US Rates Strategy
POLITICS CHEAPS IN (PART I)

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Our tactical position remains LONG, *as we still anticipate the potential for yields to decline further, albeit at a slower rate than before. Activity momentum is beginning to show early signs of deceleration, the labour market continues to rebalance, and the disinflationary trend persists.*

However, our current recommendation is to ***take profits in the 4.10% area*** *(as opposed to our previous suggestion of 4.0%) for two reasons:*

1. *We maintain our expectation that the Fed will initiate a disinflationary rate-cutting cycle this year, rather than entering a recessionary one. The potential for sharp declines in yields, unless accompanied by a significant economic slowdown (which is not our baseline scenario), remains limited.*
2. *The market is increasingly sensitive to fiscal risks associated with the election. If the bear-steepening of the UST curve seen after the first Trump-Biden debate is indicative (our tentative baseline), it suggests that an increase in yields before the elections and potentially afterwards, depending on the outcome, cannot be ruled out.*

Against this backdrop and given our increase of duration exposure up to 4.70%, the risk-reward ratio of maintaining a long position beyond 4.10% has significantly deteriorated in recent times.

We are strategically maintaining an OVERWEIGHT position:

1. *We maintain our expectation of a gradual moderation in the macroeconomic outlook*
2. *We anticipate Quantitative Tightening (QT) to cease entirely by Q1 2025..*

However, we are reassessing the strategic outlook. *The influence of US politics on our baseline has grown, and the likelihood for further fiscal easing could mitigate the downward pressure on rates resulting from a softening macro environment.*

According to polls, we cautiously predict that 1) Trump will win the elections and 2) the market will react as it did in 2016 with US rates easing (10Y) after rising ahead of the elections. *Given this scenario, it remains sensible to stay strategically OVERWEIGHT. However, the high uncertainty regarding the election outcome and its fiscal implications, has led us to put under review our strategic outlook.*

In Part II, we will further elaborate on this point.

While the performance of Bunds remains closely linked with that of USTs, ***we are not reconsidering our strategic positioning on Bunds****. We anticipate that if fiscal concerns lead to sustained upward pressure on UST yields, this would spill over to Bunds, causing an unwarranted tightening of financing conditions in the Euro Area, potentially pressuring the ECB to adopt a more dovish policy.*

TACTICAL VIEW - Still LONG, but raise take profit bar

Our tactical position remains LONG, as we still anticipate the potential for yields to decline further, albeit at a slower rate than before.

Activity momentum is beginning to show early signs of deceleration, the labour market continues to rebalance, and the disinflationary trend persists. This may lead markets to price in an even (moderately) lower neutral rate.

However, **our current recommendation is to take profit in the 4.10% range** (as opposed to our previous suggestion of 4.0%).

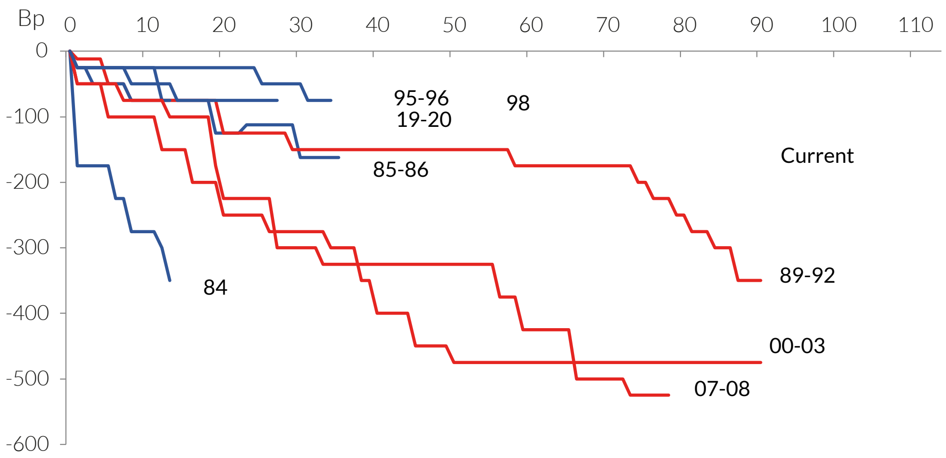
I. PRICING

We maintain our expectation that the Fed will initiate a disinflationary rate-cutting cycle this year, rather than entering a recessionary one. The potential for sharp declines in yields, unless accompanied by a significant economic slowdown (which is not our baseline scenario), remains limited.

Market pricing (180bp over the next 24 months; **Figure 1**) discounts a disinflationary cycle, in line with our baseline, while Fed's dot plot is slightly more hawkish (**Figure 2**). Unless markets start flirting with the idea of a recessionary cycle, downside for yields is limited.

FIGURE 1.

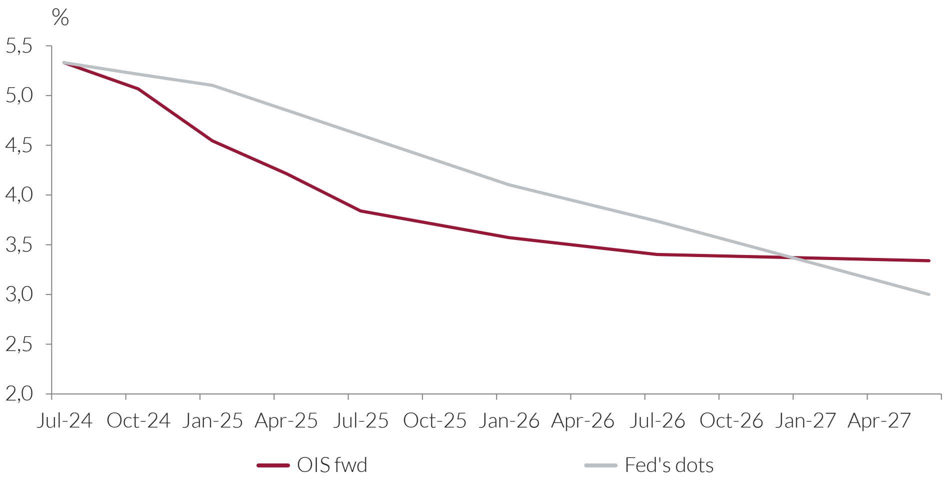
Disinflationary cycle fully priced in



Recessionary cycles are in red, disinflationary cycles are in blue.
Source: Bloomberg, Anima Research

FIGURE 2.

Fed's dot plot more hawkish than markets

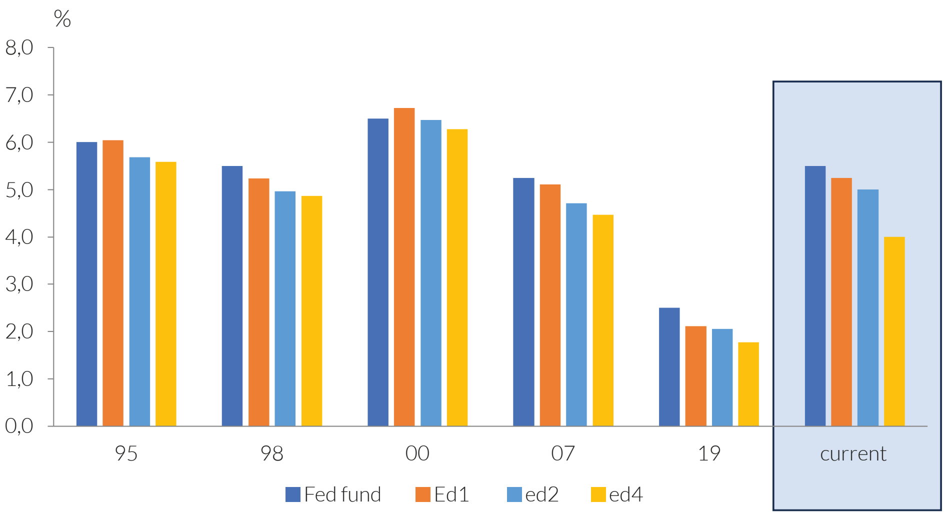


Source: Bloomberg, Anima Research

Moreover, markets are more aggressive than they have been in the past ahead of a rate cut cycle (**Figure 3**). This is also reflected in 2Y and 10Y UST yields trading well below the Fed fund rate.

FIGURE 3.

Markets are more aggressive than in the past in pricing rate cuts in coming months



The chart shows the 1st, 2nd and 3rd Eurodollar contracts ahead of the first rate cut in different rate cut cycles. For the current one, we use OIS futures instead of Eurodollar contracts.
Source: Bloomberg, Anima Research

History tells us that on average in disinflationary cuts cycles, 10Y UST yields end the cutting cycle some 85bp higher than the Fed fund (Figure 4). If we think that the Fed will take the Fed fund rates in the 3-3.5% area and history is any guide, we should expect 10Y yields to be in the 3.80-4.30% area at the end of the cutting cycle. We can allow some further room to the downside, considering that the amount of Treasuries on the Fed's balance sheet will remain higher than in the past, but even in this case, the room for a decline in yields remain limited.

FIGURE 4.

UST yields at the end of 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
219-2020	1,75	1,15	-60
Average			84

Source: Bloomberg, Anima Research

II. THE SPECTRE OF FISCAL POLICY

The market is increasingly sensitive to fiscal risks associated with the US election. If the bear-steepening of the UST curve seen after the first Trump-Biden debate is indicative (our tentative baseline), it suggests that an increase in yields before the elections and potentially afterwards, depending on the outcome, cannot be ruled out.

The Congressional Budget Office (CBO) baseline envisages an average deficit/GDP ratio of 5.5% in the period 2025-2029. While noteworthy, this is a conservative assumption as both Biden and Trump have further fiscal easing in the pipeline. The IMF, for instance, assumes a deficit/GDP ratio of 6.5% in the period 2025-2029 (on average).

While it is no news that risks to the US budget deficit are skewed to the upside in coming years, markets have largely ignored fiscal risks as they have been dominated by macro developments.

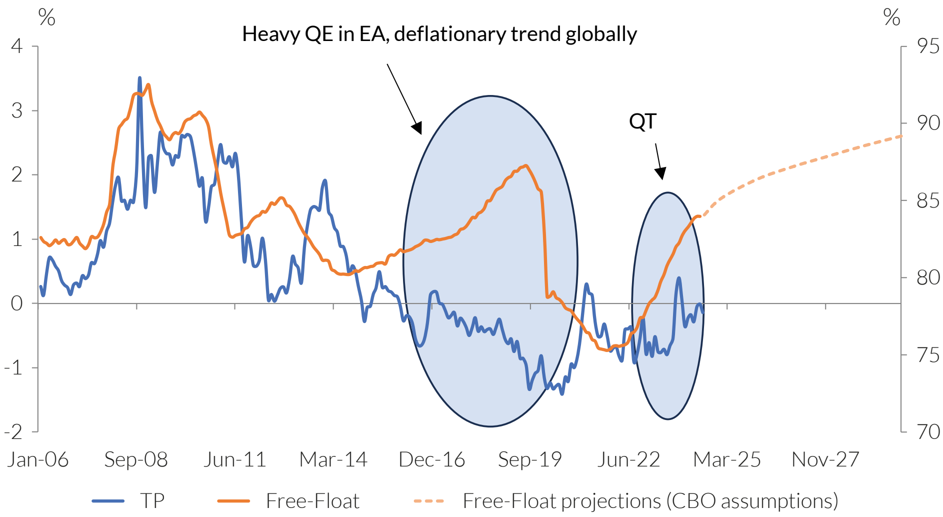
This exposes USTs yields to spikes before and (possibly) after November elections, through the following channels:

A) **Higher term premium (TP) due to expectations of higher supply/free-float of USTs.** TP is in negative territory and does not price in the rising amount of free-float in USTs[1] (**Figure 5**).

1 The free-float is total US marketable debt excluding the amount held on the Fed's balance sheet as a proportion of total US marketable debt.

FIGURE 5.

TP does not price correctly the increasing amount of UST free-float



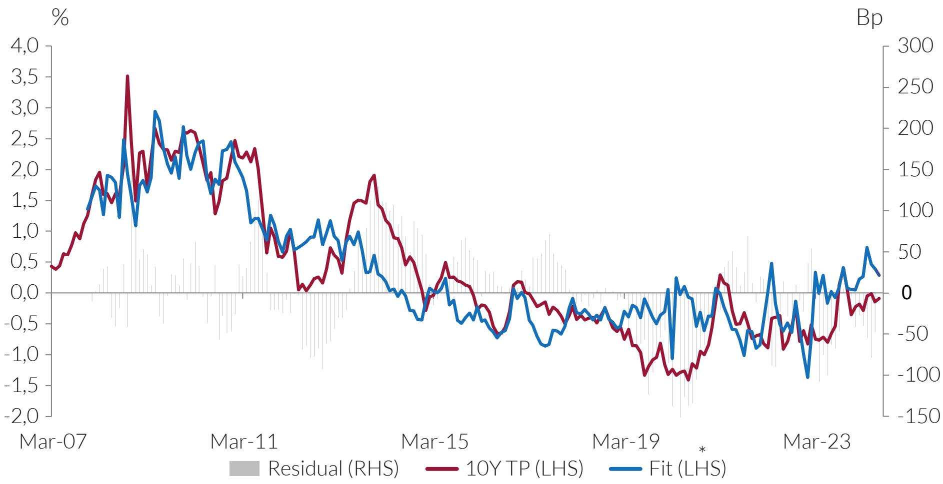
Source: Bloomberg, Haver Analytics, CBO, Anima Research

In this respect our model indicates that the TP is too low now and should be well in positive territory (**Figure 6**). Going forward, for 1pp increase in the free-float of USTs, the TP should increase 10bp, all else being equal.

We calculate that in the CBO baseline scenario, the free float of USTs would increase by 1.25pp next year and pass 1.5pp in case of fiscal expansion measures. This would translate, all else being equal, in around 13-15bp (or even higher) TP increase.

FIGURE 6.

TP is too low according to our model

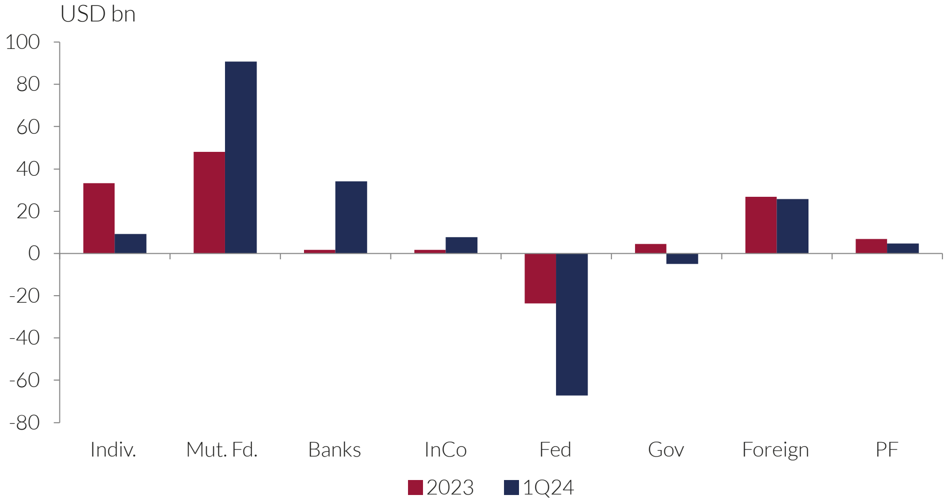


**The model regresses the ACM term premium on 1) Unemployment rate 2) Inflation risk premium 3) Rates volatility 4) Free float of USTs. The model is estimated on monthly data from 2008 until present.*
Source: Bloomberg, Haver Analytics, CBO, Anima Research

Against this backdrop, the fact that foreign investors are an important source of demand for USTs in 2024 (**Figure 7**) is a further source of concern, as they are price-sensitive. This may exacerbate the increase in TP triggered by an increase in the supply of USTs.

FIGURE 7.

Foreign investors remain a very important source of demand for USTs



Source: Bloomberg, SIFMA, Anima Research

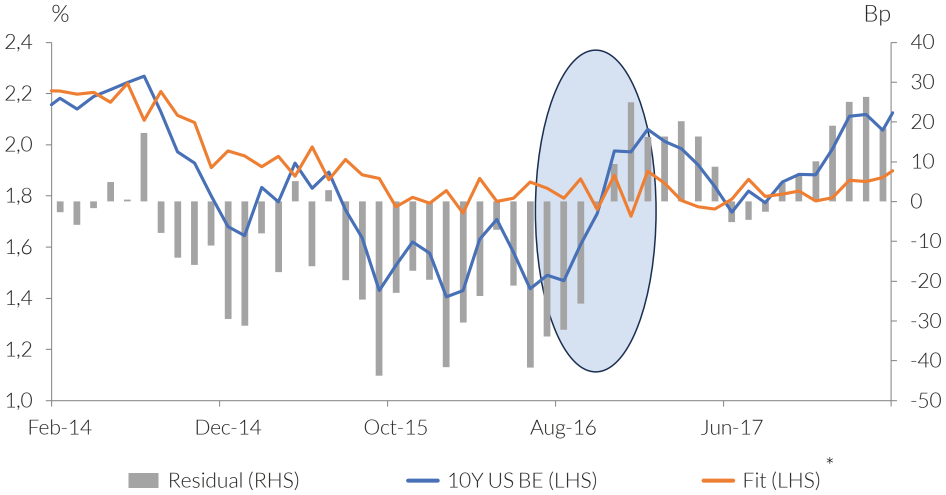
B) Higher breakeven rates. Higher deficits have been contributing to higher inflation in the post-Covid period[2]. In its most recent Fiscal Monitor3, the IMF estimates that the contribution from easy fiscal policy in the US to core inflation was about 0.5pp in 2023, having remained stable at that level over the previous two years. Against this backdrop, going into the elections and in anticipation of more fiscal easing, the market may price in a less disinflationary environment, as it was the case in 2016 (**Figure 8**).

Whether rising rates will be the post-election environment is yet to be seen, though. The outcome will be key in that regards. Biden and Trump are both pro-fiscal easing, however the underlying approach to it is very different. The former favours increasing spending, the latter cutting taxes. We will elaborate on this key point in the second part of this note.

2 Pre-Covid, fiscal deficits were countercyclical, meaning they were higher in moment of economic crisis, when growth and inflation dropped.
3 https://www.imf.org/en/Publications/FM/Issues/2024/04/17/fiscal-monitor-april-2024, pag.6 and https://www.chicagofed.org/publications/working-papers/2022/2022-37

FIGURE 8.

Breakeven rates rose post Trump elections in 2016, leading to high positive residuals in 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

C) Monetary policy expectations. Expectations of wider fiscal deficit could also halt the ongoing dovish repricing of the Fed. Even more so now as the markets still vividly remember the unexpected rise in inflation witnessed post COVID.

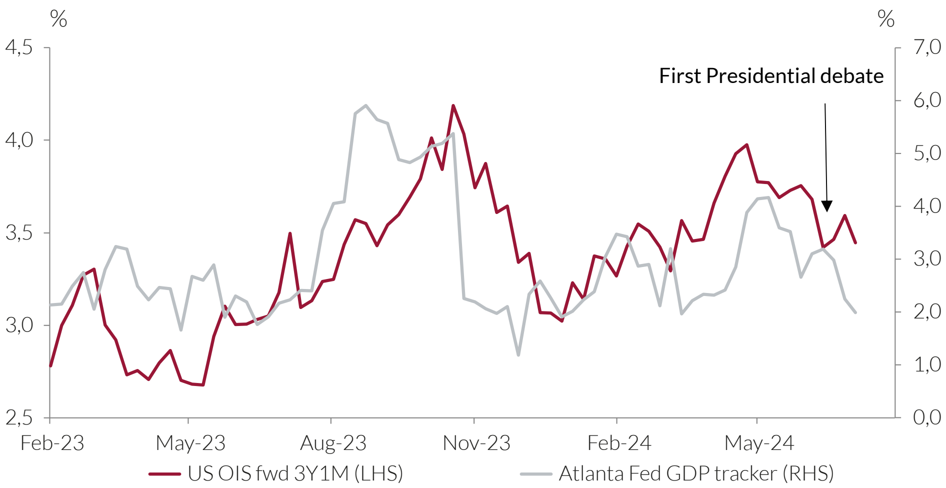
Two considerations in this respect:

i) Market reaction after the first Presidential debate. While since the end of April a combination of weaker-than-expected growth and inflation data has contributed to a downward revision of the neutral rate priced in by markets (**Figure 9**), the trend was temporarily interrupted following the first Presidential debate (**Figure 9**).

i) Market reaction after 2016 Presidential elections. Back then, markets started pricing in a more hawkish Fed in the medium to long-term owing to expectations of higher fiscal deficit and higher inflation (**Figure 10**).

FIGURE 9.

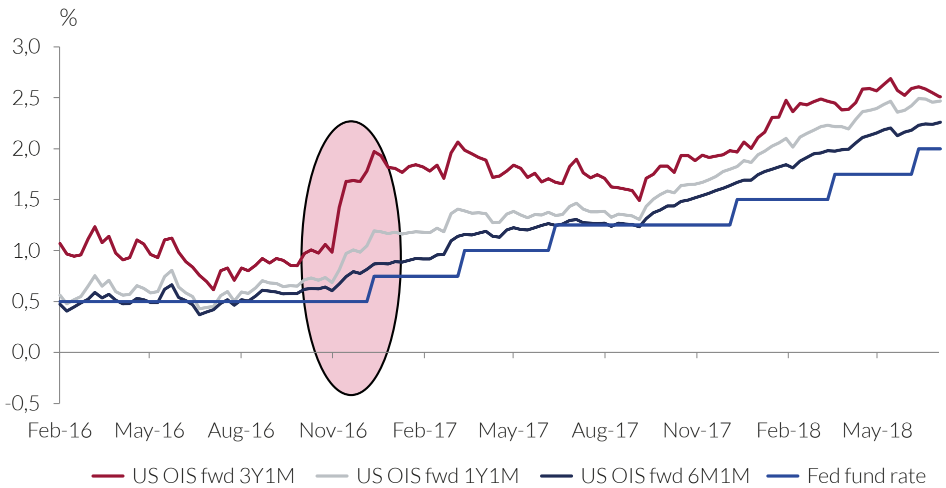
Macro in the driver's seat until the first Presidential debate



Source: Bloomberg, Anima Research

FIGURE 10.

Post-Trump elections in 2016, markets revised higher medium/long-term monetary policy expectations



Source: Bloomberg, Anima Research

Against this backdrop and considering we have been accumulating duration exposure through 4.70%, risk-reward of insisting on a long positioning beyond 4.10% have diminished remarkably lately.

STRATEGIC VIEW – WE REMAIN OVERWEIGHT, WITH A BUT

We are strategically maintaining an OVERWEIGHT position:

1) *We maintain our expectation of a gradual moderation in the macroeconomic outlook.*

2) *We anticipate Quantitative Tightening (QT) to cease entirely by Q1 2025.*

However, we are reassessing the strategic outlook. The influence of US politics on our baseline has grown, and the likelihood for further fiscal easing could mitigate the downward pressure on rates resulting from a softening macro environment.

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