Rates Strategy Focus
UST – THE TIME TO ACT

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We turn tactically moderately LONG *(vs. NEUTRAL before).* ***We recommend accumulation in the 4.60-4.70% area (10Y)****. However, given that the UST curve is heavily inverted and the term premium is negative, we prefer shorter maturities, specifically 5 years.*

Although further upward revision of monetary policy expectations are not negligible*, we find current levels appealing for the following reasons:*

1. *Carry offers good protection in the event of sell-offs, provided yields (5Y/10Y) remain within 5.10-5.20% (higher than the peaks in October). To get there, the market should at least price out rate cuts entirely for 2024 (not our baseline).*
2. *The recent FFR repricing-led sell-off appears to be overpriced. Beta between FFR future Dec24 and 10Y/5Y UST yields surged to 80% (the highest since November and above LT average of 60%).*
3. *Breakeven rates are close to this cycle's highs owing to geopolitical tensions. Unless tensions escalate further, current levels look stretched.*

Meanwhile, ***we increase the threshold to 4% (from 3.8%) for taking profit in case of a rally****.*

Strategically, we remain OVERWEIGHT *for the following reasons:*

1. *The labor market continues to re-balance, which should ease underlying inflationary pressure.*
2. *Assuming shelter and core goods price momentum does not accelerate again (our baseline), returning supercore momentum to the pre-COVID level may not be as out of reach as headline*

data would suggest.

3. *We remain of the opinion that the Fed will cut rates this year by 50bp starting in H2.*
4. *We expect the Fed to slow down QT already from H2, a factor that will contribute positively to the demand/supply balance of USTs.*

*Against this backdrop, **we continue to expect yields at the end of 2024 to be lower than current levels**. However, **we remain of the opinion that the scope for a decline appears to be limited**.*

We turn tactically moderately LONG (vs. NEUTRAL before)

Following the recent sell-off, we turn tactically moderately LONG and we recommend continuing accumulate gradually in the 4.60-4.70% area. However, given the UST curve is heavily inverted and the term premium is negative, we prefer shorter-maturities, notably 5Y.

Odds of further upward revision of monetary policy expectations is non-negligeable. However:

A. **All things considered, USTs are appealing.**

Table 1 shows what would the P&L of a long position on 5Y UST be under different market scenarios, assuming we enter the trade at the time of writing (4.60-4.70%) and keep the position until year-end.

According to our calculation, yields should sell-off 75bp from current levels to register a loss.

TABLE 1.

P&L of long 5Y position under several market scenarios

Delta Yield (bp) / Yield (%)	25	50	60	75	100
4,65	1,9%	0,8%	0,3%	-0,4%	-1,6%

Source: Anima Research

Meanwhile, to breakeven, yields should surge 60bp from current levels (which would send yields well above last October's highs). To reach those levels we think that markets would have to at least price out all the remaining cuts for 2024 (**Figure 1**) and possibly even price in a toughening of the Fed's rhetoric.

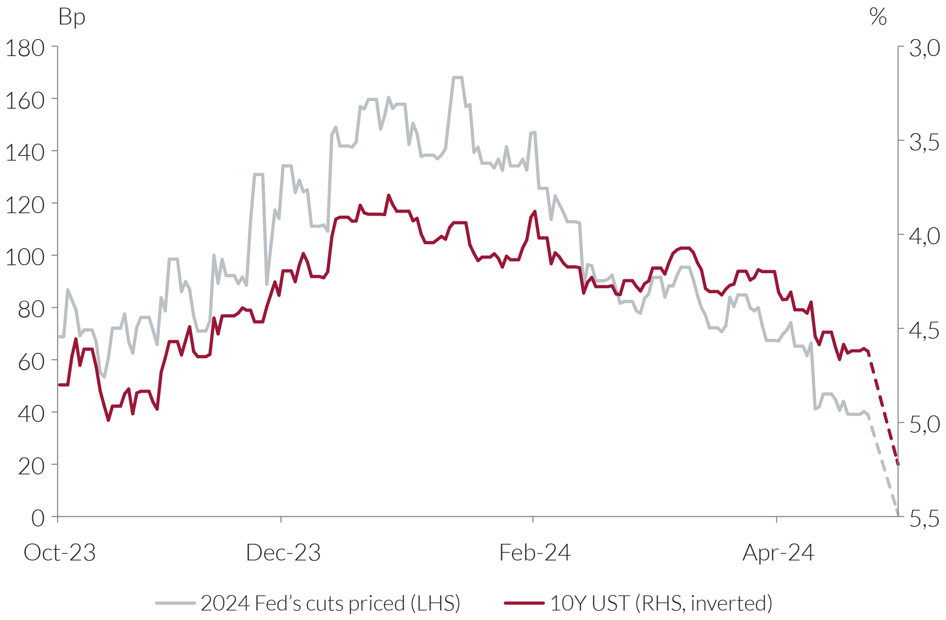
Further reinforcing our view:

- Our analysis assumes pass-through between the FFR future Dec24 and 5/10Y yields is close to 1, very high by historical standards (see next paragraph).

- Even allowing for some overshooting, 60bp of yield increase look like a sizeable sell-off if markets does not start pricing rate hikes again. If the Fed were to keep rates unchanged this year, real yields would have only around 10-15bp to the upside according to our fair value model (**Figure 2**).

FIGURE 1.

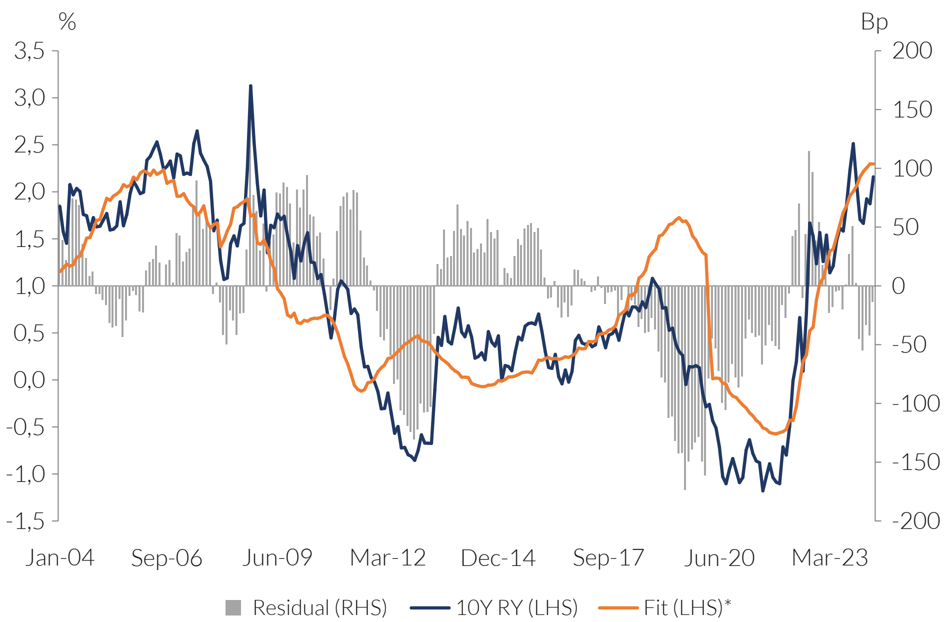
What if markets price out all rates cuts for 2024?



Source: Bloomberg, Anima Research

FIGURE 2.

Real yields have little upside according to our model, even if markets price out Fed's rate cuts



**The model regresses 10Y UST real yields on potential growth, the Fed Fund rates and the Fed's holdings of USTs as a percentage of marketable debt. The model is estimated on a sample of quarterly data going from 2003 until present.*
Source: Bloomberg, CBO, Anima Research

B. UST yields have overreacted to change in monetary policy expectations.

Figure 3 shows that in the last month or so the sensitivity of UST yields to monetary policy expectations has sharply increased and it now stands at the higher end of the last year range (around 80%) and not too far from the highs back in October. However, back in October, markets were still expecting that the Fed could deliver a further rate hike by year-end as the Fed had not yet pivoted, a very different situation from the current one.

FIGURE 3.

UST yields have become overly sensitive to monetary policy expectations

The line shows the 1-month rolling beta between daily changes in 10Y UST yields and Fed Fund future Dec24.
Source: Bloomberg, Anima Research

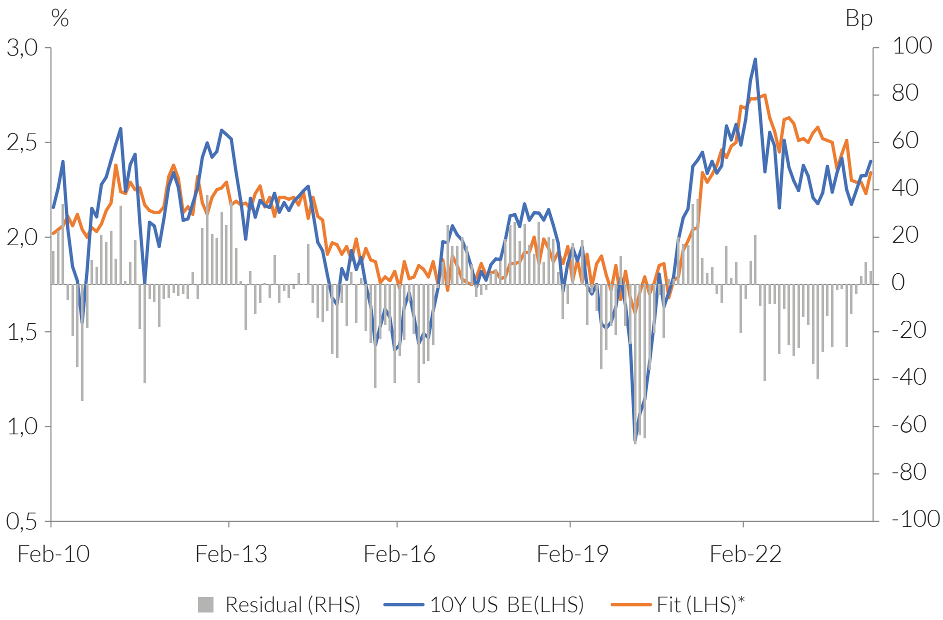
C. Breakeven rates are near this cycle highs.

In response to geopolitical tensions in the Middle-East, oil prices rose, leading to a rise in breakeven. The movement has been particularly pronounced in the US, where concerns of second round effect from the geopolitical tensions in the Middle East added to concerns about the sustainability of the deflation process.

We think that unless tensions escalate further, current breakeven levels look a bit stretched and we certainly do not see further upside potential from here. Indeed, Figure 4 shows that current levels of 10Y breakeven rates are moderately higher than our model's fair value and should decline further if the disinflation process continues (as per our baseline) and inflation expectations moderate (which we expect to happen unless geopolitical tensions escalate).

FIGURE 4.

Breakeven are a tad too high according to our model



**The model regresses 10Y US breakeven rates on PCE core inflation, oil prices and consumers' inflation expectations in the next 5-10 year as captured by the U-Mich survey. The model is estimated on monthly data in a sample going from 2003 until present.*
Source: Bloomberg, Anima Research

We raise the bar for profit taking at 4%

Meanwhile, **we increase the bar for taking profit in case of a rally in USTs to 4% (from 3.8% previously)**.

The rationale is that more evidence is emerging that the neutral level of the Fed fund rate might indeed be higher than previously thought for the following reasons:

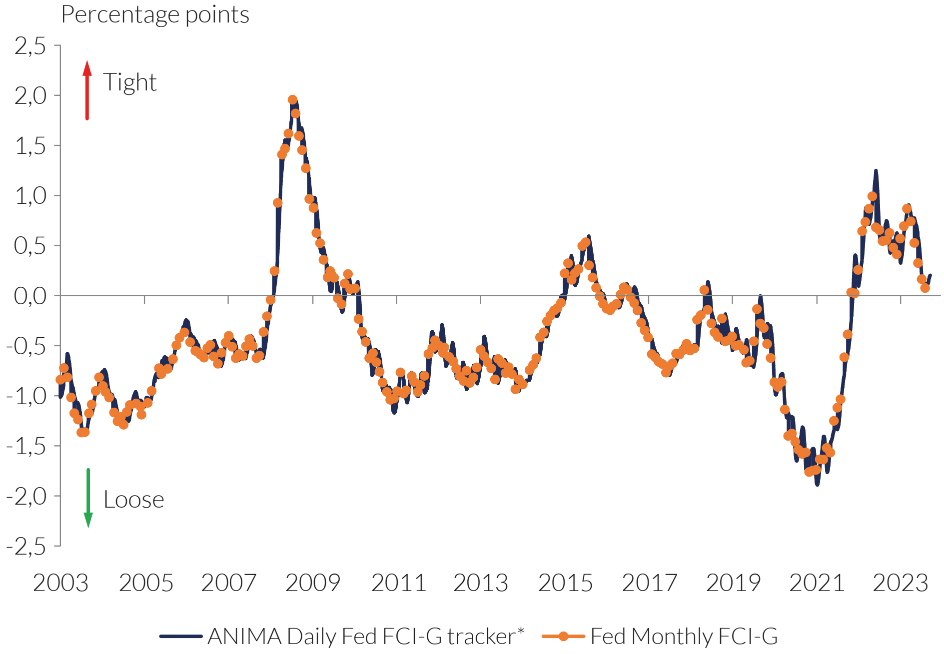
A. Financing conditions continue to indicate that the Fed's monetary policy is not that restrictive (**Figure 5**).

B. The Congressional Budget Office has revised up potential growth in the US and it now stands at 2.2%, rising from 1.9% in 2021 (**Figure 6**). The reason behind the upgrade is two-fold: 1) An increase in the labor force mainly due to a rise in immigration 2) An increase in productivity.

C. Our Taylor Rule shows that allowing for a natural rate of interest at 1.5% (vs. 0.75% estimated by Laubach and Williams), the neutral rate for the Fed fund rates would stand at around 3.5%; allowing for an inflation target at 2.5% would lift the neutral terminal rate above 4% (**Table 2**).

FIGURE 5.

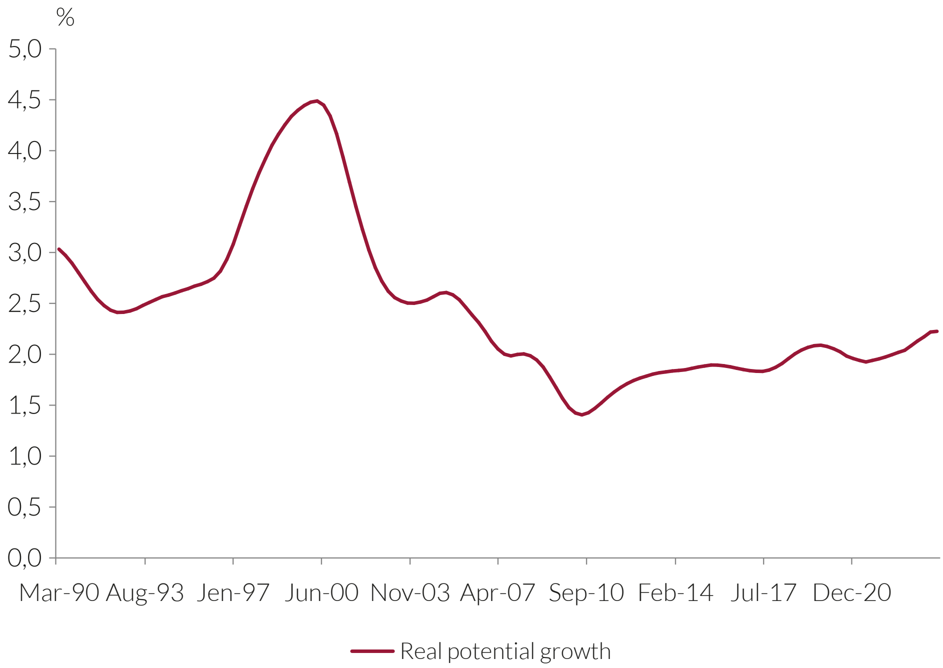
Financing conditions are not that restrictive on growth



Source: Haver, Anima Research

FIGURE 6.

10Y UST-FF future Dec24 (LHS)



Source: CBO, Haver, Anima Research

TABLE 2.

FFR in 2024, assuming a real natural rate at 1.5%

Unemployment rate / PCE core	3,5	4,0	4,5
3,5	6,3	5,8	5,3
3,0	5,5	5,0	4,5
2,5	4,8	4,3	3,8
2,0	4,0	3,5	3,0

Source: Bloomberg, Anima Research

We remain strategically OVERWEIGHT

For the following reasons:

1. The labor market continues to re-balance and this should help ease underlying inflationary pressure.

2. Assuming shelter and core goods prices momentum do not re-accelerate (our baseline), returning supercore momentum to pre-COVID level may not be that out of reach; at least not as much as headline data would suggest.

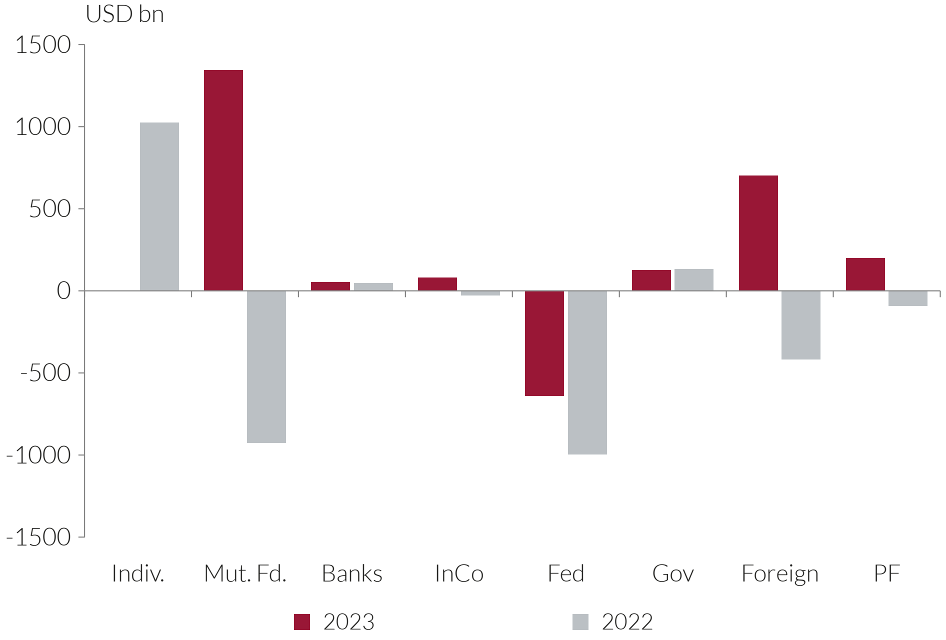
3. We remain of the view that the Fed will cut rates this year, by 50bp, starting in H2.

4. We expect the Fed to slow down QT already from May/June, a factor that will contribute positively to the demand/supply balance of USTs. Indeed, since QT started in 2022, the Fed has been contributing negatively to demand for USTs (**Figure 7**) and it will contribute negatively also this year, although at a slower pace (we expect the Fed to lower the cap on UST redemptions from USD 60bn to USD 30bn in May-June). We expect that from 2025 the Fed will stop contributing negatively to flows into USTs, removing a source of increase in net supply.

Against this backdrop, **we continue to expect yields to end 2024 lower than current levels.** However, **we remain of the view that the scope for a decline looks limited**.

FIGURE 7.

Buyers and sellers in USTs



Source: SIFMA, Anima Research