US Rates Strategy
UST– GETTING THERE

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Since we first flagged upside risks to UST yields in the case of Republican sweep[1], 10Y rates surged 65bp. However, the market appears to have adopted a different view of the Fed's likely response compared to the stance taken in 2016, which was incorporated into our baseline.

Instead of assuming that the Fed would maintain a passive approach until President-elect Trump's policies eventually flare up inflation, the increase in real rates alongside stable breakeven rates suggests the market discounts a pre-emptive response from the Central Bank that will keep medium-term price pressures at bay, effectively capping the term premium.

Cumulative rate cuts priced in through 2025 declined from 115bp to 55bp since the end of August. A resilient macro-outlook has certainly contributed to this shift; however, our qualitative analysis shows the "Trump effect" contributed to a larger extent.

We don't expect the market to change narrative remarkably before President-elect Trump is sworn in. This will keep a lid on the UST sell-off that started in mid-September.

Against this backdrop, we remain of the view that UST yields have more room to increase from current levels (around 4.45%) – especially if the market were to take the view that Trump's policies warrant a higher neutral rate – though not as much as we expected in August. Accordingly, ***we now believe that 4.60%-4.70% is the appropriate entry-level to turn gradually LONG under a Republican sweep*** *(4.80%-4.90%, previously).*

1 - See "US ELECTION - THE TRUMP CASE – Rates", 26 August 2024

The new entry-level should also hold even if the market realigns with the Fed's dot plot and our Fed forecast, both envisaging further cumulative easing of 125bp by the end of 2025. In that scenario, we would expect real rates to decline and breakeven rates to increase.

A word of caution. *Although no longer our tactical baseline, UST yields at 4.80%-4.90% cannot be entirely ruled out at this stage. For that to happen, either growth would need to exceed our current projections and/or President-elect Trump's policies would need to create near-term inflation, which neither our baseline nor the 2017 trade war experience suggest. This is yet another reason to keep* ***our strategic OVERWEIGHT stance outlook under review (with a negative outlook)****.*

I) Taking stock of Trumps' victories

In the aftermath of the election[2] , we recommended turning tactically LONG from NEUTRAL by accumulating exposure on USTs at 4.80%/4.90% (10Y) in the event of a Republican sweep.

Taking stock of the latest developments, we maintain the view that UST yields still have room to rise from the current level (4.45% at the time of writing), although slightly less than we had previously anticipated.

Compared to our underlying assumptions, the market seems to have embraced a different Fed reaction function than the one seen in 2016, which was incorporated into our baseline.

In the following, ***we outline the reasons why 4.60%-4.70% (10Y) now represents a more appropriate entry point for gradually turning LONG***.

II) Same winner, different market reactions

UST sell-offs under the microscope. Although 10Y rates surged following both Trump's landslide victories in 2016 and 2024, the market seems to have factored in a different Fed reaction function compared to 2016, which was incorporated into our baseline.

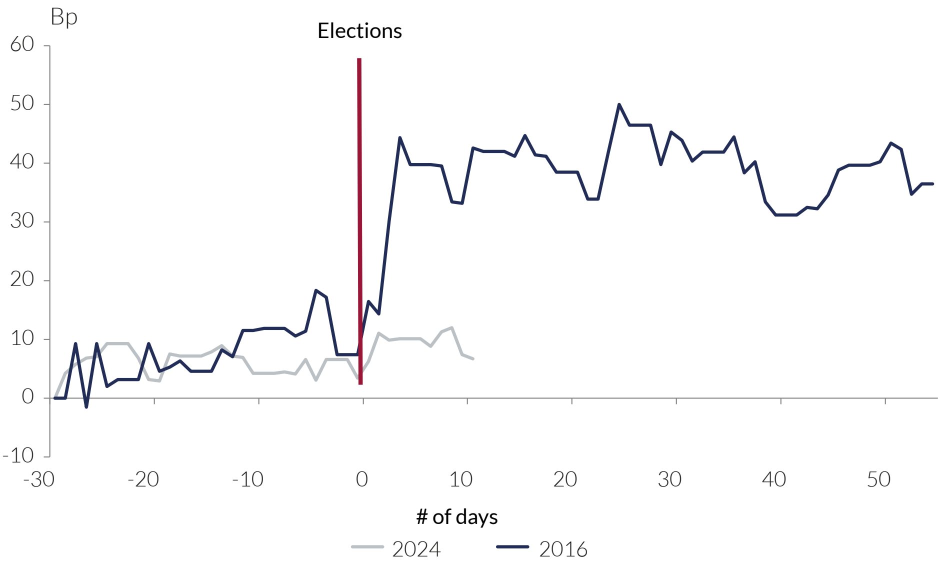
Instead of assuming that the Fed would maintain a passive approach until President-elect Trump's policies eventually flare up inflation, the increase in real rates alongside stable breakeven rates suggests the market discounts a pre-emptive response from the Central Bank that will keep medium-term price pressures at bay.

Market-driven inflation expectations did not rise post-election. The 5Y5Y forward inflation swap surged by 35bp after the 2016 election but has only increased by 5bp recently (**Figure 1**). This resulted in a muted rise in term premium, compared to a jump of around 30bp observed in 2016 (**Figure 2**).

2 - See "TAKING STOCK OF A LIKELY TRUMP VICTORY", 6 November 2024

FIGURE 1.

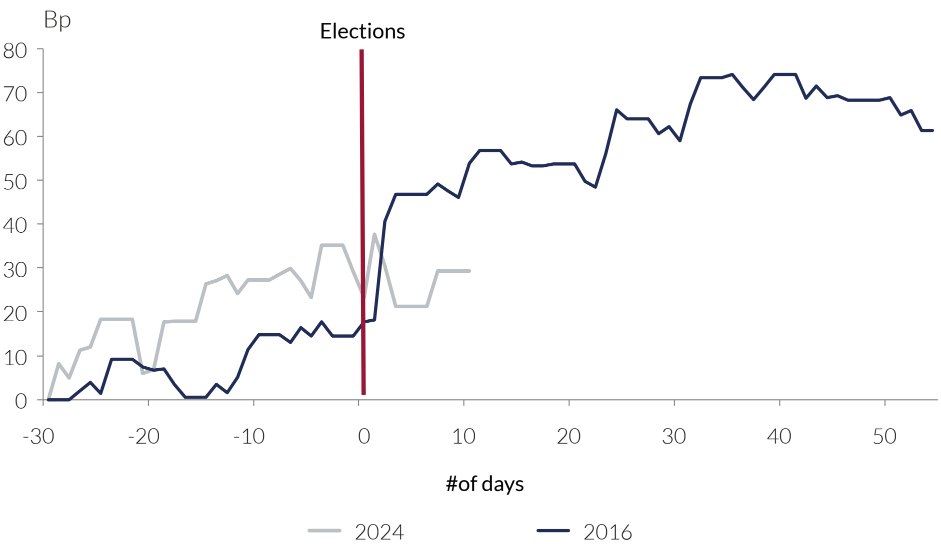
The 5y5y forward inflation swap: 2016 vs 2024 election



Source: Bloomberg, ANIMA Research

FIGURE 2.

Term premium (10Y): 2016 vs 2024 election



Source: Bloomberg, ANIMA Research

On the surface, real rates broadly behaved in the same way. However, most of the increase this time occurred ahead of the election (**Figure 3**).

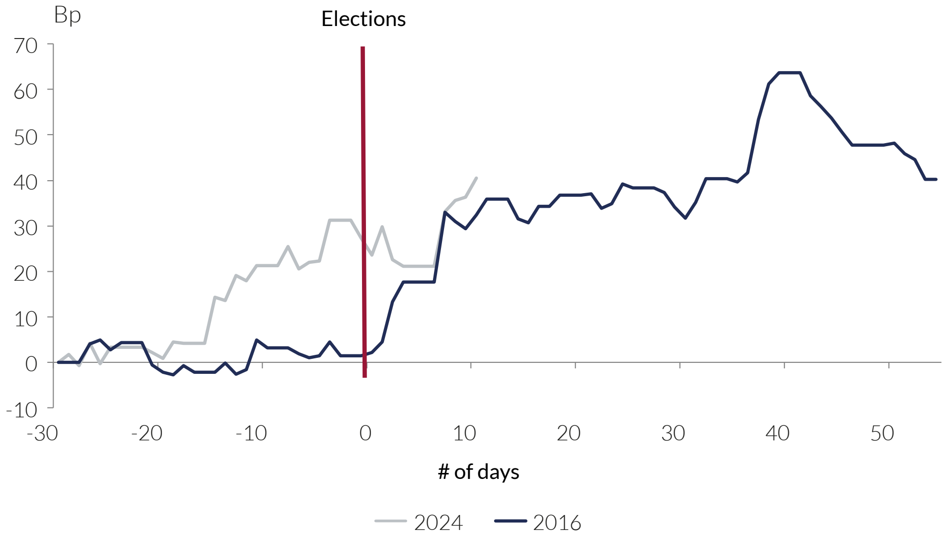
Figure 4 shows that expectations for the Fed fund rates in one-year time climbed by 20bp post-election, with an increase of around 30bp ahead of the election. The same pattern was observed for the neutral rate priced by markets.

A resilient macro-outlook certainly played a role in the rise of monetary policy expectations and real rates, though our qualitative analysis shows that the "Trump effect" contributed to a greater extent. (Figure 5).

Indeed, the fact that real rates and breakeven rates did not rise in tandem, supports our view that the markets are not entirely discounting a generalized improvement in the economic outlook, but rather expecting a more hawkish Fed monetary policy aimed at keeping inflation under control.

FIGURE 3.

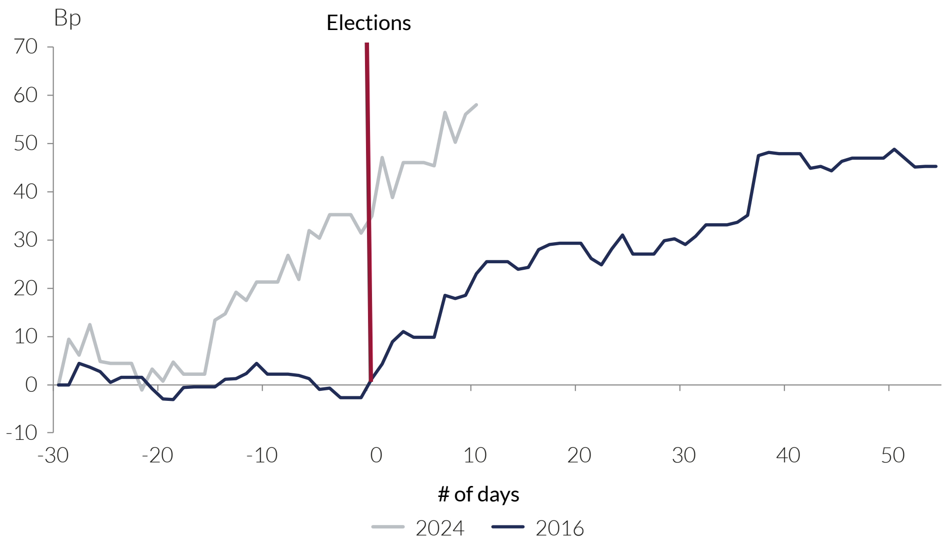
Real rates (10Y): 2016 vs 2024 election



Source: Bloomberg, ANIMA Research

FIGURE 4.

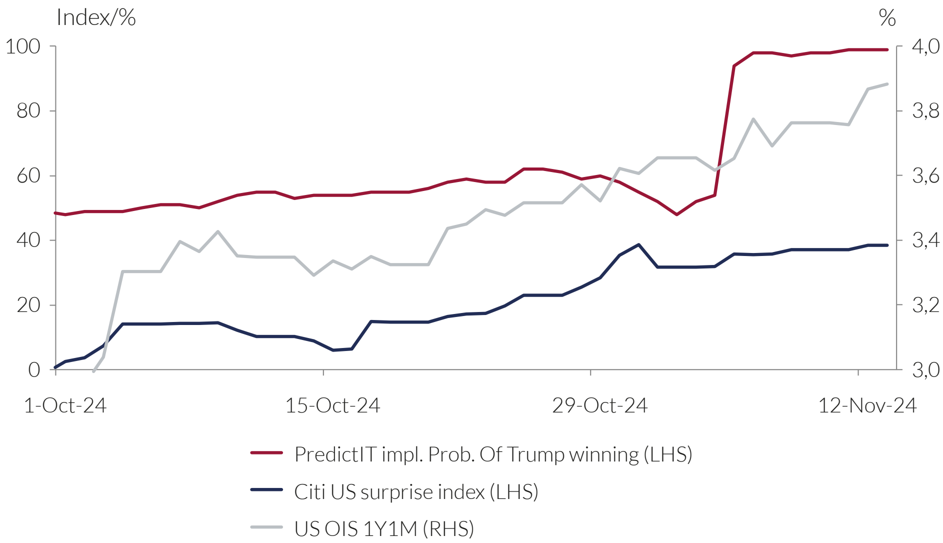
Very sharp rise in the 1Y1M OIS forward post-election, in contrast to 2016



Source: Bloomberg, ANIMA Research

FIGURE 5.

Monetary policy expectations fueled by Trump's victory



Source: Bloomberg, ANIMA Research

III) Our take

We think the rates markets' reaction to the latest Trump's victory was different compared to 2016, for the following reasons:

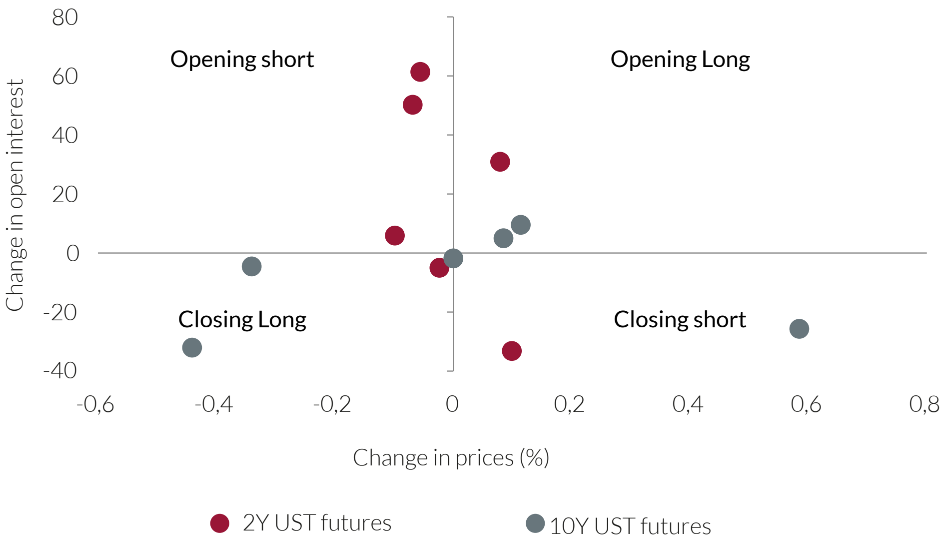
1) In contrast to 2016, markets have priced in a much more hawkish stance from the Fed post-election, with the rate cuts expected in 2025 falling from 100bp on 22 October to 55bp currently. In investors' minds, under Trump 2.0, the Fed will be much more proactive than under Trump 1.0, acting as a break to the rise in inflation by cutting rates significantly less and significantly slower, should Trump deliver his agenda (which appears to be the market's baseline). Against this backdrop, the risk of higher inflation resulting from Trump's policies is seen as a factor that could swiftly shift the Fed's reaction function back towards prioritising the inflation target, rather than maintaining a balance between that target and full employment. This explains why inflation expectations have risen by a much smaller margin than in 2016. This is backed by market activities in UST futures: post-elections, new short positions on UST futures were predominantly opened at shorter maturities (**Figure 6**).

2) Monetary policy is now more restrictive than it was in 2016 (**Figure 7**). In investors' mind, this likely limits the pass-through of inflationary policy to the real economy compared to 2016.

3) The US economy is expected to continue its soft landing, with consensus forecasting a moderate slowdown in growth. This contrasts the end of 2016, when growth was expected to pick up.

FIGURE 6.

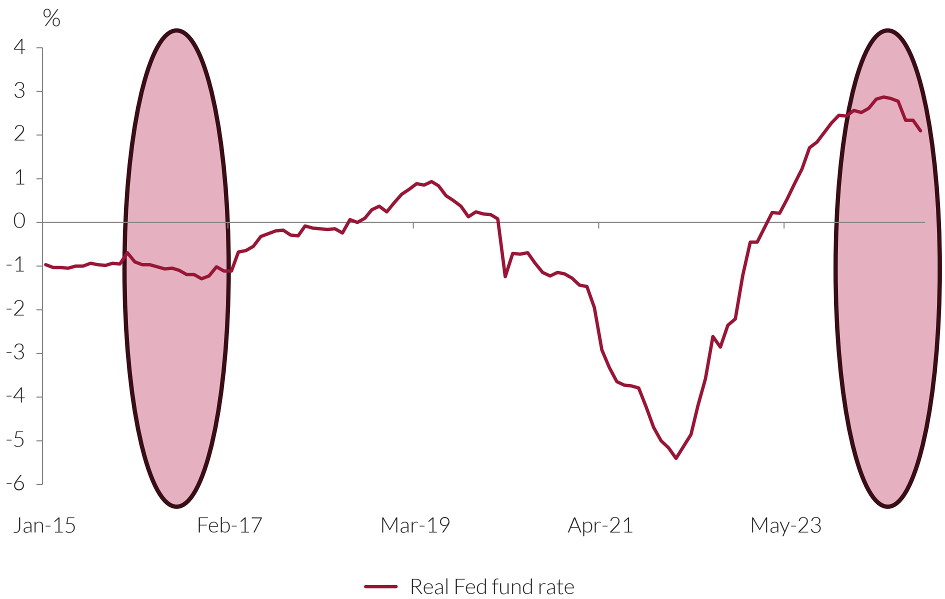
New short positions were predominantly opened at shorter maturities



Source: Bloomberg, ANIMA Research

FIGURE 7.

Fed's monetary policy is much more restrictive than it was in 2016



Source: Bloomberg, ANIMA Research

IV) What's next from here?

We don't expect the market to change narrative remarkably before President-elect Trump is sworn in. This will put a cap on the UST sell-off that began in mid-September.

We think it is difficult to argue for a rise in both breakeven rates and real rates at the same time in the near term, as occurred in November/December 2016. If the rate markets continue to price in the risk of inflationary policies via a more hawkish Fed, real rates will rise further, led by an upward revision of monetary policy. However, any rise in breakeven rates will remain capped. In other words, the more hawkish the Fed expectations become, the less room there will be for long-end yields to rise and for the curve to steepen.

Meanwhile, if the market comes to view the Fed as reactive rather than proactive in managing inflation risks, this could trigger an increase in breakeven rates and term premiums, leading to a steepening of the curve much more pronounced than what we have observed so far. However, in this case, real yields would retrace lower, led by more dovish monetary policy expectations, partially offsetting the rise in break evens.

We continue to believe that the bias for UST yields remains on the upside in the near term. The market may perceive that Trump's policies warrant a higher neutral rate. For context, in late April, markets were pricing the neutral rate at around 4% (vs. 3.70% now). If markets adopt the same view, 10Y yields could rise to around 4.70%. According to our analysis, 85% of the increase would come from a rise in real rates, while break evens would move little.

Against this backdrop, we remain of the view that UST yields have more room to increase from current levels (around 4.45%) – especially if the market were to take the view that Trump's policies warrant a higher neutral rate – though not as much as we expected in August. **Accordingly, we now believe that 4.60%-4.70% is the appropriate entry-level to turn gradually LONG under a Republican sweep (4.80%-4.90%, previously).**

V) 5% out of the window?

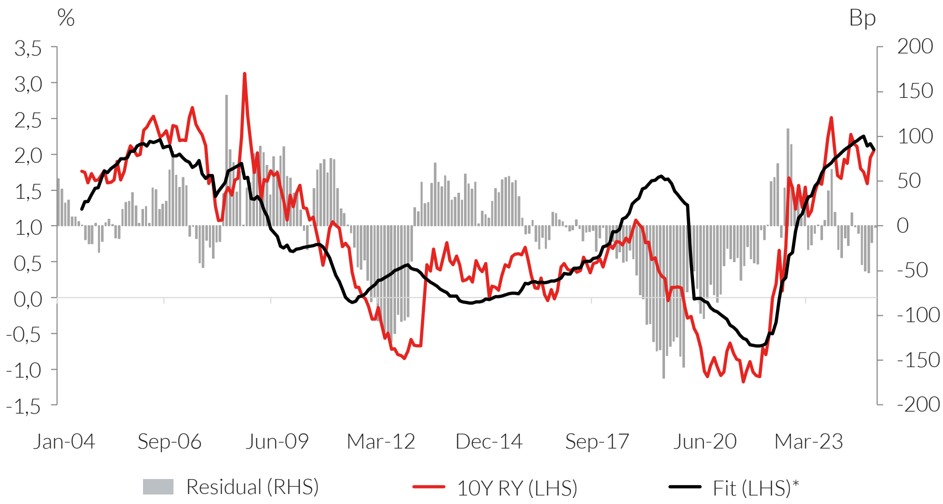
Considering that our models suggest that both real and breakeven rates are currently trading near fair value (**Figure 8** and **9**), a simultaneous rise in both real rates and breakeven rates from this point would, in our view, require the following conditions:

1) Very positive surprises in economic data that lead markets to revise the growth potential upwards by around 2%.
2) Clear evidence that Trump is heading towards a full implementation of his agenda, implying a sizeable rise in the deficit and a rise in inflation.
3) A reactive rather than proactive Fed that continues to cut rates, while only marginally accounting for the inflationary risks arising from the future implementation of Trump's policies, leading to a further loosening of financial conditions.

While we cannot entirely rule out the possibility of markets pricing in this scenario in the short term, the probability has declined significantly in recent weeks. Against this backdrop, we believe the risk-reward profile of beginning to extend duration at 4.60%-4.70% (10Y) has improved.

FIGURE 8.

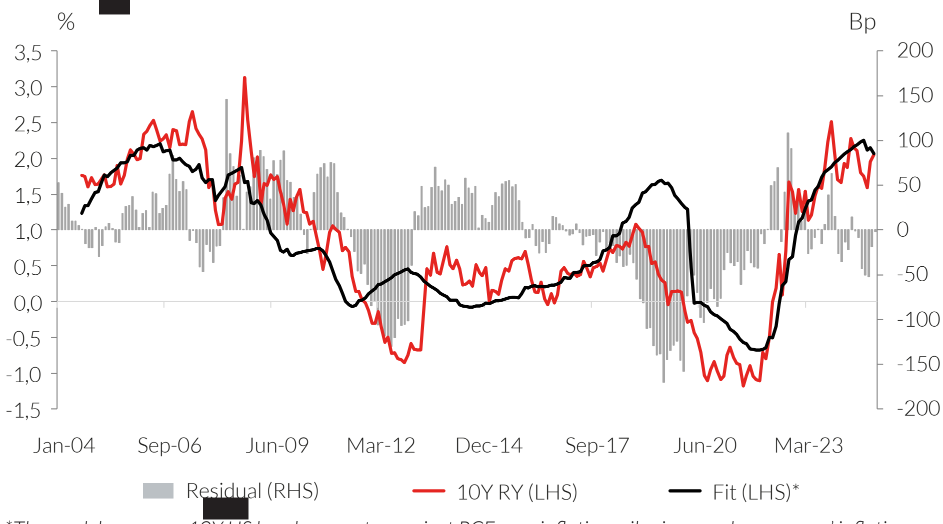
10Y real UST yields are near fair value



**The model regresses 10Y UST real yields against potential growth, the Fed Fund rates, and the Fed's holdings of USTs as a percentage of marketable debt. The model is estimated using a sample of quarterly data from 2003 to the present.*
Source: Bloomberg, CBO, ANIMA Research

FIGURE 8.

10Y real UST yields are near fair value



**The model regresses 10Y US breakeven rates against PCE core inflation, oil prices, and consumers' inflation expectations for the next 5-10 years, as captured by the U-Mich survey. The model is estimated using a sample of monthly data from 2003 to the present.*
Source: Bloomberg, ANIMA Research

Against this backdrop, we also maintain our strategic CONSTRUCTIVE outlook at this stage, for the following reasons:

1) We continue to expect the US economy to soft-land, with inflation gradually converging to target. Meanwhile, in our baseline scenario, Trump's policies will not be inflationary, and fiscal policy will only start to affect the economic outlook from 2026 onwards.
1) We expect the Fed to maintain a disinflationary rate-cut cycle, with the Fed Funds rate gradually converging towards neutral.

That said, **we maintain our strategic outlook under review, with a negative outlook** at this stage, as uncertainty remains high in a Republican sweep scenario, and visibility on Trump's agenda remains low.

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