As markets start to price a more significant Fed rate-cutting cycle, bond yields should fall in the months ahead. (UBS)

Bond yields are likely to end the year lower

29 May 2024, 1:56 pm CEST, written by UBS Editorial Team

US Treasury yields rose to four-week highs on Tuesday after auctions of the 2-year and 5-year notes brought in USD 139bn of fresh supply. The yield on the 10-year US Treasury rose 7 basis points to 4.54%, and that on the 2-year bond was up 3 basis points to 4.98%. Comments from Minneapolis Fed President Neel Kashkari that further rate hikes are not yet ruled out also put pressure on the bond market.

CIO continues to believe that US sovereign yields should end the year lower as inflation and economic growth slow and the Fed cuts rates in the last months of the year. We expect the yield on the 10-year US Treasury to fall toward 3.85% as the year progresses, underpinning our most preferred view on fixed income.

US inflation should trend lower. US house prices edged up 0.1% month over month in March, a significant slowdown from the 1.2% rise in February, according to the latest data from the Federal Housing Finance Agency. On an annual basis, prices increased 6.7% in March after advancing 7.1% in February. We believe the softening housing market and the slowing price trend in new rental leases suggest that shelter inflation should continue to decelerate in the months ahead. While consumers' 12-month inflation expectations ticked up in the latest Consumer Confidence survey from the Conference Board, hard data continues to suggest that inflation should trend lower for the rest of this year following April's encouraging print.

The Fed remains on track for policy easing later this year. While Kashkari suggested rate cuts are not imminent, he also noted that the odds of the Fed raising rates "are quite low." This is in line with recent Fed communications on its patient approach, and echoed Chair Jerome Powell's view that the central bank's next move is unlikely to be a hike. With a softening labor market and slowing economic growth, we continue to expect the Fed to start policy easing in September, with a total of 50 basis points of rate cuts this year.

The pace of the Fed's balance sheet runoff is set to taper. Starting next month, the Fed will slow the pace of its quantitative tightening (QT) with a new monthly cap of USD 25bn on the sale of US Treasury securities, down from USD 60bn. We believe this should reduce upward pressure on real rates and drive the next leg lower in yields.

So, as markets start to price a more significant Fed rate-cutting cycle, bond yields should fall in the months ahead. We favor quality bonds within the fixed income space, and see value in complementing a core holding in quality bonds with a satellite in riskier credits to improve overall portfolio yields.

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Original report - **Bond yields are likely to end the year lower, 29 May 2024.**