Economics

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Far out man: Bond yields and distant forecasting

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Forecasting is difficult, especially about the future, and even more so when the future is more than five years away. But whether today's 10-year Treasury yields are fairly priced does entail coming to a view on what the latter half of this decade will look like, and its implications for the path of short-term rates. Or at a minimum, investors today need a view about what markets will be assuming about that future two or three years from now.

Many forecasts assume that the next few years will entail a path back to full employment and a zero output gap. In our case, owing to unprecedented fiscal stimulus, we have the economy actually overshooting that destination, before being contained by Fed rate hikes.

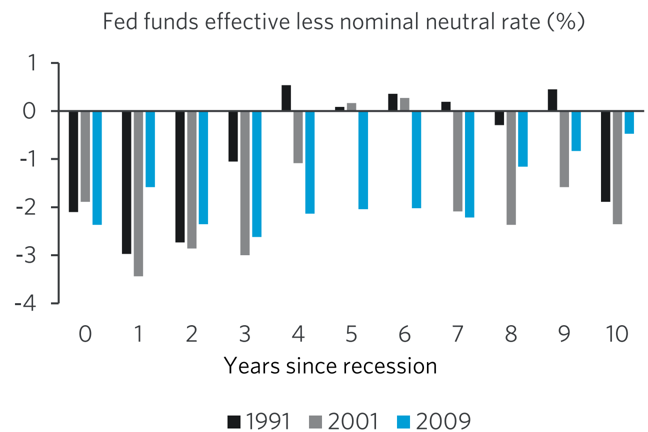
But what comes after that is really a black box. What can we learn from looking at the range of outcomes for the economy and interest rates that we would have been facing in the decade ahead, as we stood in year one of the past few economic recovery and expansion cycles?

Fed funds: Is there a typical path?

The conventional wisdom is to imagine that the fed funds rate hits bottom during a recession, converges to the neutral rate, and then hovers there. But that "textbook" case isn't really that common. Benchmarking where rates were in years one, two, three and so on after a recession year shows a much more diverse set of outcomes, even when we track rates relative to where the nominal neutral rate was at the time (Chart 1 & 2).

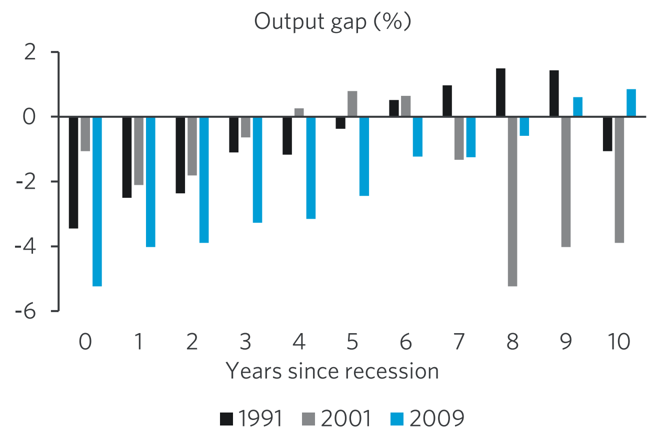
The oddest path was the one carved out in the 1980s. That special case came from the fact that inflation was tumbling, as were neutral rates, and we entered the expansion with rates well above neutral while both the central bank and markets took time to figure out where the new norm would lie. So we'll leave that cycle out of the analysis.

Chart 1: Hiking cycles aren't uniform



Source: Bloomberg, Laubach-Williams, CIBC

Chart 2: Output gaps don't follow pre-ordained paths after a recession



Source: CBO

Much of the remaining variation across cycles lines up with how well other forces, including fiscal policy and the global economy, were combining to steer the economy towards the goal of a zero output gap, or pushing it away from that desired steady state. Some cycles, like the one after the 2008 recession, saw growth sputter for a long while before gaining momentum, others didn't last the life of a 10-year bond by being cut short by a renewed recession.

At least in their first half decade, two cycles, those starting in 1991 and 2001, came closest to matching the "textbook", with a fairly steady reduction in the output gap and then at least a bit of time in which the economy avoided falling sharply backward. In those cycles, the fed funds rate generally transitioned from stimulative to where the neutral rate was at the time. At least for the next few years, if no new negative shock emerges, markets might act "as if" something akin to those cycles will be the case in the remainder of this decade.

Treasuries: Diversity, but still a theme if you look for It

For various reasons, looking out to 10-year rates, Treasury yields show even more variety in terms of their paths in the years following a recession. As in the case of the funds rate, bond yields also capture the degree to which various headwinds buffeted the economy and stalled progress, generating a renewed downturn. Further back, it took several cycles for the inflation premium that had been built up after the inflation of the 1970s to melt away, as investors became increasingly confident that the CPI pace would stay grounded

But if we zero in on more recent cycles, in which memories of inflations past were distant enough to not matter much, there is a common thread. While the path to get there is varied, by years 4-5, 10-year rates typically sit near the neutral fed funds rate (Chart 3).

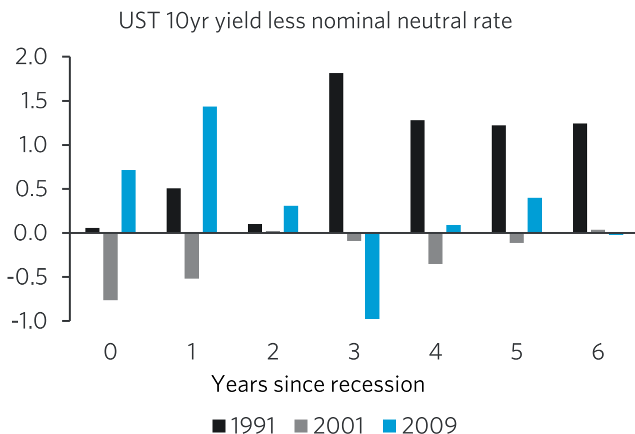
Could this time be different? Of course. We are talking, after all, about an outlook for 2025-2026. But at least for the first few years, our macro forecast, which has the US economy surging through a zero output gap on the back of pent up consumer demand and the lagged impacts of fiscal stimulus, leans if anything towards an earlier normalization in bond yields. That quick relief from a negative output gap will put this cycle well ahead of the gradualist pace we saw in earlier decades (Chart 4).

In today's context, taking 10-year Treasuries back to the neutral rate over the next few years would put them somewhere in the vicinity of 2½%, or about 100 bps higher than where they now stand.

There are forces that could push the neutral rate higher, including a lower savings rate as households draw down savings built up during the pandemic, or green industry and government infrastructure capital spending. Anything that either reduces savings or increases capital spending at a given rate of interest will tend to lift the neutral rate.

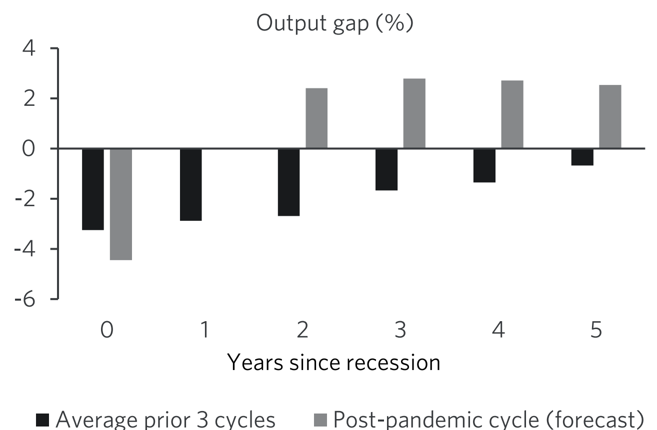
But against that, we have slower demographics globally, and therefore slower trend GDP growth, which serves to reduce the need for capital spending aimed at capacity additions. For now, we'll stick with a mid-2% range for both the neutral rate, and an eventual if multi-year destination for 10-year Treasuries.

Chart 3: 10-year yields tend to sit near estimates of neutral fed funds rate 4 or 5 years after a recession



Source: Bloomberg, Laubach Williams, CIBC

Chart 4: Bond yields could rise sooner this cycle, with economy expected to heal faster



Source: CBO, CIBC

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