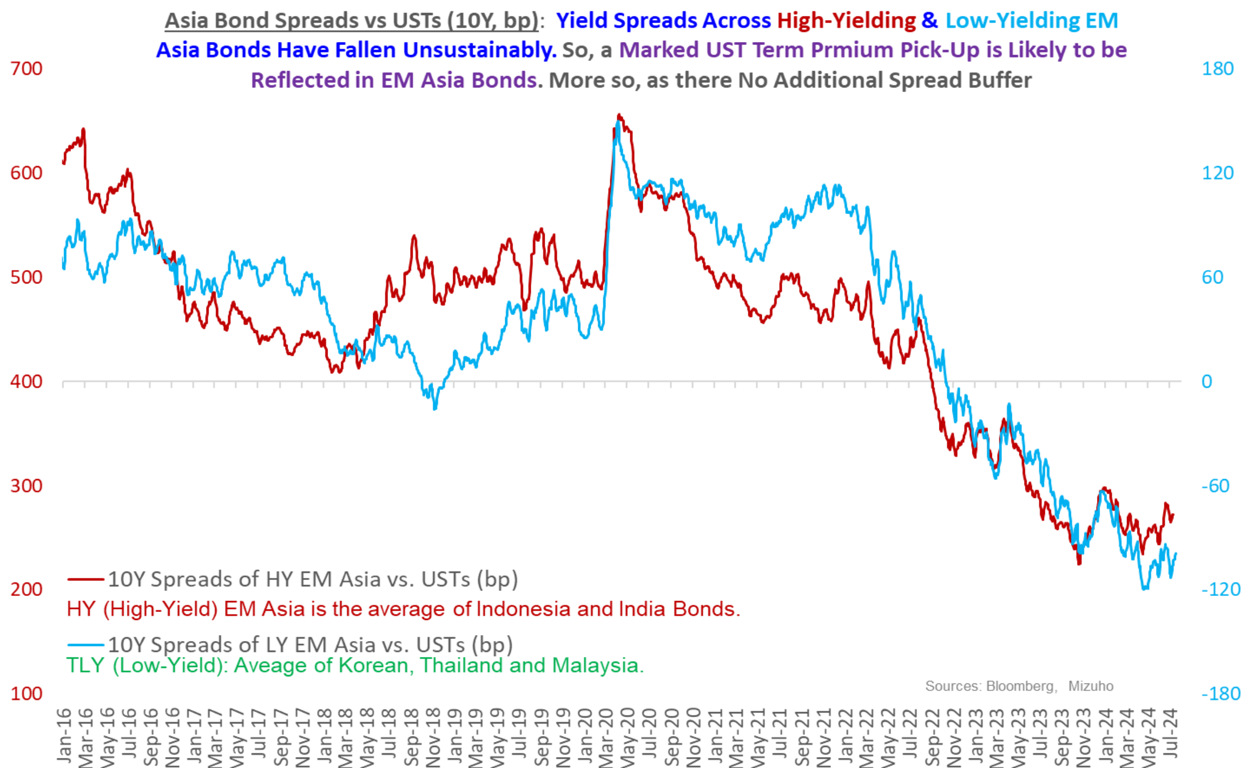
- Even with most of the "inversion" fading, it is still **not outlandish to expect term premium**, as *approximated by 10Y-2Y spreads,* to rise **by around 50-100bp** in coming months.
- And a broadly consistent lift in on alternate measures of modelled term premium as well (whether including or excluding convexity), with a similar rise between 50-100bp as well.
- Admittedly, model assumptions could vary actual outcomes dramatically. But that does not distract from **significantly steeper yield curves** with *greater premium outside of short rate expectations.*





Rubbing Off on EM Asia Curves Too

- Given that **EM Asia yields** have, , **piggy-backed long-end UST yields** through Fed cycles, **pronounced restoration of UST term premium is likely to rub off** on **to EM Asia curves** too.
- Moreover, **lower neutral rates already incorporated into EM Asia's monetary policy** (led by India, Indonesia and Philippines), could stifle depth of rate cuts vis-à-vis the Fed; thereby accentuating steepening bias in EM Asia too.

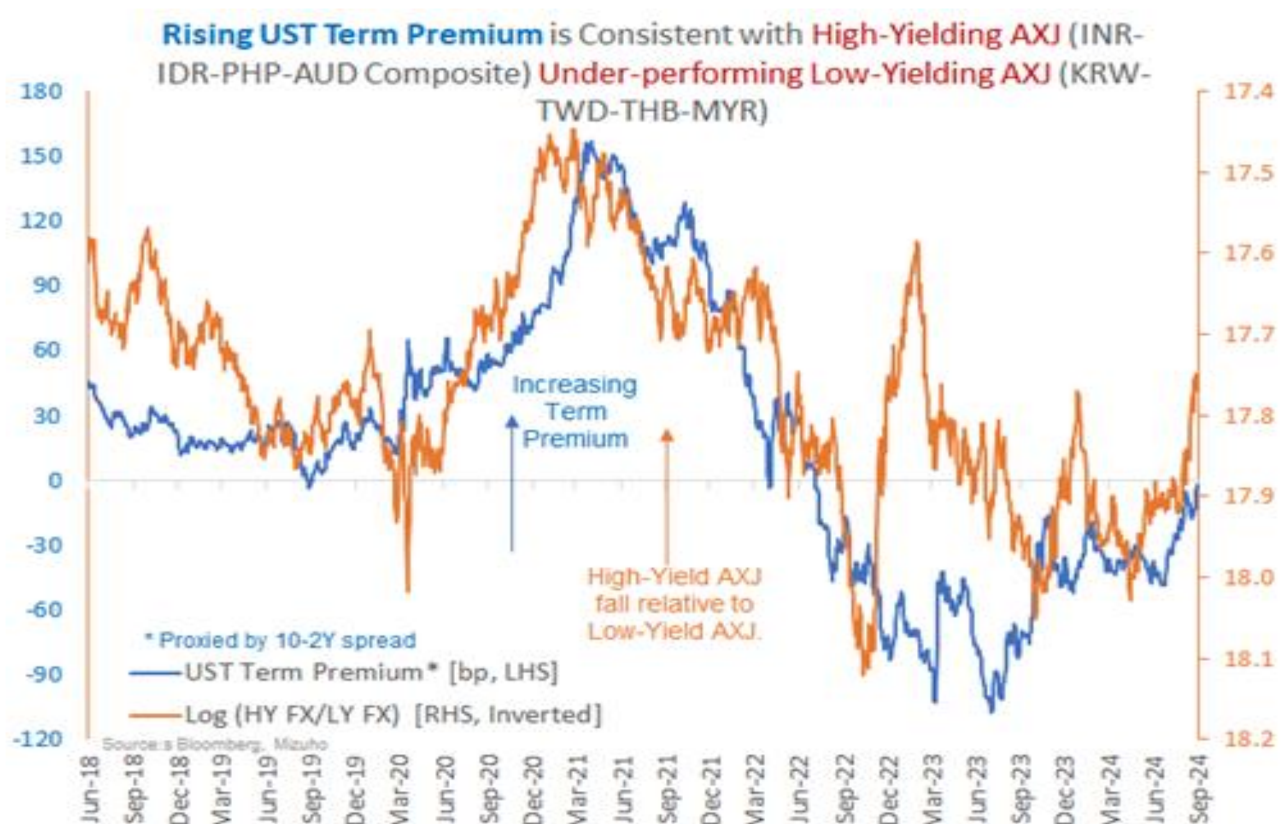


- Notably as more emphatic downside at the front-end has already **incorporated into the term structure**, leaving little room for further out-performance. Possibly even entailing some payback.

At the Cost of Risk Re-pricing in EM Asia …

- But the **path to a steeper UST yield curve will probably** be a **bumpy** one **for EM Asia** assets and FX too.
- Possibly even **entailing risk re-pricing** that involves spot of capital outflows.
- This is particularly in the context with a steeper UST yield curve typically diminishing the attractiveness of EM Asia yields.
- Especially given the starting point of substantially eroded EM Asia spread over USTs.

… That is Harsher on High-Yield AXJ



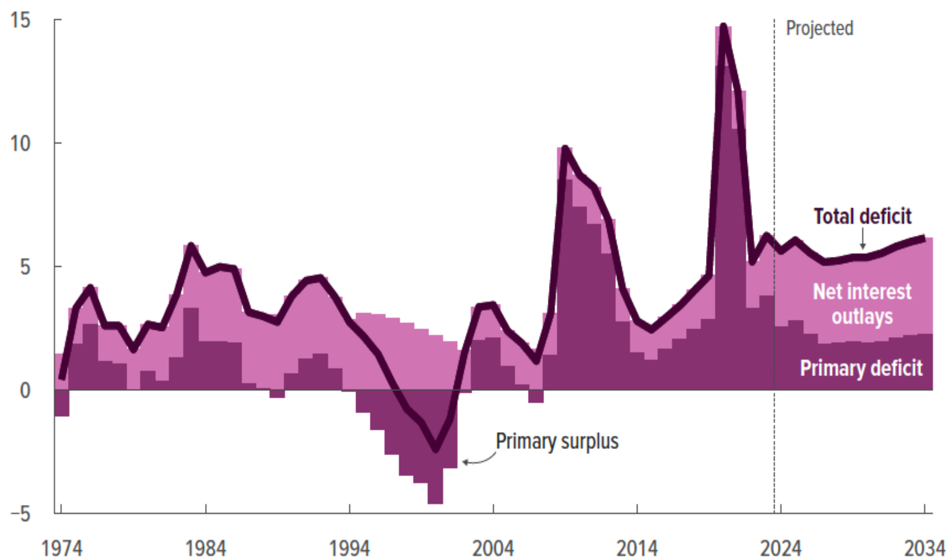
- Specifically, the **ability to swap credit risk (in EM Asia) for more pronounced comparative term premium pick-up in USTs**.
- In other words, *going out the "risk -free" curve rather than going down the credit curve.*
- Attendant pressure on EM Asia currencies is par for the course.
- And given the credit risk-to-term premium swap involved, higher-yielding EM Asia currencies are left at a relatively greater disadvantage (vis-à-vis lower-yielding EM Asia FX).

Box 1. Why Our Fiscal & Consequent Yield Curve Views are Agnostic to Politics

- Partly because of obscured political projections.
- Not only is it **difficult, but arguably misguided, to holistically pin down candidate-dependent fiscal policies *in a vacuum.***
- But mostly, because our base case, limited view is that **neither the Democrats nor the Republicans have the fiscal high ground**.
- Instead, it is merely the nature of their "fiscal sins" that differ (spending vs. tax cuts).
- Hence, defaulting largely rely on the CBO's estimates for fiscal deficit is a good start.
- And the **projections for fiscal deficit to be in the ballpark of 5.5-6..0% for the next decade** (2025 through 2035) are reasonable, albeit worrying.
- Crucially, **net interest payments (NIP) starting to become the dominant source of fiscal burden** (see the CBO Figure 1.1 below), necessarily limits fiscal options and **imposes harsher constraints**.
- Notably, NIP is set to make-up **60-65% of total deficit** in from 2025-2034 compared to **just over a quarter of total fiscal deficit** from **2010 to 2014** when fiscal deficit averaged a comparable 6.1%).
- This means two things, that underpin a worrying fiscal trajectory with increasing incentive to term out debt.
- First, **incremental, policy-driven variations in primary deficits (ex-NIP) will have diminished sway on total fiscal deficit** and the **attendant bond issuances required**.
- Second, the **incentive to term out debt issuances grows** as interest rate burden crowds out current budget spending requirements.

Figure 1-1.

Total Deficit, Net Interest Outlays, and Primary Deficit



In CBO's projections, the total budget deficit—the amount by which outlays exceed revenues—equals 6.1 percent of GDP in 2034. Net interest payments grow in relation to GDP, reaching 3.9 percent of GDP in 2034. Primary deficits increase in 2025, decline over the next few years, and then increase again.

Data source: Congressional Budget Office. See www.cbo.gov/publication/59710#data.

When October 1 (the first day of the fiscal year) falls on a weekend, certain payments that would have ordinarily been made on that day are instead made at the end of September and thus are shifted into the previous fiscal year. All projections presented here have been adjusted to exclude the effects of those timing shifts. Historical amounts have been adjusted as far back as the available data will allow.

Primary deficits or surpluses exclude net outlays for interest. When outlays exceed revenues, the result is a deficit. In this figure, deficits and surpluses were calculated by subtracting revenues from outlays; thus, positive values indicate deficits, and negative values indicate surpluses. When outlays are subtracted from revenues, as recorded in the federal budget and in the tables in this chapter, negative values indicate deficits, and positive values indicate surpluses.

GDP = gross domestic product.

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