Opening remarks for "Treasury yields: Exploring the impact on markets"

Official Monetary and Financial Institutions Forum Roundtable

Good afternoon. Thank you, Mark, for the introduction. Before we jump in, let me just say that the views I'll be sharing today are my own and do not reflect those of the Federal Reserve Bank of Boston or the Federal Reserve System.

To start, I'd like to set the stage for our discussion today with some perspectives on the recent behavior of Treasury yields and what might be driving this behavior. This first chart on slide one shows movements in 10 year yields for a few advanced economies over about the past year through the first week of November. As you can see, yields in the US, UK, and the euro area have all risen about 1 percentage point this year with Japanese yields up by a little bit less. One of the reasons that the rise in US yields might be particularly salient now is that unlike some of these other countries that have seen more gradual increases in yields, the rise in the US was almost all concentrated in the latter part of this year. Though yields have come back down by a fair amount over the past few weeks, they increased by just over a full percentage point between July and the end of October, interestingly, a period over which the policy rate has been on hold.

Market participants and market watchers have given a wide variety of potential explanations for this run-up in yields. Slide 2 shows responses from the most recent October NY Fed Surveys of Primary Dealers and Market Participants. Respondents were asked to assess the importance of various factors in explaining the increase since July in the 5-year, 5-year forward nominal Treasury yield. The answers were really all over the place with a number of explanations like interest rate risk, the fiscal outlook, and perceptions of potential growth, which could be related to the concept of the long-run neutral policy rate (or r*), all roughly receiving the same weight. Other market intelligence collected by the NY Fed also reflected a belief that there was not a single factor that was most obviously driving yield movements.

For the rest of the talk today, I'd like to focus on this idea that beliefs about potential growth are a main driver. We can see some support for this idea from the paths of output, shown on slide 3, again for the same set of countries. What we see here is that output growth in the US since the pandemic has been far more resilient when compared to other advanced economies. Much of this is due to the truly unprecedented amount of fiscal stimulus, particularly direct support to households, that we saw during the pandemic. Indeed, the differences are even larger if we look at personal consumption. A lot of this gap in growth experiences really opened up over this past year and again, moreso during the summer and fall, corresponding to the time when US yields really took off. The fact that the economy remained resilient even after the large and very steep increase that we've seen in policy rates since March 2022 really made people, and here I don't just mean policymakers, start wondering whether the neutral rate, or r*, which has been trending down for a long period of time, might indeed now be higher than we thought.

Against this backdrop of a possibility of a higher r* combined with policymakers increasingly stressing the data dependent nature of policy, markets have become more attuned to incoming data. Slide 4 shows some early evidence of this. Each of the charts here plot one-day changes in 2- and 10-year yields as well as an estimate of the 10-year term premium against indices of labor market and inflation data release surprises. The lighter dots and fitted line reflect the relationships prior to July while the darker dots show the observations since July. In all of these cases, we see larger market reactions to US macroeconomic data releases in the past few months compared to historical experience. This increased sensitivity might then be a factor in both the overall change in the level of yields and the volatility that we've seen in recent weeks. One reason that I think recognizing the role of data releases is important is that this is ultimately tied to the key question of whether the increase in yields is reflecting some exogenous tightening of credit conditions, for example a repricing of risks, which may be more of a substitute for tightening by the Fed, or whether it's endogenous to the economy and to the Fed's actions and communications.

The final slide that I'll be showing today lays out some of these arguments. Here, I'm again focusing on the increase in yields from July through the end of October. Over this period, as I'm sure you are all familiar with, much of the increase has been chalked up to rising term premiums. In fact, the estimate from the D'Amico, Kim, and Wei decomposition shown in the chart on the left is one of the most conservative in this assessment, attributing just over half of the yield increase to term premiums. At first glance, it might be tempting to think that this rise in term premiums is something that may stick around even if there's a change in the policy stance. However, there's some suggestive evidence that this isn't the case. The right chart presents one very simple way of seeing this by decomposing the rise in term premiums into those that occurred on days of data releases, and here I've importantly also added a bar for Fed events including the policy announcements, minutes releases, and speeches made by Chair Powell. What we see here is that a large fraction of the increase in term premiums happened on days of either data releases or Fed events. I'll add that we can draw the same qualitative conclusions if we look at other term premium estimates or if we also include the recent pullback in yields over the past month.

Of course, this analysis is extremely simplified and still quite preliminary but it is one way of trying to shed some light on the questions of the degree to which recent movements in yields are influenced by Fed policy and the economy versus being a substitute for Fed policy and whether we can expect recent moves to persist. Looking ahead, there are other important questions as well such as the impact that fluctuations in yields will have on the macroeconomy and I'm looking forward to continuing our conversation.