Rates Strategy
UST: BACK TO FUNDAMENTALS

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

We remain tactically NEUTRAL. We shifted mechanically to NEUTRAL from MODERATELY LONG at the end of April, as 10Y UST yields fell below our take-profit level of 4.20%.

We still believe the next move will be upward. However, compared to last month, the forces driving this shift have broadened:

1. Trade tensions are de-escalating rapidly. While the new global trade equilibrium is likely to be less favourable than during the pre-US election period, it appears significantly more functional than the scenario once threatened by the Trump administration on Liberation Day.

2. As a corollary to point 1, we believe that concerns over de-dollarisation have declined significantly among global investors. This removes the pain threshold ceiling of 4.50%, at which we would previously have expected either the Fed intervention or a policy reversal by the US administration. In other words, as the risk of the US losing its safe-haven status has receded, partly due to President Trump's softer tariff stance, we expect UST yields to resume trading "freely", driven by market and macroeconomic factors, rather than fears of a secular shift in global asset allocation preferences.

3. Building on point 1, we have revised down the projected likelihood of a US recession from 45% to 25-30%. At the same time, while our baseline forecast still anticipates a slowdown, we now see the risks as tilted to the upside.

4. Although significantly reduced, the remaining tariffs are still expected to slow the pace of inflation convergence towards target, compared to expectations prior to the election.

5. We expect market focus to shift to the upcoming Budget. In this context, there is a risk that the already unfavourable supply/demand balance in USTs could deteriorate further, depending on the final version of the budget bill currently under discussion in Congress.

6. While market expectations for the Fed have aligned with both our view and the Fed's own guidance, anticipating two rate cuts this year, down from four at the end of April, we do not rule out the possibility that the market could adopt an even more hawkish stance, particularly if incoming data and/or fiscal policy surprises to the upside. Given this backdrop, **we are raising the threshold at which we would begin to gradually accumulate exposure to 4.70-4.80%** (previously. 4.50-4.60%). However, we believe the risks around this level remain skewed to the upside.

Strategically, we remain CONSTRUCTIVE with a NEGATIVE outlook, as a more accommodative than expected fiscal stance could drive an increase in the term premium.

We believe the strategic outlook remains highly uncertain and may evolve depending on future developments in both the growth trajectory and fiscal policy.

Remaining NEUTRAL tactically

We remain tactically NEUTRAL. We mechanically shifted to NEUTRAL from MODERATELY LONG at the end of April, as 10Y UST yields fell below our take profit level of 4.20%.

We continue to hold the view that the next move for rates will be upward. However, compared to last month, the forces underpinning this move have broadened.

1. Trade tensions are de-escalating very quickly

The new global trade equilibrium is likely to be less favourable than before the US elections, yet far less dysfunctional than the scenario threatened by the Trump administration on Liberation Day. In our view, this will exert upward pressure on UST yields in the short term.

Figure 1 illustrates how the easing of trade tensions since 9 April has influenced the performance of rates markets. We distinguish two different phases:

1. In the first one, from 9 April (when President Trump announced a 90-days grace period for the tariffs imposed on Liberation Day, with the only exception of China) until the end of April, real yields declined. This reflected a significant reduction in concerns over de-dollarisation, alongside a persistently gloomy economic outlook, as evidenced by falling short-term yields and breakeven rates

2. Since the beginning of May, the decline in trade uncertainty has coincided with positive surprises in economic data (both soft and hard), which has led to rising expectations for monetary policy, as well as increases in short-term yields, real yields, and breakeven rates. Meanwhile, stocks surged and the dollar index showed mixed performance. We expect this pattern of market movements to continue in the near term, as at least some of the recent weakness in soft data is likely to reverse.

FIGURE 1
Market changes during trade tensions de-escalation

	Trade uncertainty	2Y UST	10 UST	10Y BE	10Y RY	DXY	S&P
2-9 apr	5,47	4,8	20,3	-3,57	23,99	-0,87	-3,77
9-30 apr	-5,50	-30,6	-17,3	-6,18	-11,07	-3,34	2,06
30 apr-present	-3,38	39,9	38,1	12,36	24,34	0,72	6,99

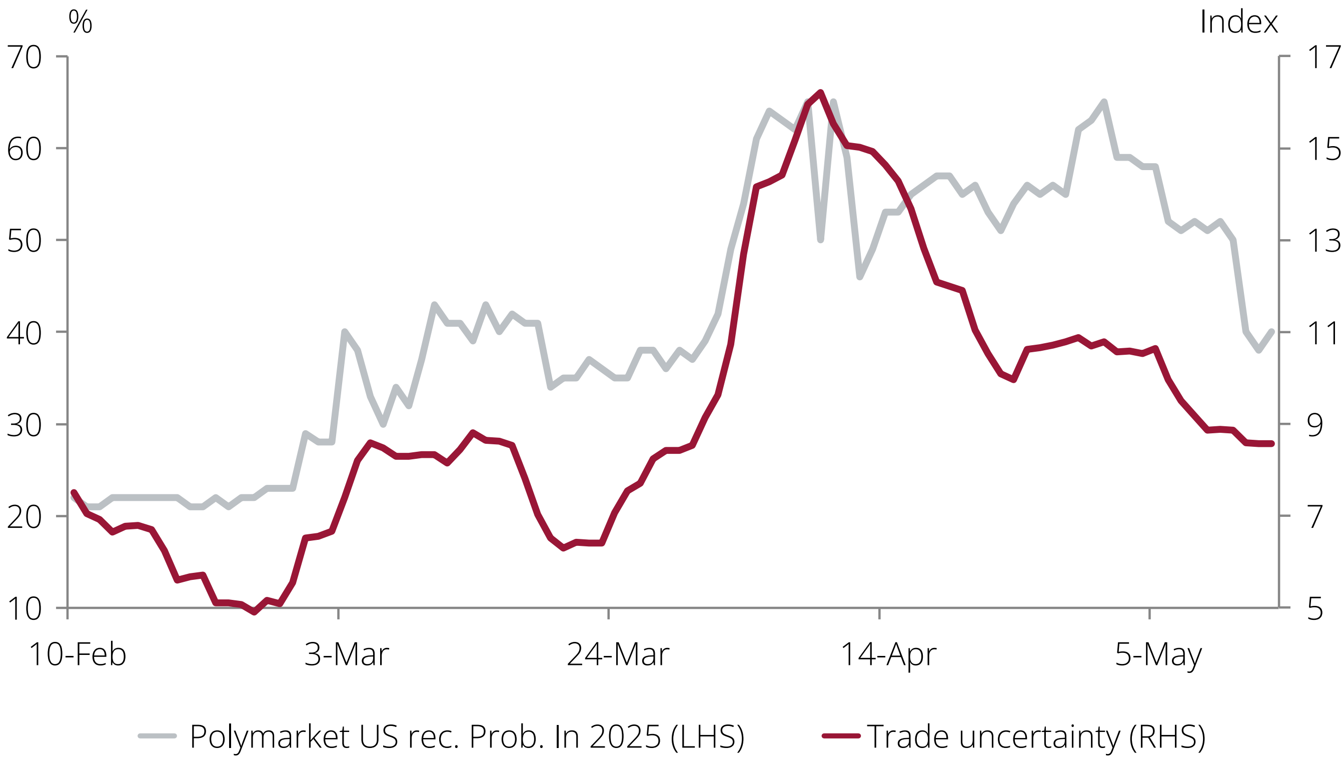
Source: Bloomberg, ANIMA Research

2. Lower recession probability

We have reduced the projected likelihood of the US economy entering a recession from 45% to 25–30%, while also considering the risks around our baseline growth forecast for this year, which still anticipates a slowdown, as tilted to the upside. **Figure 2** shows that the latest phase of easing trade uncertainty has contributed to a drop in recession probabilities, further supported by improvements in both hard and soft economic data.

FIGURE 2

Recession probability declining as trade uncertainty declines



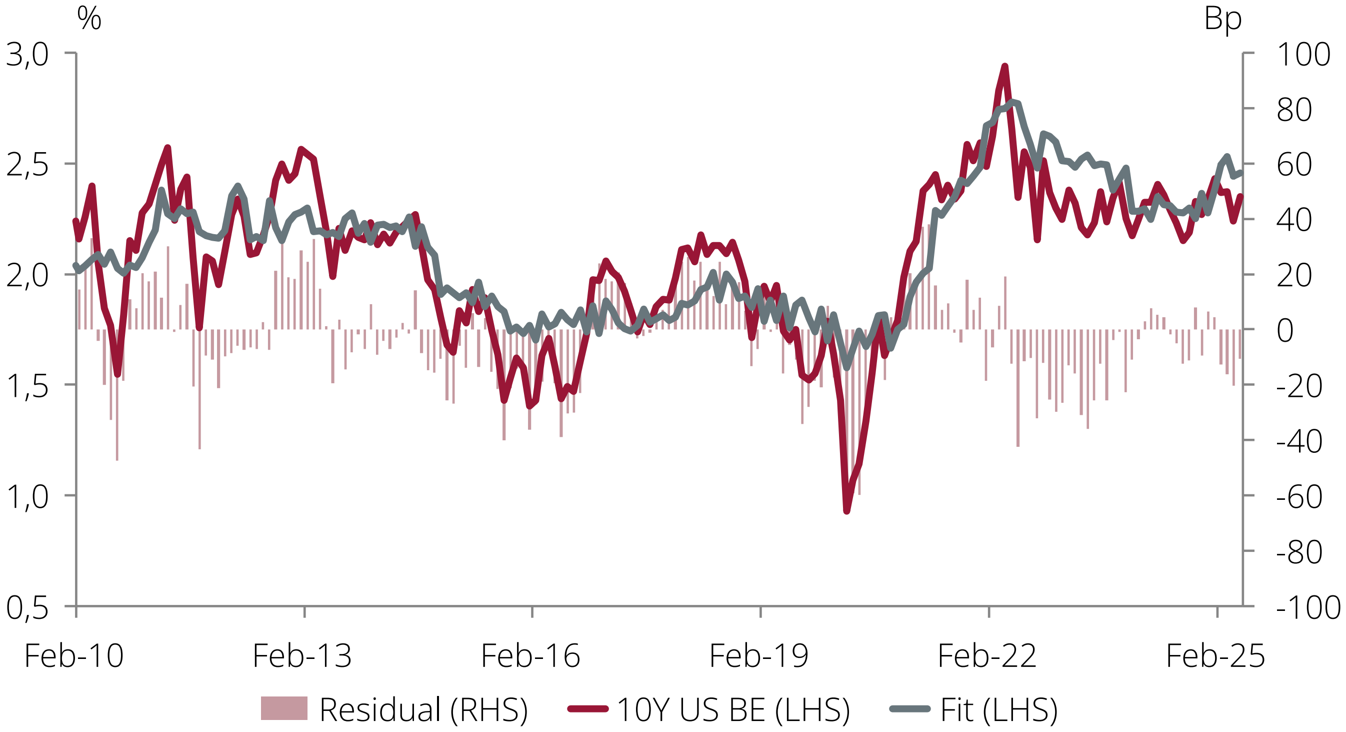
Source: Bloomberg, Haver Analytics, ANIMA Research

3. Slower convergence of inflation towards target

Although tariffs have been substantially reduced, the remaining tariffs are expected to slow the convergence of inflation towards the target compared to pre-election expectations. **Figure 3** shows that even after the recent increase, breakeven rates are trading below their fair value and **Figure 4** shows that the inflation risk premium remains historically low. Against this backdrop, should the process of disinflation slow down, and economic data remain relatively resilient (our baseline), we would expect breakeven rates to increase.

FIGURE 3

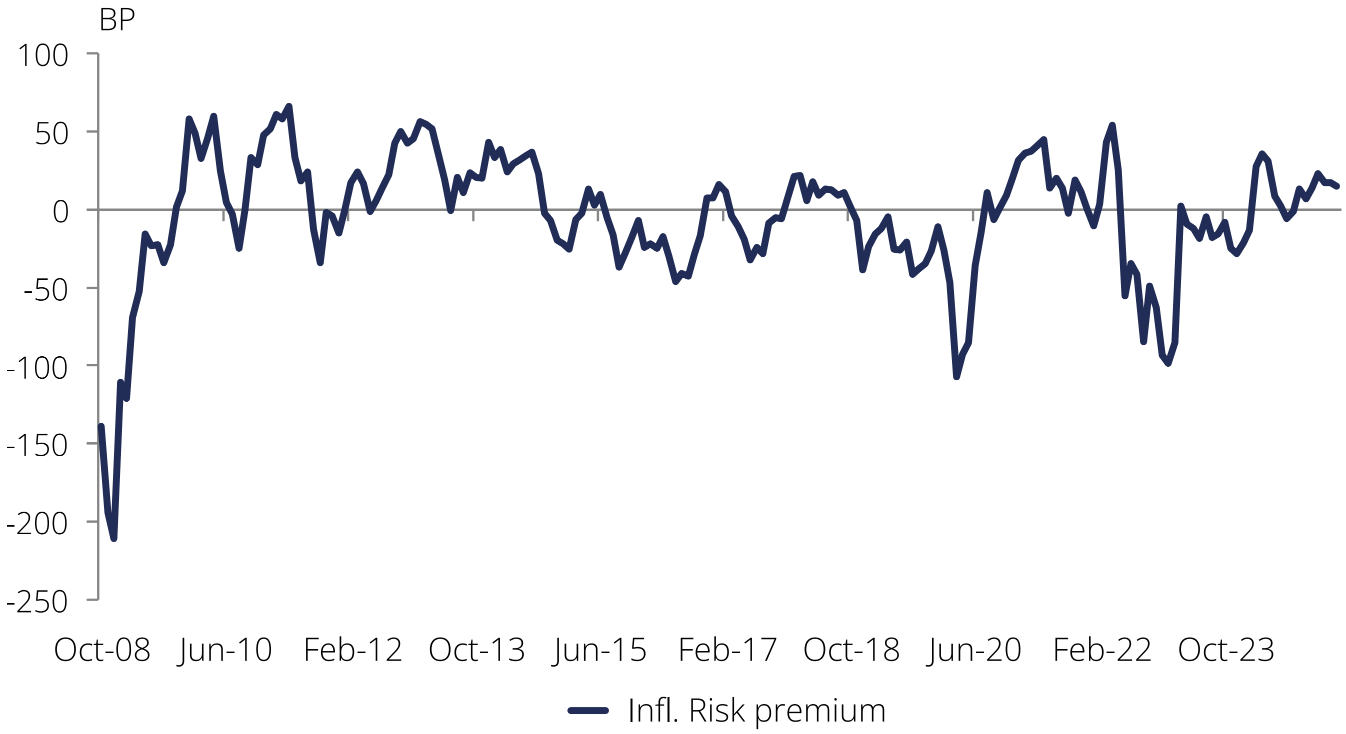
US breakeven rates are trading below their fair value



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

FIGURE 4

Inflation risk premium remains historically low



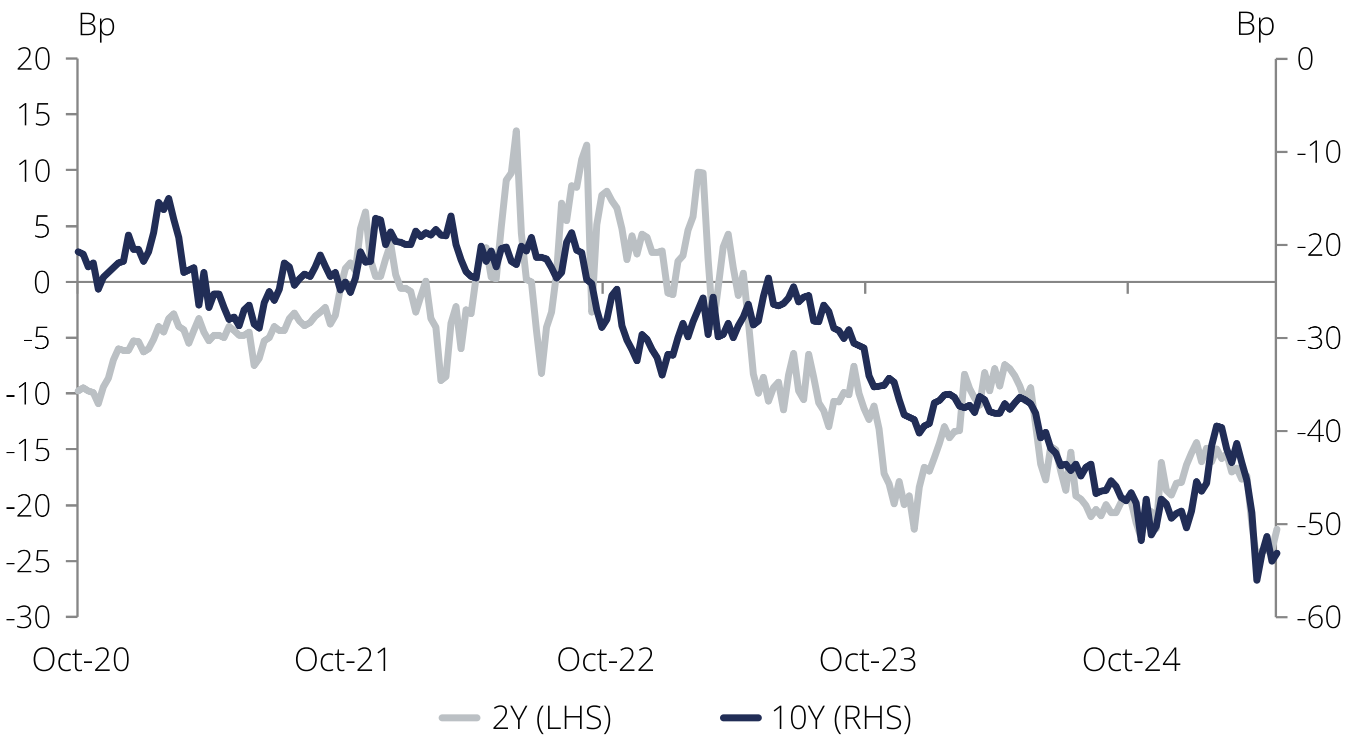
Source: Bloomberg, ANIMA Research

4. Fiscal outlook on top of investors' mind

Investors remain especially sensitive to fiscal outlook, as demonstrated by the fact that, even after the trade agreement between China and the US, USTs continue to trade at historically cheap levels versus swaps (**Figure 5**).

Against this backdrop, there is a risk that the already unfavorable supply/demand balance in USTs, could worsen further, depending on the final budget bill currently under discussion in Congress.

FIGURE 5
USTs continue to trade at historically cheap levels versus swaps

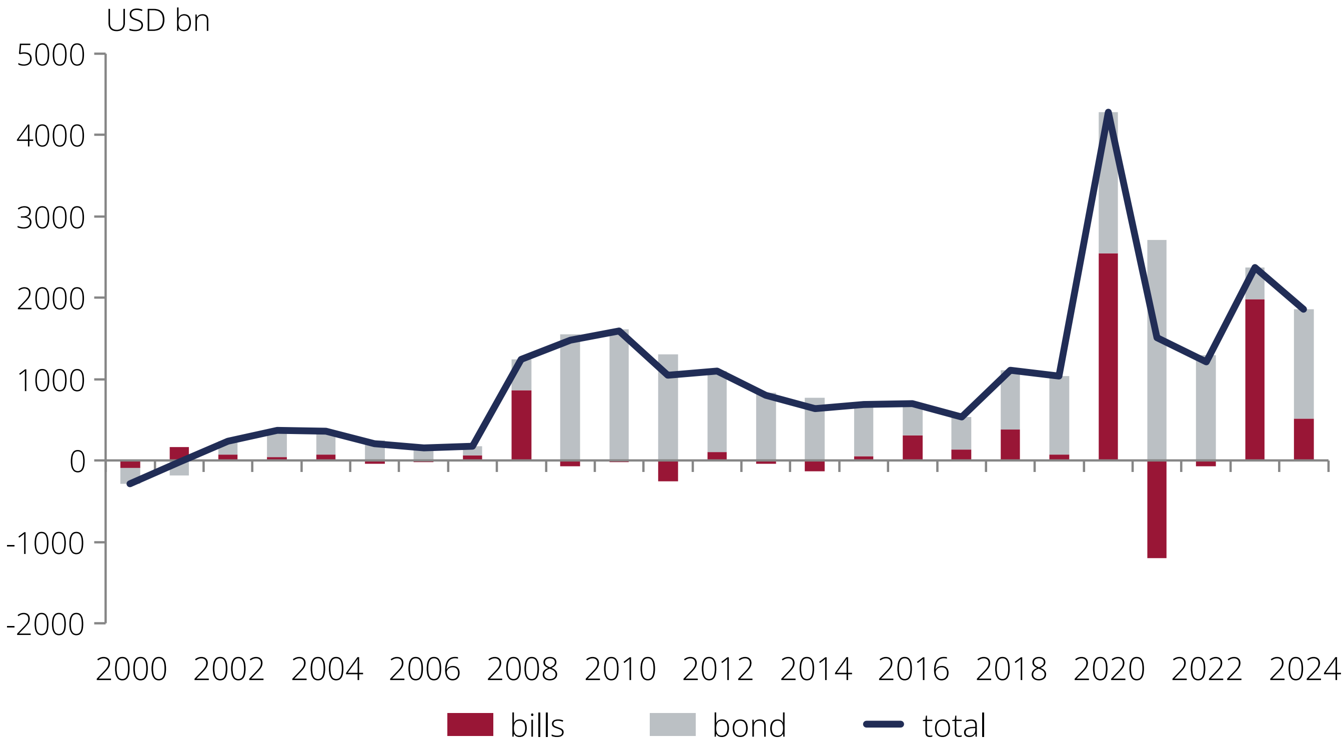


Source: Bloomberg, ANIMA Research

Increasing net supply requires strong demand to prevent a rise in term premium.

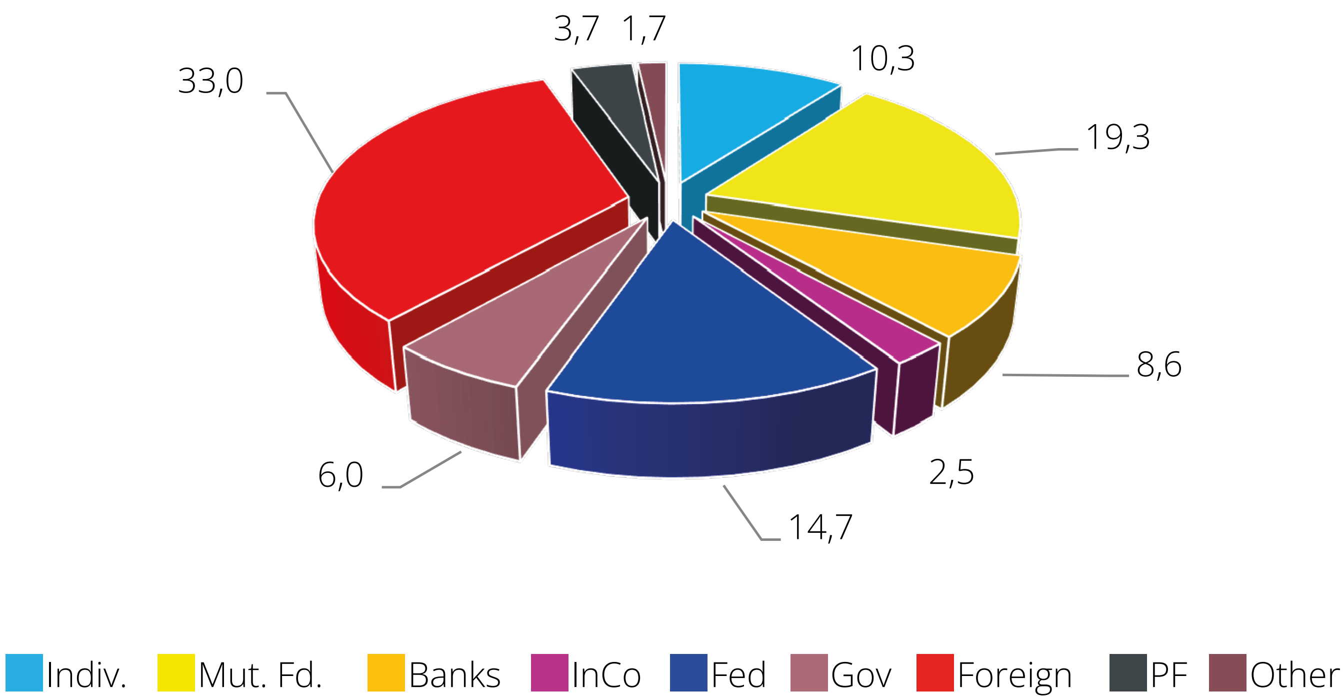
In recent years, yearly net issuance of USTs has reached USD 2tn, a historically high figure (**Figure 6**). Over the past two years, the most active investors absorbing UST issuance have been foreigners, mutual funds and retail investors, who are also the primary holders of US marketable debt (**Figure 7**).

FIGURE 6
Net UST supply reached USD 2tn



Source: Bloomberg, SIFMA, ANIMA Research

FIGURE 7
Holders of US government marketable debt



Source: SIFMA, ANIMA Research

Looking ahead, with net supply likely to exceed USD 2 trillion per year (regardless of the final version of the fiscal bill, the deficit will increase), strong demand for USTs will be essential to prevent an excessive rise in the term premium.

Against this backdrop, we expect **foreigners** to remain the main marginal investors in USTs for the following reasons:

1. While **individual investors** have room to increase their exposure to USTs (**Figure 8**), currently representing only 1.4% of their total assets, they tend to be very sensitive to yield levels and typically invest mostly in short and medium-term maturities. With the Fed expected to cut rates this year, the appeal of USTs to retail investors may diminish.

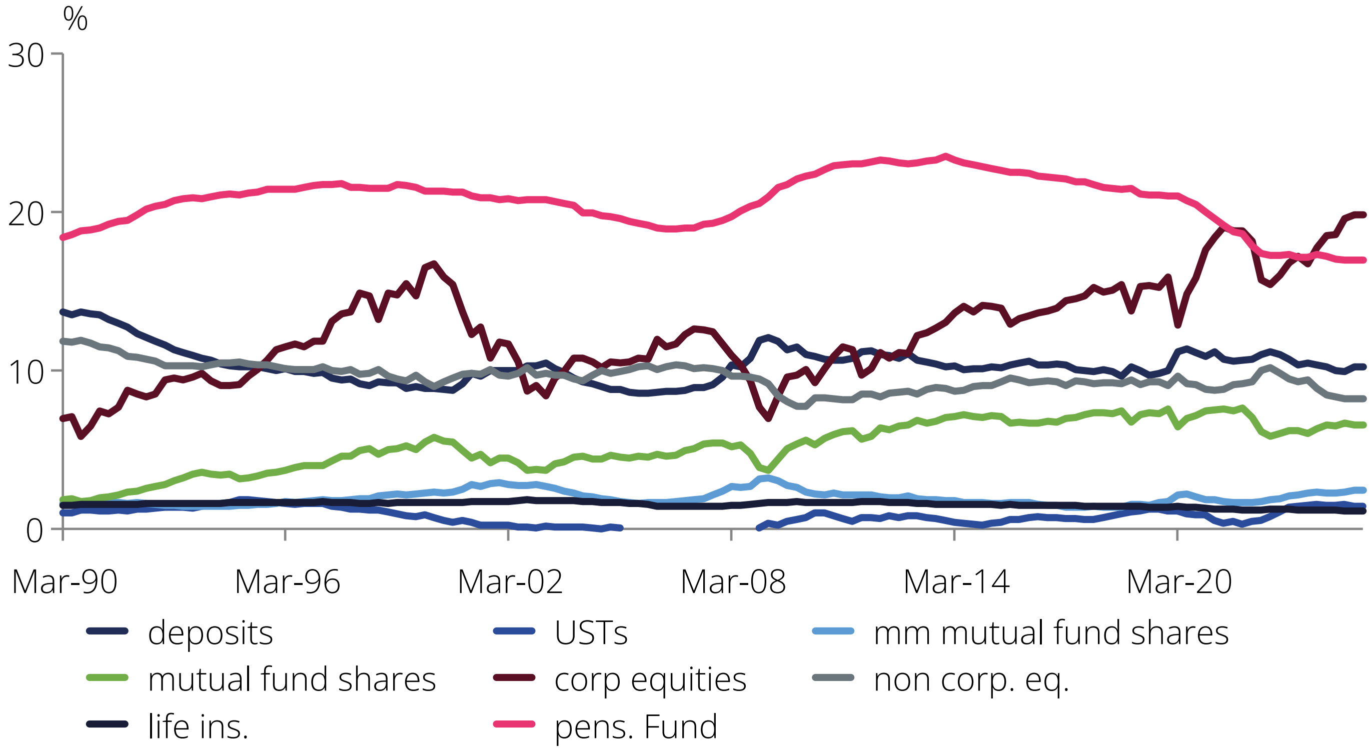
2. Although the **Fed** will no longer reduce its exposure to USTs as rapidly as before, we do not anticipate a reactivation of quantitative easing, unless there is a major disorderly move in the UST market or inflation (which is not our baseline). Even then, any QE would likely be temporary and provide only limited support to USTs.

3. If the Trump administration relaxes regulations around the Supplementary Leverage Ratio (SLR), **domestic banks** could, in principal, net-buy between USD 0.5tn and USD 1.5tn of USTs[1]. While this would support demand, we believe it might not be a game changer, given that any increase in exposure would likely be gradual and banks might prefer only a modest rise in the ratio of USTs to total assets.

1 - This would increase the ratio of USTs to total assets from the current 7.5% to 10-13%.

FIGURE 8

Financial assets of households (% of total assets



Source: Bloomberg, Haver Analytics, ANIMA Research

Foreigners, especially private, have been heavy buyers of US government debt in 2023 and 2024, with positive inflows into USTs also recorded up until March this year (latest available TIC data). However, demand of USTS from foreigners most likely slowed down sizably in April, as indicated by Japanese flows and preliminary data from ETF. The easing of trade tensions has certainly helped and should continue to alleviate fears of de-dollarisation, but the next major test for foreign investors' appetite for USTs will be the fiscal bill.

Rates market implications of the upcoming Budget. Republicans aim to have a final fiscal bill approved by Congress by July. To achieve this via reconciliation[2], we believe significant compromises will be required among the different factions within the Republican party.

Against this backdrop, our baseline expectation is that the extension of the TJCA will be approved, with its negative impact on the deficit partly offset by spending cuts, resulting in a relatively moderate increase in the deficit (USD 2.8–3 trillion from 2026 to 2035). If this materialises, we would expect a short-term market reaction consistent with the lower bound of our accumulation threshold (4.70%).

2 -The aim of the Republicans is to pass the fiscal bill via reconciliation, a procedure that allows the bill to pass with a simple majority in Congress, as happened in 2017 with Trump's first tax cuts bill. However, using this method requires that the bill be agreed upon by both the House and the Senate, and currently, there are two significantly different versions in each chamber (the House version includes substantial spending cuts to partly offset tax cuts, while the Senate version includes virtually no tax cuts).

Should Republicans pass a more aggressive fiscal easing package (e.g., an increase in the deficit exceeding USD 3 trillion over the next ten years), we expect a near-term sell-off in USTs, which would probably also extend to the medium-term, with the curve bear-steepening and the term premium rising, consistent with the higher range of our accumulation threshold (4.80%) or possibly higher (see **THE TRUMP CASE- RATES**, August 2024).

This would be due to:

1. Markets anticipating a larger-than-expected increase in the free-float of USTs, which would drive up the premium demanded by investors.

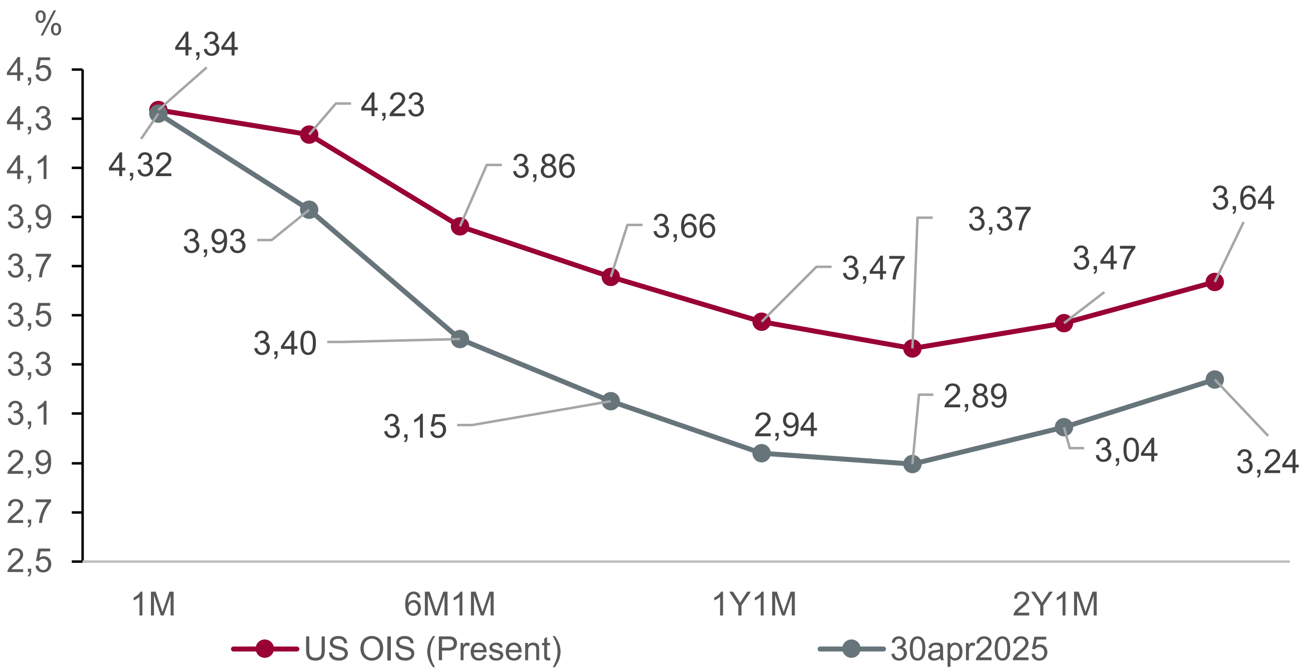
2. A fiscal stimulus when the economy is growing moderately below potential (likely in 2026, barring renewed trade tensions) could push inflation higher.

5. Markets could become more hawkish on the Fed

Market expectations for the Fed this year have aligned with ours and the Fed's, now anticipating two rate cuts, down sharply from four cuts at the end of April (**Figure 9**). Nevertheless, we do not rule out the possibility that the market could adopt a more hawkish stance, particularly if soft economic data start to surprise on the upside. **Figure 10** shows that while short-term market expectations have partly priced in improvements in US soft economic indicators, longer-term expectations have somewhat lagged behind.

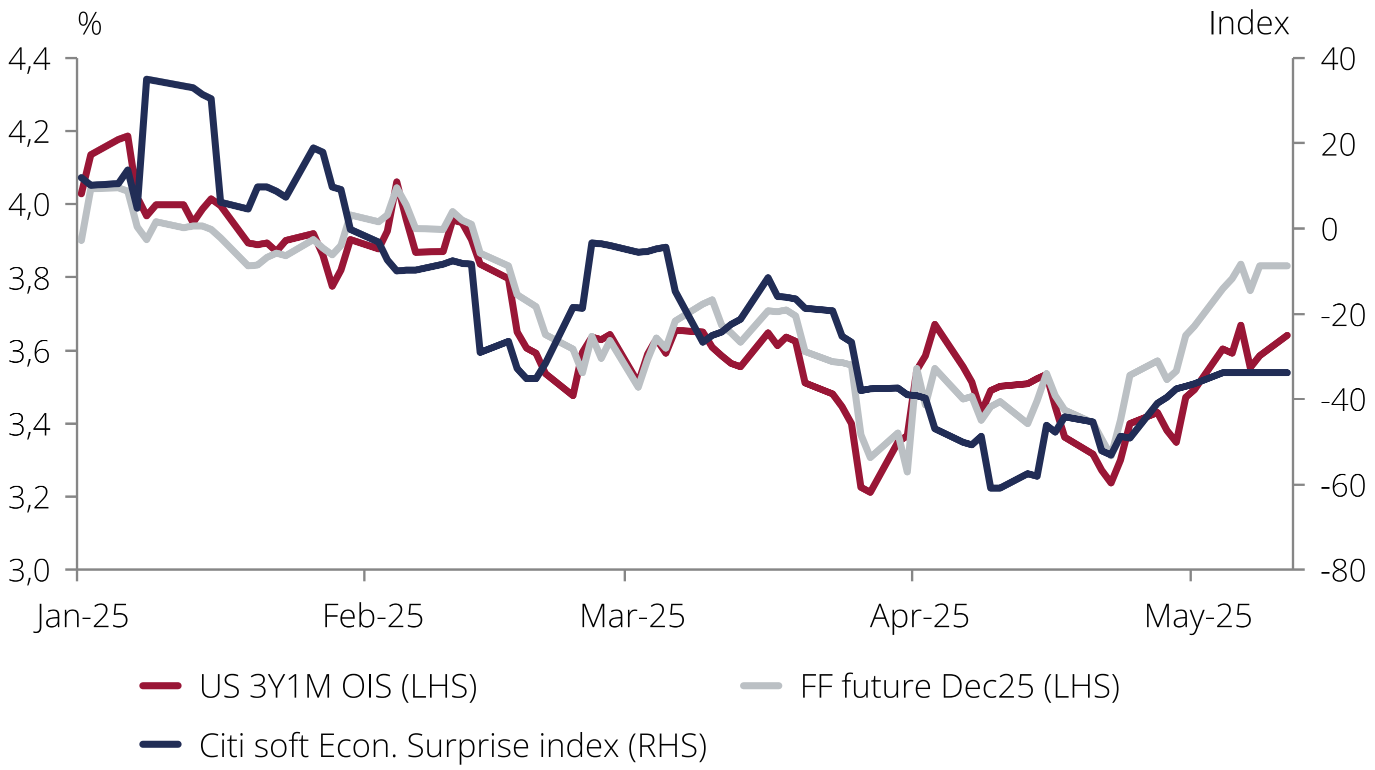
FIGURE 9

Monetary policy expectations on the Fed have become much more hawkish



Source: Bloomberg, ANIMA Research

FIGURE 10
Monetary policy expectations on the Fed have become much more hawkish



Source: Bloomberg, ANIMA Research

Against this backdrop, we are raising the threshold to begin gradually accumulating exposure to 4.70-4.80% (previously 4.50-4.60%). However, we believe that the risks around this level are skewed to the upside.

Strategically CONSTRUCTIVE with a negative outlook

Strategically, we remain CONSTRUCTIVE but maintain a NEGATIVE outlook, as a more accommodative fiscal stance than expected could lead to an increase in the term premium.

We believe the strategic outlook remains highly uncertain and may evolve depending on developments in the growth outlook and fiscal policy over the coming months.

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

VALERIO CEOLONI
Senior EM/FX Strategist
valerio.ceoloni@animasgr.it

MATTEO GALLONE
Junior Macroeconomist
matteo.gallone@animasgr.it

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