Rates Strategy Focus USTs – A very soft landing

Chiara Cremonesi
Senior Rates Strategist
Investment Research

We remain tactically NEUTRAL. *For the following reasons:*

1. *We expect that strong macro data will continue to put upward pressure on UST yields in the short-term, regardless of the Fed's new mantra that solid growth is not an obstacle to get inflation to 2%.*
2. *Negative term premium is not consistent with the current macroeconomic context, even accounting for better-than-expected news on the refunding side and a likely slow-down of QT.*
3. *Disinflation is in the prices. Both survey- and market-based measures of inflation expectations are in line with historical averages + inflation risk premium is well into negative territory.*

Against this backdrop, we maintain our tactical neutral position. We recommend an opportunistic approach: buy at 4.40%, sell at 3.80% (10Y).

Strategically, we remain OVERWEIGHT. *Although we no longer expect the US economy to enter a recession this year, we are sticking to our constructive view. For the following reasons:*

1. *Over the last month, markets have moved towards our Fed call. At the time of writing futures price 90bp of rate cuts this year from 135bp last month (ANIMA: 100bp). As the first rate cut draws close, the room for an upward revision of monetary policy expectations has narrowed.*
2. *Policy mistake risks have declined lately. Recent public appearances suggest FOMC members prefer a cautious approach to avoid the risk of inflation backfiring.*
3. *Compared to our above-consensus baseline, growth risks are now tilted to the downside.*

Against this backdrop, we continue to expect lower yields at the end of the year. However, the scope for a decline looks limited. *For several reasons:*

1. *At the end of easing cycles, 10Y yields tend to exceed the Fed terminal rate, on average by 200bp in recessionary cycles and by 85bp in disinflationary cycles. At the time of writing, the terminal rate priced in for this (disinflationary) rate cut cycle is 3-3.50%. If history repeats itself, this is consistent with 10Y UST landing in the 3.8-4.3% range.*
2. *The long-term equilibrium of USTs yields is not dramatically below current levels. Assuming potential growth of 1.7% (as estimated by the Congressional Budget Office) and the Fed's inflation target, 10Y UST yields should trade at around 3.7% in steady-state.*
3. *We see limited room for a further fall in markets' pricing of the terminal rate in coming months. In turn, this would limit the scope for a fall in 10Y yields from current levels.*

We remain tactically NEUTRAL on USTs

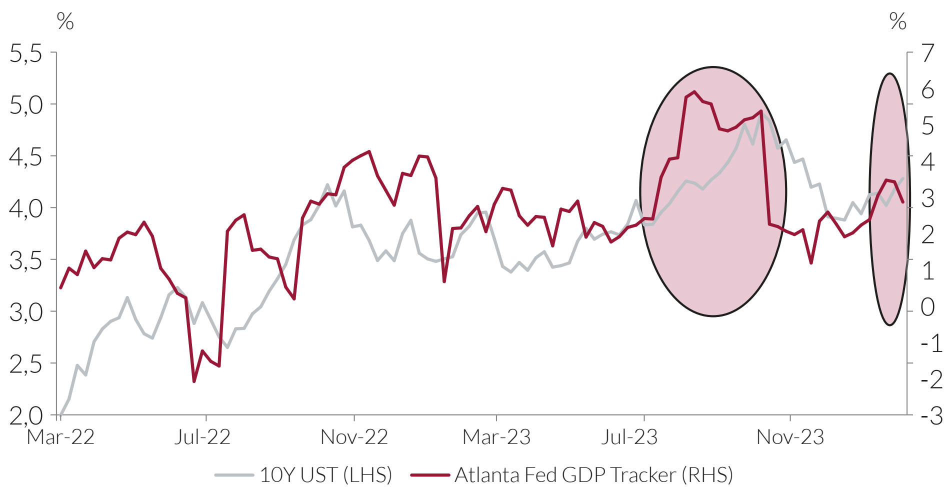
We remain tactically NEUTRAL for the following reasons:

A. Strong macro data will continue to put upward pressure on UST yields in the short-term.

Although the Fed's reaction function looks skewed towards inflation, we expect the market to keep pricing in the risk that solid economic activity may slow-down disinflation.

FIGURE 1.

Upward revisions to growth leading UST yields to the upside



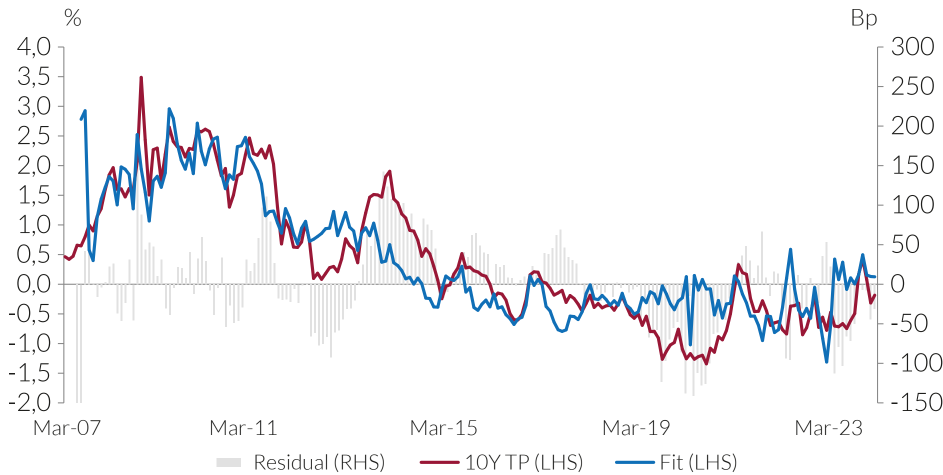
Source: Bloomberg, Anima Research

B. The term premium remains in negative territory

Although refunding risks declined lately, we remain of the view that negative term premium is inconsistent with the macroeconomic context. According to our model, the term premium should be well in positive territory (**Figure 2**). Moreover, while demand for Treasuries has been solid so far and QT will likely slowdown in H2, traditional investors, especially domestic investors, look historically overexposed (**Figure 3**), and the supply of free-float is expected to rise.

FIGURE 2

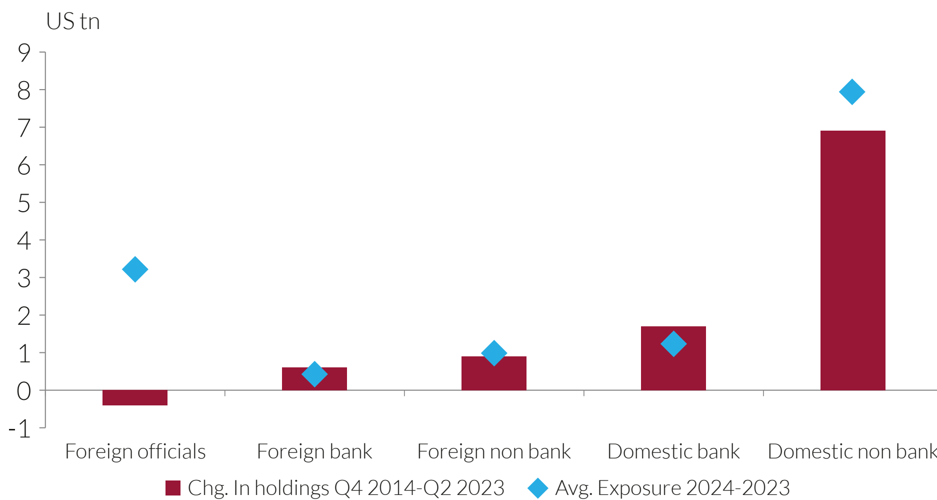
Our model point to higher term premium



Source: Bloomberg, Anima Research

FIGURE 3.

Traditional investors look overexposed



Source: IMF, Anima Research

C. Disinflation is in the prices.

Both survey- and markets-based measures of inflation expectations are in line with historical averages (**Figures 4 and 5**).

Considering that 1) the historical average includes the long period of below-target inflation, and 2) post-pandemic uncertainty surrounding the steady-state equilibrium of inflation, breakeven rates have little room to fall further in our view.

FIGURE 4.

Survey-based inflation expectations

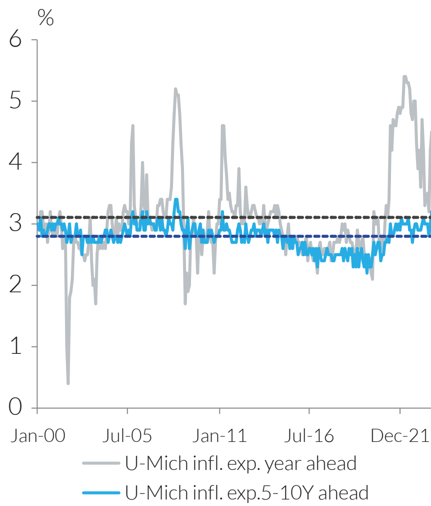
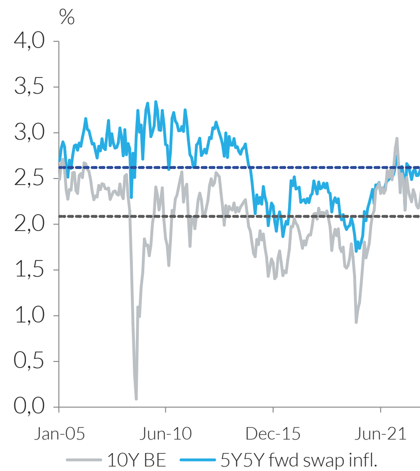


FIGURE 5.

Market-based inflation expectations



Source: Bloomberg, Anima Research

Against this backdrop, we maintain our tactical neutral position. We recommend an opportunistic approach: buy at 4.40%, sell at 3.80% (10Y).

1. We remain strategically OVERWEIGHT

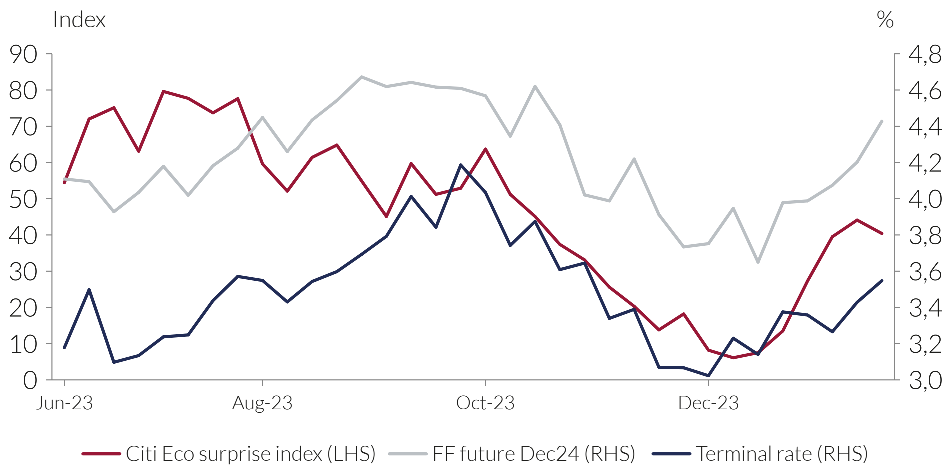
Last month, we put our strategic outlook under revision owing to mounting upside risks to our growth baseline. Although we no longer expect the US economy to enter recession this year, we maintain our constructive strategic positioning on USTs and continue to expect 10Y yields to end the year below current levels. For the following reasons:

A. Fed pricing look fair.

Since mid-January, the US economy has returned to surprise to the upside. This, coupled with an upside surprise in the January inflation data, has led to a re-pricing of monetary policy expectations, with markets now expecting in total 90bp of rate cuts in 2024, around 50bp less than a month ago, but broadly in line with our baseline (100bp; **Figure 6**). As the first rate cut draws close, room for upward revisions of monetary policy expectations have narrowed.

FIGURE 6.

Positive economic surprises led to re-pricing of the Fed



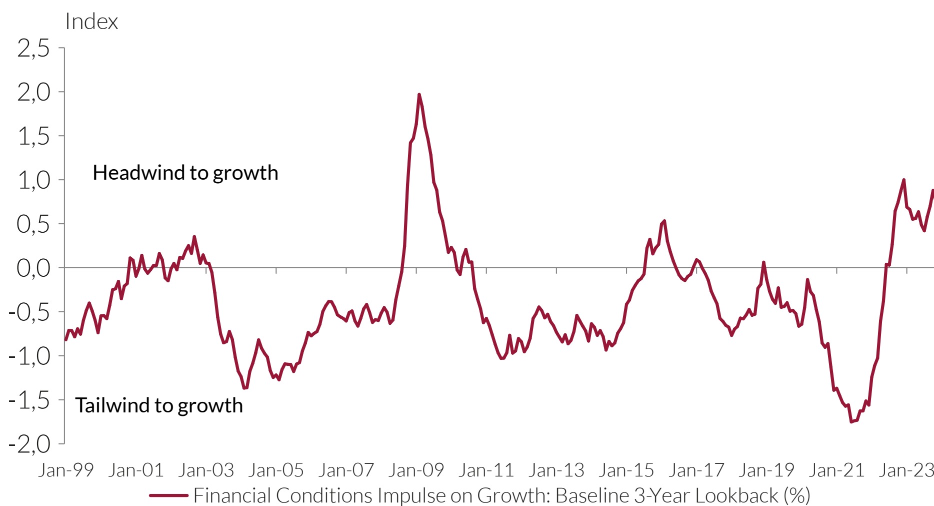
Source: Bloomberg, Anima Research

B. Risks of a policy mistake have declined lately.

Recent public appearances suggest FOMC members prefer a cautious approach to avoid risks that inflation backfires. This reduces risks that inflation may re-accelerate should financial conditions ease too much owing to an overly aggressive precautionary rate cut cycle. According to the Fed1, current level of financial conditions still represents a headwind to growth, but their negative impulse on growth is fading (**Figure 7**).

FIGURE 7.

Current financial conditions "work" according to the Fed, but warrants caution in cutting rates



Source: Bloomberg, Haver, New York Fed, Anima Research

1 https://www.federalreserve.gov/econres/notes/feds-notes/a-new-index-to-measure-us-financial-conditions-20230630.html

C. Growth-wise, risks are to the downside

Compared to our revised growth profile, risks are to the downside. We forecast growth to average 2.6% this year, compared to 1.6% expected by the consensus. Against this backdrop, odds that growth could further surprise to the upside have declined. Meanwhile, the longer the cycle progresses, the higher the probability of downside surprises.

Against this backdrop, **we continue to expect lower yields at the end of the year. However, room for a decline looks limited** (For more please see next section).

2. A very soft landing for long-end UST rates

While we remain strategically constructive, we do not expect 10Y yields to end 2024 much lower current levels.

For the following reasons:

A. In most of the past Fed's cutting cycles, 10Y yields ended the cycle well above the terminal rate.

Whether it was a recessionary cycle or a disinflationary cycle, 10Y yield landed well above the Fed fund terminal rate. **Table 1** and **Table 2** show that in past recessionary cycles the 10Y traded 200bp above the Fed fund terminal rate on average at the end of the cycle, while in disinflationary cycles it traded on average 85bp above the terminal rate.

Taking into account that, according to our Taylor rule, in a disinflationary cycle the Fed fund terminal rate would be around 3-3.50%, while in a recessionary cycle it would be in the 1-2% range, 10Y yields would end a disinflationary cutting cycle in the 3.8-4.3% range and a recessionary cutting cycle in the 3-4% range.

At the time of writing, 10Y yields hover around 4.25%. Therefore, we should not expect a huge drop ahead in yields by the end of the year then, especially considering that our baseline is a disinflationary rate cycle.

TABLE 1:
Recessionary cuts cycles

Date	Fed fund terminal rate (%)	10Y @end cycle (%)	10Y/terminal rate spread (bp)
1980	9,50	10,09	59
1981	12,00	13,98	198
1982	8,50	10,47	197
1989-1992	3,00	6,35	335
2001-2003	1,00	3,52	252
2007-2008	0,25	2,21	196
Average			206

Source: Bloomberg, Anima Research

TABLE 2:
Disinflationary cuts cycles

Date	Fed fund terminal rate (%)	10Y @end cycle (%)	10Y/terminal rate spread (bp)
1984	8,25	11,51	326
1985-1986	5,88	7,14	126
1995-1996	5,25	5,58	33
1998	4,75	4,71	-4
2019-2020	1,75	1,15	-60
Average			84

Source: Bloomberg, Anima Research

B. The long-term equilibrium of USTs yields is not too far from current levels.

In the long-run, long-maturities UST yields should reflect the level of potential growth of the economy plus the inflation target. **Figure 8** shows that before the global financial crisis, 10Y USTs were trading close to this long-term equilibrium.

QE, higher demand for safe-haven assets and risk aversion have depressed USTs yields well below their long-term equilibrium between 2008 and 2021, but since 2021 10Y UST have re-aligned with their long-term equilibrium, which is currently in the 3.7% area.

We think that absent an external shock that triggers a sharp rise in risk-aversion and/or a resumption of QE, 10Y UST yields will not undershoot their long-term equilibrium level in a sustainable way in the medium-term.

FIGURE 8.

10Y UST yields have re-aligned to their long-term equilibrium

Source: Bloomberg, CBO, Haver, Anima Research

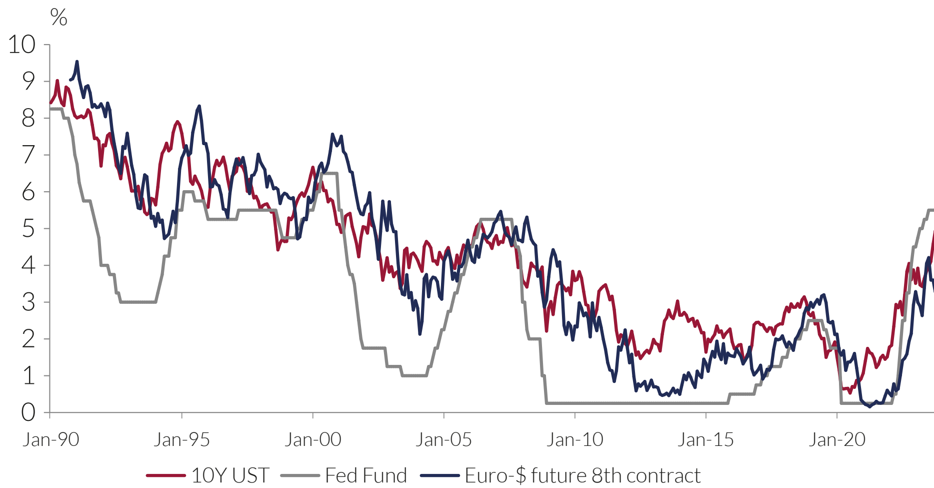
C. We see limited room for a further fall in markets' pricing of the terminal rate in coming months.

Figure 9 shows that 1) in the past, markets' expectations on the Fed fund's terminal rate were very reactive and started falling only once the Fed started cutting rates, 2) in cutting cycles, the terminal rate priced in by markets has always been higher than the realized Fed fund terminal rate, 3) 10Y yields have generally been highly correlated to the Fed's fund terminal rate priced in by markets.

Differently from the past, in the current cycle, investors have been pricing a terminal rate much lower than the current Fed funds rate well ahead of the start of the rate cut cycle. This combined with our expectations for a disinflationary rate cut cycle points to limited room for a further fall in markets' pricing of the terminal rate in coming months. In turn, this would limit the room for a fall in 10Y yields from current levels.

FIGURE 9.

Markets are already pricing a low Fed fund terminal rate compared to the past



Source: Bloomberg, Anima Research

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