J.P.Morgan

US Treasury Market Daily

Long-end RV look

- The Treasury curve bullishly flattened, with long-end yields declining 4bp, alongside softer domestic data and despite weaker-than-average demand at today's 30-year TIPS auction. TIPS breakevens ended 4-7bp narrower
- We recommend unwinding our 33:65 weighted 10s/20s/30s belly-richening trade, as the 1.125% May-2040s have outperformed recently and now trade at a significant premium to our par curve
- Additionally, we like selling the 3% May-2042s, a $44bn issue of which the Fed already owns a 70% share, and buying the 3% Nov-2044s, a $44bn issue which is only 24% SOMA-owned, on a level-neutral basis
- The 10-year note grinds to lower yields and retraces more of last week's selloff. Now testing the 0.64-0.66% 50-day and 100-day moving averages, the next key short-term resistance rests at 0.57-0.59%. In our view, the tone stays bearish as long as that resistance remains intact

Fixed Income Strategy

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Statistics for various on-the-run Treasury yields, curve spreads, and TIPS breakevens

		Close	1d chg (bp)	WTD chg (bp)	YTD chg (bp)	3m avg	3m low	3m high	3m pctl.
Yields (%)	4wk	0.07	0.5	-0.5	-135.7	0.11	0.07	0.16	5%
	13wk	0.10	0.1	0.1	-145.6	0.13	0.10	0.17	5%
	26wk	0.12	0.1	-0.2	-146.3	0.15	0.10	0.19	19%
	52wk	0.12	0.0	-0.7	-146.3	0.15	0.12	0.20	10%
	2y	0.14	0.0	-0.8	-138.7	0.16	0.11	0.23	25%
	5y	0.27	-1.0	-3.2	-145.0	0.30	0.19	0.48	26%
	10y	0.64	-3.1	-6.5	-128.6	0.66	0.51	0.90	34%
	30y	1.38	-3.8	-6.4	-101.5	1.39	1.19	1.68	38%
Curves (bp)	2s/5s	12.7	-1.0	-2.4	-6.3	13.9	8.4	26.1	24%
	5s/10s	37.7	-2.1	-3.3	16.4	35.9	31.2	43.1	55%
	2s/10s	50.4	-3.1	-5.7	10.1	49.8	40.2	68.9	35%
	10s/30s	73.3	-0.7	0.1	27.1	72.6	64.3	80.6	55%
TIPS BEs (bp)	5y	151.3	-3.5	-3.5	-17.5	122.3	80.6	157.2	92%
	10y	162.8	-5.1	-3.1	-14.7	140.0	111.1	168.8	90%
	30y	167.0	-6.9	-3.0	-13.0	158.6	145.8	173.9	76%

Source: J.P. Morgan

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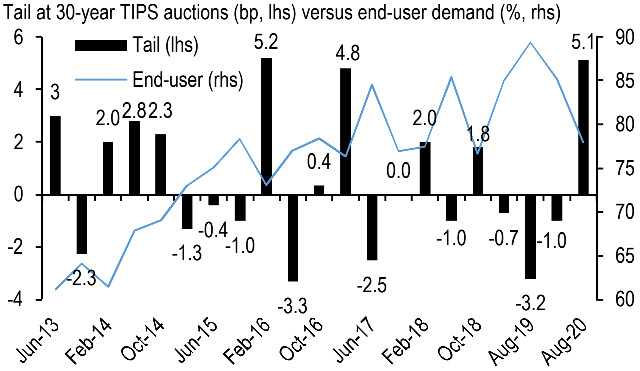
Market views

The Treasury curve bullishly flattened, with long-end yields declining 4bp, as domestic data weakened: jobless claims rose by135k to 1.106mn in the week ending August 15 (consensus: 920k), and the Philadelphia Fed survey declined 6.9 points to 17.2 (consensus: 20.8), with weakness in the new orders component (see *US: Unemployment claims and Philly Fed both disappoint*, Jesse Edgerton, 8/20/20). The flattening occurred even though another long duration Treasury auction was met with weaker-than-average demand: the 30-year TIPS auction cleared at -0.272%, the lowest 30-year auction yield on record, but 5.1bp cheap to pre-auction levels, the largest tail since February 2016 (**Exhibit 1**). End-users were awarded 77.9% of the offering, 7.3%-pts below the previous auction and 8.6%-pts below the previous 3-auction average. This now marks the fourth consecutive long-end auction that tailed, following the July 20-year auction, last week's 30-year nominal auction, and yesterday's 20-year auction. It is early to call this a trend, but it is interesting that end-user demand has not kept up with the larger auction sizes recently, thus requiring larger concessions to underwrite. TIPS breakevens narrowed in a near parallel fashion through the morning, but the long end underperformed following the auction, ending 7bp tighter on the day.

Exhibit 1: The 30-year TIPS auction cleared 5.1bp cheap to pre-auction levels, the largest tail since February 2016, amid a decline in end-user demand

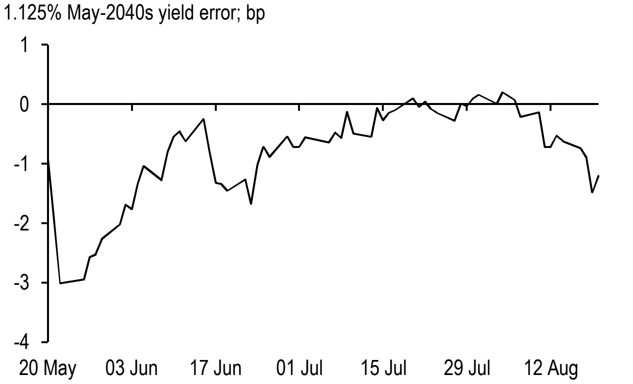
Tail at 30-year TIPS auctions (bp, lhs) versus end-user demand (%, rhs)



Source: US Treasury, J.P. Morgan

Exhibit 2: May-2040s have richened to our fitted curve in anticipation of SOMA demand

1.125% May-2040s yield error; bp



Source: J.P. Morgan

Long-end RV update

Turning to relative value, we recommend unwinding our 33:65 weighted 10s/20s/30s belly-richening trade, as it has hit our self-imposed 3-month horizon (see Trade recommendations). When we recommended this trade in May, it was because the 20-year sector appeared somewhat cheap and was the best yield per unit of duration among benchmark maturities. This has largely mean reverted and the 20-year sector appears fairly valued along the curve after adjusting for the level of rates and the slope of the curve. However, it appears old 20s—the 1.125% May-2040s—have outperformed recently: **Exhibit 2** shows the issue consistently traded rich to our par curve for the first 6 weeks following the debut auction in May, but gradually cheapened as it was reopened twice and reached its terminal size of $54bn. However, the May-2040s have richened more than 1.5bp relative to the curve over the last two weeks, likely in anticipation of Fed purchase activity. Recall that the Fed excludes on-the-runs from its POMOs, and excluded this bond from today's operation, even though it's no longer the on-the-run, likely because the 1.125% Aug-2040s have yet to settle.

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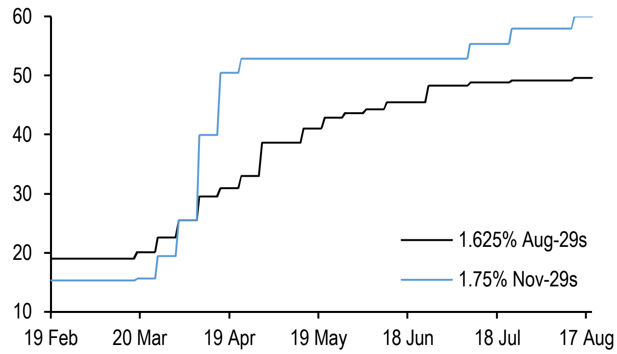
Exhibit 3: The Fed consistently purchased near off-the-run 10-year notes in its purchase operations during the spring and summer…

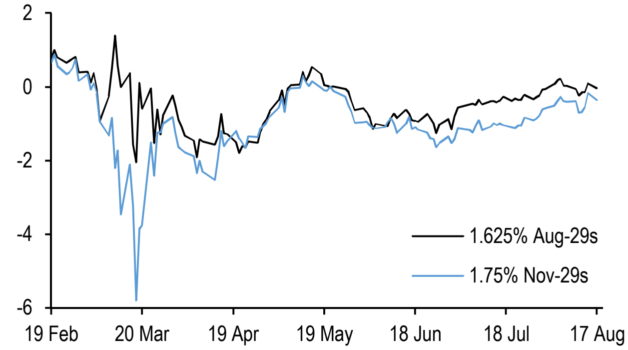
SOMA share of 1.625% Aug-2029s and 1.75% Nov-2029s; %



Source: Federal Reserve Bank of New York

Exhibit 4: …even though these issues traded rich to our fitted curve

1.625% Aug-2029s and 1.75% Nov-2029s yield errors; bp

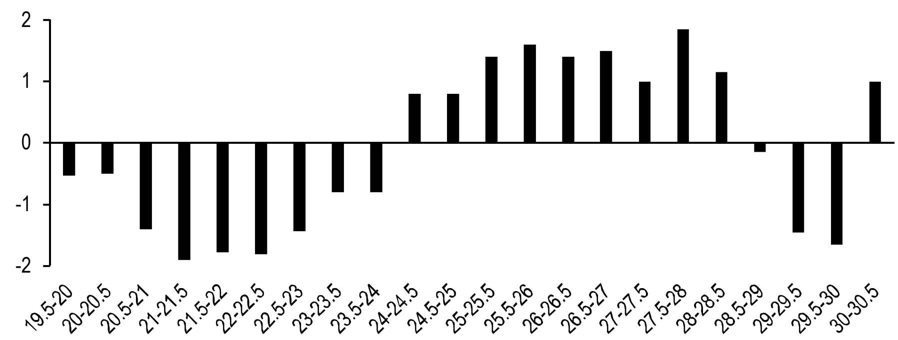


Source: J.P. Morgan

Going forward, it's likely that the Fed will lean heavily on old 20s in purchase operations in the 7- to 20-year sector, as the SOMA has reached its 70% holding limit for nearly all bonds in the 11- to 20-year sector of the curve. While there is an ample supply of CUSIPS in the 7- to 10-year sector where the SOMA is not constrained by high ownership shares, the Fed's purchases focused on near off-the-run 10-year notes during parts of the spring and summer, buying large quantities of Aug- and Nov-2029s, even though they traded rich to the curve (**Exhibits 3 & 4**). Size likely motivated these considerations as both of these issues have more than $85bn outstanding, making it easier for the Fed to purchase in large quantities. Looking ahead, while the 1.125% May-2040s are likely to remain rich as the Fed begins to buy them in September and beyond, we are hesitant to be long this issue when they already trade at a significant premium to our par curve.

Exhibit 5: The 20- to 23-year sector looks rich while the 24- to 28-year sector appears cheap to our fitted curve

Average yield errors by maturity bucket in 6-month increments; 3-month z-score



Source: J.P. Morgan

However, we think there are other relative value opportunities at the long end as well. **Exhibit 5** displays 3-month z-scores of yield errors relative to our fitted curve for bonds in the 20- to 30-year sector of the curve, grouped in 6-month increments, and shows that most bonds in the 20- to 23-year sector of the nominal curve trade rich to the curve, while most issues in the 24- to 28-year sector trade cheap to the curve. **Isolating relative value, we like selling the 3% May-2042s, a $44bn issue of which the Fed already owns a 70% share, and buying the 3% Nov-2044s, a $44bn issue which is only 24% SOMA-owned. Naturally, given these issues are more than 2 years apart, there is curve flattening risk in this trade, and we**

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recommend a 100:98 weighting to compensate for this curve sensitivity (see Trade recommendations).

Trade recommendations[1]

- **Initiate 100:98 3% May-42s/3% Nov-44s flatteners**
  We think there is relative value in selling May-42s and buying Nov-44s.
  - Sell 100% risk, or $11mn notional of T 3% May-42s (yield: 1.203%; bpv: $2270/mn).
  - Buy 100% risk, or $10.1mn notional of T 3% Nov-44s (yield: 1.304%; bpv: $2482/mn)

  Weighted spread is 10bp. One-month weighted carry is 0bp and roll is -0.1bp

- **Unwind 33:65 10s/20s/30s belly-richening flies**
  We unwind this trade at our self-imposed 3-month holding limit.
  - Unwind short 33% risk, or $17mn notional of T 0.625% May-30s (yield: 0.678%; bpv: $961/mn)
  - Unwind long 100% risk, or $28.2mn notional of T 1.125% May-40s (yield: 1.175%; bpv: $1768/mn)
  - Unwind short 65% risk, or $13.5mn notional of T 1.25% May-50s (yield: 1.398%; bpv: $2392/mn)

  (*US Treasury Market Daily*, 5/20/20). P/L since inception: 3.3bp of yield.

Technical Strategy

The **10-year note** continues its grind to lower yields after yesterday's bearish reversal day failed to see follow through. Now probing resistance at the **0.64-0.66%** 50-day MA, 100-day MA, and Aug 38.2% retrace level, the next key zone of short-term levels rests at the **0.57-0.59%** tactical pattern breakdown and Aug 61.8% retrace (**Exhibit 6**). In our view, the short-term tone stays negative while cheaper than that area. So far, the rebound has had a corrective tone with a lot of backing and filling as compared to the linear and impulsive nature of last week's selloff. In theory, that suggests the price action is counter-trend. Furthermore, the Treasury market has maintained a loose correlation to the direction of the US COVID-19 outbreak statistics since late-Mar, and with the continued improvement in the aggregated data, we believe that momentum can help keep bearish pressure on bonds into Sep. Tactical support rests at **0.69%**. Last week's yield high held the **0.73%** Jun 50% retrace. Next support rests at the **0.785%** Jun 61.8% retrace. That coincides with an area that marked a key inflection for the **10-year note** during the springtime. The early-Jun break through that well-defined support led to a sharp yield rise to the **0.95-1.00%** medium-term support zone. At minimum, we think the market can test that **0.78%** area into Sep. If a selloff accelerates through that support again, we would look for the **1.00%** area to cap yields again. To lower yields, the **0.50%** Aug yield low rejected anticipated range resistance at **0.475-0.54%**.

[1] For a list of trades closed in the last 12 months, see *Treasuries*, US Fixed Income Markets Weekly, 8/14/20.

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Exhibit 6: The 10-year note grinds to lower yields and retraces more of last week's selloff. Now testing the 0.64-0.66% 50-day and 100-day moving averages, the next key short-term resistance rests at 0.57-0.59%. In our view, the tone stays bearish as long as that resistance remains intact.

10-year note, daily bars; %

Source: J.P. Morgan, CQG

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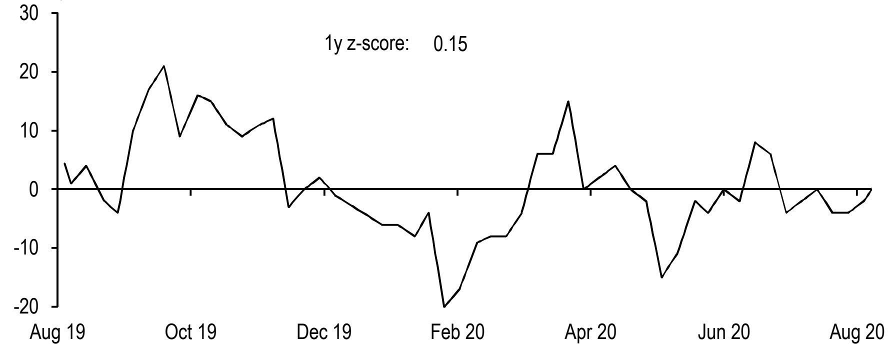
Appendix: Position technicals overview

Exhibit A1: J.P. Morgan Treasury Client Survey

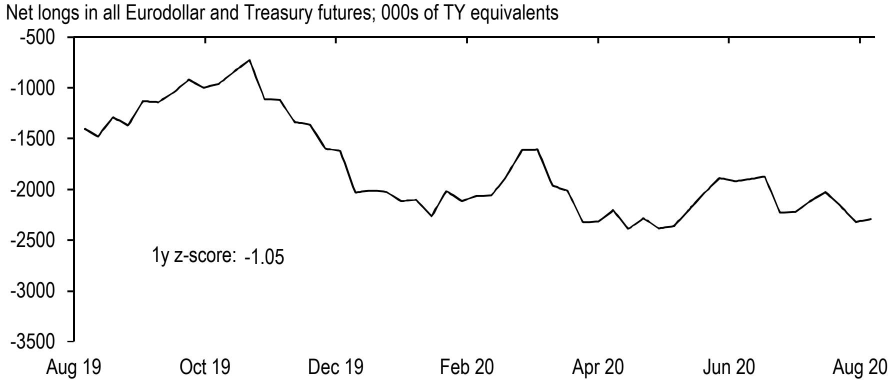
Net longs; %



Source: J.P. Morgan

Exhibit A2: CFTC non-commercial positions

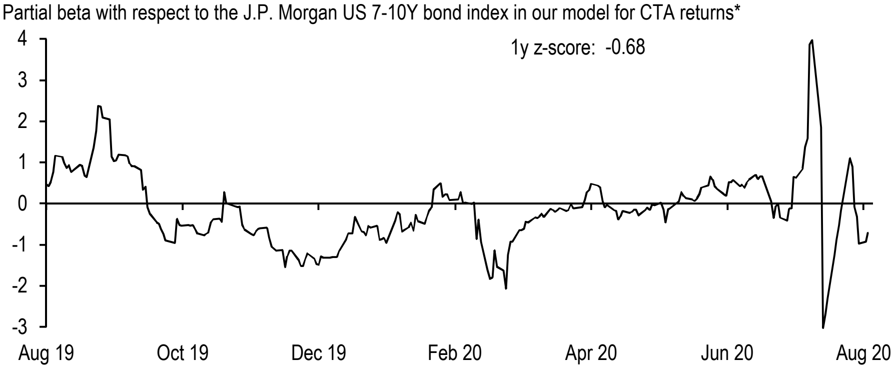
Net longs in all Eurodollar and Treasury futures; 000s of TY equivalents



Source: CFTC

Exhibit A3: CTA exposure to 10-year Treasuries

Partial beta with respect to the J.P. Morgan US 7-10Y bond index in our model for CTA returns*



* Model is a 1-month regression of daily excess returns on the CTA index versus daily excess returns on 1) J.P. Morgan US 7-10Y bond index, 2) J.P. Morgan ex-US Global Bond Index, 3) S&P500 index, 4) J.P. Morgan global cash index, and 5) Goldman Sachs Commodities Index

Source: Bloomberg, SG, J.P. Morgan

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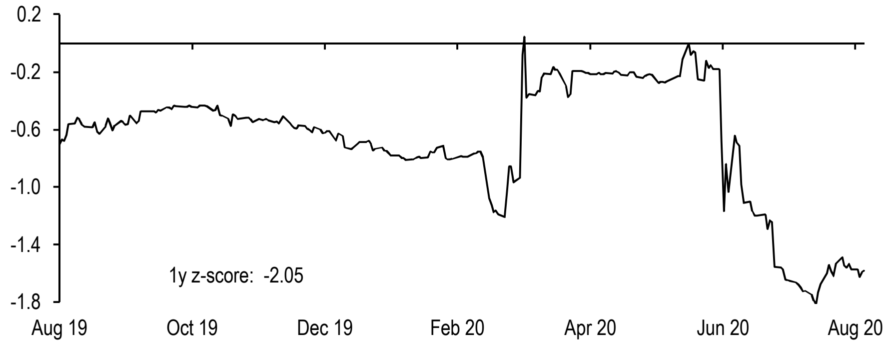
Exhibit A4: Active Core Bond Fund* Managers' exposure to 10-year Treasuries

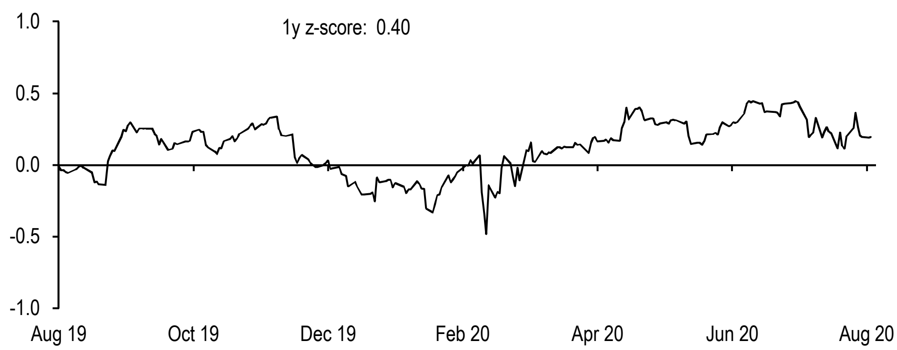
Partial beta with respect to 10-year US Treasury yields in our model for active bond fund excess returns**



* The core bond fund index is comprised of the 20 largest (by assets under management) actively-managed US core bond funds
** Model is a 3-month regression of daily excess returns on the bond fund index versus daily changes in 1) 10-year US Treasury yields, 2) 5s/30s Treasury curve, 3) constant-maturity 5-year CDX.IG spread, 4) MBS Libor option-adjusted spread, and 5) 3Mx10Y swaption volatility; Source: Bloomberg, J.P. Morgan

Exhibit A5: Macro Hedge Fund exposure to 10-year Treasuries

Partial beta with respect to the J.P. Morgan US 7-10Y bond index in our model for macro hedge fund returns*

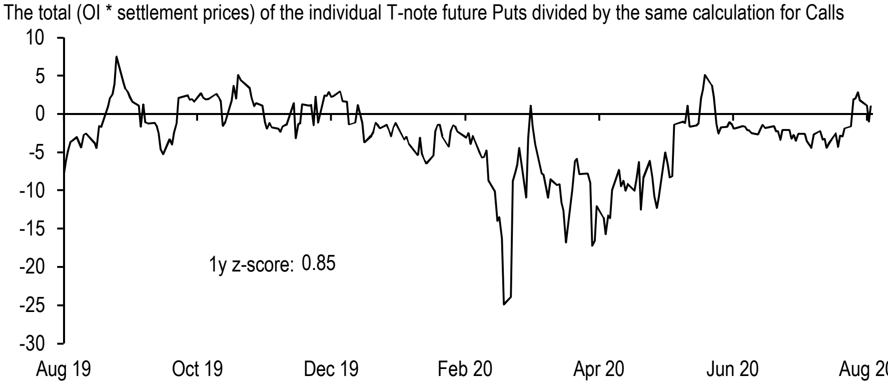


* Model is a six-week regression of daily excess returns on the HFRX Macro/CTA index versus daily excess returns on 1) J.P. Morgan US 7-10Y bond index, 2) J.P. Morgan ex-US Global Bond Index, 3) S&P 500 equity index, 4) MSCI G7 ex-US equity index, 5) J.P. Morgan global cash index, and 6) Goldman Sachs Commodities Index.

Source: Bloomberg, HFR, J.P. Morgan

Exhibit A6: T-note dollar weighed Put/Call ratio

The total (OI * settlement prices) of the individual T-note future Puts divided by the same calculation for Calls



Source: CFTC, Bloomberg, CQG, CME, J.P. Morgan

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