## Rates Strategy

# Positioning through the energy storm

## AUTHOR

**Chiara Cremonesi**
Senior Rates Strategist
chiara.cremonesi@animasgr.it

***We remain NEUTRAL on USTs tactically and recommend adding exposure at 4.30–4.40%.*** *In the near term, risks to yields are balanced as follows:*

*To the upside:*
*1) Middle East instability continues.*
*2) US macro fundamentals are at odds with levels reached before the war.*

*To the downside:*
*1) Positioning is generally short, especially at the short end.*
*2) The Fed's pricing has greatly rebalanced, and it is now broadly in line with the Fed's dots.*
*3) Trump's reaction to the Supreme Court ruling on IEEPA tariffs reduces near-term fiscal deterioration risks.*

*Meanwhile,* ***we keep the bar to turn SHORT at 3.75%, but place it under review, with risks tilted to the upside.***

***Strategically, we remain NEUTRAL but remove our negative outlook.*** *Concerns about the Fed's independence and institutional checks have eased, the administration is likely to avoid a cliff in tariff revenues when the Section 122 tariffs expire in July, and the probability of additional fiscal easing has declined following weaker political support.*

***On Bunds, we remain LONG tactically.***
*We do not expect yields to increase much further from here for the following reasons:*
*1) Unless the conflict persists over the medium term (not our baseline), we do not expect the energy shock to translate into higher core inflation.*
*2) Current ECB pricing (2 rates hikes by year-end) seems overly aggressive.*
*3) Unlike the US, higher energy prices in the EA primarily represent a negative terms-of-trade shock, which should ultimately weigh more on growth than on core inflation, but investors have not priced in any negative effect on growth so far.*

***We continue to recommend extending exposure at 3.00-3.10%*** *to take advantage of the current, misplaced, market adagio that seems to be taking for granted that the ECB will raise rates.*
***We leave the bar to turn NEUTRAL at 2.45%.***

***Strategically, we stay NEUTRAL.*** *If the conflict were to become prolonged, we would turn more constructive as a stagflationary scenario could eventually push long-term yields lower.*

***On BTPs, we remain LONG tactically.***
***We raise the level to add exposure to 3.85-3.90%*** *(from 3.65–3.75%)* ***and the bar to turn NEUTRAL to 3.20%*** *(from 3.10%).*

***Strategically, we remain NEUTRAL at this stage.*** *In the event of a prolonged conflict, we would turn more negative strategically, as BTPs would likely underperform core bonds.*

# UST: Turning more constructive

## 1) We remain tactically NEUTRAL

**We remain NEUTRAL tactically and continue to recommend extending exposure at 4.30-4.40%.**

**We see a risk that UST yields could go higher in the short term** for two reasons:

1) As long as instability prevails in the Middle East, the peak for UST yields might still be ahead of us, unless markets start expecting that a prolonged conflict could lead to a sharp negative impact on growth.

   Since the start of the Middle East conflict, USTs have not benefited from their traditional role as a safe haven but have been driven by high energy prices and expectations of a more hawkish monetary policy by the Fed. Meanwhile, growth expectations have remained constructive, consistent with solid macro fundamentals in US and expectations of an improvement in the US terms of trade following the increase in energy prices. This is well illustrated by the following market moves since the start of the conflict:

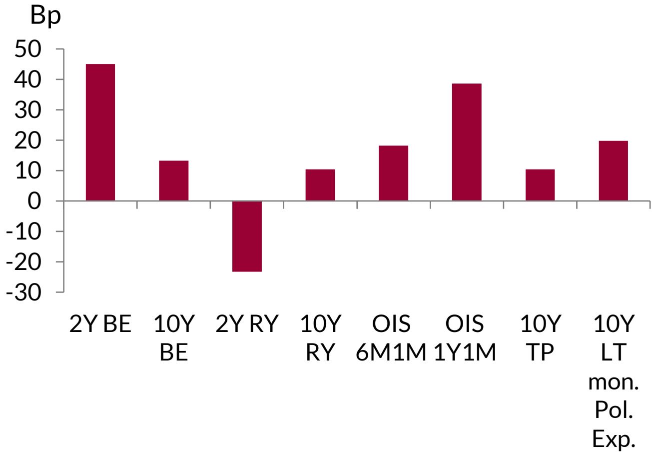
   - ✓ Real yields have increased at the longer maturities, and the real yield curve has steepened (Figure 1).
   - ✓ At longer maturities, the increase in yields was mostly driven by an increase in long-term monetary policy expectations rather than the term premium (Figure 1).
   - ✓ The money market curve has steepened (Figure 2).
   - ✓ The dollar appreciated against major currencies. While this could be partly due to its role as safe haven in crisis, we believe that the dollar appreciation was also driven by expectations of an improvement in the US terms of trade.

2) If we take out the premium related to the Middle East conflict, UST yields at the end of February were too low to be consistent with macro fundamentals (Figure 3).

   The UST rally in February was mainly driven by concerns related to expectations of an AI-led rise in unemployment and this further widened the disconnect between macro fundamentals and government bond yields (Figure 4). Given the high uncertainty around AI's impact on employment and still-solid US growth, the rally leaves yields vulnerable to an upward correction in our view, especially in the case of better-than-expected macro data.

**Figure 1**

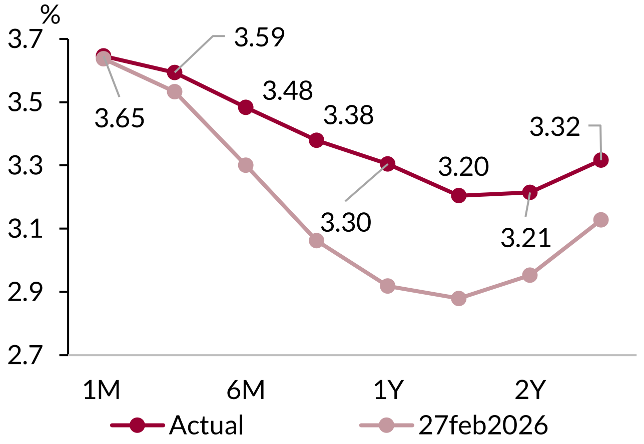
**Changes since the start of Middle East conflict**




*Source: Bloomberg, ANIMA Research*

**Figure 2**

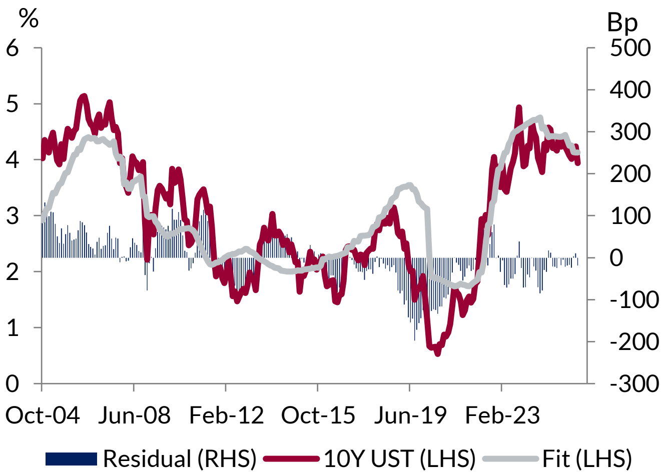
**The money market curve has steepened**




*Source: Bloomberg, ANIMA Research*

**Figure 3**

**Pre-conflict UST yields too low vs. fundamentals**

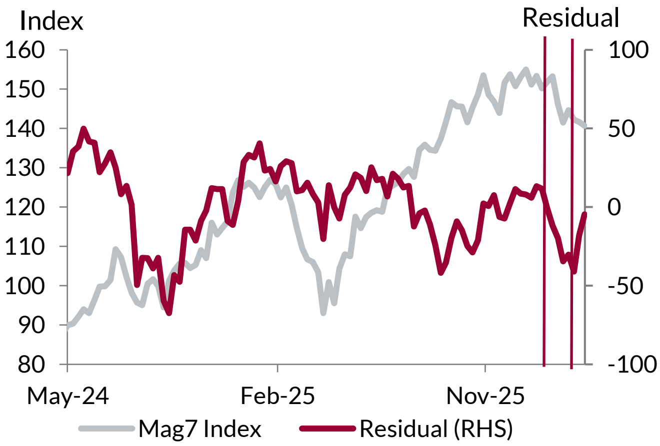



*The model regresses 10Y US nominal rates on the Fed funds rate, PCE core inflation, potential GDP growth, and USTs held by the Fed as a share of US federal marketable debt outstanding. The model is estimated on monthly data covering the period from 2003 to the present.*

*Source: Bloomberg, Haver Analytics, IMF, ANIMA Research*

**Figure 4**

**February UST rally mainly triggered by AI-related fears**




*Residuals refer to a model regressing 2Y UST yields on the Fed fund rate, Citi Economic Surprise Index, and Fedspeak BBG index. The regression is run on weekly data from the start of 2024 to present.*

*Source: Bloomberg, ANIMA Research*

That said, **domestic developments in the US in the last month have weakened our case for a large increase in yields in the near term, largely for idiosyncratic reasons.**

1) Positioning on USTs is generally short, with a significant build-up of positions, especially at the short end of the curve, since the start of the Middle East conflict (Figure 5).

2) Fed's pricing has greatly rebalanced and is now broadly in line with the Fed's dots, with markets pricing just one rate cut by the Fed compared with almost three at the end of February.

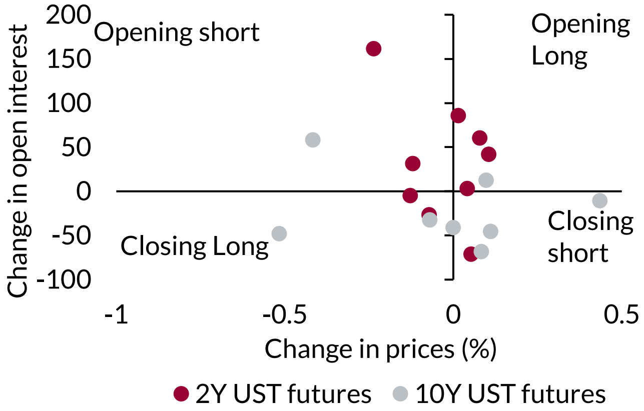
3) Trump's reaction to the Supreme Court's ruling on IEEPA tariffs reduces the risk of an abrupt deterioration in the fiscal outlook and partially lowers the political risk premium embedded in the UST curve.

   - ✓ Risks of higher deficit in the near term have receded. First, the Supreme Court has not ruled on refunds, which will make the process difficult for importers and subject to legal pushback by the Trump administration. Moreover, we expect a large number of the countries that have signed bilateral trade agreements with the US to keep them in place instead of paying a general 15% tariff under Authority 122 until July, on top of existing tariffs and the possibility of higher tariffs in July under Authority 232 or 301. While it is far from sure that the deficit this year will not surpass 6% of GDP (in the Congressional Budget Office baseline, the deficit/GDP ratio this year is 5.8%), we expect investors to no longer price in the risk that the deficit could rise as high as 7% of GDP this year.

   - ✓ The Court's decision lowers the risk of a further sharp increase in the political risk premium embedded in the UST curve since President Trump took office. While uncertainty around trade policy will remain high and President Trump will likely continue to challenge the institutional order, the message from the Supreme Court ruling on IEEPA tariffs is that checks and balances on presidential powers remain effective. Against this backdrop, we still expect the political risk premium to remain high, but the risks that it could go even higher in the near term have greatly receded (Figure 6).

**Figure 5**

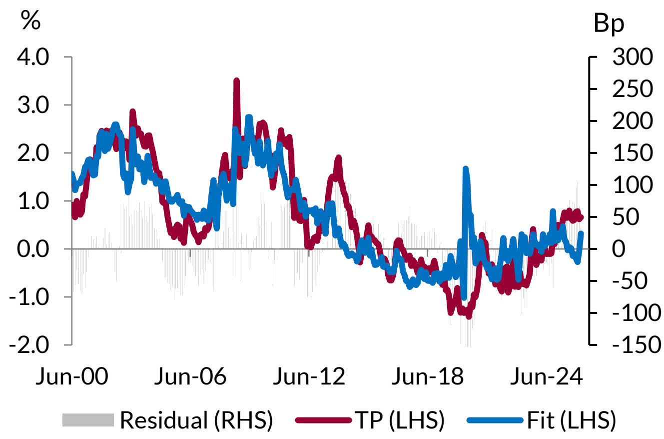
**Investors have opened new short positions in March**




*Source: Bloomberg, ANIMA Research*

**Figure 6**

**Political risk premium has probably peaked**




*Our model that regresses the 10Y term premium on the unemployment gap, the inflation risk premium, rate-market volatility, and the free float of government bonds. The model is estimated using monthly data from December 1999 to the present. We interpret the residual of this model as the political risk premium.*

*Source: Bloomberg, Haver Analytics, IMF, ANIMA Research*

Meanwhile, **we leave the bar to turn SHORT at 3.75%, and put it under review, with risks tilted to the upside.**

We originally lowered the bar to turn SHORT (from 3.95%) when the US and Israel hit Iran, as we believed that UST could benefit, at least partly, from its traditional role of safe haven in the Middle East conflict. This has not been the case, but we leave the bar to turn SHORT at this level for a different reason. If instability in the Middle East recedes, investors are likely to reprice down their monetary policy expectations for the Fed. Moreover, investors' concerns about the impact of AI on unemployment could return as a driver of USTs, particularly following the last weaker-than-expected NFP release.

## 2) We remain strategically NEUTRAL, but remove our negative outlook

**Strategically, we remain NEUTRAL but remove our NEGATIVE OUTLOOK**, for the following reasons:

1) Like in the near term, **we see a less compelling case for the political risk premium embedded in the UST curve to increase sharply in the medium term**. Concerns about the Fed's independence and about the effectiveness of checks and balances have receded. Moreover, given that the Middle East conflict is highly unpopular among the US electorate, markets are pricing an increasingly higher probability of a Democratic sweep at the Mid-Term elections (Figure 7).

2) Given the importance and the size of the tariffs' revenues, **we expect the Trump administration to do everything it can to avoid a cliff in tariff revenues in July**, when tariffs imposed under Section 122 are due to expire.

3) Following the conflict in the Middle East, **we see a lower probability of President Trump proposing additional measures of fiscal easing compared to before**. For two reasons:

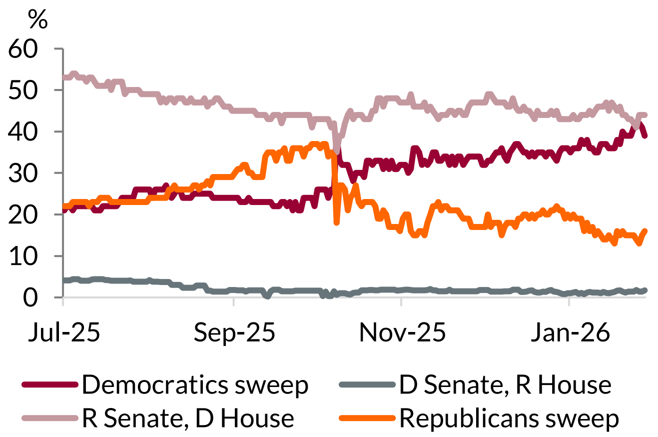
   ✓ The longer the Middle East conflict lasts, the higher the likelihood of extra military spending. While we do not expect extra-military spending to lead to a much higher deficit (according to the latest news the Pentagon is expected to request an extra USD 50bn), it will make any extra spending aimed at tackling affordability less likely, in our view (Figure 8 shows the extra spending in each of the past Middle- East wars for the US).

   ✓ Support for President Trump among Republicans is declining, and this makes extra-fiscal spending less likely, given that it would have to be approved by Congress.

4) Albeit marginally, January and February labour market data reduce the risk of US overheating.

**Figure 7**

**Probability of a Democratic sweep rising**




*Source: Bloomberg, Polymarket, ANIMA Research*

**Figure 8**

**Fiscal deficits and primary deficits**

| War | Duration | Type of War | Cost (USD bn) |
|---|---|---|---|
| Gulf War | 7 month | Air + Ground | 61 |
| War in Afghanistan | 20 years | Air + Ground | 2000-2300 |
| Iraq War | 8 years | Air + Ground | 1700-3000 |
| US intervention against ISIS | 12 years | Mostly Air | 50+ |
| US intervention in Syria | 12 years | Mostly Air | Several |
| 2026 US-Iran War | 3 weeks | Mostly Air | 11+bn in first week |

*Source: Bloomberg, Brown university, US government spending, ANIMA Research*

# Bund: Hawkish reaction

## 1) We remain tactically LONG

**We remain LONG tactically.**

**We do not expect yields to increase much further from here** for the following reasons:

1) Unless the conflict persists over the medium term, leading to further supply disruptions and even higher energy prices, we do not expect that the temporary shock to energy prices will translate into higher core inflation. Unlike in 2022, savings have been depleted, the ECB's monetary policy stance is not accommodative but neutral, and financing conditions are much tighter than they were at the beginning of 2022 (Figure 9).

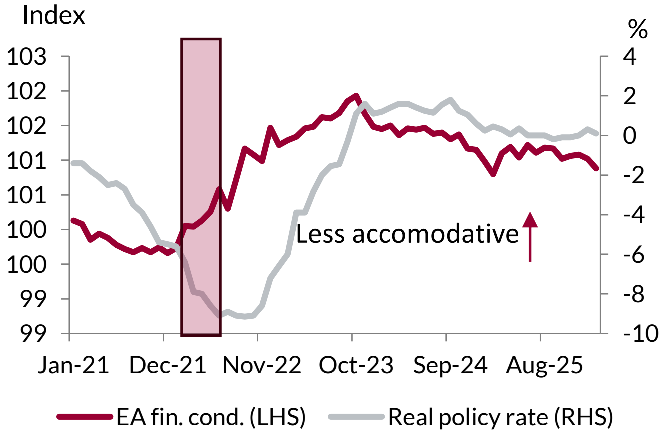
2) Against this backdrop, even one rate hike by the ECB is difficult to justify unless core inflation surprises sharply to the upside.

3) Unlike the US, higher energy prices in the EA primarily represent a negative terms-of-trade shock, which should ultimately weigh more on growth than on core inflation, but investors have priced in hardly any negative effect on growth so far. This is reflected in the different EA rates-markets reaction in this conflict compared to the start of the Russia-Ukraine war, despite the fact that the supply shock is very similar in nature. Figure 10 shows that since the start of the conflict:

    - ✓ Real yields have dropped only at the short end, while they have remained steady at the long end, leading to a steepening of the real yield curve.
    - ✓ The money market curve has steepened, pricing a series of rate hikes by the ECB that the market does not perceive as a policy mistake (yet).

**Figure 9**

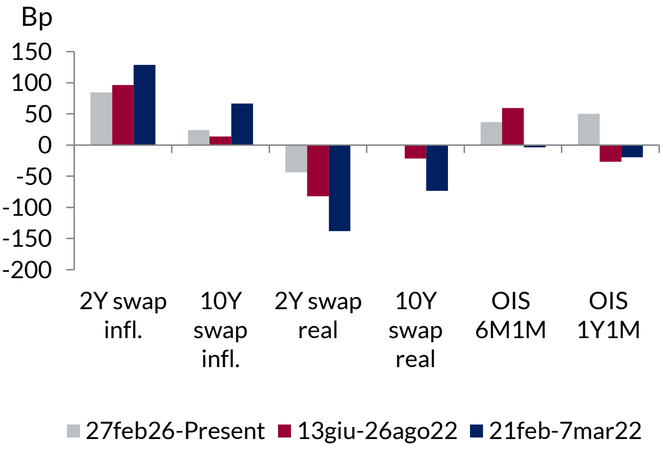
**Financing conditions less accommodative vs. 2022**




*Source: Bloomberg, Goldman Sachs, ANIMA Research*

**Figure 10**

**Markets not pricing any negative growth impact**




*Source: Bloomberg, ANIMA Research*

That said, **we continue to recommend extending exposure at 3.00-3.10%** to take advantage of the current, misplaced, market adagio that seems to take for granted that the ECB will raise rates.

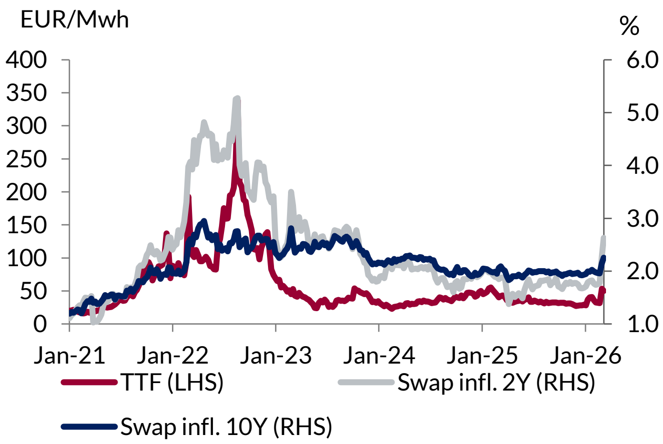
1) Until tensions in the Middle East recede and energy prices decline, Bunds will likely remain under selling pressure, with yields moving higher on the back of higher breakeven rates. Figure 11 shows that in the 2022 episode breakeven rates peaked only when energy prices peaked.

2) Nominal yields could peak even later if the ECB adopts a more hawkish rhetoric. Figure 12 shows that in the 2022 episode, nominal yields peaked later than breakeven, as real yields started climbing after the peak in energy prices, driven on the one hand by rising core inflation and on the other hand by the ECB's tightening monetary policy cycle.

**We leave the bar to turn NEUTRAL at 2.45%.**

**Figure 11**

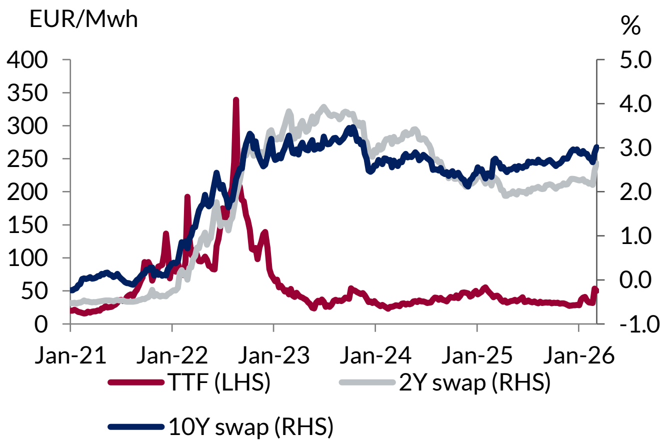
**EA: breakeven peaking on energy-price highs…**




*Source: Bloomberg, ANIMA Research*

**Figure 12**

**…but nominal yields peaked later**




*Source: Bloomberg, ANIMA Research*

## 2) We remain strategically NEUTRAL

**Strategically, we remain NEUTRAL** at this stage**,** as in our baseline any inflation and growth impact of the Middle East conflict would be transitory, while the fiscal package in Germany would keep yields at relatively high levels.

**The main risk is that the Middle East conflict persists for longer than expected**. This would lead the EA economy towards a stagflationary scenario, with the ECB turning more hawkish and the growth outlook deteriorating further. Against this backdrop, long-term yields would decline in the medium term.

# BTP

## 1) We remain tactically LONG

**We remain LONG tactically.**

While the widening of BTPs vs. Bund since the start of the Middle East conflict has not been dramatic, BTPs have underperformed the rest of the EGBs (Figure 13). This is because Italy is more vulnerable than other EA countries to the increase in energy prices, has little fiscal space and suffers more when funding costs rise.
Moreover, even after the recent widening, periphery spreads continue to look tight compared to credit spreads (Figure 14).
**While we remain LONG as political stability and fiscal discipline will continue to protect BTPs from excessive widening in risk-off contexts, we would refrain from adding to accumulation at this stage** for the following reasons:

1) If instability in the Middle East persists, more widening of the BTP-Bund spread and more BTP underperformance could be ahead.

2) BTPs are more vulnerable than Bunds to a more hawkish ECB. ECB's rhetoric has turned more hawkish lately, as our understanding is that concerns are mounting within the Governing Council that higher energy prices could lift inflation above the target.

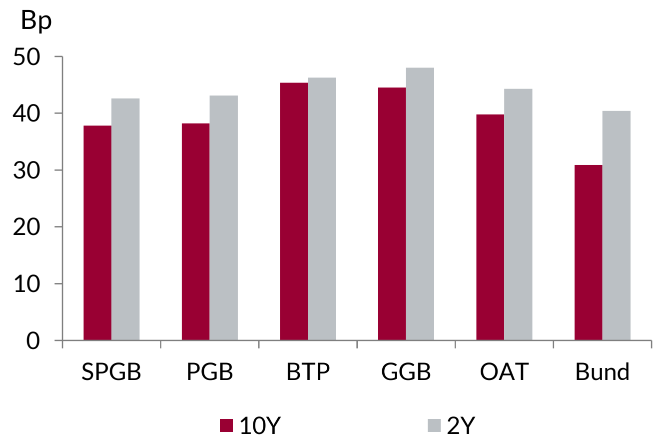
Against this backdrop, **we raise our bar to add more exposure to 3.85-3.90%** (vs. 3.65-3.75% before) **and increase our bar to turn NEUTRAL to 3.20%** (vs. 3.10% before).

## 2) We remain strategically NEUTRAL

**Strategically, we remain NEUTRAL at this stage**. In the event of a prolonged conflict, we would turn more negative strategically, as BTPs would likely underperform core bonds.

**Figure 13**

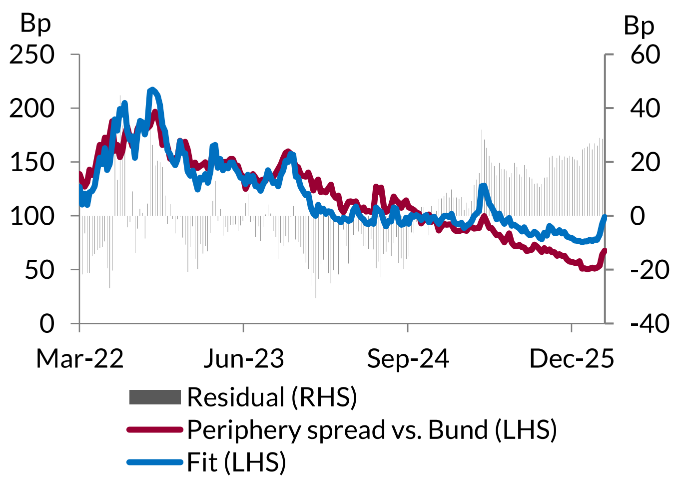
**BTPs underperforming the rest of EGBs in the conflict**




*Source: Bloomberg, ANIMA Research*

**Figure 14**

**Periphery spreads still tight vs. credit spreads**




*Source: Bloomberg, ANIMA Research*

## ANIMA INVESTMENT RESEARCH


**FABIO FOIS**
Head of Investment Research & Advisory
fabio.fois@animasgr.it

**CHIARA CREMONESI**
Senior Rates Strategist
chiara.cremonesi@animasgr.it

**FRANCESCO PONZANO**
Junior Equity Strategist
francesco.ponzano@animasgr.it

**MATTEO GALLONE**
Junior Macroeconomist
matteo.gallone@animasgr.it

**COSIMO RECCHIA**
Senior Equity Strategist
cosimo.recchia@animasgr.it