U.S. Treasurys: The Calm Before Another Storm

- U.S. Treasury yields are consolidating after surging since mid-September. This period of calm may persist in the near run, but fundamental drivers point to higher bond yields. Indeed, we expect the 10-year Treasury yield to eventually retest its cyclical high of near 5%.
- The selling pressure on U.S. Treasurys has primarily been in response to investors realizing economic growth is stronger and more resilient than they expected, which has also reduced the need for Fed rate cuts. This is a constructive environment for equities and corporate bonds.
- However, the next major upleg in U.S. Treasury yields is likely to be driven more so by higher inflation expectations, a greater term premium, and an ongoing upward adjustment in the projected nominal neutral fed funds rate. If so, this will create fresh storm clouds for the risk-on rally.
- For now, we recommend maintaining a pro-growth bias. Stay below benchmark duration, overweight inflation protection and corporate bonds, while underweight U.S. government bonds within both fixed-income and multi-asset portfolios. We also have short recommendations on the 10-year U.S. Treasury outright and on 5-year U.S. Treasurys versus German bonds (tighten stop). We are also long U.S. high-yield corporate debt and 5-year CPI swap rates.

U.S. Treasury yields have risen sharply in response to better-than-expected U.S. economic data, and a paring back of expectations for deep Fed rate cuts in 2025. Government bonds faced additional selling pressure from the election outcome, due to expectations for greater fiscal stimulus and much larger federal government budget deficits.

U.S. Treasury yields are now consolidating after surging since late September…

U.S. Treasury yields have now begun a consolidation phase after surging since mid-September. The market is likely to ascribe some relief with the nomination of Scott Bessent as the next Treasury Secretary, though it is unclear whether he will be able to overcome the inevitable rise in the term premium that we expect. As such, we expect a period of calm in the near-run. Note however, that government bonds are not yet cyclically oversold (**chart 1**) and fundamental drivers will keep the underlying trend for yields tilted upward. The path following President-Elect Trump's first election victory in 2016 also points to higher bond yields (**chart 2**). Indeed, we expect the benchmark U.S. 10-year Treasury yield to eventually retest and breach its October 2023 high of near 5%.

…but cyclical fundamentals still point to higher yields

So far, U.S. Treasury yields have risen primarily in response to investors realizing that economic growth is stronger and more resilient than the consensus previously expected, which has also reduced the need for Fed rate cuts and put upward pressure on perceptions of the longer-term nominal neutral policy rate[1]. The next major upleg in bond yields (following the current consolidation) is likely to be driven more so by a realization that consumer price inflation is holding well above consensus expectations, which will force a further recalibration of nominal neutral rate projections by the Fed and bond investors. At the same time, concerns over increased debt issuance and general economic uncertainty from isolationist policies will widen the Treasury term premium[2].

It is worth noting that every sequential breakout to new cyclical highs in U.S. Treasury yields over the past four years has created a storm across financial asset markets, leading to material weakness for equities and the traditional 60/40 portfolio (**chart 3**). The next time around could prove even more painful (i.e. when the U.S. 10-year Treasury yield retests 5%), given that the driving force will be higher inflation expectations and an increased term premium, rather than much stronger economic growth conditions. This comes at a point when the forward price/earnings multiple for the S&P 500 is now 25% above its October 2023 levels.

Chart 1 **Treasurys Are Still Far From Oversold On A Cyclical Basis**

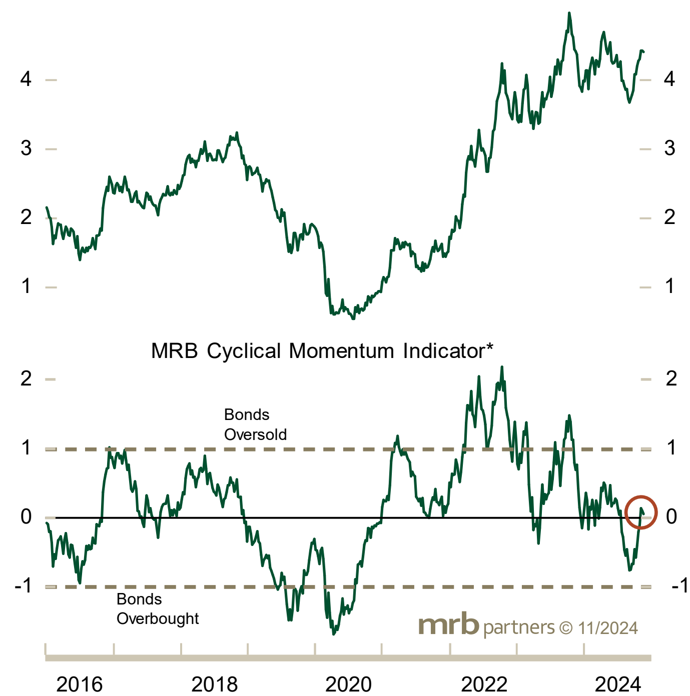
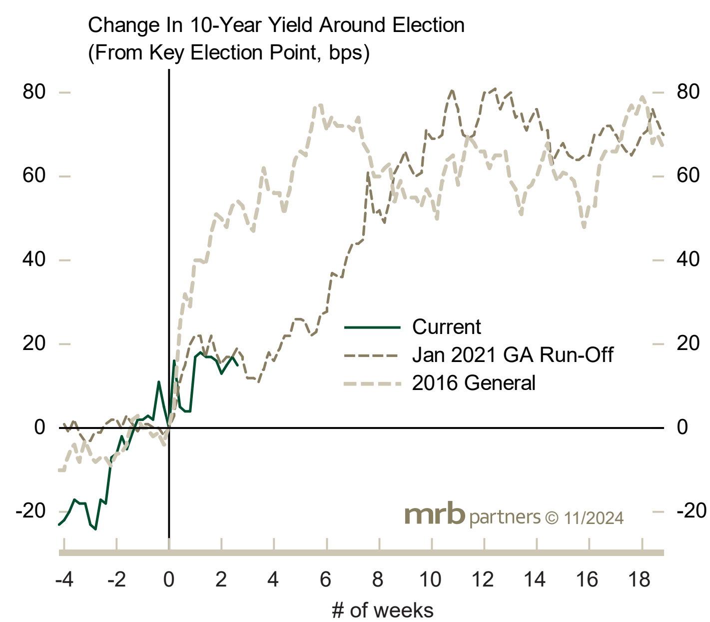


Chart 2 **U.S. Treasuries Election Playbook**



[1] 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 *Research Highlight:*** "*The Impact Of A Higher Neutral Fed Funds Rate*", July 17, 2024

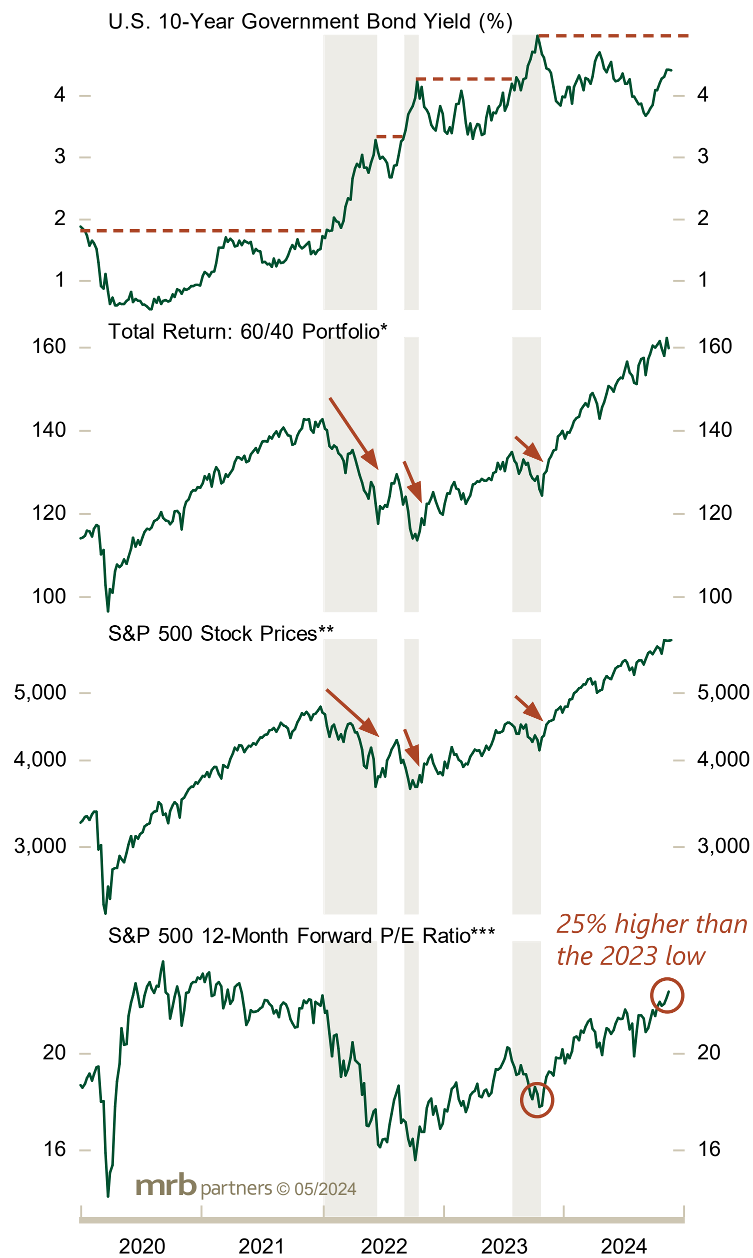
[2] **MRB *Research Highlight:*** "*Fixed Income: The Return Of The Term Premium*", October 31, 2024

In short, this is the calm before the next storm. The risk-on phase in equities and corporate bonds should persist for now while U.S. Treasury yields consolidate. However, we recommend clients stay flexible in their pro-growth positioning and watch bond yields for an indication that storm clouds are starting to form once again.

The Fed Is Starting To Realize Its Dovish Mistake

MRB's view since the beginning of 2024 has been that the Fed would push ahead with rate cuts but that this would be a policy mistake caused by a misplaced assertion that the interest rate setting was "very restrictive"[3]. Instead, our research highlighted that monetary and financial conditions were still supportive (rather than restrictive) and that the Fed's dovish pivot would cause the U.S. economy to continue expanding at a pace well above its potential growth rate, which has been the case[4]. We began shorting U.S. Treasurys on the first Fed rate cut, warning that macro reality would not support the excessive easing priced into the bond market[5]. This call proved timely, with investors already pricing out about 80bps of cumulative easing by the end of next year (**chart 4**).

Chart 3 **Each Breakout In Bond Yields Is Painful For Financial Asset Markets**



* 60% global equities, 40% G7 bonds; rebased
** Shown in log scale
*** Source: Refinitiv I/B/E/S Global Aggregates
Note: Shaded for the equity sell-off

[3] MRB "*U.S.: The New Fed Is Still The Old Fed*", December 14, 2023, MRB "*U.S. Fed: Prepping To Cut, But Temper Your Expectations For 2025*", July 30, 2024, MRB "*Global Fixed Income – Rate Cuts: Not Needed, But Coming In Any Case*", July 30, 2024 and MRB "*U.S. Fed: The Makings Of Another Dovish Error*", September 19, 2024

[4] MRB "*2024 U.S. Economic Outlook: Continued Resilience*", December 7, 2023, MRB "*U.S. Economy: "No Landing" Is Underway*", February 7, 2024, MRB "*It's Premature To Worry About The U.S. Economy*", June 6, 2024 and MRB "*U.S. Economy: On Firmer Ground Than You Thought*", October 2, 2024

[5] MRB "*Absolute Return Strategy: Sell The News*", August 29, 2024 and MRB "*Fixed Income – U.S. Treasurys: Reality Bites Again*", October 9, 2024

More recently, we forecasted that strong economic data and sticky inflation would force the Fed to reconsider its easing campaign, potentially causing the bond market to price in an extended pause[6]. This shift is now beginning, with commentary by FOMC officials suggested that they are starting to realize their dovish misstep. Most notably, Fed Chair Powell admitted that the "*economy is not sending us any signals that we need to be in a hurry to lower rates*"[7], which is in sharp contrast with his statements a couple of months ago when he was desperate to ease policy. Indeed, the Fed's dovish bias contrasts with the macro reality. This mismatch could be amplified if the Trump Administration adds further fiscal stimulus that results in stronger growth and/or higher consumer price inflation.

Several Fed officials have also talked up the nominal neutral policy rate as we predicted would be the case[8]. Indeed, Dallas Fed President Lorrie Logan recently noted *"I see substantial signs that the neutral rate has increased in recent years, and some hints that it could be very close to where the fed funds rate is now."* Logan noted that widely consulted models of the long-run neutral Fed funds rate provide estimates ranging between 2.7% and 4.6%, with the upper end being consistent with the current policy rate. Importantly, she concluded that "*I believe it's best to proceed with caution"* since *"if we cut too far, past neutral, inflation could reaccelerate and the FOMC could need to reverse direction"*.

Chart 4 **Higher U.S. Treasury Yields As Fed Rate Cuts Get Priced Out**

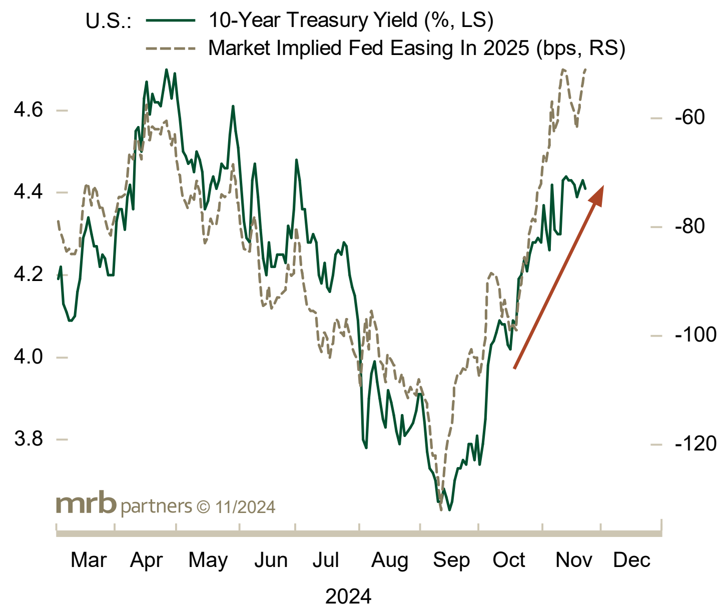
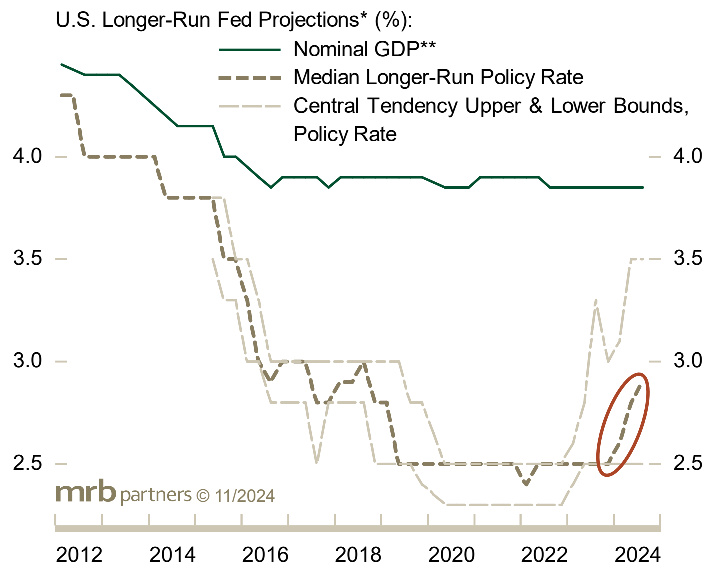


Chart 5 **The Fed Finally Lifted Its Neutral Rate Estimate This Year**



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

The Fed has been capitulating all year on its overly depressed estimate of the nominal neutral fed funds rate, which embeds a misplaced secular stagnation bias (**chart 5**).

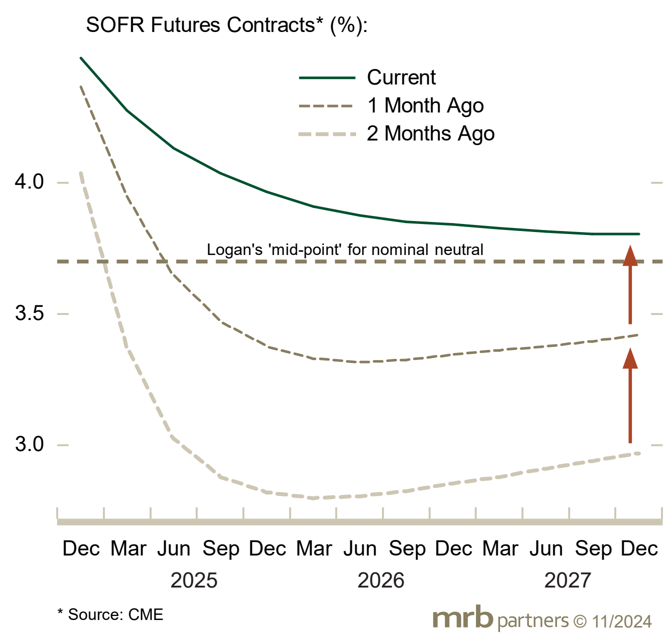
6 **MRB** "*When Will Inflation Steer The Fed Again?*", September 12, 2024 and **MRB** "*Trump 2.0: What It Means For The Fixed Income Market*", November 13, 2024

7 See **Board of Governors of the Federal Reserve System** "*Recent Developments*"

8 **MRB** "*The Fed Is (Predictably) Talking Up The Neutral Rate*", November 18, 2024

However, Logan's speech was the first time (in decades) that a Fed member explicitly acknowledged the possibility of a nominal neutral rate in line with MRB's view of around 4.5%[9]. We expect the Fed will upgrade its long-term dot plot assessment again to 3% or higher at its December meeting and will continue to adjust its projected nominal neutral rate higher in 2025.

Chart 6 Fed Policy Curve Has Adjusted Significantly Higher



After being too aggressive at pricing in rate cuts, the bond market is now front-running the capitulation at the Fed, with policy rates expected to bottom around 3.7% (**chart 6**). However, this estimate, which is slowly realigning with forecasts of long run nominal GDP growth, will be lifted again as it become clear that consumer price inflation (and thus nominal GDP growth) has a higher run-rate than previously believed by the consensus (see below). In turn, this will continue to progressively lift the floor underneath U.S. Treasury yields.

Inflation Will Run Well Above Consensus Expectations

Fed rate cuts were not needed…

…policy was not restrictive

We have repeatedly warned that bond investors are grossly underestimating the underlying inflation trend in the U.S. economy[10]. The ***secular*** disinflationary drags that created a prolonged low inflation era of near-2% core consumer price inflation ended by the late-2010s[11]. Our research suggests that these secular drags may have lowered inflation by a percentage point during that era, which means (in the absence of these drags) the underlying trend in consumer price inflation is now likely over 3%[12].

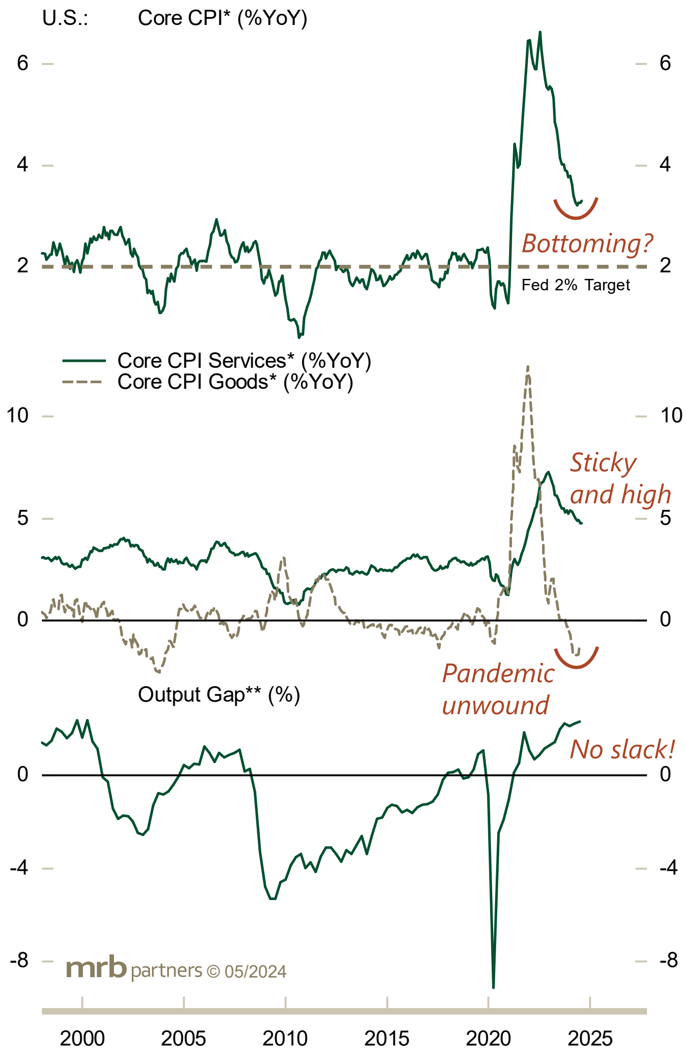
[9] **MRB** "***R-Starring The U.S. Economy***", September 6, 2023, **MRB** "***U.S. Treasurys: Understanding The Fed's Influence***", September 13, 2023, **MRB** "***How Are U.S. Treasurys Being Valued?***", October 1, 2021 and **MRB** "***U.S. Fed: Cautious, But Still Dovish In Intent***", June 13, 2024

[10] **MRB** "***An Inflation Problem Is Brewing***", June 3, 2021, **MRB** "***U.S. Unanticipated Inflation: Lessons From The Past 40 Years***", January 11, 2022, **MRB** "***U.S. Inflation: Beware The Current Complacency***", August 17, 2023 and **MRB** "***U.S. Inflation: What Will Be The Underlying Run Rate?***", June 5, 2024

[11] Included the greatest increase in globalization in modern history, the widespread implementation of technological advancements stemming from the tech revolution, and the massive deleveraging drags in the U.S. (and euro area) economy.

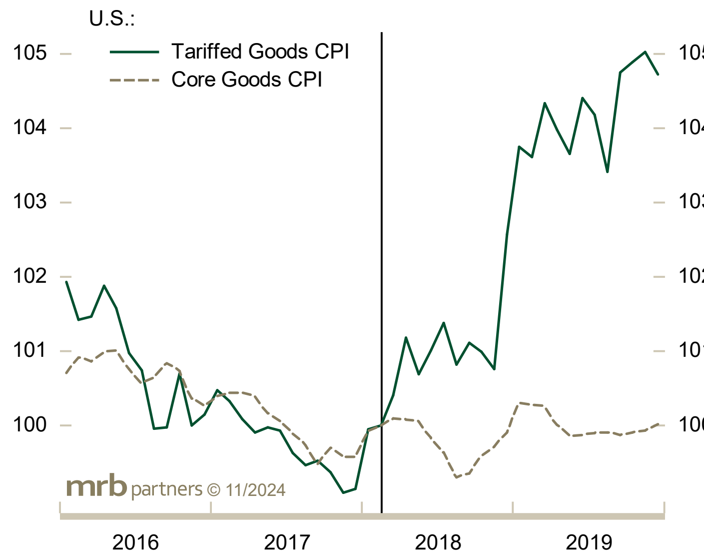
[12] **MRB** "***U.S. Inflation: What Will Be The Underlying Run Rate?***", June 5, 2024

Chart 7 U.S. Inflation Will Trend Above 3%



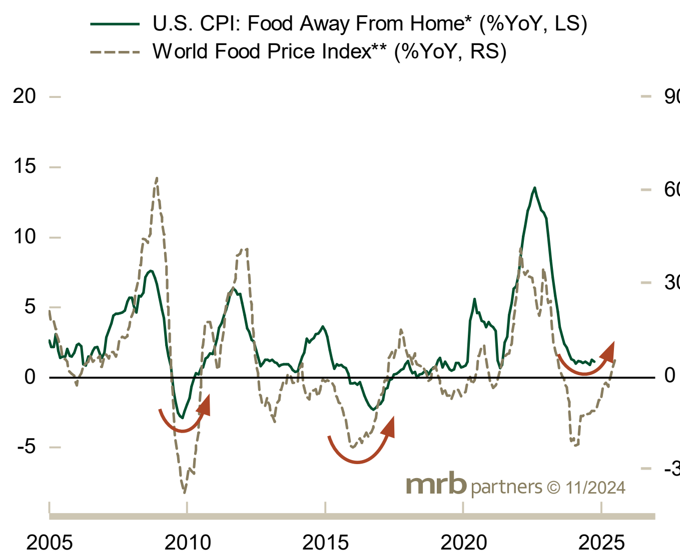
* Core excludes food & energy; source: U.S. Bureau of Labor Statistics
** Current GDP relative to potential GDP; source: Congressional Budget Office

Chart 8 Tariffed CPI Rose While Core Goods Bottomed In Trump 1.0



* Rebased to February 2018 = 100; sources: U.S. Bureau Of Labor Statistics, MRB Calculations
Note: Vertical line denotes tariff implementation

Chart 9 Upside Risks For Food Inflation



* Source: U.S. Bureau of Labor Statistics
** Advanced 9 months; source: UN Food & Agriculture Organisation

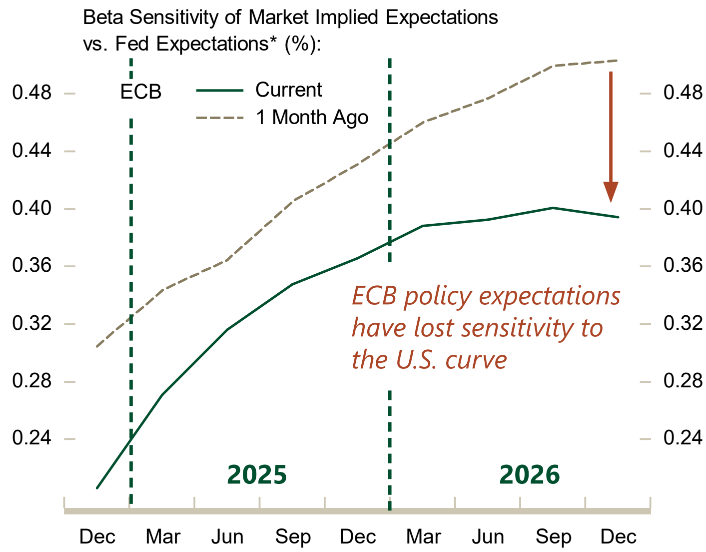
Cyclical forces will also keep inflation hotter now, particularly service sector inflation. The U.S. economy is expanding above its potential rate, with no spare capacity, a historically tight labor market, and relatively high wage growth. This is before new inflationary policies are added by the Trump Administration. Indeed, US core services CPI is holding at a very elevated rate of near 5% (**chart 7**).

The run rate of inflation is higher than the consensus believes

Moreover, the pandemic-related supply distortions in goods prices have fully unwound and are no longer creating disinflation drags. Instead, core goods CPI inflation could lift materially if Trump imposes broad-based tariffs (**chart 8**). Separately, global food prices are accelerating and suggest upside risks to U.S. food prices (**chart 9**).

In short, the underlying run rate of consumer price inflation is higher than the Fed and bond investors currently realize, which should slowly be demonstrated by the inflation data over the next several months. We remain overweight inflation protected securities within a global fixed income portfolio and are long 5-year US CPI swaps. A breakout in the latter would also encourage bond investors to revise up their estimates for the longer-term neutral fed funds rate and "fair value" of U.S. Treasurys.

Chart 10 ECB Policy Expectations Have De-Coupled From The Fed



* 3-month rolling beta on Euribor daily changes vs U.S. SOFR; source: Bloomberg

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U.S. Treasurys Will Continue To Lead G7 Yields Higher

There is a relative shift in central bank expectations underway, with the Fed becoming less dovish while other central banks are bringing forward rate cuts, as we forecasted would occur[13]. Indeed, regional monetary policy expectations have become less sensitive to shifts in Fed expectations. This has been particularly evident with the euro area (Euribor) market (**chart 10**), and is also having an impact further out the curve in 10-year government bond yields.

This relative divergence trend should persist and continue to support U.S. bond underperformance. While expectations of fewer Fed rate cuts should (over time) contribute to expectations for shallower easing cycles elsewhere, this is not imminent. Euro area growth expectations remain subdued, the latest economic data has been weak, uncertainty over trade policy is elevated, the economy is operating with modest slack (unlike the U.S.), and the German election (and fiscal picture) is likely to remain unresolved until sometime in 2025 Q1.

Treasurys will continue to lead the selloff, since...

...the U.S. economy is stronger and more inflationary than the G7

While bond market reactions around the U.S. election have been material, the spread between U.S. Treasurys and German Bunds has so far moved in a similar manner as following Trump's first electoral victory (**chart 11**). This previous roadmap suggests a further near-term widening in spreads, although we are wary of directly comparing the cycles too far out as the state of the economies differ, as well as some of the policies proposed.

[13] MRB "*Divergence Re-Emergence: Opportunities In Regional Bond Markets*", October 1, 2024, MRB "*Government Bonds: Upgrade The Euro Area & Downgrade Japan*", October 18, 2024 and MRB "*Bank of Canada: A Case For Frontloaded Easing*", October 22, 2024

Likewise, foreign investment into the euro area bond market should persist for now, much like the late-2010s when the ECB pursued very easy monetary policy measure to support the economy (**chart 12**). That said, we are careful not to extrapolate those trends too far since our research points to stronger economic prospects among the southern euro area members which could help offset the weakness in Germany[14]. Nonetheless, for now we remain underweight U.S. Treasurys in a global fixed-income portfolio and short 5-year U.S. versus German government bonds.

Final Word: *Government bonds are likely to consolidate their losses in the near run. However, we expect the benchmark 10-year U.S. Treasury yield to eventually retest its October 2023 high of roughly 5%. The Fed may go on an extended pause which would lift rate expectations further, but much of the rise in bond yields will be driven by higher inflation expectations (rather than improving economic growth), a greater term premium, and an ongoing upward adjustment in the projected nominal neutral fed funds rate.*

The risk-on phase in equities and corporate bonds should persist for now, supported by solid corporate fundamentals and strong profits[15]. However, the next material upleg in government bond yields is likely to force another (and potentially larger) de-rating in risk-assets.

Chart 11 **Election Playbook: U.S./German Spreads Will Remain Wide**

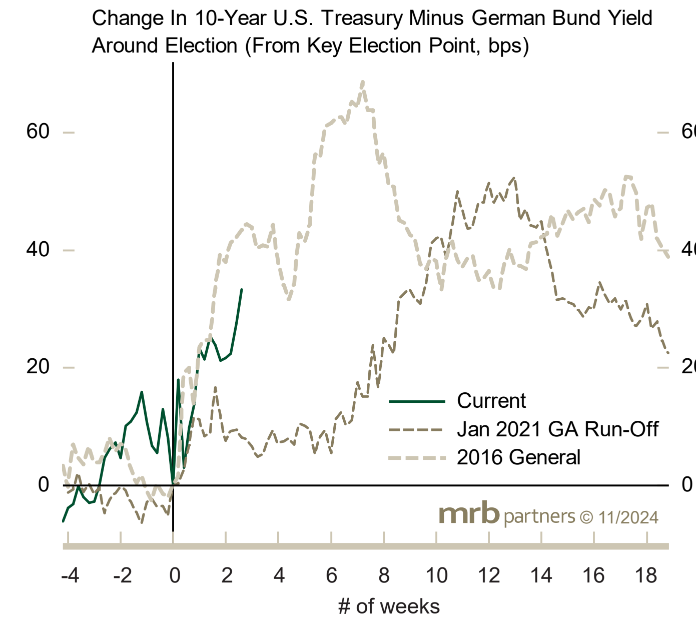
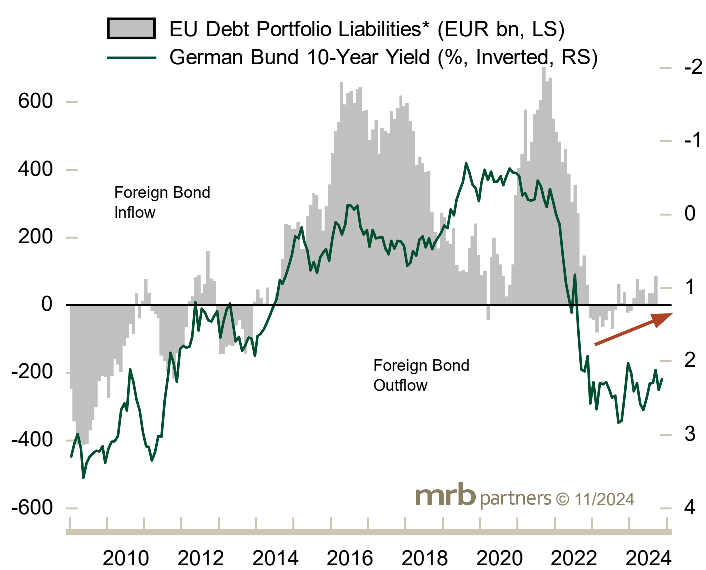


Chart 12 **Foreign Investment Flows Cap German Rates For Now**



* 12 month sum; source: ECB

[14] MRB "*Euro Area: Member Divergences Provide Opportunities*", October 23, 2024, MRB "*Euro Area Economy: Under Pressure, But More Resilient Than Perceived*", November 7, 2024 and MRB "*Webcast: Dissecting Diverging Trends In The Euro Area*", November 12, 202

[15] MRB "U.S. Corporate Bonds: Solid Fundamentals Will Keep Spreads Tight", October 21, 2024

The ***MRB TradeBook*** *currently has a short recommendations on the 10-year U.S. Treasury outright and on 5-year U.S. Treasurys versus German bonds. We will tighten the stop on the latter to 206 bps to protect 50 bps of profits. We also have long positions in U.S. high-yield corporate debt and 5-year CPI swap rates[16]. In terms of* **MRB*'s Asset Allocation Strategy***, *we recommend staying below benchmark duration, overweight inflation protection, and underweight U.S. government bonds within both fixed-income and multi-asset portfolios[17].*

Stay underweight U.S. Treasurys

Mazen Issa
Strategist, Fixed Income

Phillip Colmar
Partner, Global Strategy

[16] **MRB** "***Absolute Return Strategy: Positioning For The New Fat Tail U.S. Economy***", November 20, 2024

[17] **MRB** "***Asset Allocation Strategy: Temptation Is One Thing Investors Can't Resist***", November 1, 2024

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