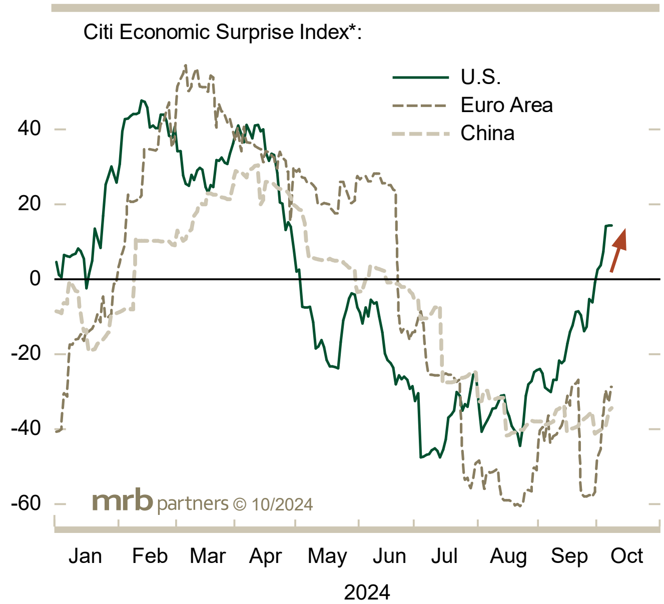
U.S. Treasurys: Reality Bites Again

- The Fed and bond investors have underestimated the strength and durability of the U.S. economy and the likelihood that consumer price inflation will hold well above the Fed's 2% target. This leaves ample scope for continued upside surprises in the economic data (both in absolute terms, and relative to other G7 economies) and the need for a continued scaling back of Fed rate cut expectations.
- The Fed and investors maintain an overly depressed estimates of the long-run neutral fed funds rate, which will be progressively revised up and lift the floor underneath long-dated U.S. Treasury yields.
- At the same time, there is currently no term premium in the U.S. Treasury market which is inconsistent with the likelihood for a higher inflationary environment and greater policy uncertainty following the U.S. election.
- Remain below benchmark duration and underweight U.S. Treasurys within a broader global fixed-income portfolio. We also maintain short recommendations in U.S. Treasurys outright and relative to German bonds.

MRB has challenged the consensus on the Fed's easing cycle, characterizing it as a dovish misstep, and that expectations for deep rate cuts through to the end of 2025 will not pan out[1]. A portion of this repricing has already occurred following last Friday's payroll report, benefitting our short recommendations on U.S. Treasurys. Still, we expect risks for Treasury yields to remain skewed decisively upward over the next 6 to 12 months.

We recently argued a case for higher U.S. Treasury yields and a spread widening versus other regional bond markets[2]. This report outlines several factors that support these views.

U.S. Data Surprises: Leader Of The Pack



* Source: Citi

[1] **MRB:** "*U.S. Fed: The Makings Of Another Dovish Error*", September 19, 2024 and **MRB:** "*Absolute Return Strategy: Sell The News*", August 29, 2024

[2] **MRB:** "*Fixed Income – Divergence Re-Emergence: Opportunities In Regional Bond Markets*", October 1, 2024

There is little evidence supporting the Fed's assertion that monetary policy became "very restrictive", and thus was a threat to the economic expansion. The U.S. economy is on track to continue expanding at a pace well above its long-term potential run-rate[3]. Aggregate financial conditions are supportive and have become even more so of late, and high-frequency indicators are pointing to strong, rather than weak, growth ahead. Our research has shown that the increase in the unemployment rate is attributed to an unusually large increase in immigration, not weak labor demand[4]. Recent strong employment data and continued low layoffs are consistent with solid corporate profits, and undermine the case for ongoing 50bps rate cuts, and in fact imply little need to provide meaningful interest rate relief.

At the same time, our most-likely scenario of inflation resurfacing or even holding well above the Fed's 2% target remains one of the most non-consensus views in the markets today. The secular disinflationary drags of the 2010s have faded, pandemic-related distortions have now unwound, and the U.S. economy has limited slack[5]. This presents a threat for U.S. Treasurys as investors recalibrate their inflation view in the months ahead.

Solid and durable nominal economic growth will also keep upward pressure on the Fed and bond market estimates of the nominal neutral policy rate[6].

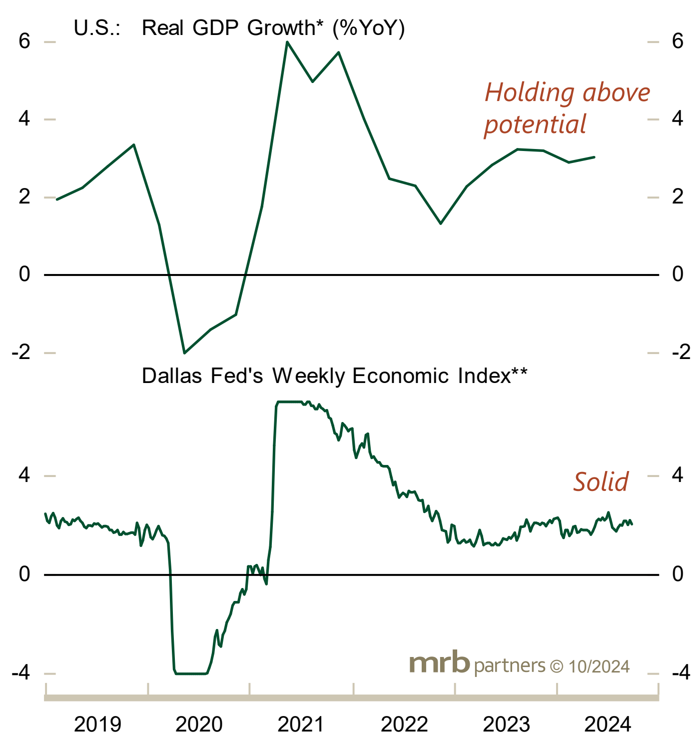
[3] **MRB:** "*U.S. Economy: Key Indicators*", August 22, 2024

[4] **MRB:** "*U.S. Labor Market: Less Bearish Than It Appears*", August 9, 2024

[5] **MRB:** "*When Will Inflation Steer The Fed Again?*", September 12, 2024

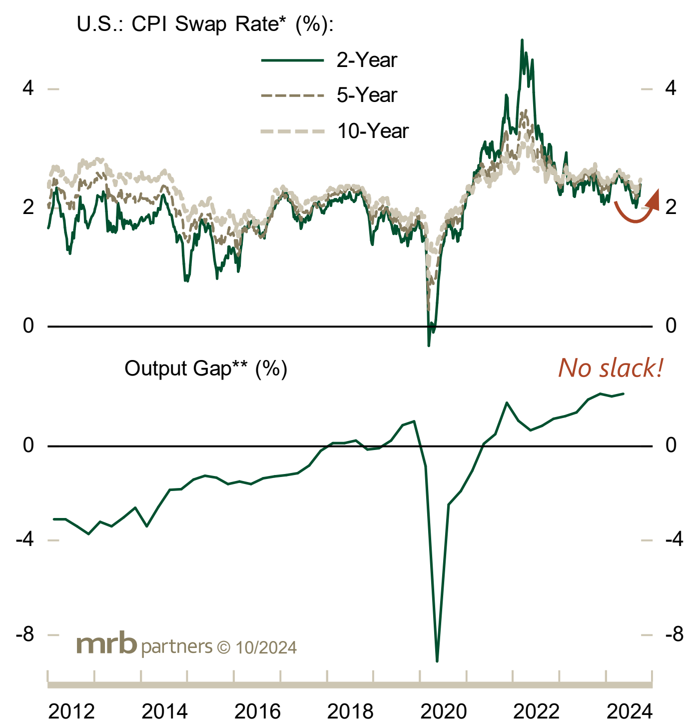
[6] The "equilibrium" or "neutral" policy rate is used interchangeably to refer to the rate that is consistent with aggregate output at its potential growth rate and stable inflation at the central bank target in the medium-to-long term. **MRB:** "*The Impact Of A Higher Neutral Fed Funds Rate*", July 17, 2024

U.S. Economy: More Durable Than Perceived



* Truncated above 6 and below -2; source: U.S. Bureau of Economic Analysis
** Truncated above 7 and below -4; smoothed

Market Is Too Complacent On Inflation Risks



* Source: Bloomberg, Macrobond
** Current GDP relative to potential GDP; source: Congressional Budget Office

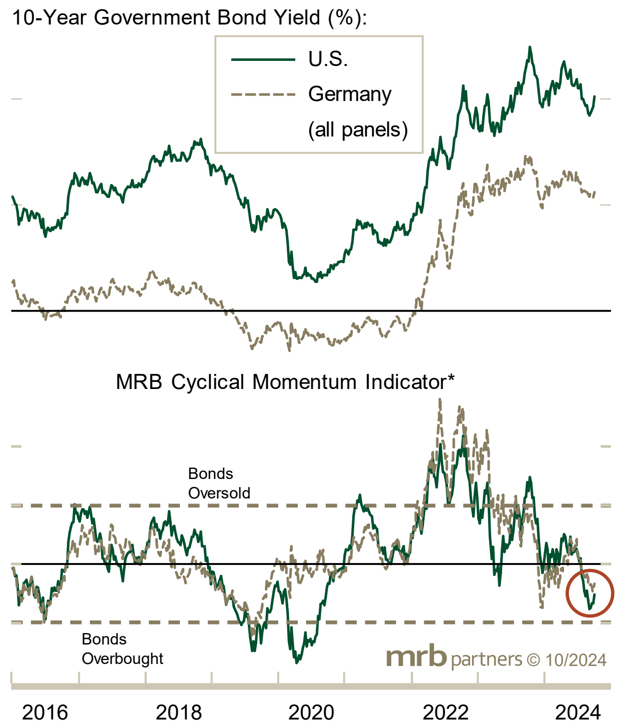
U.S. data surprises have beaten consensus expectations recently, and have diverged positively from those in the euro area and China (see **chart** on page 1). That said, encouraged by a dovish Fed Chair Powell, the Treasury market has been fixated on soft employment data, which is why the very strong payroll report last Friday forced a recalibration. Hurricane Helene and now Milton will distort upcoming claims data and the next employment report, but investors are likely to discount this and focus on a broader range of economic data in the interim. Historically, hurricanes distort the economic data for a short period, but do not change the underlying trend (and act to boost GDP in net terms, as the affected regions rebuild and re-purchase lost items, etc.).

U.S. Treasurys remain overbought based on the *MRB Cyclical Momentum Indicator*, and a lot of Fed rate cuts are still priced into the curve. As a result, we expect the bond market will respond asymmetrically, with a greater sensitivity to positive rather than downside economic surprises. Thursday's CPI report will be a litmus test.

Note that historical seasonality in the U.S. economic data suggests more upside surprises in the near run. Over the past 20 years, the U.S. economy has generally performed better-than-expected in the final quarter of the year, on both an absolute and relative basis (versus the G7).

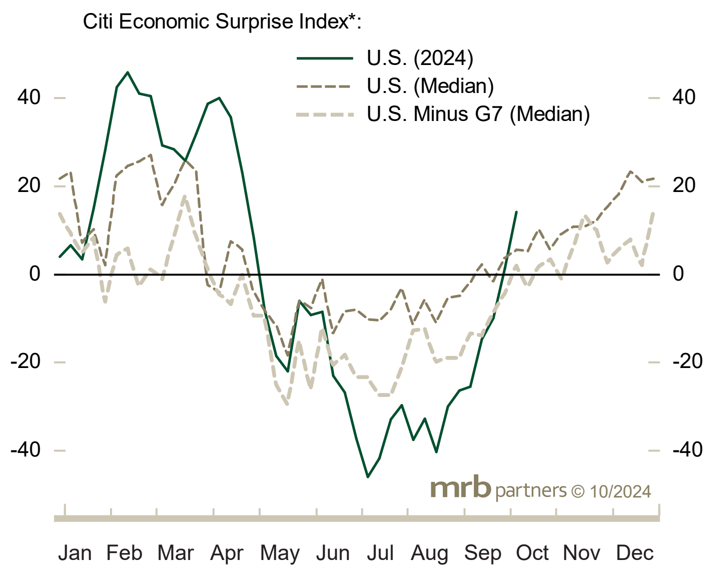
The ebb and flow of yields in many of the G7 bond markets tends to correlate with U.S. Treasurys. Indeed, G7 yields often display as much sensitivity to the U.S. economy as their own. Nonetheless, the spread between the U.S. and German bond yields tracks the differential between their respective economic surprise indexes. The latter should continue to move in favor of the U.S. and support our short position on 5-year U.S. Treasurys versus German bonds.

Government Bonds Are Still Overbought



* Standardized

The U.S. Economy Tends To Positively Surprise In Q4

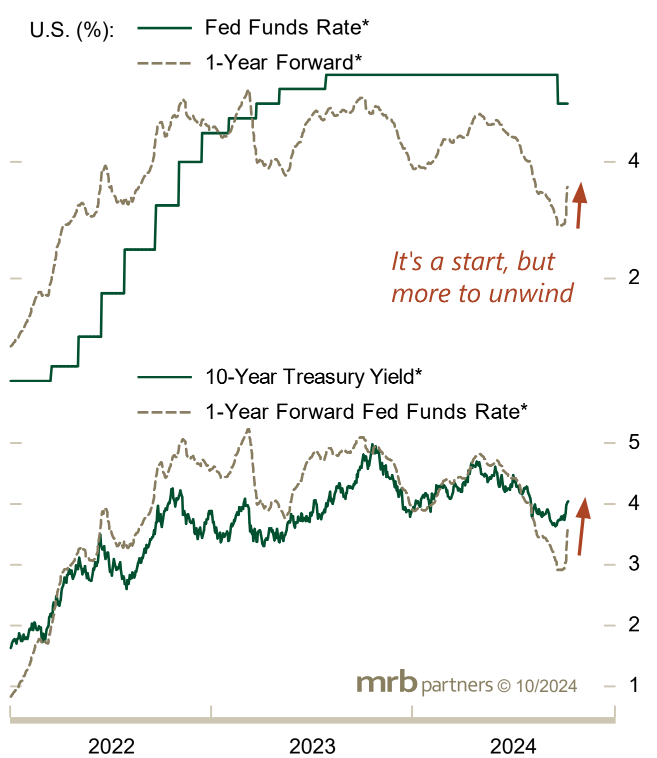


Note: Median over the last 20 years

Fed rhetoric has become slightly less dovish since the September rate cut, with Powell acknowledging that "*the economy is in solid shape*", which is in stark contrast to July when he noted that the "*downside risks to employment are now real*". This could be the start of another Powell pivot, albeit in the near run any changes in rhetoric are likely aimed at stemming further downside in bond yields, rather than pushing yields sustainably higher. Financial conditions are already very easy and lower yields could stoke even stronger growth, and eventually lead to upside inflation surprises. Thus, the central bank may not want to see lower bond yields if the economy proves resilient, even though the Fed has been remarkably quiet in the face of rapid asset inflation.

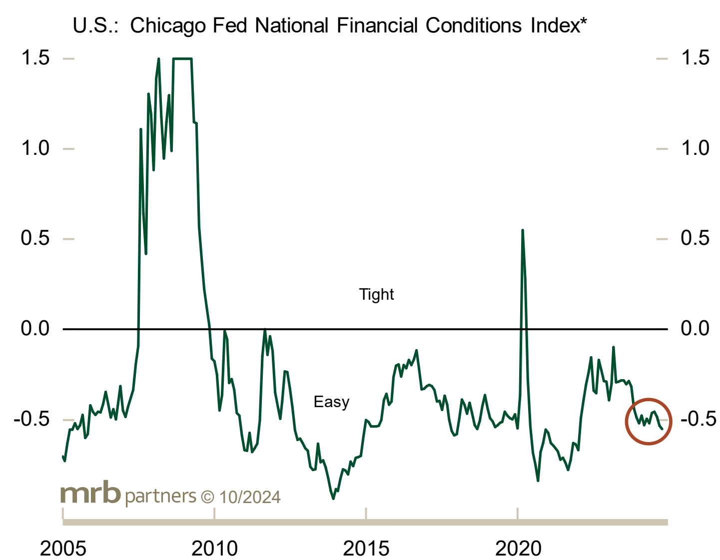
In response, the U.S. Treasury market has been repricing since the first Fed rate cut. The market has revised up expectations of the fed funds rate for the end of 2025, from 2.9% to 3.35%. This is now higher than the Fed's expectation of 3.1% published in the latest *Summary of Economic Projections*. There has also been a collection of central bank speakers from the ECB, BoC, BoE and RBNZ that have signaled greater willingness to front-load further easing (as we had warned, and which the RBNZ delivered this week). Meanwhile, the BoJ has signaled less urgency to tighten policy soon. All things equal, the policy bias of these central banks should lead to G7 ex-U.S. bond market outperformance versus Treasurys.

Market Priced In Too Many Fed Rate Cuts



* Source: Bloomberg

Financial Conditions Remain Very Easy

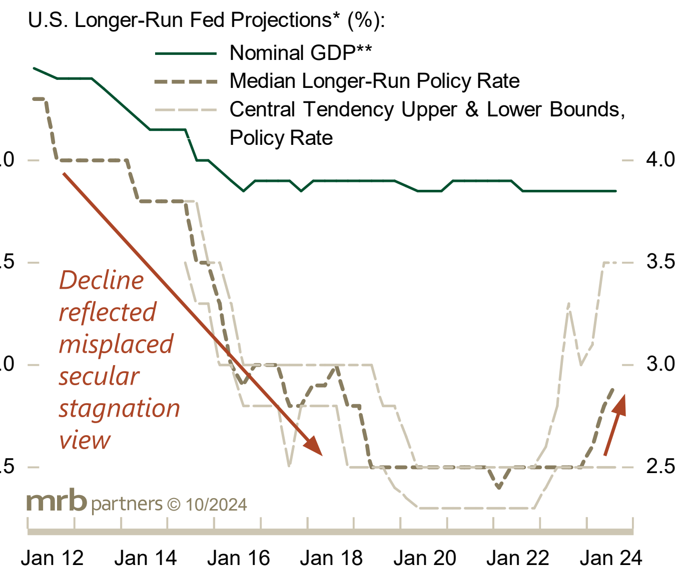


* Truncated above 1.5; source: Federal Reserve Bank of Chicago

One can use the projected path of the fed funds rate coupled with an estimate of its long-run equilibrium to value bonds. When doing so, the U.S. Treasury market's expected rate path implies that "fair value" of the 10-year U.S. Treasury yield is currently around 4.15%, whereas the Fed's projection leaves "fair value" around 3.85%. Note that neither estimate assumes a positive term premium[7], i.e. both are too low in our opinion.

Pricing long-dated U.S. Treasurys based on the projected policy rate is heavily influenced by the long-term equilibrium or neutral policy rate assumption. MRB's research has warned that the neutral rate is 4.5% or higher, in contrast with the Fed's latest median estimate of 2.9%[8]. The Fed's estimate is rooted in a misplaced secular stagnation view derived from the 2010s, and is much lower than the central bank's implied projection of long-run nominal GDP growth of around 4% (and even the latter projection is too low based on our research!). The Fed and bond investors will continue to raise their long-run estimate over time which, in turn, will continue to lift the floor underneath bond yields.

A Continued Recalibration Higher In The Nominal Neutral Rate



* Source: Federal Reserve
** Midpoint of central tendency plus 2% inflation

U.S. Treasury Yields Are Tracking Fed Rate Expectations

[7] The extra yield or return that investors demand for holding longer-term bonds compared to shorter-term bonds, essentially acting as compensation for the increased risk associated with longer maturities.

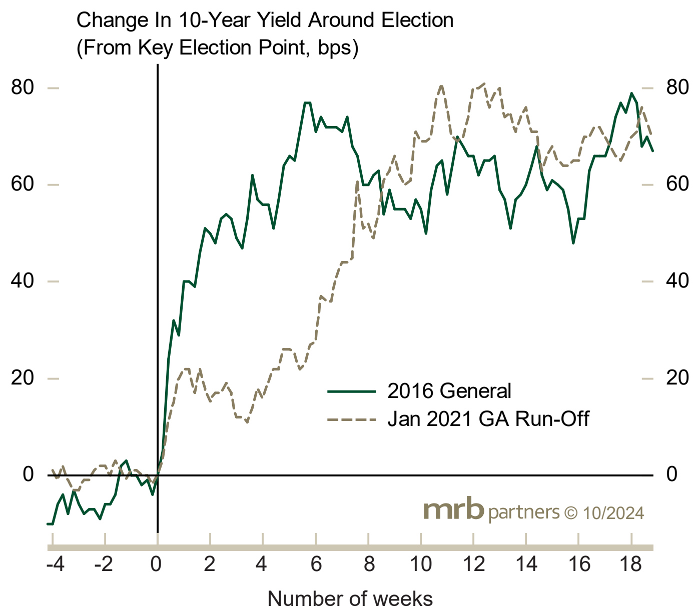
[8] **MRB:** "***The Impact Of A Higher Neutral Fed Funds Rate***", July 17, 2024

The U.S. election could also put upward pressure on U.S. Treasury yields given that both candidates propose policies that will increase the federal deficit and debt levels significantly[9]. Both parties also promote protectionist policies that would be inherently inflationary[10].

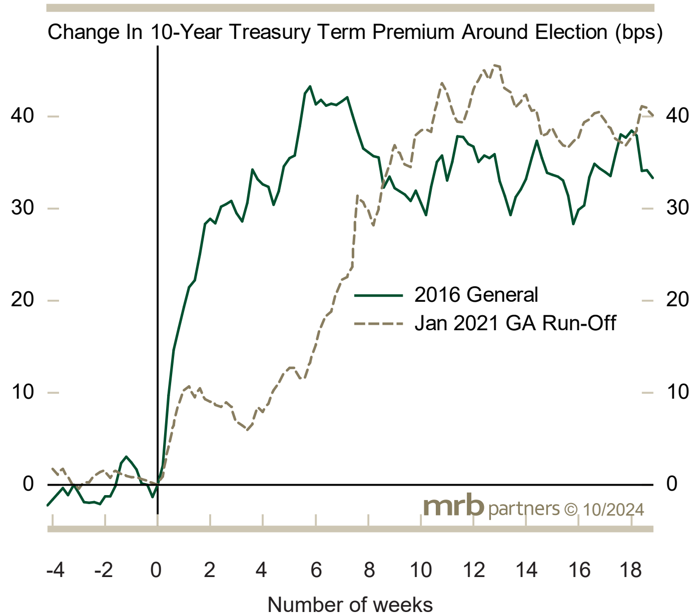
A unified government for either party would amplify risks, and the election could serve as a catalyst to increase the term premium (which is currently negative). Note that the last two election cycles were followed by a backup in the 10-year U.S. Treasury yield and the term premium. In the event of a split Congress, there may be another battle over the next debt ceiling which has yet another deadline in January 2025. While both parties appear comfortable running sizable deficits, they have very different spending objectives.

In short, there is a case for heightened uncertainty and a higher term premium regardless of the U.S. election outcome.

Past Elections Have Led To Higher Nominal Treasury Yields ...



...And A Higher Term Premium



[9] **MRB:** "*U.S. Election 2024: Are Markets Too Complacent?*", October 2, 2024

[10] **MRB:** "*Theme: Pivoting To Protectionism = Self-Inflicted Pain*", August 22, 2024

Final Word: *Current pricing in the U.S. Treasury market leaves risks skewed to the upside for yields. The Fed and bond investors have underestimated the strength and durability of the U.S. economy and the likelihood that consumer price inflation will hold well above the Fed's 2% target. This leaves ample scope for continued upside surprises in the economic data (both in absolute terms, and relative to other G7 economies) and the need for a continued scaling back of Fed rate cut expectations. At the same time, the Fed and investors will continue to revise up their overly depressed estimates of the long-run neutral fed funds rate, which will progressively lift the floor underneath long-dated U.S. Treasury yields. Finally, there is currently no term premium in the U.S. Treasury market which is inconsistent with the higher inflationary environment and likelihood for greater policy uncertainty following the U.S. election.*

Within the MRB Asset Allocation Strategy, we remain below benchmark duration and recommend an underweight allocation to U.S. Treasurys relative to other G7 bond markets and within a broader global fixed-income portfolio. The MRB TradeBook has a short recommendation on the 10-year U.S. Treasury, as well as a spread trade favoring 5-year German bonds over U.S. Treasurys.

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