

US Rates Strategy

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A hawkish Fed and higher 10y yields

Ten-year yields have risen since Chair Warsh's first FOMC press conference. Term structure models suggest that much of the increase reflects the hawkish tilt in the Fed's reaction function. While higher term premia have also added to 10y yields, it is harder to pin down the cause.

- **Since the start of the Iran conflict at the end of February, 10y yields have risen 125bp.** Most of the increase (70bp) has occurred since Chair Warsh's first FOMC meeting on June 17.
- Term yields can be decomposed into the average expected short-rate and a risk premium that compensates the investor for locking in a term rate rather than continuously rolling overnight rates.
- **The average expected short-rate embedded in 10y yields has increased between 80-95bp since the end of February, or about 70% of the increase in 10y yields.** Expected short rates account for about 60% of the increase in 10y since Warsh's first FOMC meeting.
- While Warsh has studiously avoided providing forward guidance, his remarks reveal a distinct tightening bias and impatience with above-target inflation. Our [LLM analysis](#) suggests that the relative hawkishness among FOMC members has increased since last year.
- **The term premium embedded in 10y yields has risen 35bp since February.** Most of this has occurred since the June FOMC meeting. **The inflation risk component accounts for about 5bp of the increase in 10y yields since June.**
- **Because the term premium is a residual it is difficult to determine why it has risen since June (and declined this month).**
- Our sense is that fiscal policy uncertainty after the mid-term election may push the term premium higher. But the Fed's efforts to restore price stability will bring down the average expected short rate, reversing much of this summer's increase in 10y yields.

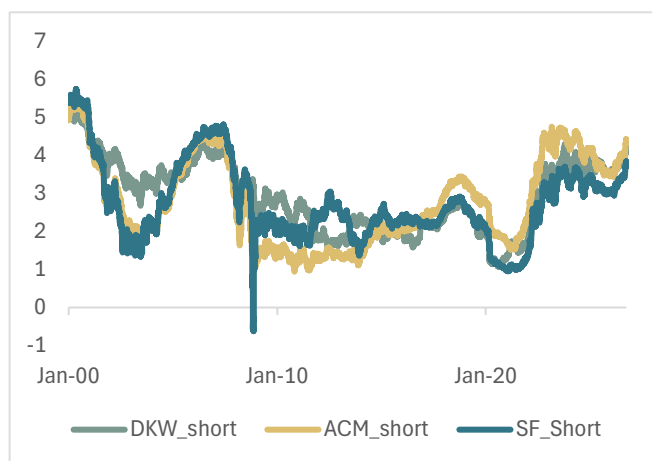
Deconstructing yields

Ten-year yields are the sum of the expected path of short-term interest rates and a term (risk) premium. The risk premium compensates investors for "locking in" a term rate and waiting for a single payment 10y hence compared against rolling the same investment every day at the overnight rate for 10y. As regular bonds pay interest every 6m, it makes sense to construct measures of term premia using zero coupon bonds.

Most term structure models use a small number of factors (generally 3, but sometimes 4 or 5) to compare excess returns against zero coupon yields.¹ They differ in how they estimate the expected average short-rate and whether they include additional information from TIPs prices. Models like ACM are “yield only”; the expected short-rate path is derived from yields across the maturity curve. Others, like KW and variants, incorporate survey measures of the expected Fed policy path based on surveys such as the Blue Chip and the Survey of Professional Forecasters.² The DKW model builds on the KW framework but it adds in yields on TIPs to break out changes in real yields and inflation expectations.³ This allows the term structure model to include an estimate of inflation risk compensation. The Federal Reserve Bank of San Francisco also produces a three-factor term structure model that is conceptually similar to ACM.⁴

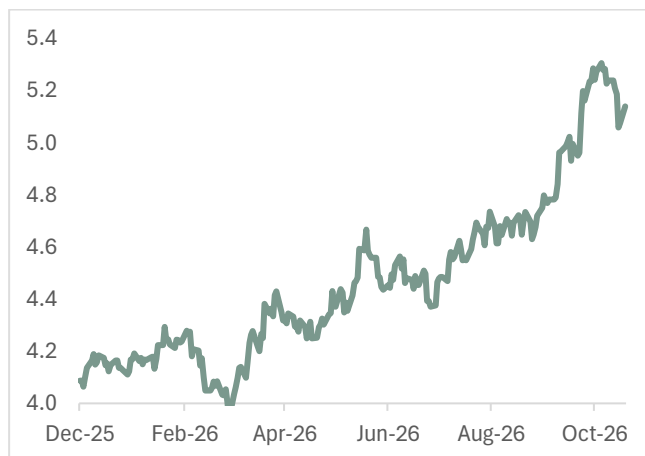
Over long periods all the models have similar expected average short-term rate expectations with an average correlation of about 80% (Figure 2). All three measures increased when the Fed began raising interest rates in 2022 and each has risen to pre-GFC levels. But while they are directionally similar, the average expected short rate as of September 30 is different across each measure; 3.70-4.36%. As the term premium is a residual, this means that the level varies with the model used. **We think it makes more sense to look at decompositions of the change in yields.**

Figure 1: Expected short-term rate path (%)



Source: Federal Reserve Board, Federal Reserve Banks of New York and San Francisco, SMBC Nikko

Figure 2: 10y yield (%)



Source: Bloomberg, SMBC Nikko

¹ See, for example, “Pricing the Term Structure with Linear Regressions”, T. Adrian, R. Crump, and E. Moench, Journal of Financial Economics, October 2013

² See, “An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behavior of Long-Term Yields and Distant-Horizon Forward Rates”, D. Kim and J. Wright, Federal Reserve Board, 2005.

³ See “Tips from TIPs: The Informational Content of Treasury Inflation-Protected Security Prices”, S. D’Amico, D. Kim, and M. Wei, Journal of Financial and Quantitative Analysis, 2018

⁴ See “The Affine Arbitrage-Free Class of Nelson-Siegel Term Structure Models”, J. Christensen, F. Diebold, G. Rudebusch, Journal of Econometrics, 2011.

Hawkish tone

We use the term structure models to decompose the recent change in the 10y yield into its component parts: the average expected short-rate and the term premium. Between the start of the Iran conflict in early March and the end of September, 10y yields have risen 125bp (Figure 2). But about 60% (or 72bp) of the increase in 10y yields has occurred since mid-June and Fed Chair Warsh's first FOMC appearance. In October, 10y yields have fallen.

The term structure models suggest that market expectations for Fed policy have risen since the start of the Iran conflict. Indeed, since the end of February, the average expected short-rate embedded in 10y yields has increased between 80-95bp. **That is, most (~70%) of the increase in 10y yields since the start of the Iran conflict reflects the market's reassessment of the Fed's short-term rate path.** Next, we examined the increase in 10y yields since Warsh's first FOMC press conference (June 17). Ten-year yields increased 70bp between June 17-September 30. Changes in the expected short-rate path account for 60% of the increase. The balance (of around 30bp) reflects higher term premia.

It is not difficult to identify the source of the increase in short rate expectations. At his June FOMC press conference, Fed Chair Warsh noted that "inflation was a choice" and in the statement, the FOMC noted that it "will deliver price stability". His subsequent appearances have been just as hawkish. And while he has studiously avoided providing forward guidance, his remarks reveal a distinct tightening bias and impatience with above-target inflation. Our [LLM analysis](#) suggests that the relative hawkishness among FOMC members has increased since last year. Even the commentary from some notable doves last year has scored more hawkishly this summer. The FOMC's dot plot moved higher in September despite minor revisions to their growth and inflation forecasts in the Survey of Economic Projections. **Our sense is that much of the increase in average expected short-rates reflects the market's repricing of the Fed's reaction function this summer.**

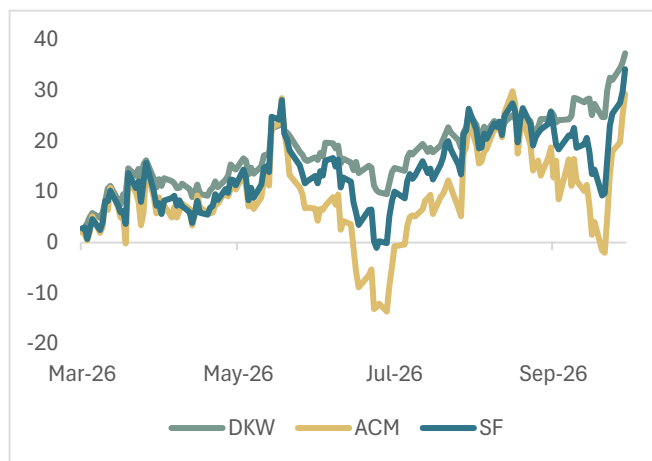
The remainder of the increase in 10y yields since February has been driven by a higher term premium. **The term premium embedded in 10y yields has risen 35bp since February** (Figure 3). But most of the increase (85% or 30bp) has occurred since the June FOMC meeting. Using the DKW framework we separated the increase in the term premium into a nominal short rate component and an inflation risk component. **The inflation risk component accounts for about 8bp of the increase in 10y yields since February** although most of this (5bp) has occurred since mid-June (Figure 4).

Dissecting term premia

Because the term premium is a residual it is difficult to determine why it has risen since June (and declined this month). This also makes it difficult to uncover effects that may be overwhelmed by offsetting influences.

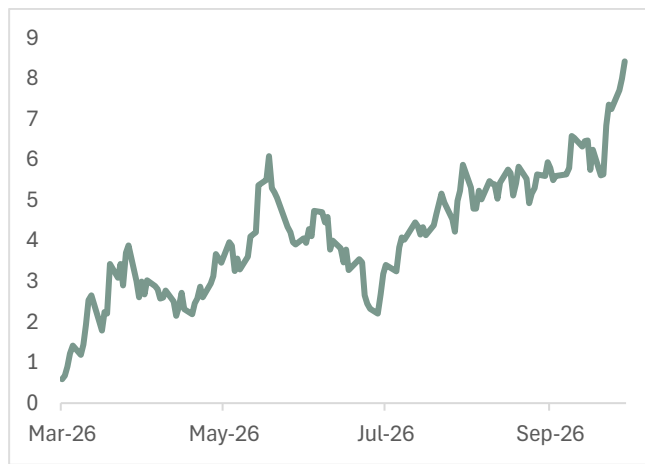
In theory, the real term premium is sensitive to anything that increases uncertainty about fiscal policy as well as factors that change the supply of duration. Not surprisingly, the Treasury's buyback announcement on August 19, caused term premium measures to fall 3-10bp. The effect was short-lived despite expectations that the increase signaled more aggressive term yield management. Ahead of next month's refunding these expectations may be building and could account for the recent decline in the term premium. But while the Treasury may increase the size of its liquidity buybacks, we think it is less likely they will reduce the auction sizes of 10s and longer maturity securities at the November refunding. We do not expect the Treasury to eliminate the 20y coupon.

Figure 3: 10y term premium (%)



Note: Cumulative change since February 27. Source: Federal Reserve Board, Federal Reserve Banks of New York and San Francisco, SMBC Nikko

Figure 4: Inflation risk premium (%)



Note: Cumulative change since February 27. Source: Federal Reserve Bank of San Francisco, SMBC Nikko

It is possible that the buyback announcement effect was overwhelmed by duration supply from *outside* the Treasury market. Heavy corporate issuance may be crowding out Treasuries and pushing term premia higher. That said, this issuance has been robust all year, so why the effect on Treasury yields would show up since June is somewhat of a mystery.

Our sense is that the 10y term premium could increase after the mid-term elections as a turnover in Congress increases policy uncertainty. The size of this effect may depend on the extent of any “blue sweep”. This could increase the likelihood that Republicans “refocus” on affordability issues that in turn make them more amenable to Democratic proposals to increase government spending.

That said, longer-term factors argue for a higher term premium. As the debt/GDP ratio continues to increase, we expect term premium to rise. Plante et al. note that standard models estimate each 1% increase in the ratio increases 10y by about 3bp.⁵ Roughly 80% of the increase comes from the higher term premia the market demands to absorb this additional supply. We also think the [shift in Treasury demand](#) from buy-and-hold investors to hedge funds that require financing has increased interest rate volatility. This suggests that term premia across the curve should be higher.

⁵ This is similar to other estimates. See “Revisiting the Interest Rate Effects of Federal Debt”, M. Plante, A. Richter, and S. Zubairy, Federal Reserve Bank of Dallas, July 2025

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