CIO continues to expect a softer labor market, slower growth, and lower overall inflation will give the Fed confidence to start trimming rates by mid-year, for a total of 75 basis points. (UBS)

US Treasury yields rise on still-strong price pressures

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The 10-year US Treasury yield climbed to near its year-to-date high on Thursday after the latest economic data showed the path to lower rates remains bumpy.

The producer price index (PPI) for February rose by a stronger-than-expected 0.6% month-over-month, while initial jobless claims for last week (ending 9 March) slipped from the week before. This came after a second straight month of hotter-than-expected consumer price index (CPI) data earlier this week.

This combination caused markets to scale back expectations of the timing and extent of rate cuts from the Federal Reserve this year. Futures markets are now pricing just 76 basis points of easing for 2024, the least amount so far this year and down from close to 160 basis points at the start of the year. Investors have also become less convinced that the Fed will start easing at the June meeting—also a turnaround from the start of 2024 when markets were fully pricing a rate reduction in March. The 10-year Treasury jumped 10 basis points as a result, the largest daily move in the past month, to just below 4.3%.

The latest set of US releases adds to a string of mixed economic indicators that have contributed to the recent interest rate volatility. But our base case remain for a soft landing with falling inflation, and we expect yields to fall this year with rate cuts on the way.

Inflation should return to a downward trend in the coming months. The February PPI release showed wholesale price inflation for energy, food, and air travel accelerated from a month ago, but price growth for services, including financial services and healthcare, slowed compared to January. Similarly, the latest CPI showed big gains in gasoline and used car prices, but price rises in owners' equivalent rent cooled, with core inflation declining to levels last seen in 2021.

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We think the Federal Reserve will tolerate a couple of months of disappointing inflation data, as we don't expect the US central bank to move until June. We believe inflation should recede in the coming months on a more balanced labor market and slowing economic growth.

The labor market is less overheated. Fewer jobless claims showed resilience in the jobs market, but there have also been signs of cooling. The February labor report released last week pointed to a moderation in average hourly earnings growth, while the unemployment rate rose to the highest level since January 2022. The January Job Openings and Labor Turnover Survey (JOLTS) also showed that the quits rate remains at the lowest level since August 2020, while businesses reported better labor availability in the Fed's Beige Book.

The economy is cooling. US retail sales increased 0.6% year-over-year in February, a smaller rebound than markets had been expecting, suggesting a moderation in consumer spending. It also triggered a downward revision in the GDPNow reading from the Atlanta Fed, a running estimate of growth based on the latest data. The annualized economic expansion now stands at 2.3% in the first quarter, down from an estimate of 2.5% last week. Overall, we expect the US economy to grow around the trend rate of 2% this year as restrictive monetary policy continues to feed through the economy.

So, we continue to expect a softer labor market, slower growth, and lower overall inflation will give the Fed confidence to start trimming rates by mid-year, for a total of 75 basis points. This should contribute to a rally in 10 year Treasuries, with the 10-year yield forecast to fall to 3.5% by the end of the year. We are most preferred on quality bonds. We especially like the five-year duration point, and we think investors should also consider exposure to actively managed fixed income strategies to improve diversification.

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