

## Rates Strategy

# UST: Going neutral

## AUTHOR

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*We switch to a tactically NEUTRAL position (vs. LONG before).*

*In our view, following the recent rally spurred by the Jackson Hole (JH) speech that turned out to be more dovish than expected, upside risks for UST yields have increased. This is due to the following reasons:*

*1) We remain of the view that the US economy will avoid recession this year. We expect economic momentum to pick up in Q4, after troughing in Q3.*

*2) A more dovish-than-expected Fed should help reinforce our fundamentally based growth baseline. A Fed seemingly more focused on growth than inflation reduces the risks that the economy will hit the wall.*

*3) We now expect the peak of tariffs' pass-through to inflation to happen in October (previously expected during the summer).*

*4) Current Fed pricing is partly the result of political pressure on the Fed to cut. If political pressures on the Fed persist or even become successful, the build-up of term premium at the long maturities will likely continue, keeping the UST curve in a steepening mode. Even more so given still sound economic growth and slow tariff pass-through to inflation. In fact, the slower the pass-through, the longer the uncertainty regarding the new, post-tariff, price level equilibrium will last.*

*At the same time, we believe that the following factors could broadly offset upward pressure on UST yields in the near-term:*

*1) In July, the US Treasury announced that it will not increase coupon issuance, while it will increase the frequency of buybacks at the long end starting from Q3.*

*2) Tariff-related revenues could lead to a decline in the deficit in 2025 compared to 2024 and compared to investors' expectations.*

*3) In aggregate, evidence on foreign demand for USTs remains relatively benign.*

*Against this backdrop, we now recommend increasing exposure only at 4.50-4.60% and turning SHORT at 3.80%.*

*Strategically, we remain CONSTRUCTIVE with a NEGATIVE outlook, as the medium-term outlook remains highly uncertain and heavily dependent on the policies of the Trump administration.*

# We switch to a tactically NEUTRAL stance

In July, we turned tactically LONG on USTs at around 4.50% (10Y), but we recommended a very gradual accumulation. Following the recent rally in USTs, we switch to a NEUTRAL position. While on the one hand, upside risks to UST yields have increased, on the other hand, we identify a few factors that could offset, at least partly, upward pressure on UST yields in the near-term.

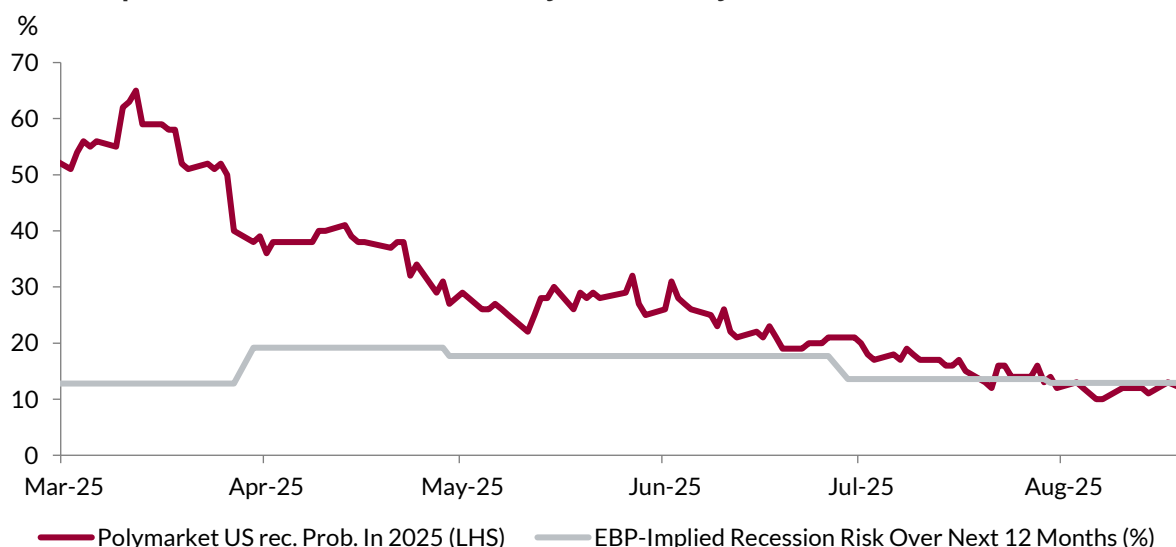
## Upside risks on yields have increased

### 1. No recession in sight

Despite signs that economic growth is slowing in the US, there are no worrying signs that point to a recession. On the contrary, we expect the US economy to start re-accelerating in Q4. Consistent with this, Figure 1 shows that recession probabilities, both from betting markets and models, have remained very low recently, and we expect this to remain the case in the near term.

**Figure 1**

**Recession probabilities have remained very low recently**



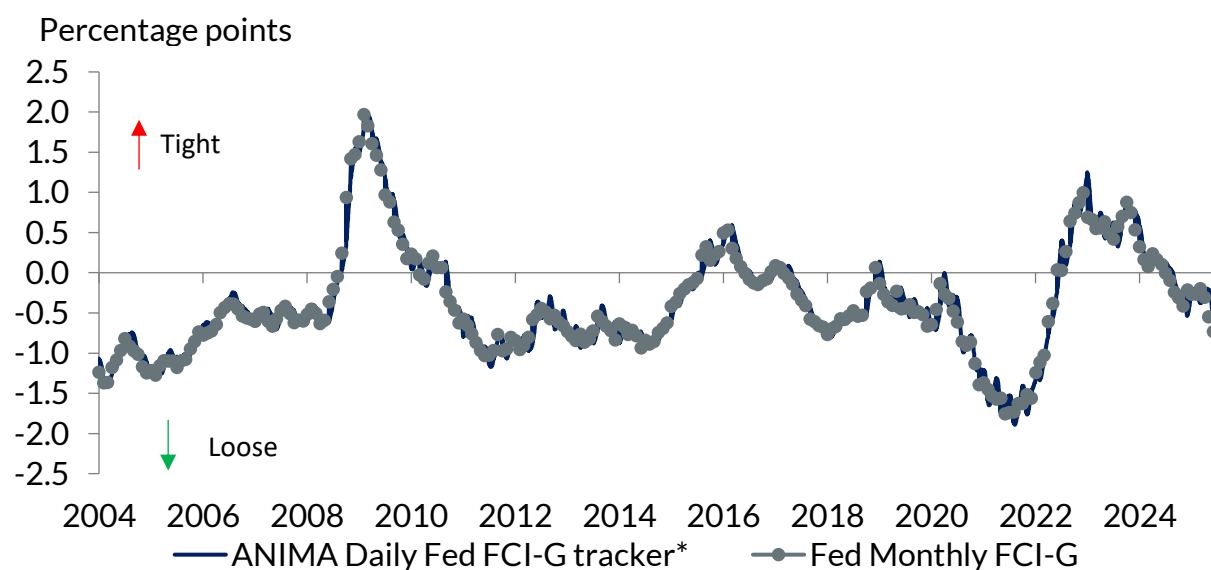
Source: Bloomberg, Haver Analytics, ANIMA Research

## 2. A dovish-leaning Fed will be growth-supportive

A more dovish-than-expected Fed should help reinforce our fundamental-based growth baseline. A Fed seemingly on alert mode regarding growth more than inflation, reduces risks that the economy will hit the wall, especially considering that financing conditions are growth-stimulatory at present (Figure 2).

**Figure 2**

**Financing conditions are growth-stimulatory**

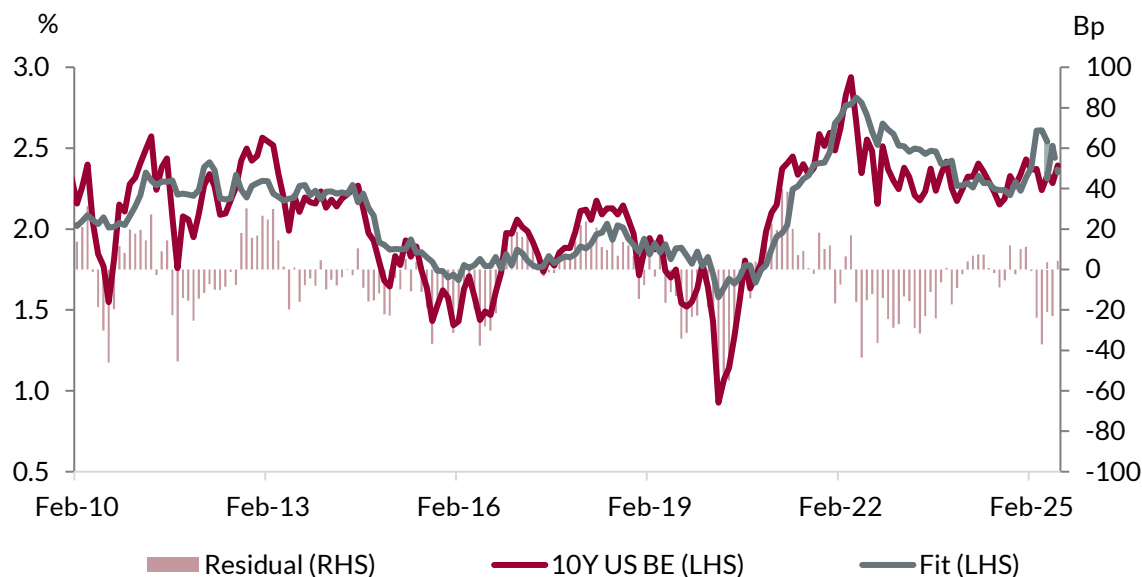


Source: Bloomberg, Haver Analytics, ANIMA Research

## 3. Tariff-related inflation peak postponed

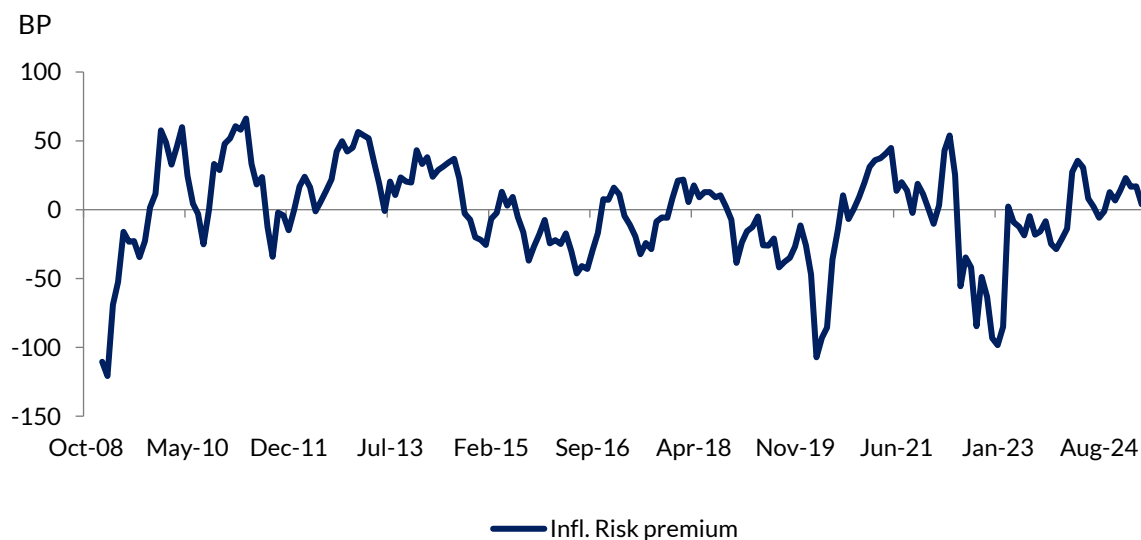
We now expect the peak of tariffs' pass-through to inflation to happen in October (previously expected during the summer). While this might not be a reason per se to expect yields to pick up as Chair Powell made clear that a slow build-up of tariff-related inflationary pressures can still be consistent with a one-off hike in price levels without necessarily pointing to building second-round effects on inflation, we believe that a tariff-pass through unfolding in slow motion will keep the market on its toes regarding potential upside surprises on inflation.

Figure 3 shows that 10Y breakevens are trading near our model fair value and the inflation risk premium priced by markets remains low (Figure 4). Against this backdrop, it is likely that breakeven rates could rise once we approach the peak of tariff-related increase in inflation. Given that we have moved the peak of tariff-related inflation forward to September-October (vs. summer before), in the next weeks, we could see markets pricing in a higher inflation risk.

**Figure 3****US breakeven are fairly priced**

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

Source: Bloomberg, ANIMA Research

**Figure 4****Inflation risk premium hovering at low levels**

Source: Bloomberg, ANIMA Research

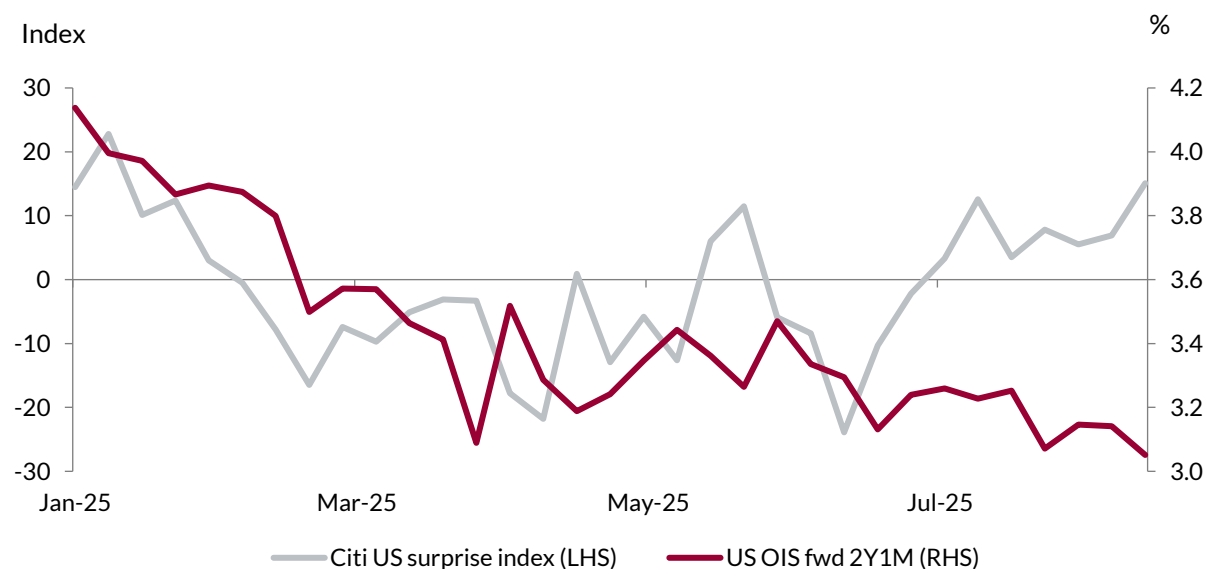
## 4. Dovish Fed pricing for the wrong reasons might weigh on the long end

Markets are discounting that the Fed will cut rates to 3% (around neutral) by September 2026. Figures 5 and 6 show that the recent market repricing of the Fed's path has moved in a more dovish direction compared to what both US economic

surprises and Fed members' rhetoric would have suggested, even when accounting for the dovish shift in rhetoric by Powell at Jackson Hole.

**Figure 5**

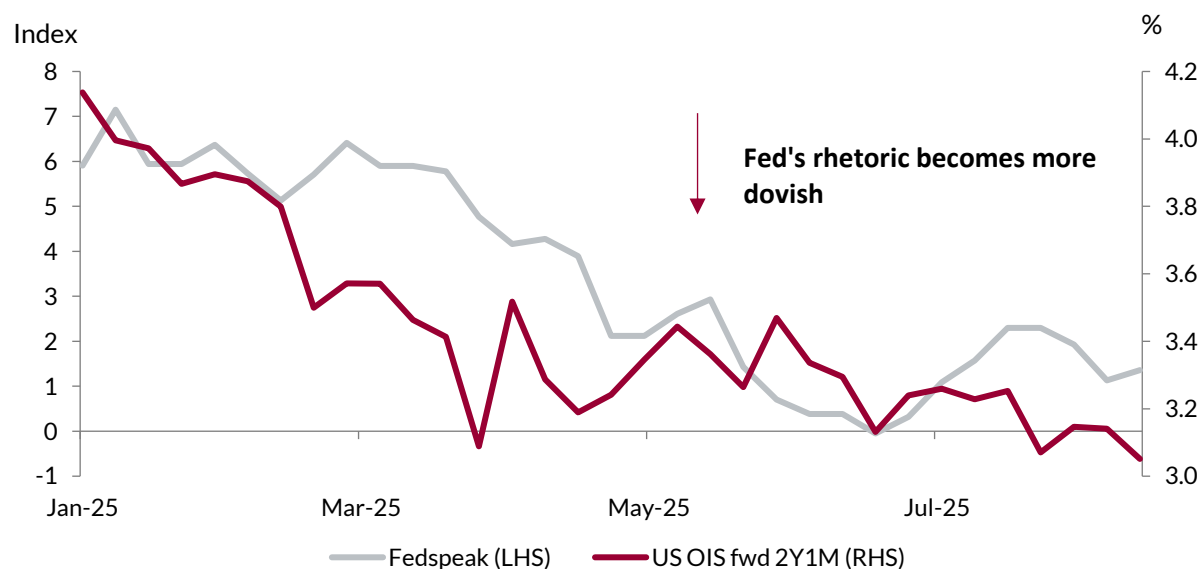
**Fed pricing more dovish than what US economic surprises suggest**



Source: Bloomberg, ANIMA Research

**Figure 6**

**Fed pricing more dovish than what Fed members' recent rhetoric suggests**



Source: Bloomberg, ANIMA Research

While not very sizeable, this moderately dovish mispricing of the Fed's path by markets is due to the recent political pressure on the Fed to cut rates, in our view.

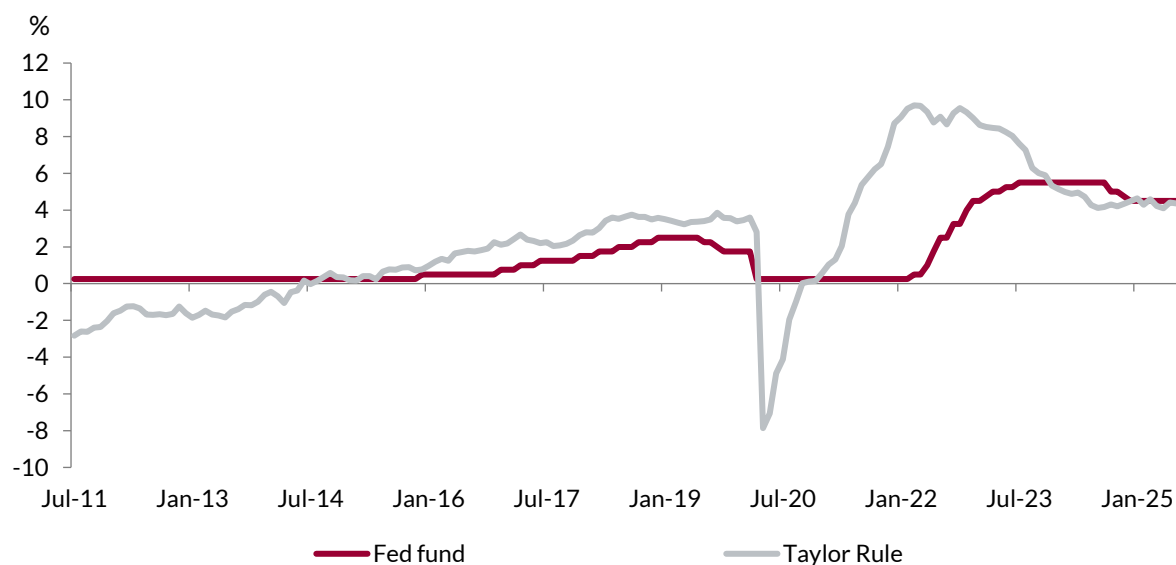
If political pressure on the Fed persists, amid still sound economic growth and expectations of tariff-related increases in inflation, **we believe that the build-up of**

**term premium at the long maturities will likely continue, keeping the UST curve in a steepening mode.** For the following reasons:

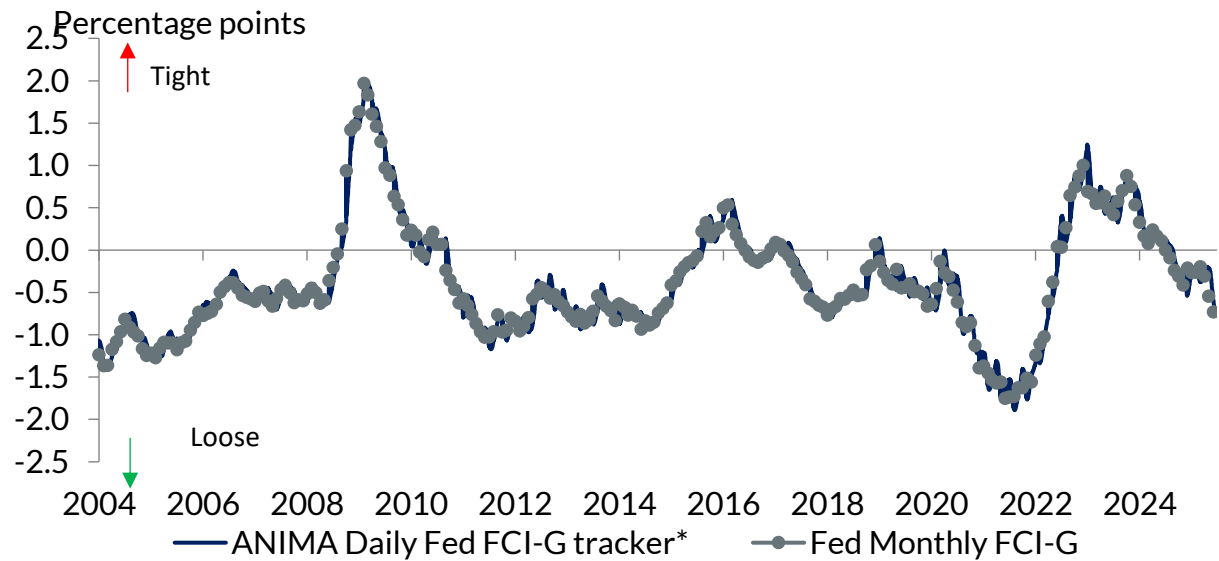
- According to a traditional Taylor rule, at the moment the Fed funds rate is right where it should be. In other words, at face value, the macroeconomic context does not call for a cut in the near term (Figure 7).
- Our daily Fed financing conditions tracker shows that financing conditions are growth-stimulatory at the moment, and have been consistently moving on an easing path in the last few months (Figure 8).
- While the term premium (10Y) is already at almost 80bp, having increased from 0bp since Trump's elections, historically it is still at low levels (Figure 9).
- Before 2008, a looser Fed monetary policy stance compared to the macroeconomic backdrop (we measure it through the spread between the Fed funds rate and the Taylor rule prescription) was associated with a surge in the term premium. Between 2008 and 2022, this relationship did not hold, most likely due to QE and heavy demand for government securities. Figure 9 shows that this relationship may now be back on track, pointing to higher term premiums in case the Fed adopts a looser monetary policy stance compared to the macroeconomic backdrop.

**Figure 7**

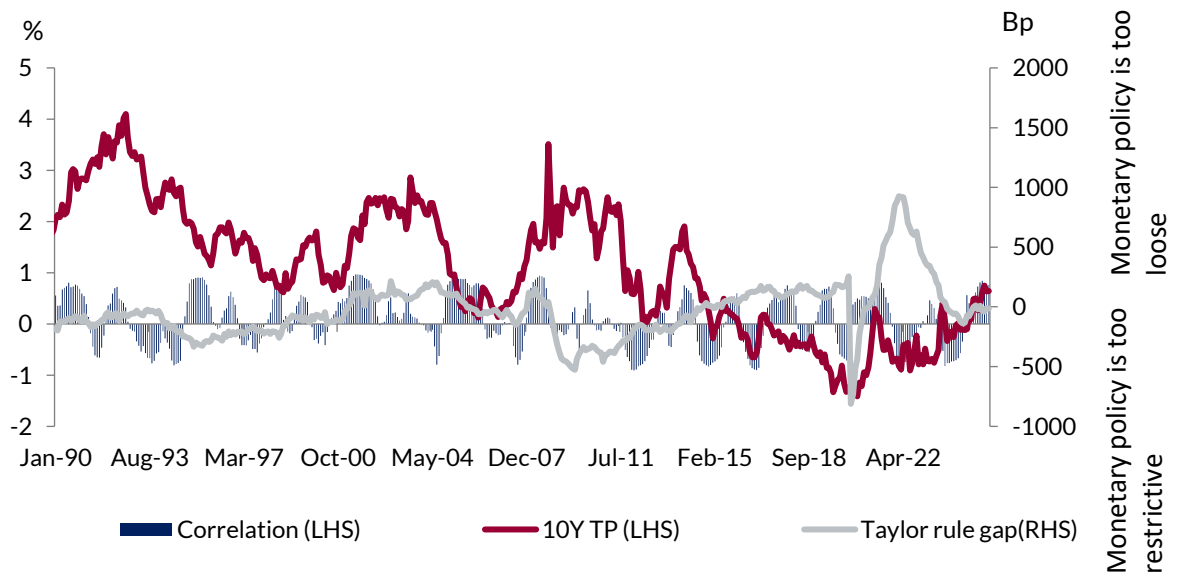
**Fed Funds rate is where it should be according to a traditional Taylor rule**



Source: Bloomberg, Haver Analytics, ANIMA Research

**Figure 8****Financing conditions are growth stimulatory**

Source: Bloomberg, Haver Analytics, ANIMA Research

**Figure 9****Excess Fed's easing leads to higher TP**

Source: Bloomberg, Haver Analytics, ANIMA Research

# Factors offsetting upside pressure on UST yields

## 1. Issuance mix will lend a helping hand in H2

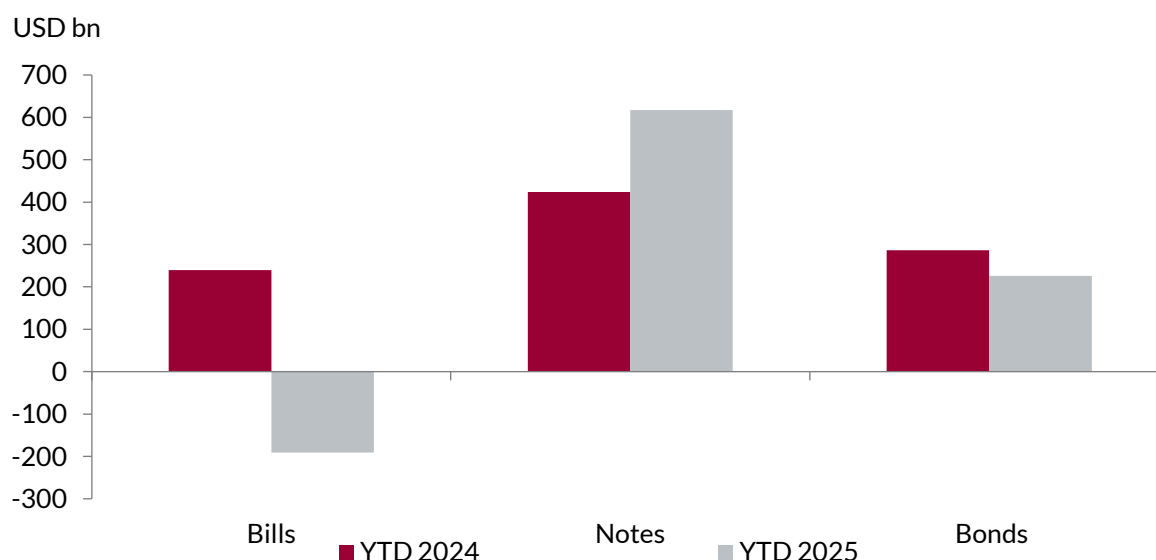
In the Q3 borrowing plan, US Treasury reported that:

- It will maintain coupon supply unchanged for the next several quarters.
- It will increase bill supply during Q3 and most likely increase it further in October.
- The Treasury will increase the volume of quarterly buybacks from USD 30bn to USD 38bn in the 10-20Y and 20-30Y buckets, lengthen the maturity of TIPS buybacks and will increase the volume of yearly cash management buyback operations from USD 120bn to USD 150bn. The Treasury will also increase the number of institutions that can directly access buybacks operations.

This should alleviate supply pressure in H2 2025, compared to H1 2025, when the Treasury issuance mix has been more skewed towards long-term debt rather than bills (Figure 10).

**Figure 10**

**Net borrowing is skewed towards long-term instruments in H1 2025**



Source: SIFMA, ANIMA Research

## 2. Tariff-related revenues on the rise

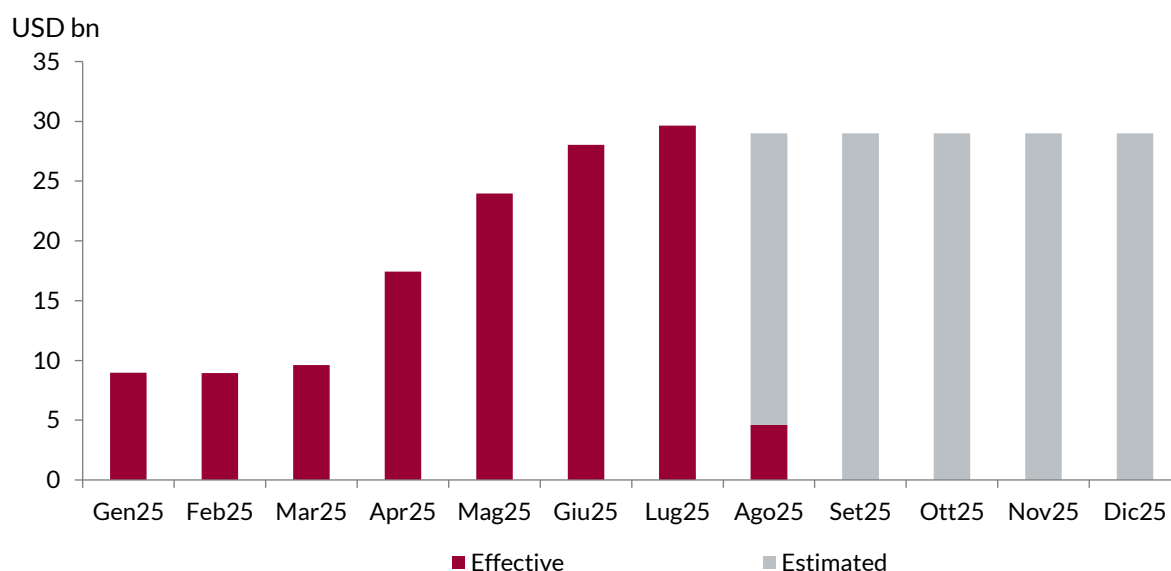
According to the US Treasury, YTD tariff revenues have amounted to more than USD 130bn. Taking into account that on average tariff revenues now amount just short of USD 30bn per month, we estimate that in 2025 tariff revenues could amount to a total of USD 270bn (Figure 11), compared to tariff revenues of around USD 100-150bn in the previous years. This is even a conservative estimate, considering that the average



tariff rate will increase in the next months. Figure 12 shows that accounting for (conservative) tariff revenues would take the deficit/GDP ratio in 2025, down to 5.7% compared to 6-6.2% in the CBO baseline and from 6.4% in 2024. Note that positive news on the budget will only affect 2025, as even accounting for tariff revenues, the deficit/GDP ratio is expected to start rising again from 2026 (Figure 12).

**Figure 11**

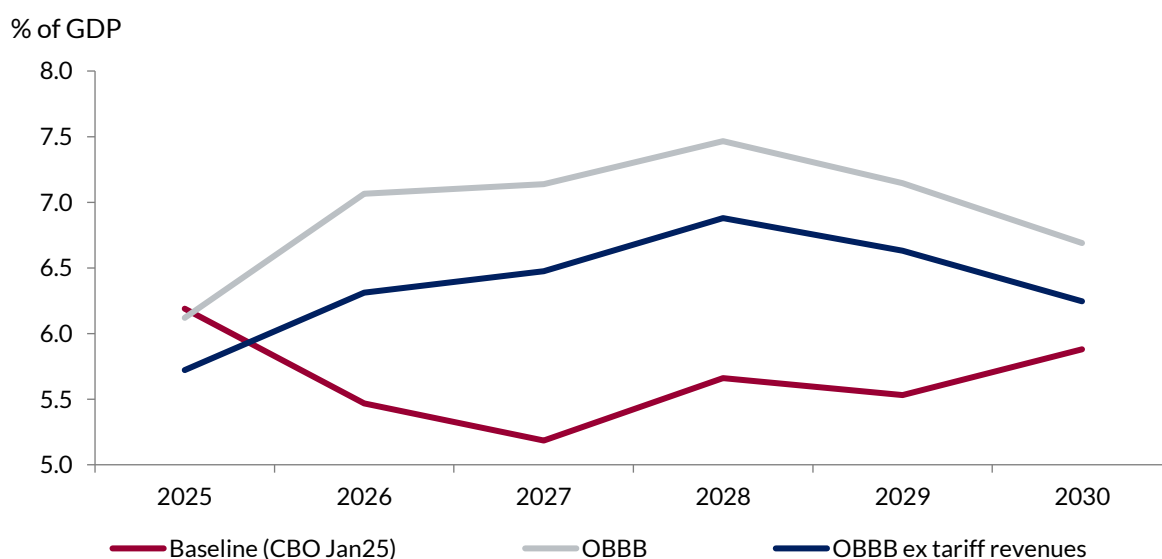
**Revenues from tariffs have reached almost USD 30bn per month**



Source: Bloomberg, ANIMA Research

**Figure 12**

**Deficit set to decline below 6% in 2025, due to tariff revenues**



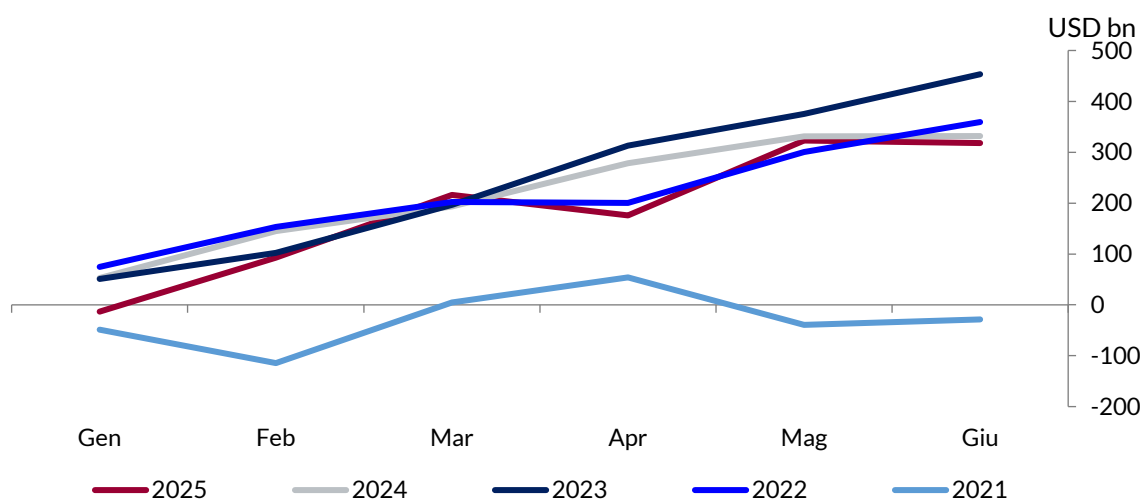
Source: Bloomberg, ANIMA Research

### 3. Constructive evidence from foreign demand

In June, foreign flows into USTs slowed down after very heavy inflows in May. That said, cumulative foreign flows into USTs in H1 2025 compared relatively well with the last few years (Figure 13). Moreover, inflows into major UST ETFs signal a continuation of the recovery following very heavy outflows in April (Figure 14). This confirms that while foreign flows into USTs are slowing down compared to the last couple of years, they are certainly not collapsing.

**Figure 13**

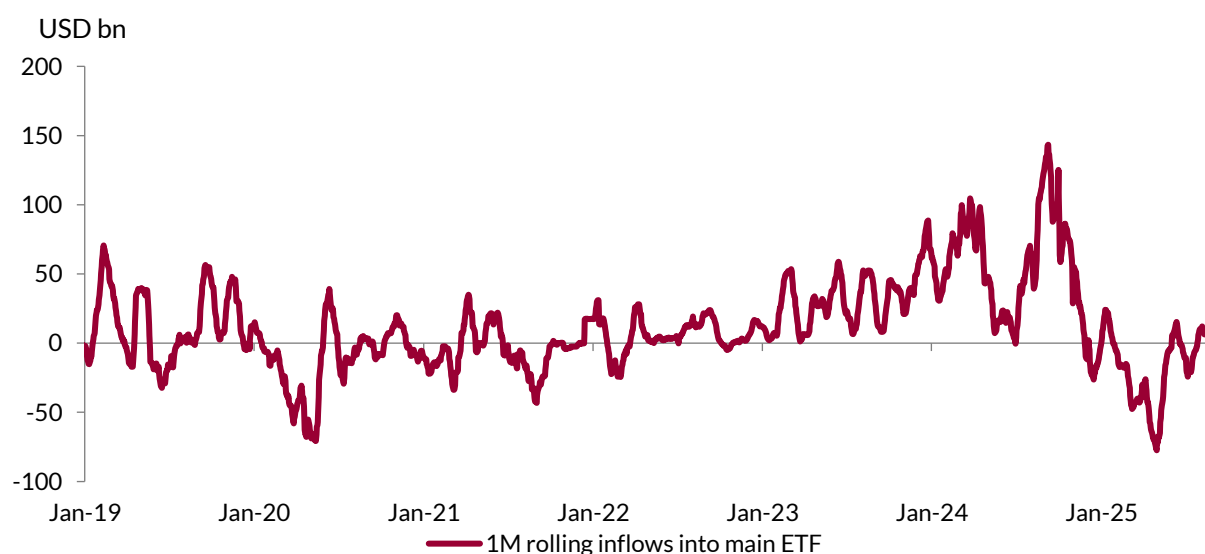
**Cumulative foreign flows into USTs in H1 since 2021**



Source: Bloomberg, ANIMA Research

**Figure 14**

**Inflows into main UST ETFs**



Source: Bloomberg, ANIMA Research

Against this backdrop, **we now recommend increasing exposure only at 4.50-4.60% and turning SHORT at 3.80%.**

## Strategic outlook

Strategically, **we remain CONSTRUCTIVE with a NEGATIVE outlook**, as the medium-term outlook remains highly uncertain and heavily dependent on the policies of the Trump administration.

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