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Interest rate volatility: Transitory or here to stay?

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Following the start of the US Federal Reserve's belated rate hiking cycle in March 2020, this year has seen a marked pickup in interest rate volatility and a significant increase in the benchmark 10-year yield in recent months, which have contributed to broader economic uncertainty. So, what exactly has been driving this volatility and is this trend going to reverse anytime soon?

Many factors are responsible, some of which are more transitory in nature, but many reflect uncertainty about more structural issues. One factor has been the resilience of the US economy during the third quarter, which has led investors to believe the Fed will maintain rates higher for longer, thereby shifting short-term rates expectations and long-term rates higher.

Another has been the surge in long-dated bond issuance by the US Treasury last quarter which generated a spike in supply, further exacerbated by the fact that the two largest buyers of US Treasuries have simply stopped buying. China and the Fed, in recent decades amassed trillions of dollars in Treasuries, issued to finance the deficits that emerged following the 2008 Global Financial Crisis and the COVID-19 pandemic. China started buying US Treasuries twenty years ago as the economy was booming, to keep a lid on its strengthening currency and ensure competitive exports. Today as the currency weakens, China is no longer buying Treasuries and may even look to sell some of its large supply. In the US, with the Fed's quantitative tightening program (reduction of its balance sheet), the bond market has essentially lost a significant technical support. Indeed, the Fed was a price-insensitive bond buyer. The flipside of losing these price-insensitive bond buyers is that they have been replaced by price-sensitive buyers, such as hedge funds, which has contributed to heightened market volatility.

With long-term rates soaring to the levels they have (10y treasury yields breached 5% last month), Central Bank rhetoric has turned more dovish, with various Fed speakers stating that the resulting tightening in financial conditions could be doing some of the work normally attributed to monetary policy tightening.

That helped Treasuries to rally, before their progress was abruptly halted by an underwhelming 30-year bond auction last week, prompting a 15bps rise in long-term borrowing costs on the day. Taken together, these outsized moves in bond yields show just how difficult it is to position oneself in this market currently.

Looking forward, there remains significant uncertainty concerning key inputs influencing long-term rates. For one, nominal GDP growth, which accounts for real GDP growth plus inflation, has experienced substantial volatility lately. There are mixed views on whether real potential GDP will remain muted or whether the burgeoning AI-driven revolution will boost productivity growth, and in turn GDP growth, over the coming years.

Another highly uncertain element is whether inflation will return below target and if so, will it remain there in a sustained fashion. How will climate change and deglobalisation influence this trend? Will inflation need to be engineered higher in order to combat the crippling refinancing costs following the surge in public debt and the sustained large-scale deficit spending implemented during the historically low interest rate era.

Something must give between the uncertain growth/inflation picture; the debt shock that will need to be addressed by Central Banks; and the increasing term premia demanded by investors to compensate for future interest rate and geopolitical shocks. It is of prime importance therefore to carefully watch and assess all of the factors affecting growth, inflation, and fiscal sustainability in coming years. Given the difficulties in identifying structural shifts in each, one would need a crystal ball to ascertain the macroeconomic landscape of the next couple of years. However, one can say with a degree of certainty that we're not out of the rates volatility woods yet.

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