Twitter Thread by Eric Basmajian

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It is difficult to change a 10-year trend.

Long-term expectations do not change as frequently as daily market fluctuations would make it seem.

A quick update on Treasury rates through the lens of the DKW model

As of Dec. 31

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In previous threads, I made the distinction between long-term secular trends in growth and inflation and shorter-term (2-6 quarters) trends in nGDP growth

https://t.co/0jBvHOWuHw

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> Consensus continues to conflate the inflation story, mixing and matching long-term and short-term charts to fit what is generally a secular inflation narrative.
>
> Here are my two cents to make the distinction clear.
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> 1)
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> — Eric Basmajian (@EPBResearch) January 4, 2021

Right now, the long-term trends are unaltered because long-term trends just don't change that fast but we have a very strong cyclical upturn in the economy, centered primarily on the shift to goods consumption bolstering the manufacturing sector and industrial commodities.

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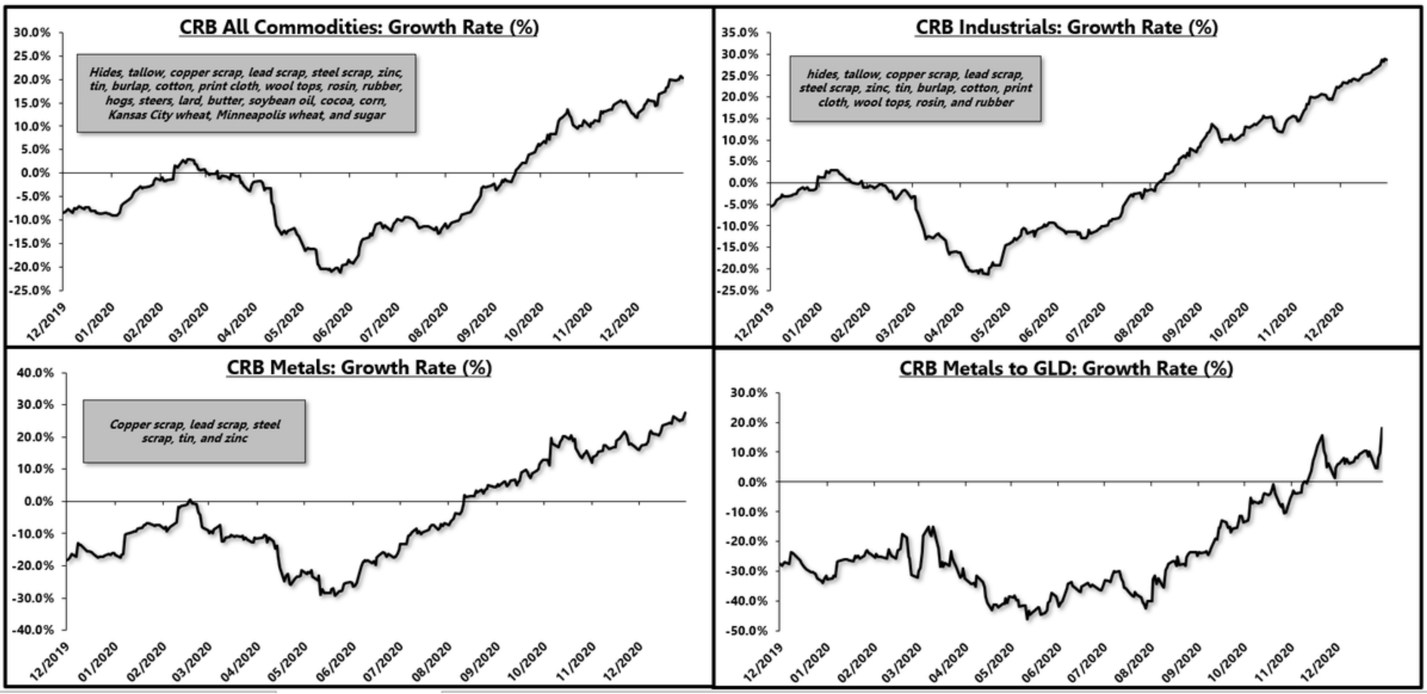

As long as the industrial sector continues to roar, TSY rates will have an upward bias as rates generally follow the trend in nGDP growth

A 10yr TSY has longterm expectations embedded in the rate so several qrters, while important, won't necessarily change the longterm trend

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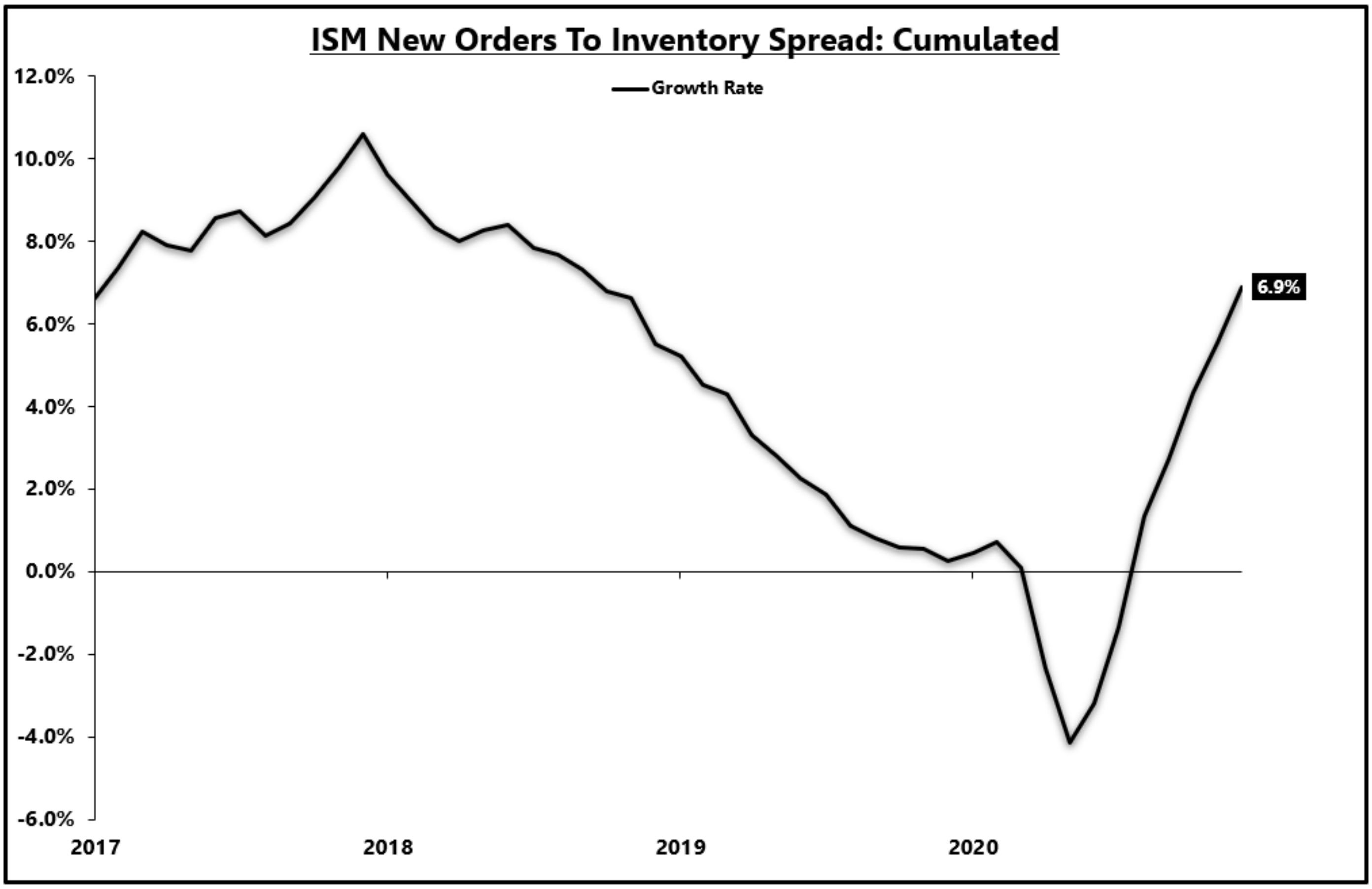

This is confirmed by the Dec update to the DKW model which breaks down *actual* inflation expectations, the expected real short-term rate (real growth), term premium, liquidity premium etc.

The DKW model is one of many models that is useful but has many limitations.

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As of Dec 31, according to the DKW model, inflation expectations are directionally rising, in line with the industrial upturn, but have only increase ~12bps from the summer low.

It is hard to alter a long-term trend with just a couple of quarters.

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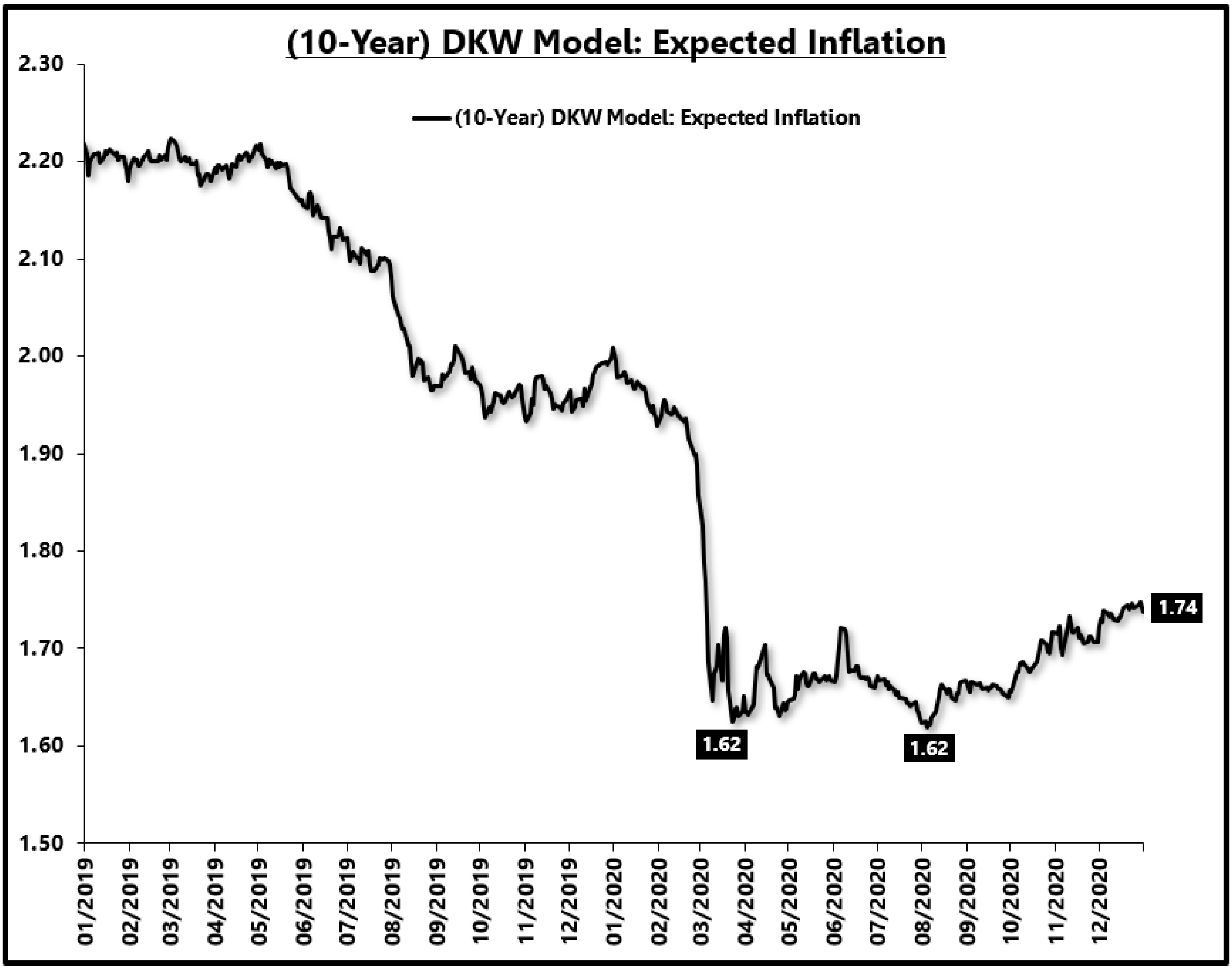

Real growth expectations remain on the floor in the DKW model as (again) a transitory upturn in growth won't alter the 10-year average rate of growth all that much.

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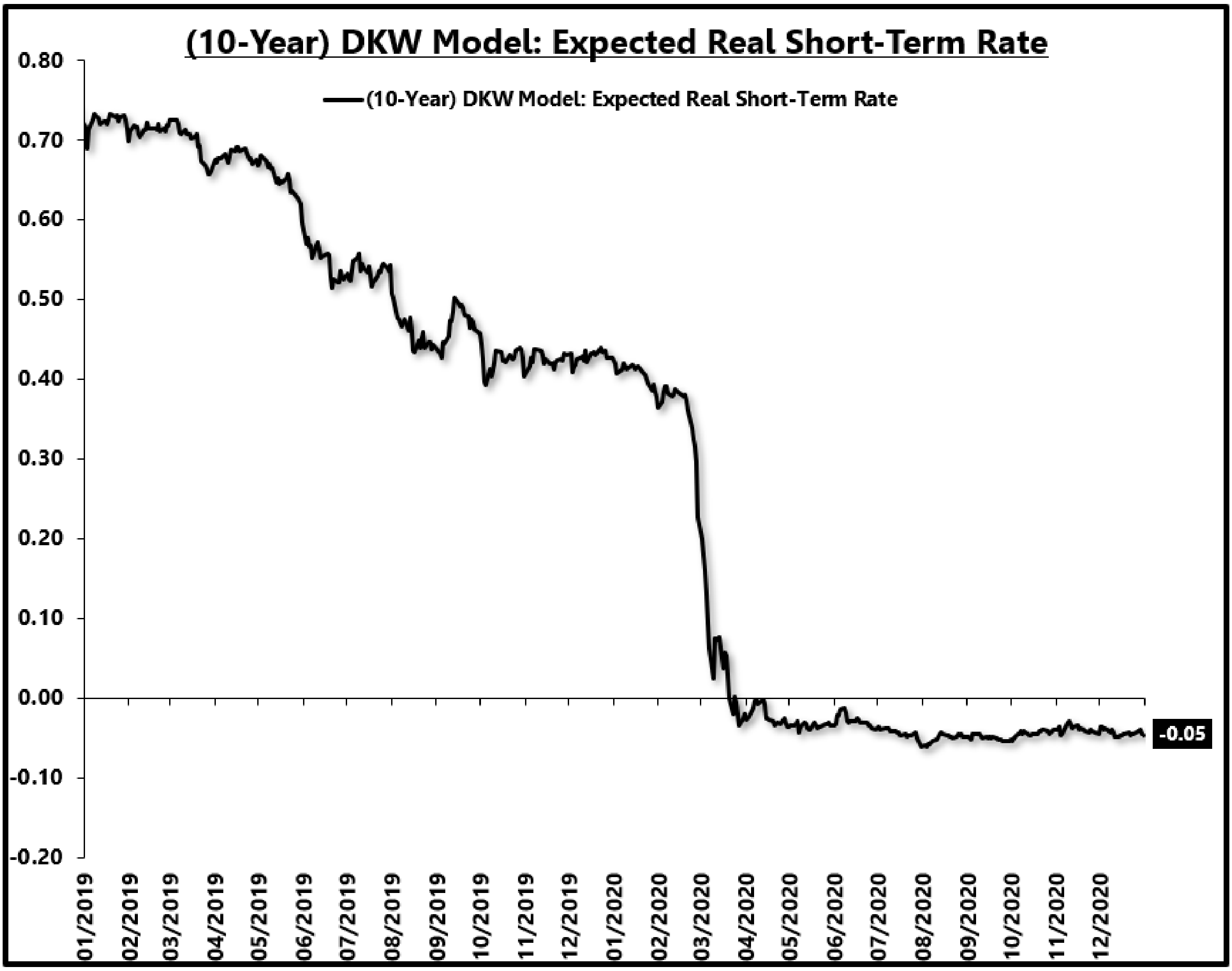

So what is causing the bulk of the move in Treasury rates?

The real term premium.

Expectations for massive fiscal spending rightfully won't alter the economy's long-term growth prospects but do place extra risk on duration in the near term.

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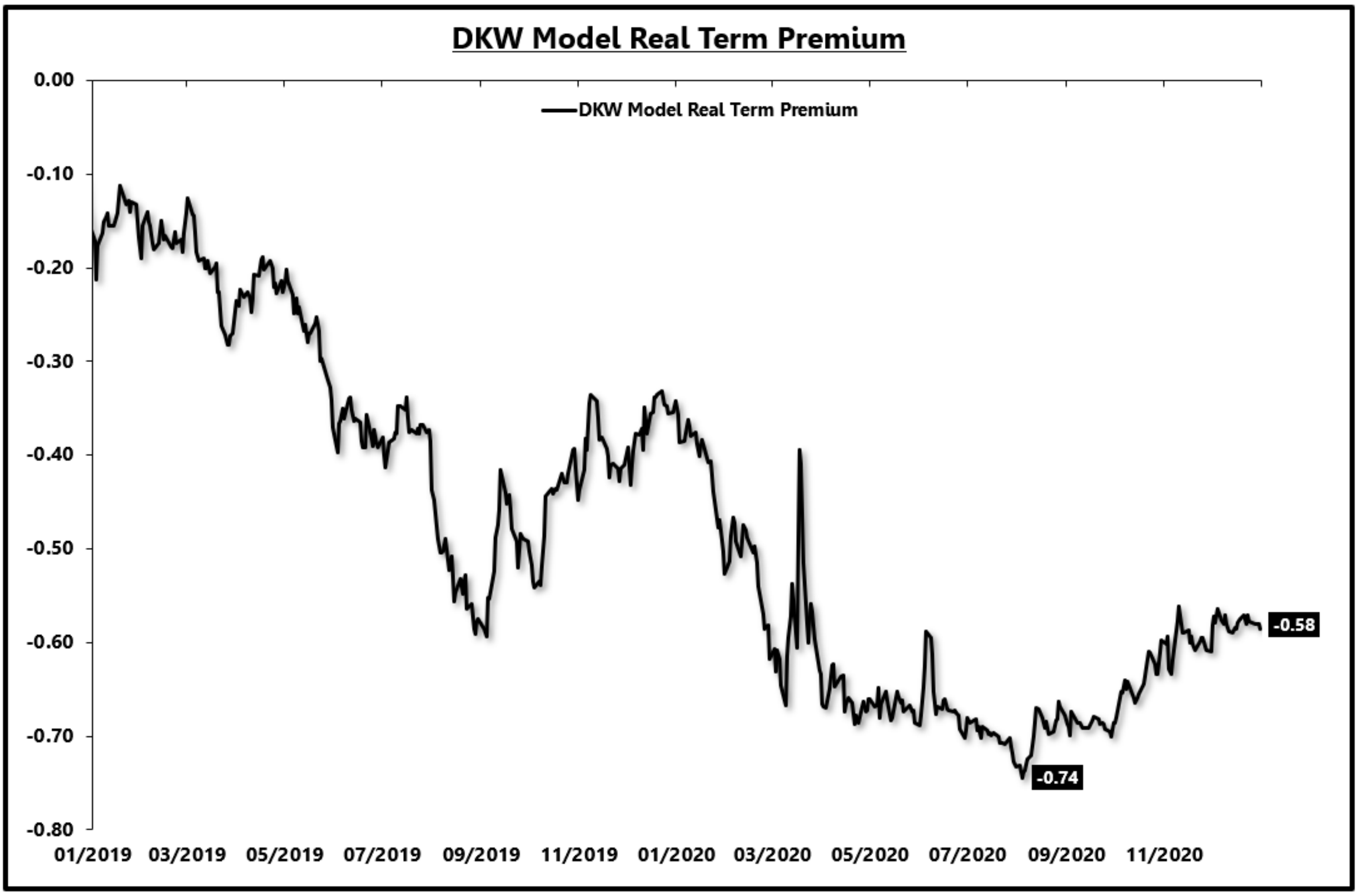

Adding actual inflation expectations and the real ST rate expectations gives what I call the "fundamental" drivers of TSY rates which have increased cumulatively about 14bps since the summer.

This makes sense with the trend in nGDP growth.

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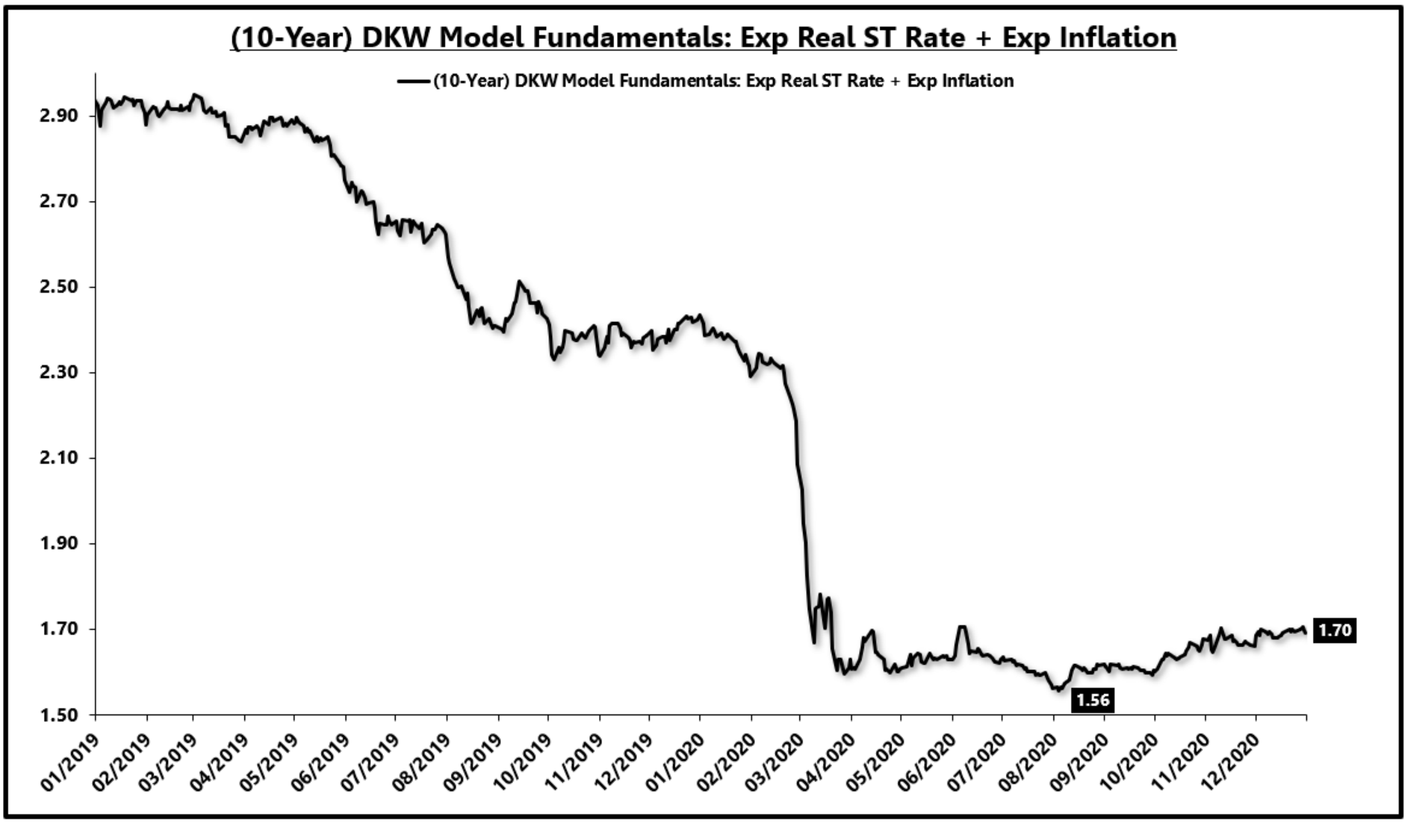

In short, the long-term trends that have caused TSY rates to decline for decades are still in place.

Weaker growth and lower inflation over the long-run will depress the risk-free rate.

In the short-term (2-6 quarters), you have to follow the direction in nGDP growth.

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Once this manufacturing upturn starts to fade (no signs yet) TSYs will be a great buy again as the next cyclical downturn in the economy will push the long-end to the zero-bound.

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@R_Perli has more timely updates on this model and can perhaps shed some light on the January move in rates so far.