Rates Strategy

UST: No need to take further risks

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We remain tactically LONG on USTs for the following reasons:

1) *We continue to believe that the US economy is not overheating.*
2) *We remain of the view that market's pricing of Fed policy is overly hawkish.*
3) *Carry considerations remain supportive. USTs continue to trade close to post-Liberation Day levels, remaining near the Trump administration's pain threshold.*

That said, we continue to take a cautious approach towards USTs this month in terms of further accumulation, as upside risks to yields have increased over the past few weeks. Our caution is based on the following consideration:

1) *The recent sell-off appears to have been macro-driven. While last month's UST sell-off was largely driven by market frustration over the longer-than-expected duration of the Middle East conflict, the recent rise in Treasury yields has been supported by stronger-than-expected economic data and markets assigning a higher probability to the economy overheating.*
2) *Markets may begin pricing in higher inflation expectations. Given the continued strength of the economy, we see a risk that inflation expectations are repriced upwards over the coming weeks.*
3) *The term premium remains relatively low and below its pre-conflict average. We believe the risks remain tilted towards a further increase in the term premium in the near term, especially taking into account the fact that under the new Chair, the Fed's reaction function has become increasingly difficult to read and in light of the extensive reform of the Fed that Chair Warsh is willing to bring.*
4) *The balance of risks surrounding the fiscal deficit has shifted to the upside due to substantial refunds of tariffs collected under IEEPA.*
5) *Positioning has become more balanced.*

Against this backdrop, we are not increasing our exposure further at current levels, and we maintain our threshold for further accumulation at 4.80%. Meanwhile, we raise the threshold for moving to a NEUTRAL stance to 4.20% from 3.95%. Strategically, we maintain our NEUTRAL stance. Solid economic growth and a more gradual convergence of inflation towards target suggests yields are likely to remain around current levels, or only modestly lower, over the medium term.

The main risk to both our tactical and strategic views remains that the US economy proves more resilient than expected.

UST: We remain tactically LONG

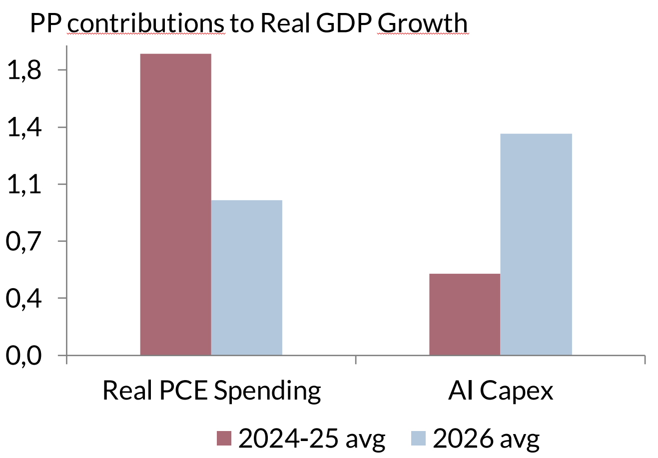
We remain tactically LONG on USTs.

1) We continue to believe the US economy is not overheating

In our baseline scenario, we expect the US economy to continue growing at around its potential, with limited risk of overheating, while recent core inflation dynamics remain consistent with the continuation of the disinflationary trend. Figure 2 shows that, while the probability of a recession implied by analysts and the UST yield curve is low, it remains higher than it was in 2021-2022.

Figure 1

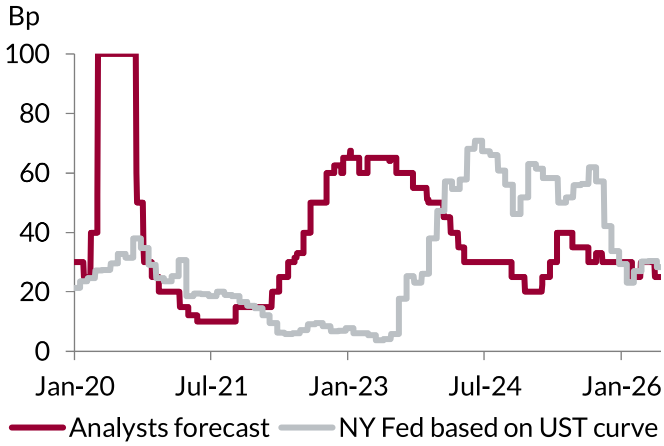
US economy from consumer to capex-centric



Source: Bloomberg, ANIMA Research

Figure 2

Low recession probability, but higher than 21-22



Source: Bloomberg, ANIMA Research

2) Market pricing of the Fed is overly hawkish

According to current money market curves, the Fed is expected to deliver around 40bp of rate hike by year-end. We believe this pricing is too hawkish for the following reasons:

1) In our baseline scenario, we expect the US economy to continue to grow at around its potential, with limited risk of overheating, while recent core inflation dynamics remain consistent with a continuing disinflationary trend. We think that the last FOMC Summary of Economic Projections forecasting PCE core inflation to end the year at 3.3% q\q is too aggressive.

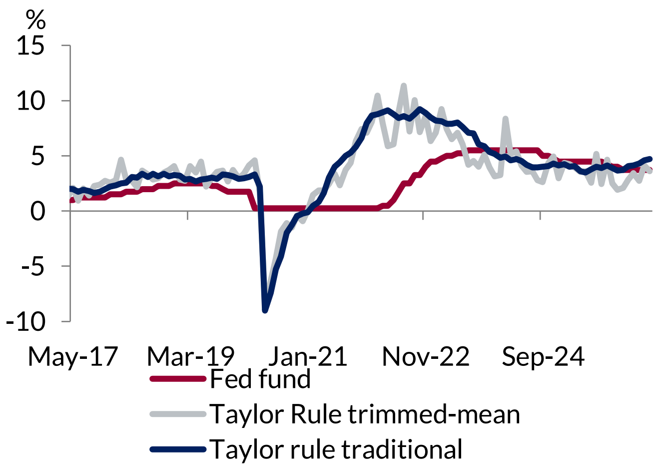
2) While the latest FOMC meeting conveyed an undeniably hawkish message, and Chair Warsh did not push against it, he left markets guessing what his view on the economy and monetary policy stance is.

Drawing from his testimony to the Senate, and the revolution he wants to bring at the Fed, Warsh might end up being more dovish on monetary policy than what he let markets believe at his first press conference. Figure 3 shows that a traditional Taylor rule based on core PCE inflation suggests that, if inflation ends the year at 3.1%, in line with consensus, the Fed funds rates should be higher than its current level. However, if trimmed mean PCE inflation is used instead of core PCE inflation (which Warsh considers a better measure of underlying inflation), the Taylor rule suggests that the Fed funds rate is already too high. While it will be difficult for Warsh to push back against a hawkish-leaning FOMC, we believe he could serve as a counterbalance to the rate-hike ambitions of some Committee members.

3) Figure 4 shows that, while the Central Bank Stance Indicator, developed by the ANIMA Artificial Intelligence Team, is trending higher, the increase has not yet been significant enough to indicate with confidence that the Fed is likely to raise rates.

Figure 3

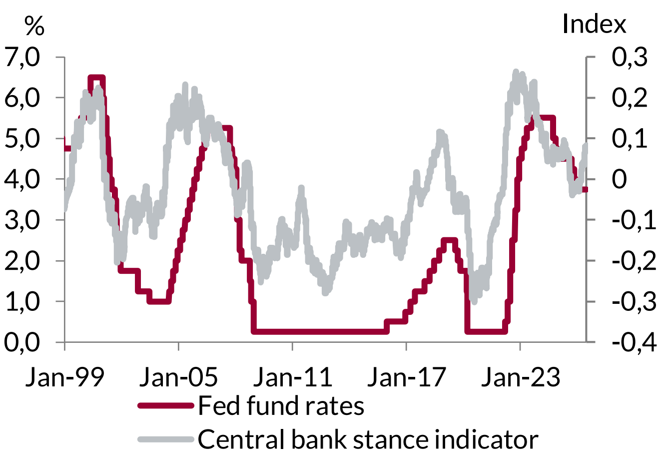
Trimmed mean inflation indicates lower Fed fund



Source: Dallas Fed, Bloomberg, ANIMA Research

Figure 4

Fed Stance Indicator* not pointing at near-term hikes



**The Hawkish/Dovish Indicator is a quantitative measure of the monetary policy stance inferred from a central bank's official communications. The indicator is constructed using a sentiment analysis model based on RoBERTa, a Natural Language Understanding (NLU) model pre-trained on a dataset of monetary policy texts to identify whether a document conveys a dovish, hawkish, or neutral tone. The score assigned to each document is defined as the difference between its hawkish and dovish probabilities, thereby capturing both the direction and the intensity of the monetary policy signal communicated. Individual document scores are then aggregated using an exponential moving average, resulting in the final indicator.*

Source: Bloomberg, ANIMA Team Artificial Intelligence, ANIMA Research

3) Carry and policy-related considerations

We first recommended building exposure to USTs when 10-year yields were around 4.40% in March, with yields reaching our target entry levels towards the end of April. Including both carry and price performance since then, and assuming the position was

established in the 10-year sector, the trade would currently have generated a total return around 0bp.
We continue to believe that maintaining this long position remains justified for two reasons:

1) As time passes, carry income should increasingly offset any mark-to-market losses.

2) Assuming the position is maintained through year-end, 10-year Treasury yields would need to rise to 4.75% before the expected carry earned over the remainder of the year is fully offset. In our view, a 4.75% 10-year Treasury yield is well above the level the Trump administration would likely find acceptable.

Getting more cautious tactically

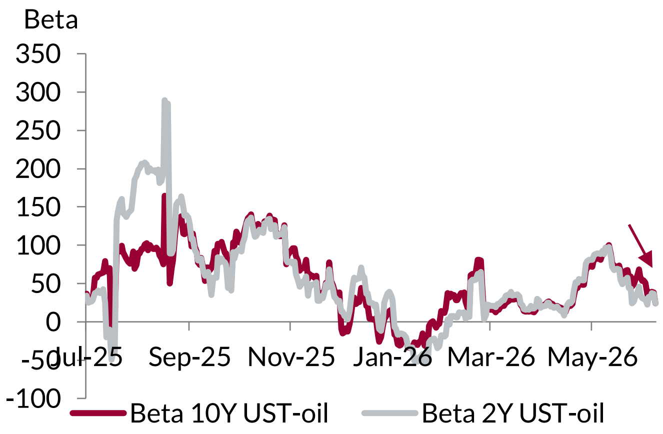
While we believe that maintaining our tactical LONG position remains appropriate, **we continue to adopt a cautious approach towards USTs this month with respect to further accumulation, as upside risks to yields have increased over the last few weeks.** Against this backdrop, **we are not increasing our exposure further at current levels. Instead, we maintain our threshold for further accumulation at 4.80%. Meanwhile, we raise the threshold for moving to a NEUTRAL stance to 4.20% , from 3.95%.**

1) The recent sell-off appears to be macro-driven

While last month's UST sell-off was largely driven by market frustration over the longer-than-expected duration of the Middle East conflict, the recent rise in Treasury yields has been supported by stronger-than-expected economic data and markets assigning a higher probability to the economy overheating (Figure 5 and 6).

Figure 5

UST performance less driven by Middle East war...

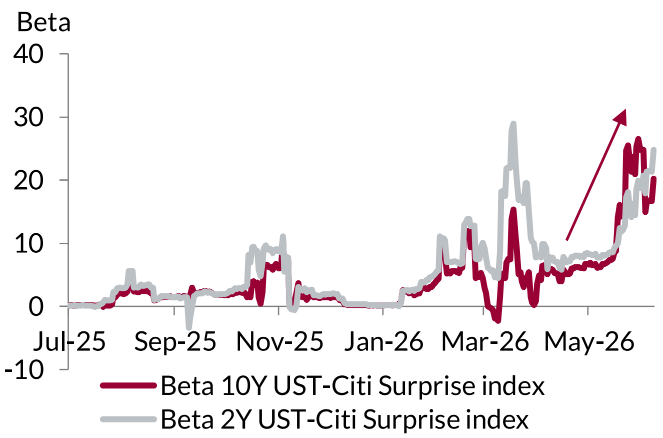


The chart shows the 1-month rolling beta, calculated on daily changes in the data.

Source: Bloomberg, ANIMA Research

Figure 6

...and more by macro data



The chart shows the 1-month rolling beta, calculated on daily changes in the data.

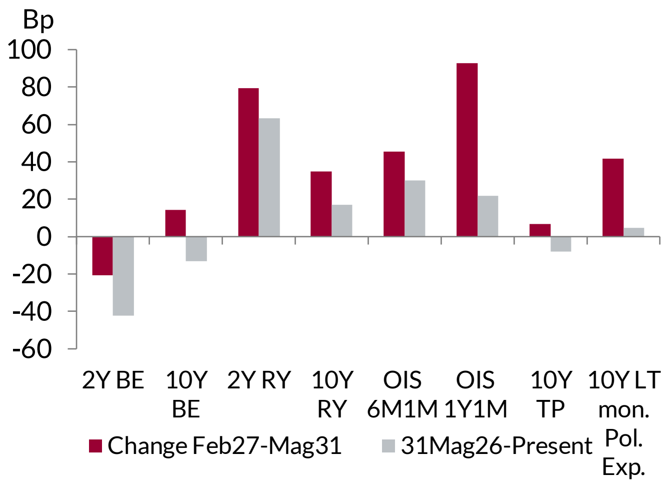
Source: Bloomberg, ANIMA Research

2) Markets may begin pricing in higher inflation risk

Since the beginning of June, breakeven inflation rates have declined sharply, while real yields have risen significantly (Figure 7). The decline in breakeven inflation rates has been greater than would be explained by the fall in oil prices alone (Figure 8). Given the continued strength of the economy, we see a risk that markets will begin to reprice inflation expectations higher over the coming weeks.

Figure 7

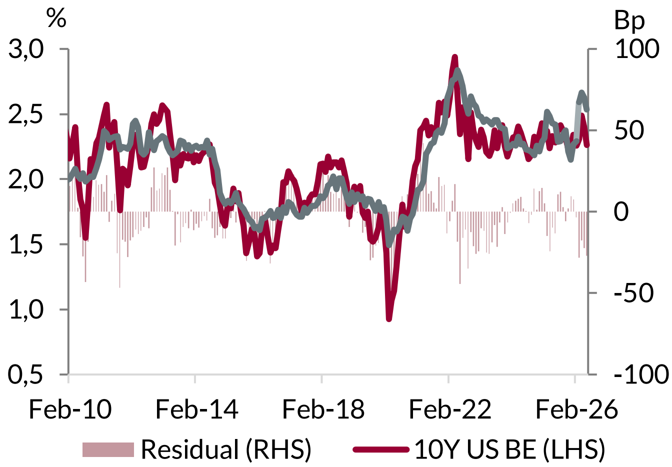
Real yields rising, breakeven declining



Source: Bloomberg, ANIMA Research

Figure 8

Breakeven decline has undershot oil prices



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, Haver Analytics, ANIMA Research

3) The term premium remains relatively low

Despite the recent rise in yields, the US term premium remains below its pre-conflict average (Figure 9). We believe the risks remain tilted towards a further increase in the term premium over the near term, especially taking into account the fact that under the new Chair, the Fed's reaction function has become increasingly difficult to read and in light of the extensive reform of the Fed that Chair Warsh is willing to bring. More in details:

1) Under Chair Warsh the Fed dropped the forward guidance and any hint to the reaction function in the meeting statement.
2) Chair Warsh did not submit his forecasts and dots, explicitly diminishing the importance of these instruments as an anchor for markets.
3) Chair Warsh argued that financial markets should not take the Fed monetary policy as an input to form their expectations but should just rely on macroeconomic data. While we do not disagree from a theoretical point of view, this leaves markets with only one effective anchor.
4) At the same time, Chair Warsh wants to radically reform the way the Fed conducts monetary policy and has appointed five task forces focusing on communication,

balance sheet policy, macro data methodology, productivity/AI, and the inflation framework.

4) The balance of fiscal risks has shifted to the upside due to substantial refunds of tariffs collected under IEEPA

While uncertainty remains high regarding both the refund process and the replacement of current tariffs after July, we believe the fiscal risks stemming from this source have increased materially in recent weeks, for the following reasons:

1) In May, the Trump administration paid more than USD 23bn in refunds, effectively offsetting tariff revenues and reducing net inflows to close to zero. June is already shaping up to be another month of sizeable refunds (Figure 10). Press reports indicate that over USD 60 billion of additional refunds have already been approved and are expected to be repaid over the coming months.

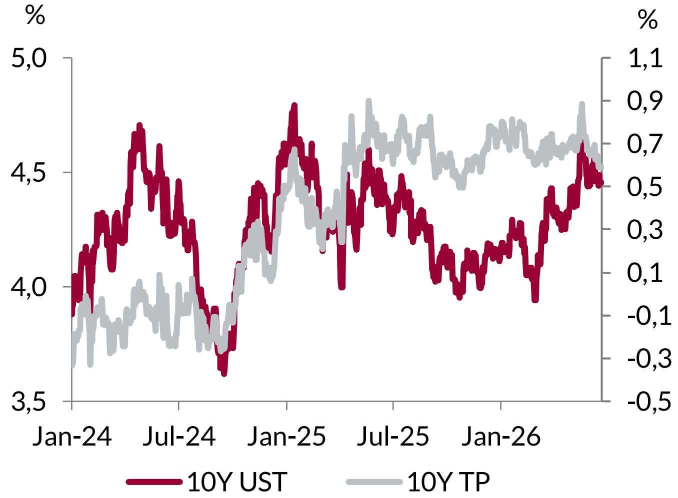
2) Meanwhile, tariff revenues have been declining gradually on a monthly basis.

3) The Trump administration has published the findings of its Section 301 investigation into Acts, Policies and Practices of various economies related to their failure to impose and effectively enforce a prohibition on the importation of goods produced with forced labour. This investigation proposes tariffs of 10-12.5% on imports from a number of countries, effective from July, when tariffs imposed under Section 122 are due to expire. The objective is to maintain tariff revenues at least broadly in line with current levels.

If we assume that tariff revenues remain around May's level for the remainder of the year, while total refunds this year amount to just short of USD 100 billion, we estimate that the fiscal deficit would increase to around 6.7% of GDP, approximately 1percentage point (or USD 300 billion) higher than the Congressional Budget Office (CBO) forecast of5.8% of GDP.

Figure 9

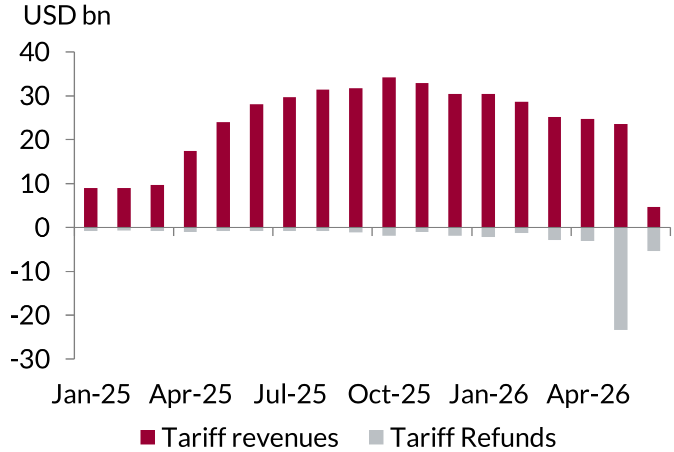
Term premium remains lower than before the war



Source: Bloomberg, ANIMA Research

Figure 10

Refunds are flowing since May worsening the tariffs revenues outlook



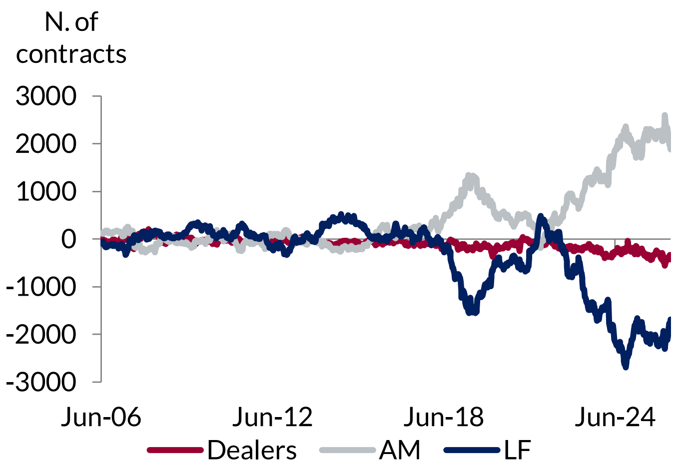
Source: Bloomberg, ANIMA Research

5) Positioning has become more balanced

Speculative investors have reduced their short positions at the front end of the curve, while asset managers have trimmed their long positions in the same segment. At the long-end of the curve, while asset managers remain long and have continued to add exposure over the last few weeks, leveraged funds have moderately trimmed their short positions (Figure 11 and 12). As a result, positioning appears more balanced than it was a few weeks ago and is therefore less supportive of a meaningful rally in Treasuries over the near term.

Figure 11

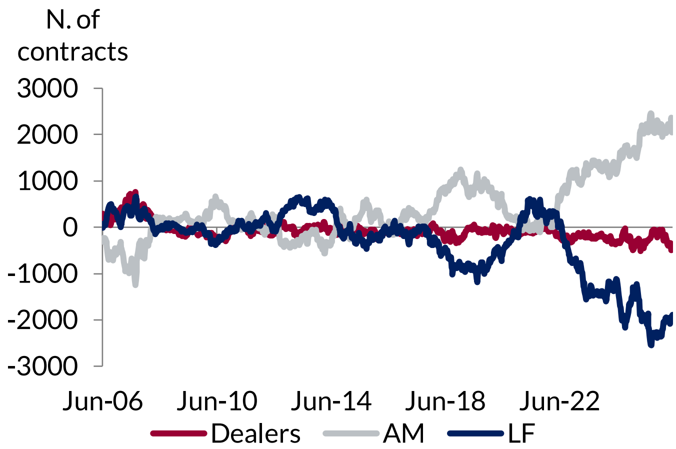
Positioning at the 2Y tenor (Futures only)



Source: Bloomberg, CFTC, ANIMA Research

Figure 12

Positioning at the 10Y tenor (Futures and options)



Source: Bloomberg, CFTC, ANIMA Research

We remain strategically NEUTRAL

Strategically, we remain NEUTRAL for now. Solid economic growth and a more gradual convergence of inflation towards target suggest that yields are likely to remain around current levels, or only modestly lower in the medium term. At the same time, a global environment characterized by more frequent supply shocks, rising public debt and a shift from less price-sensitive to more price-sensitive bond investors should prevent a significant structural rally in yields over the medium-term, absent a recession.

Risks to our view

The main risk to both our tactical and strategic views remains that the US proves more resilient than expected. Given supply-driven tightness in the labour market, demand growing above the economy's potential could lead to stronger labour demand and higher wages. Moreover, an overly resilient consumer sector, particularly among lower-income households, could give retailers confidence that consumers have sufficient capacity to absorb higher prices, particularly those resulting from rising gasoline prices. In both cases, the Fed would be forced to keep interest rates higher for longer and could even be required to tighten monetary policy further.

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