Global Markets Daily: G10 rates forecast update: The path between two tails

- G10 rates markets have repriced significantly due to the combination of front-loading of hikes, higher terminal rate pricing, and rebuilding bond risk premia. We have revised our yield forecasts to reflect these shifts, and now look for 10y USTs to end the year at 3.3%, 10y Bunds at 1.25%, and 10y Gilts at 2.25%.
- Where we had previously characterized risks to our forecasts as being skewed to the upside, the recent tightening of financial conditions and expected growth deceleration in certain markets leaves risks somewhat more balanced (and even skewed to the downside for certain markets). With markets in many cases already pricing close to our baseline for policy rates, we expect yields can move higher, but not necessarily significantly beyond what the forwards imply.
- Reduced asymmetry does not mean reduced uncertainty. While markets seem reasonably priced versus our central view, the tails of the distribution for rates over the coming years are fat. To the upside, a slower moderation in inflation could translate to more policy tightening, taking yields higher across the curve, with increased flattening pressure. On the downside, a larger slowdown in growth (and inflation) would likely warrant lower yields and steeper curves.

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G10 rates forecast update: The path between two tails

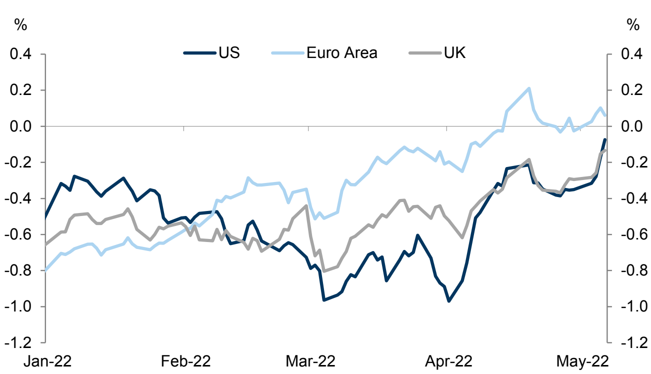
Global bond markets have remained under pressure since our last round of forecast revisions in late March. This is partly the result of further front-loading of hikes in many regions and upward repricing of terminal rates, and partly due to rebuilding bond risk premia. These changes have also been accompanied by the tightening of broader financial conditions, with significant equity market drawdowns and credit spread widening. In this report, we revise our forecasts to reflect these developments, while noting that risks to our projections, which we had previously characterized as being to the upside, are more symmetric, and even slightly skewed to the downside in some markets. For YE22 we now expect 10y USTs at 3.3% (up from 2.7% previously), 10y Bunds at 1.25% (from 0.75%), and 10y Gilts at 2.25% (from 1.95%).

While each G10 rates market has its own idiosyncrasies, there are some common elements. The biggest of these is inflation; for the majority of these economies, inflation has broadly surprised to the upside and is well above central bank targets.

While in many of these regions, our economists believe that inflation has peaked (or will peak) on a sequential basis, and in some cases like the US and UK, we expect significant growth deceleration, in level terms inflation remains sufficiently above target that central banks will likely continue to hike. Still, with markets in many cases already pricing our baseline views (or higher) on policy rates, we expect yields can continue to move higher, but not necessarily by much more than forwards imply. Outside of inflation and its implications for domestic monetary policy, another factor that could play a role is spillovers from the Euro area and Japan. Negative interest rate policy (NIRP) pursued by central banks in both those regions, along with persistently low levels of inflation in the last decade, had led to low (and in many instances, negative) nominal yields and a search for yield overseas. With the Euro area poised to exit NIRP, and the risk that the BoJ may at some point make changes to its yield curve control policy (our economists think the latter is unlikely in the near term), some term premium spillovers that held global yield lower have reversed and could extend. Indeed, despite revising our Euro area yield forecasts higher, we continue to see risks as skewed to the upside. And although the BoJ's fixed rate operations can keep 10y JGB yields pegged at around 0.25% for now, the pressure from global bond repricing will simply show up in longer maturity yields. These global factors, coupled with the elevated level of rates volatility, have helped to push term premium higher over the last two months (Exhibit 1).

Exhibit 1: Term premia have moved higher across the markets since mid-March

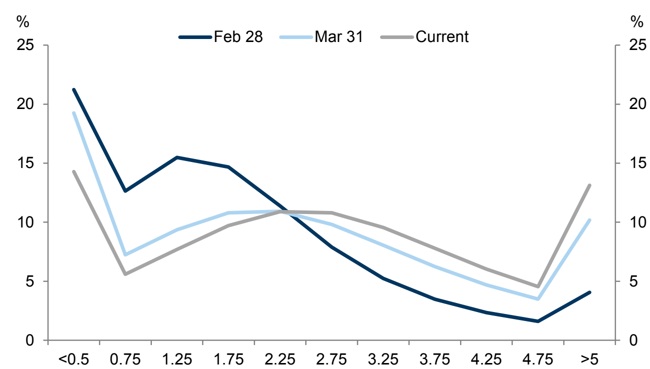
10y GS term premia estimates



Source: Goldman Sachs Global Investment Research

Exhibit 2: Macro uncertainty has led to a build-up of risk premium around both tails

Option-implied distribution for YE-2024 Fed pricing, current vs. end February and March



Source: Goldman Sachs Global Investment Research

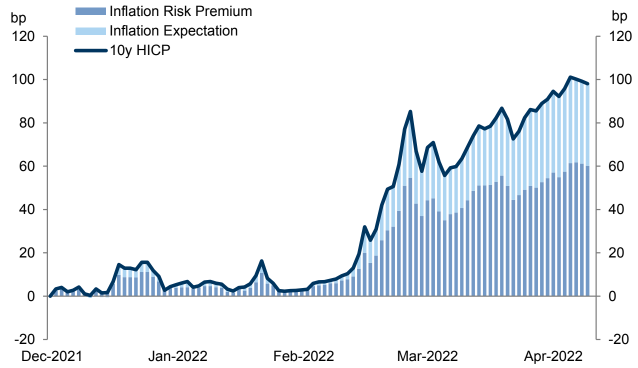
Looking at specific regions, for the US we note the Fed's indication that it was not actively considering hike increments larger than 50bp combined with the increase in term premium discussed above had helped drive a re-steepening of the yield curve from recent lows. However, we view this as a localized event. Our revised forecasts still show curve flattening, though by less than we previously thought, and at higher levels. We show our full forecast path for yields at the end of this note, but we see benchmark UST 10y yields at 3.3% and 3.15% for YE22 and YE23 respectively, with real rates remaining the primary driver of the move higher in yields. The main reason for the higher levels is the upward repricing of terminal rates globally, and the reason we expect less curve inversion is that the tightening in broader financial conditions means the Fed will likely have to be less restrictive in its policy stance than we previously assumed. With these developments, we see the distribution of terminal rate pricing as more symmetric than we had a few months ago, when these were firmly skewed to the upside; in this, our evolution of views has been mirrored in market-implied distributions as well (Exhibit 2).

One observation to highlight from the exhibit are the relatively fat tails around end-2024 pricing. This is a reflection, in our view, of the uncertainty about the state of the world. In one state, inflation fails to moderate as outlined in our economists' baseline. In such a scenario, we could see the Fed needing to hike considerably more, perhaps taking the policy rate to well over 4%. If realized, we would expect to see higher intermediate forwards and 10y UST yields as well, both likely above 3.5%, alongside significantly deeper inversion than in our new baseline. On the other side, the slowdown in growth (and inflation) could be more than we expect, resulting in a substantial bull steepening of the yield curve. The somewhat symmetric risk profile around our forecasts means these two scenarios average out to produce yields that look roughly similar to our baseline scenario. As we move through the year, if data suggest we are more likely to end up in one of the other scenarios, we could see large swings in yields and the distribution of risks. In other words, we believe our baseline view is largely priced, and realization of either of the other scenarios discussed should result in continued rate volatility.

In the Euro area our forecast changes largely reflect the significant repricing in inflation risk and the corresponding change in policy outlook. The shift in ECB communication is particularly meaningful; in the months following the relatively benign set of staff forecasts published at the March meeting, ECB leadership has taken a more concerned tone about second round effects on inflation. This has culminated in recent weeks with a large majority of GC members guiding towards a July lift-off. Amid concerns about currency weakness and the risk of de-anchoring inflation expectations (both survey and market-based), the ECB has further signaled a strong resolve to normalize policy settings quickly, despite signs of declining activity and notable sovereign spreads widening. That suggests to us that with about 3-4 hikes priced in the remainder of the year, 2022 is about fairly priced, but that 1y1y pricing has room to reprice further based on the strong inflation outcomes embedded in the HICP curve. We expect this dynamic to take 2y bund yields meaningfully higher into year-end, and revise our forecasts to 0.7% (from 0.3% before). Firming inflation risk premium should maintain upward pressure on longer-maturity yields as well (Exhibit 3), though we see risk-reward as more balanced here. Downside growth risks from the energy repercussions of the conflict in Ukraine alongside fragmentation risk could be headwinds to a material extension of the selloff at the 10y point. We expect 10y bund yields to end the year at 1.25%, and thus continue to look for a flattening of the EUR curve.

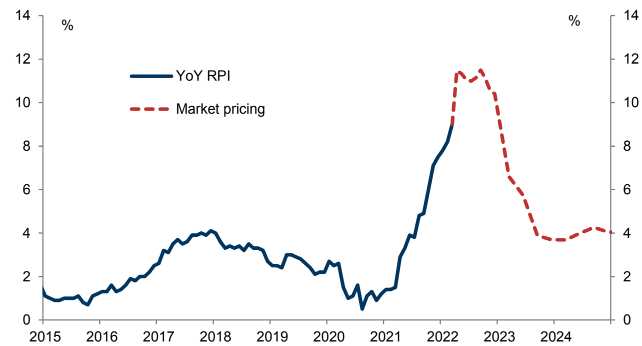
Exhibit 3: This year has seen a material repricing of European traded inflation

Decomposition of 10y HICP into risk premium and expectation components, indexed to 0 in Dec-21.



Source: Goldman Sachs Global Investment Research

Exhibit 4: With RPI expected to cross the 10% mark, we expect investors will require additional compensation to hold long-dated Gilts



Source: ONS, Goldman Sachs Global Investment Research

In the UK, our forecast revisions are more modest on account of a different policy outlook. Indeed, the BoE has been a relatively early hiker in the G10, and has broadly followed our expected policy course of action in the first part of the year. Looking forward, though the MPC harbors diverging views on the appropriate rate path, the May policy meeting suggested limited appetite to take the Bank rate much higher on the back of growth concerns. Though we believe strong inflation and GBP weakness will ultimately force the central bank to hike further, this communication shift argues for slightly lower front-end pricing in our view. However, increased probability that the BoE will subordinate inflation concerns to focus on stabilizing growth suggests markets will require a higher premium to hold GBP duration (Exhibit 4). We thus look for a comparatively steeper curve in the UK vs the EU and revise our 10y Gilt forecasts to 2.25% at year-end.

Looking across smaller English-speaking economies, we see a differentiated mix of risks to yields from here. Year-to-date moves in CAD, AUD and NZD rates have been on the larger end, reflecting their significant exposure to the global economic and commodity cycles. In Canada, we raise our forecasts for 10y yields to 3.25% at year-end 2022, about 20bp above forwards as a still firm growth backdrop and commodity tailwinds could allow for the recent repricing of the policy rate path to extend. While elevated inflation and central bank commitments to act forcefully in addressing these risks should generally keep yields on an upward trajectory in the near-term, we see more material downside risks to Australia and New Zealand yields in particular, as we think central banks will ultimately deliver less tightening than markets currently discount; we expect 10y ACGB and 10y NZGB yields to peak early next year, and outperform versus other G10 markets thereafter.

In contrast, we see risks tilted to potentially more central bank tightening in Scandinavia. In Sweden, the Riksbank's recent shift to a more hawkish stance culminated with a surprise April liftoff. Despite a modal scenario of 2-3 hikes for the rest of 2022, we think the more hawkish alternative scenario published by the central bank may provide a better guide to market pricing. With firm inflation pressures and only 5 policy meetings per year, we also think that odds of 50bps increments will remain a feature of market pricing. We thus revise our 10y yield forecast to 2.1% at year-end. And despite the Norges Bank being one of the earliest hikers in the G10, inflation shows no sign of cooling. For this reason, we see medium term risks skewed towards an extended hiking cycle to meaningfully above neutral. Reflecting this dynamic, we see further upside to 10y Norwegian yield (to 3.0% at end-22) before gradually rallying from mid-23 onward.

GS Revised Benchmark Yield Forecasts

G4 Curve Forecasts																
	USD				DEM				GBP				JPY			
	2y	5y	10y	30y	2y	5y	10y	30y	2y	5y	10y	30y	2y	5y	10y	30y
Current	2.58	2.81	2.83	2.98	0.07	0.54	0.88	1.05	1.23	1.36	1.72	1.96	-0.05	0.02	0.25	1.01
2Q22	2.80	3.15	3.20	3.25	0.40	0.90	1.15	1.30	1.60	1.70	2.10	2.25	-0.04	0.03	0.25	1.05
3Q22	3.05	3.25	3.25	3.30	0.55	1.00	1.20	1.35	1.70	1.75	2.20	2.30	-0.04	0.05	0.25	1.10
4Q22	**3.20**	**3.30**	**3.30**	**3.35**	**0.70**	**1.10**	**1.25**	**1.35**	**1.80**	**1.80**	**2.25**	**2.30**	**-0.04**	**0.05**	**0.25**	**1.10**
1Q23	3.30	3.20	3.20	3.30	0.80	1.10	1.30	1.35	1.90	1.80	2.30	2.30	-0.04	0.05	0.25	1.10
2Q23	3.30	3.15	3.15	3.25	0.85	1.20	1.35	1.40	1.70	1.80	2.30	2.30	-0.04	0.05	0.30	1.15
3Q23	3.25	3.10	3.15	3.25	0.90	1.25	1.40	1.40	1.70	1.90	2.30	2.30	-0.02	0.10	0.35	1.20
4Q23	**3.20**	**3.10**	**3.15**	**3.25**	**0.95**	**1.25**	**1.50**	**1.45**	**1.75**	**2.00**	**2.30**	**2.30**	**-0.02**	**0.10**	**0.35**	**1.20**

Deviation from Forwards																
	USD				DEM				GBP				JPY			
	2y	5y	10y	30y	2y	5y	10y	30y	2y	5y	10y	30y	2y	5y	10y	30y
2Q22	0.06	0.27	0.32	0.24	0.22	0.30	0.24	0.25	0.35	0.32	0.33	0.28	0.01	0.00	-0.02	0.04
3Q22	0.10	0.28	0.30	0.27	0.21	0.32	0.23	0.28	0.44	0.33	0.38	0.31	0.00	0.00	-0.05	0.08
4Q22	**0.14**	**0.29**	**0.32**	**0.31**	**0.25**	**0.36**	**0.24**	**0.27**	**0.54**	**0.34**	**0.39**	**0.31**	**-0.01**	**-0.02**	**-0.08**	**0.06**
1Q23	0.17	0.17	0.19	0.26	0.26	0.31	0.26	0.26	0.61	0.29	0.40	0.30	-0.02	-0.05	-0.11	0.05
2Q23	0.17	0.11	0.12	0.21	0.26	0.37	0.28	0.30	0.36	0.23	0.36	0.30	-0.03	-0.07	-0.09	0.09
3Q23	0.15	0.07	0.12	0.21	0.25	0.39	0.30	0.29	0.30	0.27	0.32	0.29	-0.02	-0.05	-0.07	0.13
4Q23	**0.14**	**0.08**	**0.11**	**0.22**	**0.25**	**0.36**	**0.38**	**0.33**	**0.29**	**0.33**	**0.29**	**0.29**	**-0.02**	**-0.07**	**-0.09**	**0.12**

Source: Goldman Sachs Global Investment Research

G10 10-Year Yield Forecasts										
	USD	DEM	GBP	JPY	CAD	CHF	SEK	NOK	AUD	NZD
spot	2.83	0.88	1.72	0.25	2.94	0.74	1.85	2.81	3.43	3.70
2Q22	3.20	1.15	2.10	0.25	3.15	1.00	1.90	2.90	3.70	3.95
3Q22	3.25	1.20	2.20	0.25	3.20	1.05	2.00	2.95	3.80	4.05
4Q22	**3.30**	**1.25**	**2.25**	**0.25**	**3.25**	**1.10**	**2.10**	**3.00**	**3.85**	**4.10**
1Q23	3.20	1.30	2.30	0.25	3.30	1.15	2.15	3.05	3.85	4.10
2Q23	3.15	1.35	2.30	0.30	3.35	1.20	2.20	3.10	3.85	4.05
3Q23	3.15	1.40	2.30	0.35	3.40	1.25	2.25	3.10	3.85	4.05
4Q23	**3.15**	**1.50**	**2.30**	**0.35**	**3.40**	**1.30**	**2.30**	**3.05**	**3.80**	**4.00**
1Q24	3.15	1.50	2.30	0.40	3.40	1.35	2.30	3.00	3.80	3.95
2Q24	3.15	1.40	2.30	0.40	3.40	1.30	2.25	3.00	3.75	3.90
3Q24	3.15	1.35	2.30	0.45	3.40	1.25	2.20	2.95	3.70	3.85
4Q24	**3.15**	**1.30**	**2.30**	**0.45**	**3.40**	**1.25**	**2.15**	**2.90**	**3.65**	**3.80**
1Q25	3.15	1.30	2.25	0.50	3.40	1.20	2.10	2.85	3.65	3.80
2Q25	3.15	1.30	2.25	0.55	3.40	1.20	2.05	2.75	3.60	3.80
3Q25	3.15	1.25	2.25	0.60	3.40	1.15	2.00	2.70	3.60	3.80
4Q25	**3.15**	**1.25**	**2.25**	**0.65**	**3.40**	**1.15**	**2.00**	**2.65**	**3.55**	**3.75**

Deviation from Forwards										
	USD	DEM	GBP	JPY	CAD	CHF	SEK	NOK	AUD	NZD
2Q22	0.32	0.24	0.33	-0.02	0.18	0.26	0.11	0.08	0.25	0.18
3Q22	0.30	0.23	0.38	-0.05	0.19	0.23	0.16	0.10	0.31	0.27
4Q22	**0.32**	**0.24**	**0.39**	**-0.08**	**0.23**	**0.24**	**0.22**	**0.11**	**0.31**	**0.31**
1Q23	0.19	0.26	0.40	-0.11	0.28	0.26	0.25	0.13	0.27	0.27
2Q23	0.12	0.28	0.36	-0.09	0.32	0.28	0.29	0.18	0.24	0.20
3Q23	0.12	0.30	0.32	-0.07	0.37	0.30	0.34	0.18	0.22	0.20
4Q23	**0.11**	**0.38**	**0.29**	**-0.09**	**0.36**	**0.32**	**0.39**	**0.14**	**0.14**	**0.14**

Source: Goldman Sachs Global Investment Research

TRADE IDEAS

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1. Stay long SGD vs short TWD, opened on October 29, 2020, at 20.95 (indexed at 100), with a revised total return target of 117, and a revised stop of 113, currently trading at 115.07.
2. Stay long AAA CLOs hedged vs. CMBX 10 AAA at a 1 to 1x notional ratio, opened on November 9, 2021, at 0.0%, with a target of +0.70% and a stop of -0.70%, currently trading at -0.06%.
3. Stay long MSCI EM vs. short EMBIG-Div, opened on November 9, 2021, at 100, and revised on 8 December to include duration (from hedged previously) together with a revised total return target of 120 and a revised stop of 86, currently trading at 94.98.
4. Stay long Dec-23 CME Copper, opened on November 9, 2021, at $9325/mt, with a target of $11,000/mt and a stop of $8,600/mt, currently trading at $9,307/mt.
5. Stay long Dec-23 Brent position, opened on December 2, 2021, at $64.6/bbl, with a revised target of $95/bbl and a revised stop of $80/bbl, currently trading at $89.1/bbl.
6. Stay long BRL DI Jan24s-Jan27s steepeners, opened on January 12, 2022, at -43bp, with a target of 60bp, and a revised stop of -130bp, currently trading at -74bp.
7. Stay long S&P GSCI Industrial Metals Total Return Index, opened on January 14, 2022, at 1879 (indexed at 100), with a revised target of 128, and a revised stop of 88, currently trading at 97.70.
8. Stay long THB vs TWD, opened on February 18, 2022, at 100, with a total return target of 108, and a stop of 96, currently trading at 99.36.
9. Stay long MYR vs PHP, opened on March 2, 2022, at 100, with a total return target of 108, and a stop of 96, currently trading at 96.98.
10. Stay long Saudi Arabia equities (Tadawul All Share Index), opened on March 9, 2022, at 12,851 with a revised target of 15,000 and a revised stop of 13,000, currently trading at 13,379.
11. Stay long 2s3s UST swap spread curve steepeners, opened on March 25, 2022, at -12bp, with a target of -4bp, and a stop of -16bp, currently trading at -14bp.
12. Stay long CMBX 6 BBB- index, opened on March 29, 2022, at $75.36, with a target of 8.0% and a stop of -5.0%, currently trading at 0.91%.
13. Sell ATM 6m expiry 2y2y midcurve receivers, opened on April 1, 2022, at 0bp, with a total return target of 30bp and a stop of -15bp, currently trading at 19bp.
14. Stay long PLN vs short KRW, opened on April 27, 2022, at 100, with a total return target of 108, and a stop of 96, currently trading at 100.67.
15. Buy 6m20y JPY A/A+ 25 payer spread, opened on April 29, 2022, at 0bp, with a total

return target of 15bp and a stop of -7bp, currently trading at 2bp.

16. Stay long EUR/GBP, opened on April 29, 2022, at 0.84, with a revised target of 0.87 and a revised stop of 0.845, currently trading at 0.858.
17. Stay long INR 1s5s NDOIS flatteners, opened on May 4, 2022, at 118bp, with a target of 80bp and a stop of 210bp, currently trading at 93bp.
18. Sell IDR 10y bonds, opened on May 9, 2022, at 6.95%, with a target of 7.70%, and a revised stop of 7.05%, currently trading at 7.38%.
19. Stay long MYR 2/5Y ND-IRS flatteners, opened on May 9, 2022, at 58bp, with a target of 15bp, and a stop of 85bp, currently trading at 54bp.
20. Stay long THB 2/10Y OIS flatteners, opened on May 9, 2022, at 124bp, with a target of 65bp, and a stop of 160bp, currently trading at 138bp.

Disclosure Appendix

Reg AC

We, Praveen Korapaty, George Cole, William Marshall, Avisha Thakkar, Simon Freycenet and Ravi Raj, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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