*Anima***Insight**

US Rates Strategy
US ELECTION: Politics cheaps in (PART II)

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Over the last months, we have taken profit on our tactical long position on USTs and we are now tactically NEUTRAL. Assuming that we get to the US presidential elections with yields around current levels, and Trump wins the elections:

1. *We would be looking to re-extend our exposure tactically only:*
   - ***At 4.40%, in a split Congress scenario***
   - ***At 4.80% in a Republican sweep scenario***

Our more cautious tactical stance in case of Republican sweep scenario reflects:

1. *The fact that markets would be more surprised by a Republican sweep scenario than by a split Congress scenario.*
2. *A higher risk of bond-unfriendly policies in a Republican sweep scenario that markets would price relatively soon after the elections, as happened in 2016.*

2. *Strategically,*
   - ***In a split Congress scenario, we would remain OVERWEIGHT, with the caveat that room for a decline in yields below current levels is limited, unless growth starts weakening more than we expect.***
   - ***In a Republican sweep scenario, we remain OVERWEIGHT, but we would place our positioning under review.***

While we believe that a full implementation of the Trump policy agenda would be unlikely even in a Republican sweep scenario and, in any case, policies would be implemented starting from H2 2025 at the earliest, a Republican sweep would bring a much more uncertain environment compared to Scenario 1.

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Scenario 1: Trump wins + Congress split

Over the last months, we have taken profit on our tactical long position on USTs and we are now tactically NEUTRAL. Assuming that we get to the US presidential elections with yields around current levels, and Trump wins the elections with a split Congress,

- We would be looking to re-extend our exposure tactically if 10Y yields reach the 4.40% level.
- Strategically we remain OVERWEIGHT, with the caveat that room for a decline in yields below current levels is limited, unless growth starts weakening sizably.

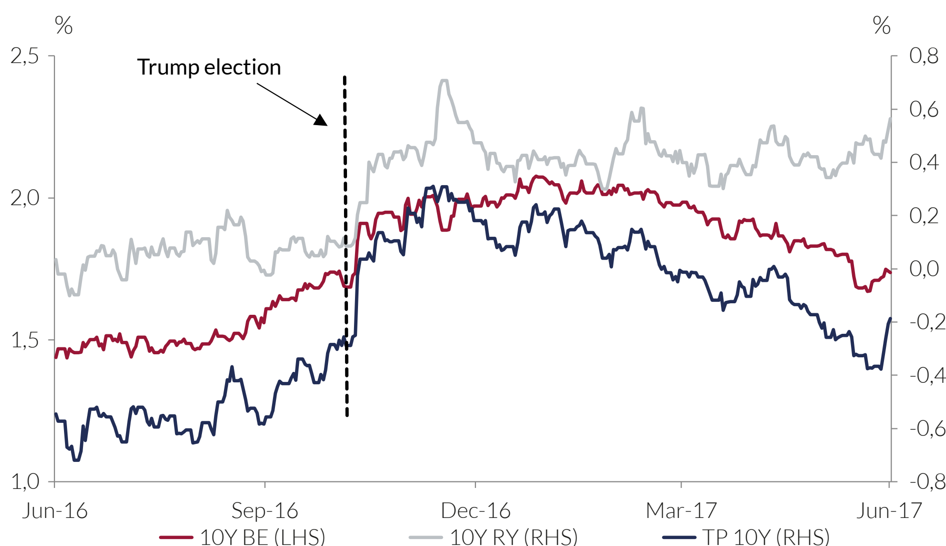
I. Tactical positioning – NEUTRAL + increasing exposure at 4.40%

We suggest remaining NEUTRAL and extending exposure to USTs in case of a spike in yields to 4.40% (10Y). The reason for this is that we expect a market reaction to a Trump victory to be short-lived and we do not expect long-term yields to overshoot the 4.40% level on a permanent basis in a scenario of a split Congress.

When Trump won the presidential elections in 2016, markets were taken by surprise and reacted by pricing higher inflation, higher growth and a higher neutral rate. In rates, this translated to higher breakeven rates, higher real rates, a higher term premium and steeper curves. For reference, 10Y UST yields surged around 80bp and the 2/10Y spread steepened around 35bp post-election. The reaction lasted a couple of months before rates corrected most of the movement in the early months of 2017, after assessing that the impact of Trump's policies would have taken time to materialize and was far from certain (**Figure 1**).

FIGURE 1.

Trump trades in rates lasted until the end of 2016 and corrected in H1 2017



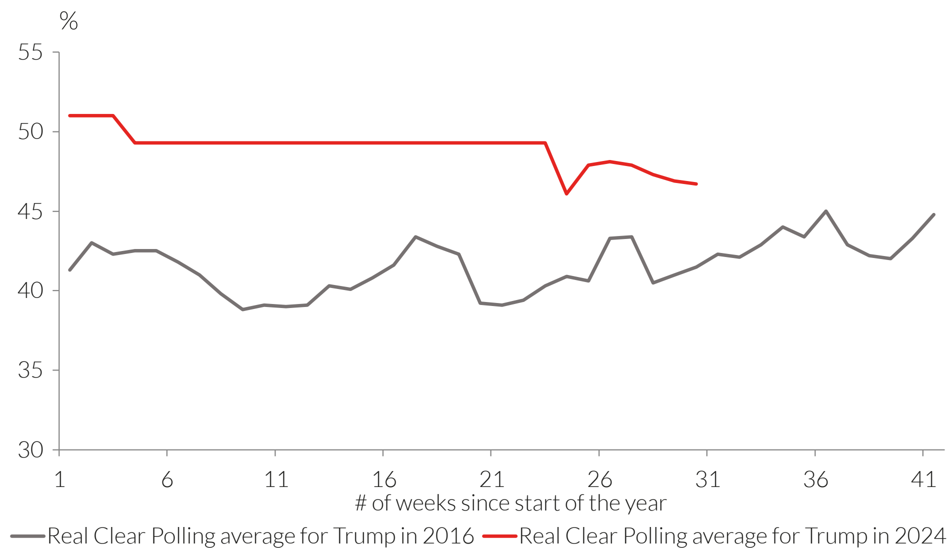
Source: Bloomberg, Anima Research

We expect the market reaction to be more limited and short-lived this time. For the following reasons:

1. **Surprise election results.** While in 2016, Trump's victory came as a surprise, this time it would be less of a surprise. The polls indicate that the probability of Trump winning the elections stands at almost 47%, vs 41% at the same stage back in 2016 (**Figure 2**).

FIGURE 2.

Polling average for Trump winning the elections are much higher than in 2016



Source: Bloomberg, Anima Research

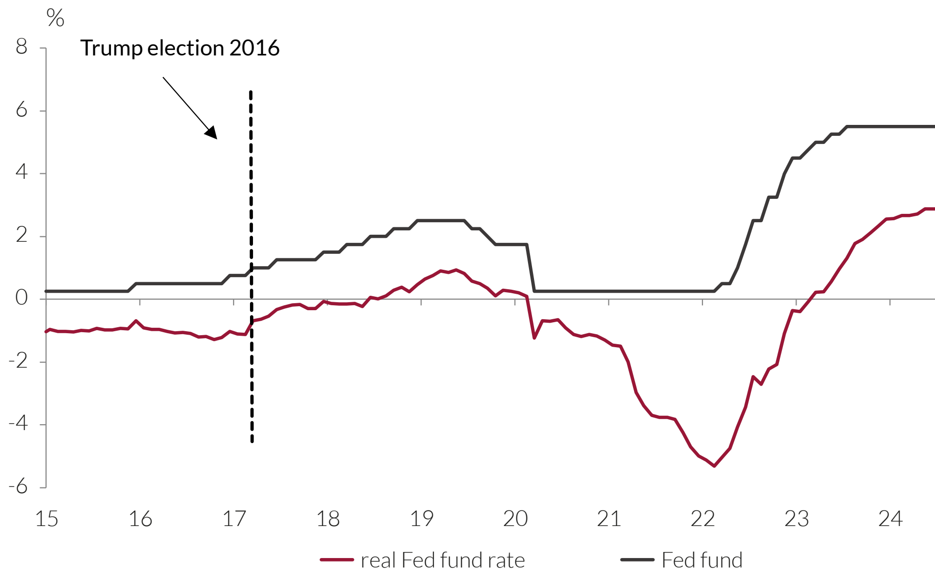
2. **Growth:** While in 2016, the world was navigating towards a period of solid synchronized growth (2017-2018), global growth is now expected to slow down, albeit gently.

3. **Inflation:** Inflation was certainly not an issue in 2016, with PCE core below 2%, but the trend during 2016 had been one of acceleration in core inflation. Meanwhile, albeit still above target, core inflation is on a declining trend.

4. **Monetary policy:** In 2016, monetary policy was accommodative (real Fed fund rate was in negative territory, **Figure 3**), while it is now quite restrictive. Accordingly, while in 2016 the Fed had already started a rate hike cycle and proceeded with rate hikes following the 2016 elections, expectations are now for the Fed to start cutting rates in September.

FIGURE 3.

At the end of 2016, the Fed's monetary policy was slightly accommodative, while it is now restrictive



Source: Bloomberg, Anima Research

All in all, **the current macro environment makes a permanent shift higher in bond yields very unlikely** in case of a Trump victory. Moreover, a split Congress would provide reassurance to the rates markets that Trump will not be able to implement his agenda in full.

Why choose 4.40% as the bar for adding exposure? In case of a split Congress, we expect a more contained reaction with respect to 2016 (around 80bp increase in 10Y yields).

Indications from our fair value models suggest that, at the moment:

1. Real yields are approximately 40bp too low.
2. Breakeven are approximately 20bp too low.
3. TP is approximately 50-60bp too low.

Therefore, our fair value models point to 50-60bp of possible upside for long-term yields from current levels, which points to the 4.40% as an appealing level to start accumulating exposure in Scenario 1.

II. Strategic positioning – OVERWEIGHT with the usual caveat

In case of a Trump victory with a split Congress, **we would suggest maintaining an OVERWEIGHT strategic positioning**.

For the following reasons:

1. **We see the impact of Trump policies on growth and inflation in a split Congress scenario as very moderate at best.**

Tariffs - We do not expect tariffs to result either in sharp upward pressure on prices or in sizeable slow-down in growth (see our macro section).

TCJA - It is highly questionable for a small extension of tax cuts (TCJA), mostly for middle/lower income brackets, to have a sizeable positive impact on growth or even be inflationary. If anything, extending the TCJA should prove growth neutral compared to the current expected spending pattern (see macro section).

2. **Term premium (TP) set to increase, but gradually.**

Even without any increase in the deficit compared to the baseline scenario, the TP is bound to rise in the coming months. The reason is two-fold:

i. It is too low compared to fundamentals.

ii. UST free-float is set to rise gradually, even in the absence of new measures.

Moreover, we calculate that in a split Congress scenario, the deficit could be USD 200bn higher on average per year, with 2026 relatively less hit by the loss in revenues if the TCJA is extended. Taking into account that in the baseline scenario the CBO projects issuance would be around USD 2tn per year in the coming years, this amount is not negligible in terms of yearly issuance absorption (**Figure 4)**. But, in terms of free-float of USTs, which is what ultimately matters for the TP, it does not move the needle dramatically (**Figure 5**).

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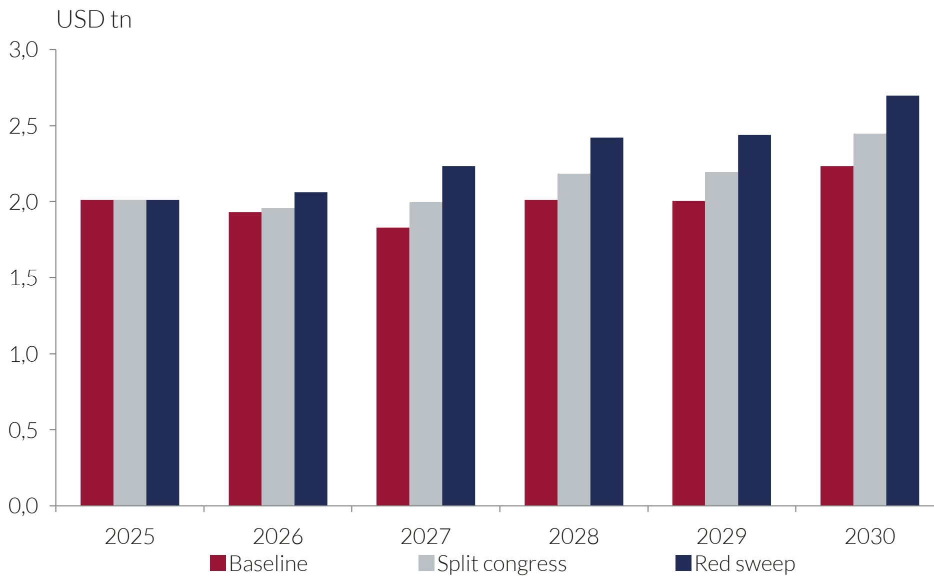
FIGURE 4.

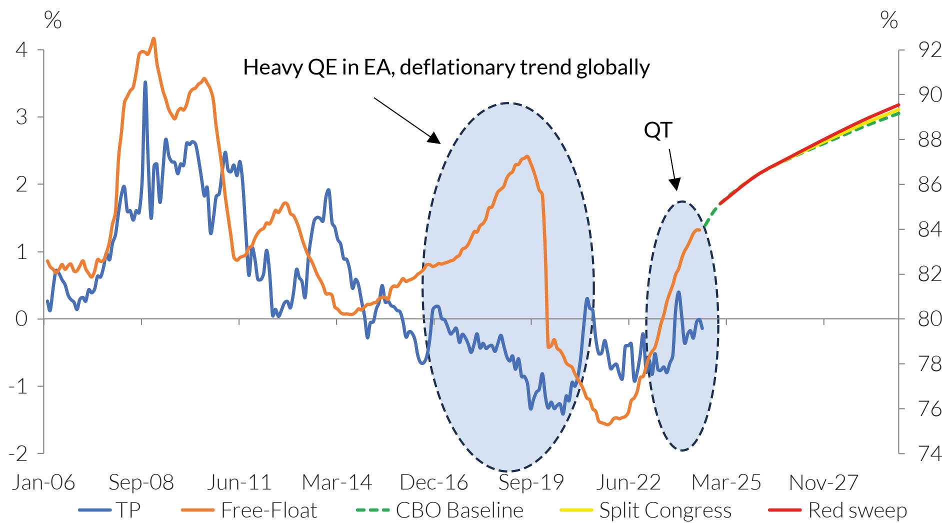
Issuance to increase in split Congress scenario, especially starting from 2027



Source: CBO, Anima Research

FIGURE 5.

Not much impact on the free-float of USTs in a split Congress scenario



Source: Bloomberg, CBO, Anima Research

Lastly, any early implementation of unilateral tariffs could bring extra revenues, providing good news on the fiscal policy front.

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3. **We do not expect the Fed to change its monetary policy stance in response to Trump policies.**

Unless the growth and inflation outlook change dramatically (not our assumption in a scenario of Trump winning the presidency and a split Congress), we expect the Fed to remain data-dependent and to deliver a gradual rate cut cycle that brings the Fed fund rate back to neutral.

A word of warning. We continue to see limited room for yields to decline from current levels. On the one hand, we continue to expect the Fed to deliver a disinflationary cut cycle; on the other hand, a Trump presidency with split Congress would not bring a sizeable change in the growth and inflation outlook. At the margin, it could bring moderately higher deficits, putting a floor on UST yields.

Scenario 2: Republican sweep

Over the last months, we have taken profit on our tactical long position on USTs and we are now tactically NEUTRAL. Assuming that we get to the US presidential elections with yields around current levels, and Trump wins the elections in a Republican sweep scenario:

- We would be looking to re-extend our exposure tactically only if 10Y yields reach the 4.80% level.
- Strategically we remain OVERWEIGHT, but we would place our positioning under review.

I. **Tactical positioning – NEUTRAL + increasing exposure at 4.80%**

Our more cautious tactical positioning in case of a Republican sweep reflects:

1. **A higher risk of an aggressive tariffs policy** that could eventually lead to higher inflation down the line (beyond 2025).

2. **A higher probability of a full extension of the TCJA.** This would be bond-unfriendly in two ways: firstly, it would raise the deficit by around USD 4tn in the 2026-2035 period. Secondly, it would lift growth and growth potential, which would translate to a higher neutral rate priced by markets and steeper curves.

Why would these considerations affect our tactical positioning? Because in the case of a Republican sweep, we expect the rates markets to price all the risks right after the elections, as happened in 2016. Unlike the case of a Trump victory with split congress, a Republican sweep would represent a surprise.

How to hedge for this scenario? In our view, the best hedging trades would be curve steepeners.

II. Strategic positioning – OVERWEIGHT, but under revision

We think that remaining strategically OVERWEIGHT would make sense even in a Republican sweep. For the following reasons:

1. **Full implementation of the Trump agenda is unlikely.**

   Despite the fact that in the first two years of its 2016-2020 presidency, Congress was controlled by Republicans, Trump did not implement his full agenda.

2. **Policy implementation is unlikely before H2 2025 and the actual economic impact will be clear well after.**

   Even under a Republican sweep, we expect tariffs to be implemented in H2 2025 at the earliest, while any extension of the TCJA would only happen starting from 2026 in any scenario. We do not expect the Fed to take into account any of Trump's policies in its reaction function before the effect of such policies are properly assessed, which means most likely even later than 2026.

3. **Deglobalization is not new to the world.**

   In recent years, globalization has continued to recede, and the world has become more adaptive to trade and supply chain disruptions. In this context, all else being equal, higher tariffs would probably have a milder negative impact on growth compared to 2016 (unless there is a fully-fledged trade war, which in any case would not happen in the short term) and a milder impact on inflation compared to 2016.

4. **Little room to expand deficit.**

   Under the previous Trump presidency, UST issuance doubled between 2017 and 2018 and has remained permanently higher since then (Figure 6). The increase was due not only to lower revenues, in particular corporate taxes, but also to higher expenditures, in particular related to defense. While the probability of another sharp increase in deficit is not zero under a Republican sweep scenario, it is nonetheless low in our view, and the reasons are two-fold:

   - The public finance outlook has largely deteriorated since 2016, especially in terms of mandatory spending and interest expenditures (which cannot be easily reduced) and the room to increase the deficit is much lower than it used to be (**Figure 7**).

   - The portion of T-bills on total marketable debt is above 20%, much higher than under the first Trump presidency and around the maximum range recommended by the Treasury. We therefore rule out a large increase in deficit being exclusively financed through T-bills (**Figure 8**).

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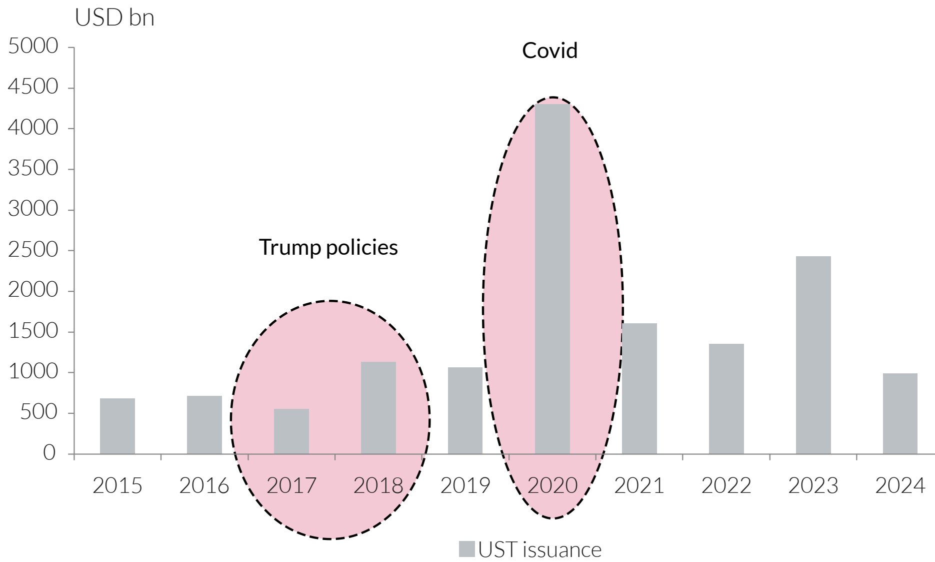
FIGURE 6.

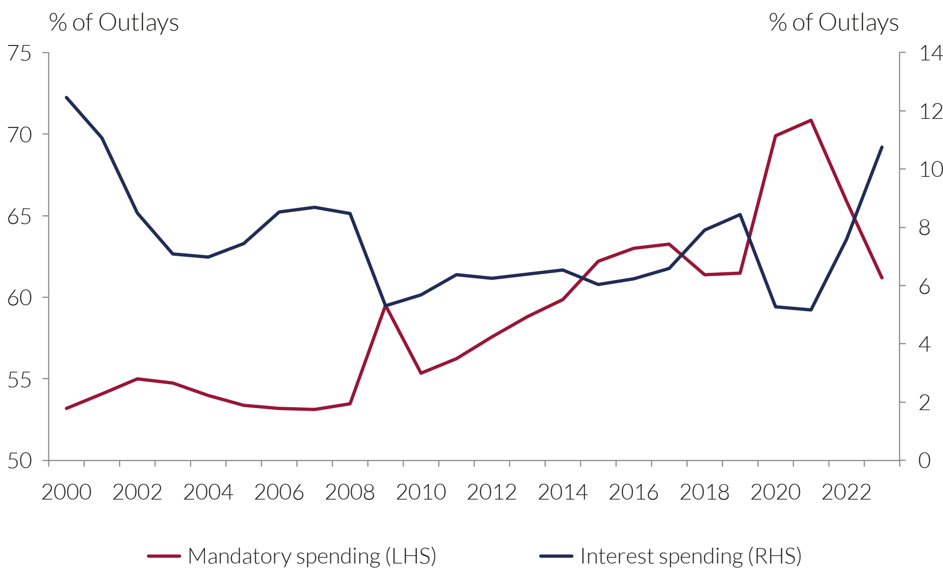
Between 2017 and 2018 UST issuance almost doubled



Source: Bloomberg, Haver, Anima Research

FIGURE 7.

Interest expenses and mandatory spending have structurally increased



Source: CBO, Anima Research

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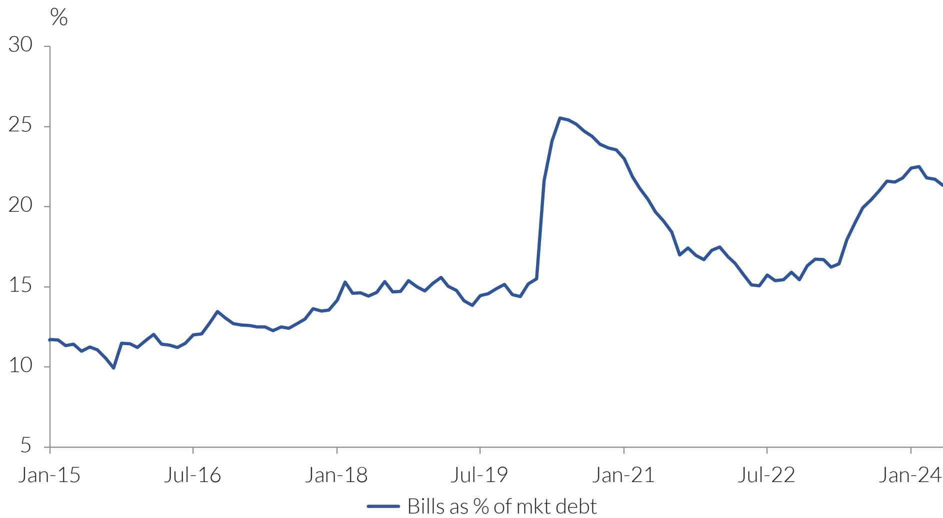
FIGURE 8.

T-bills portion of total marketable debt is historically high



Source: Bloomberg, Haver, Anima Research

That said, **a Republican sweep would bring much more uncertainty and higher risks of a bond-unfriendly environment compared to Scenario 1**, especially because Trump can be erratic and unpredictable and the rates markets might price in a higher premium in bonds as a result. For this reason, under a Republican sweep scenario we would place our strategic positioning under revision.

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