MacroResearchBoard
mrb partners ABSOLUTE RETURN
Independent Investment Strategy
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The Return Of The Term Premium

- U.S. Treasury yields have risen steadily since the Fed began its easing cycle, partially unwinding misplaced rate cut expectations. However, bond yields have further upside.
- U.S. bond investors are still far too complacent about major issues such as inflation, budget deficits, post-election policies including protectionism, and the level of the long-term neutral Fed funds rate. All these items have the potential to drive the term premium on U.S. Treasurys much higher.
- We expect the benchmark 10-year yield to eventually retest its October 2023 high of roughly 5%, despite a dovish Fed. Stay short/underweight U.S. Treasurys.
- A strong U.S. economy and solid earnings provides support for equities and corporate debt, but elevated valuations and tight spreads provide limited cushion to absorb a spike in U.S. Treasury yields and/or disruptive trade policies. For now, we are maintaining a pro-growth stance, but stay tuned.

U.S. Treasury yields have risen steadily since the Fed began its easing cycle, consistent with MRB's view that the first rate cut would mark a "sell on the news" event for Treasurys[1]. At the same time, equities have pushed to new all-time highs, in line with our view that Fed rate cuts were not required and are instead a dovish policy misstep that would extend the goldilocks environment for risk assets[2] (**chart 1**). Indeed, our long recommendations in global equities and U.S. high-yield debt have both panned out, along with our short positions in U.S. Treasurys (see page 2).

Bonds are not priced for greater inflation and policy uncertainty

That said, our research has warned that bond investors are still far too complacent about major issues such as inflation, budget deficits, policy uncertainty (including protectionism) and the level of the long-term neutral Fed funds rate[3]. All these items have the potential to drive the term premium on U.S. Treasurys much higher over the next year, causing further pain for bond investors and posing a threat to the risk-on rally.

We believe the topic of the Treasury term premium could be one of the most important investment issues over the next year, with implications across all asset classes. In turn, this report analyzes the potential for a material rise in the term premium and thus bond yields, along with the ramifications for multi-asset strategy.

[1] **MRB:** "***Absolute Return Strategy: Sell The News***", August 29, 2024
[2] **MRB:** "***Absolute Return Strategy: Extending Goldilocks***", September 26, 2024
[3] **MRB:** "***U.S. Treasurys: Reality Bites Again***", October 9, 2024

MRB *TradeBook*

View print version with historical trades (pdf format)

Current Trades

Current Trades	Initiation Date	Gain/ Loss (%)	Exit Point[1]
Equities			
Euro Area: Long Financials Vs Broad Market	17-Aug-23	13.09	8.0%
U.S.: Long Financials/Short Broad Market	10-Jan-24	2.30	0.0%
S&P 500: Equally-Weighted Vs Market Cap-Weighted	26-Jul-24	-1.42	-4.0%
Long Global Benchmark	19-Aug-24	2.40	0.0%
CLOSED Long EM Asia	23-Sep-24	**4.00**	-
CLOSED U.S.: Long Energy Equipment & Services/Short Benchmark Ex-Technology	30-Sep-24	**0.00**	-
Global: Long Industrials/Short Broad Market Ex-Technology	14-Oct-24	-1.41	-4.0%
Euro Area: Long SEU-4[2] / Short Germany	23-Oct-24	-1.35	-4.0%
Foreign Exchange & Fixed Income			
Short CAD/EUR	24-Oct-22	10.21	5.0%
Long EUR/USD	26-Oct-22	8.10	5.0%
Long U.S. High-Yield Corporate Debt	14-Nov-22	22.65	17.0%
Long EM Currency Basket	23-Sep-24	-2.15	-4.0%
Short U.S. 10-Year Government Bonds	25-Sep-24	3.66	0.0%
5-Year Government Bonds: Long Germany/Short U.S.	26-Sep-24	1.55	0.3%
Alternatives			
Long U.S. Housing In Tier 2 Cities[3]	10-Sep-20	46.66	35.0%
CLOSED Long Brent Oil	17-Sep-24	**2.00**	-
Long SEU-4[2] Housing	23-Oct-24	0.00	35.0%
Shadow Trades			
Stocks: Long Euro Area/Short U.S.	2-Jun-23	–	Stop-Buy
Government Bonds: Long Australia/Short Japan	9-Jun-23	–	Stop-Buy
Long SEK/Short AUD, CAD, GBP, NOK and NZD	18-Jan-24	–	Stop-Buy
Long 10-Year Turkish Government Bonds	10-May-24	–	Stop-Buy
U.S.: Long Bank Index/Short Regional Bank Index	2-Aug-24	–	Stop-Buy
Japan: Long Financials/Short Broad Market	9-Aug-24	–	Stop-Buy
Short U.S. Growth Stocks	16-Aug-24	–	Stop-Short
U.S. Stocks: Long S&P 600/Short Nasdaq 100	16-Aug-24	–	Stop-Buy
U.S.: Short Growth/Long Value	23-Aug-24	–	Stop-Buy
U.S.: Long Aerospace & Defense/Short Consumer Discretionary	13-Sep-24	–	Stop-Buy
Long JPY/AUD	26-Sep-24	–	Stop-Buy
Financial Stocks: Short Canada/Long Euro Area	10-Oct-24	–	Stop-Buy
Short U.S. Move 1-Month Bond Volatility Index	11-Oct-24	–	Stop-Short
U.S.: Health Care Vs Broad Market	11-Oct-24	–	Stop-Buy
Long JPY/USD	18-Oct-24	–	Stop-Buy
Long VIX Index Generic 1st Futures	25-Oct-24	–	Stop-Buy

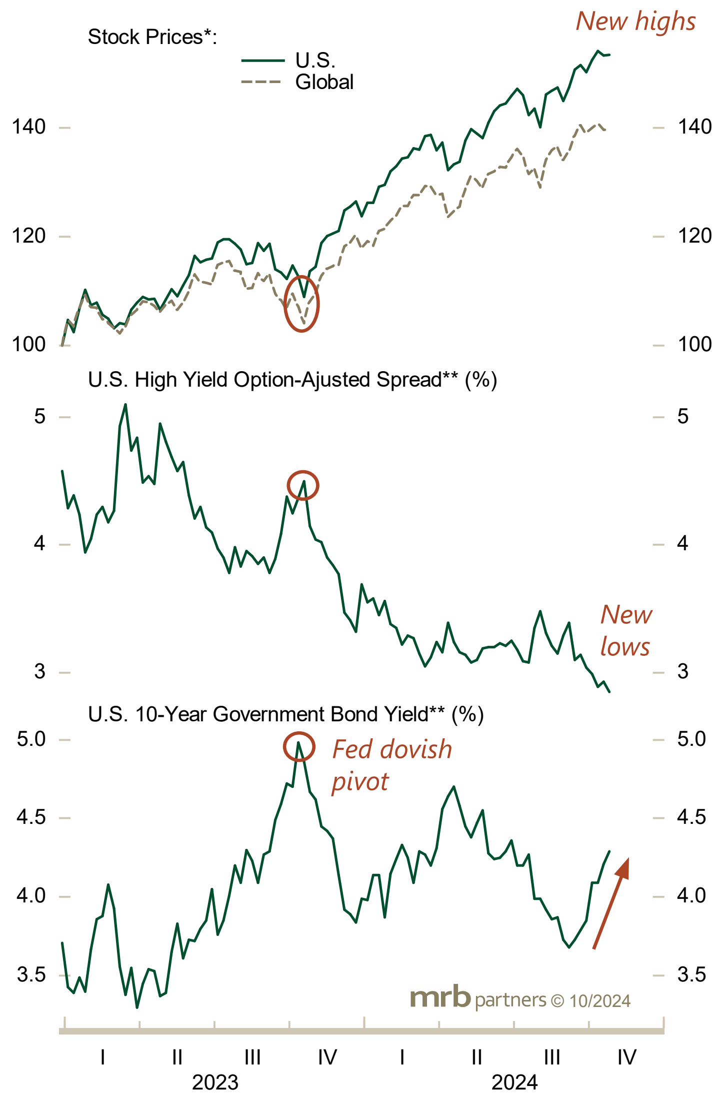
1 Exit points for equities and stock/bond ratios are expressed as the % gain/loss generated if trade is stopped out.
2 Includes Greece, Italy, Portugal and Spain
3 Proxied by the 10 cities in the U.S. S&P/Case Shiller 20-city index not in the 10-city index
Note: Gain/losses are based on daily closing values and is calculated in U.S. dollars unless otherwise stated. Recommended trades are intended to be held for a minimum of three months, and may last more than a year. Nevertheless, we use exit points in order to control risk. *Shadow Trades* are investment opportunities that we plan to implement once timing is appropriate.

What Influences The Term Premium?

The term premium (which is the compensation that investors require for bearing the risk that interest rates may change materially over the life of the bond) is sensitive to changes in economic uncertainty as well as changes in the relative demand and supply of bonds[4]. The term premium is ***not*** directly observable and needs to be extracted from bond yields. There are multiple approaches to doing so, which all have limitations.

The Fed publishes three well known versions of the term premium for the benchmark 10-year U.S. Treasury (**chart 2**), which include models by Adrian, Crump and Moench[5] (ACM), Kim & Wright[6] (KW) and D'Amico, King and Wei[7] (DKW). The ACM has historical estimates dating back to 1961, compared with 1983 for DKW and 1990 for KW. The DKW and KW measures tend to be very consistent throughout time, while the ACM model generates a more volatile, albeit still generally correlated, term premium estimate. Therefore, rather than reinventing the wheel, we will utilize these estimates for our analysis. All three term premiums are now mildly positive, but not higher than the mid-2010s despite the current higher inflation environment. Our research warns that risks are skewed decisively to the upside heading forward.

Chart 1 Fed Rate Cuts Are A Dovish Misstep



* U.S. dollars; rebased; source: MSCI
** Source: Bloomberg

Inflation Risk

U.S. Treasury term premium is only mildly positive

Expected future consumer price inflation is conceptually a different factor than the term premium (which theoretically captures inflation uncertainty) when determining

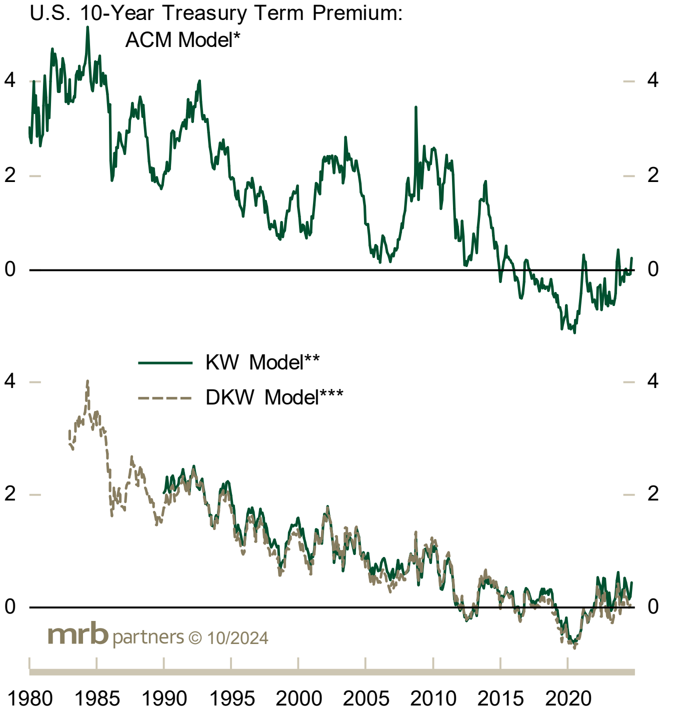
4 "*Term Structure Modeling with Supply Factors and the Federal Reserve's Large-Scale Asset Purchase Programs*", Canlin Li and Min Wei Division of Monetary Affairs, Federal Reserve Board of Governors

5 **Federal Reserve Bank of New York:** "*Treasury Term Premia: 1961-Present*", May 12, 2014

6 **Board of Governors of the Federal Reserve System:** "*Three-Factor Nominal Term Structure Model*"

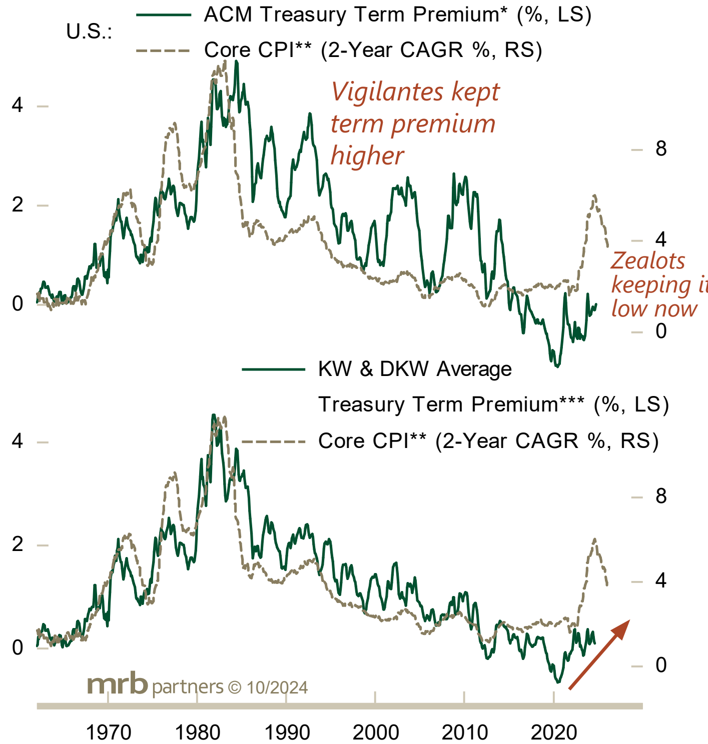
7 **Board of Governors of the Federal Reserve System:** "*Tips from TIPS: Update and Discussions*", May 21, 2019

Chart 2 Three Popular Term Premiums For U.S. Treasurys



* Adrian, Crump, & Moench (2013) Model; source: Federal Reserve Bank of New York
** Kim-Wright (2005) Three-Factor Nominal Term Structure Model; source: Federal Reserve
*** D'Amico, Kim, & Wei (2018) No-Arbitrage Term Structure Model; source: Federal Reserve

Chart 3 The term Premium Is Influenced By The Trend In Inflation



* Smoothed; source: New York Federal Reserve
** Advanced 18 months; source: U.S. Bureau of Labor Statistics
*** Smoothed; back data is ACM term premium; sources: Federal Reserve, New York Federal Reserve

government bond yields. The term premium is intended to capture inflation uncertainty rather than the path of consumer price inflation. However, in practice, the two overlap, partially because the premium investors demand for holding bonds is related to their expected purchasing power at maturity, and because upward pressure on inflation tends to create more anxiety this future purchasing power.

Investors are too complacent on the outlook for inflation…

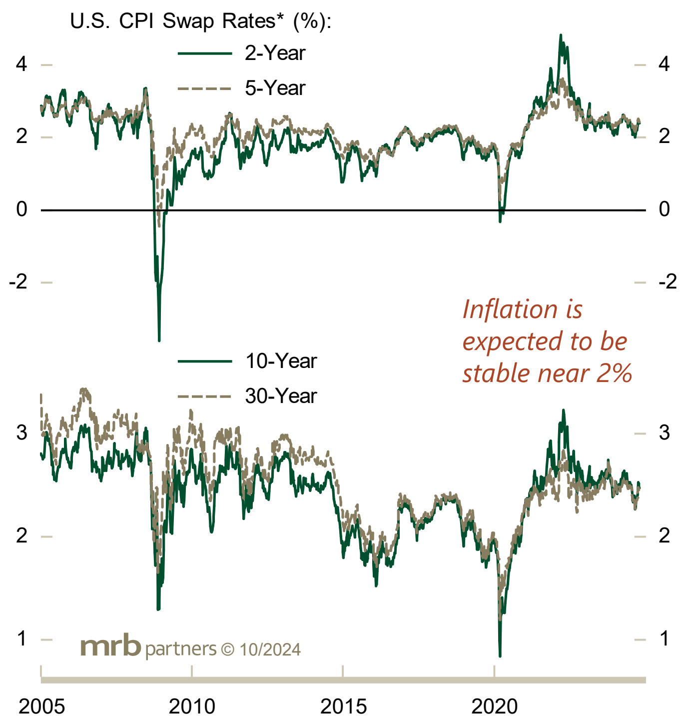
…a progressive capitulation to the new reality will push the term premium higher

Chart 3 panel 1 shows the ACM term premium estimate (which has the longest time series) against a measure of core CPI inflation. Panel 2 shows the same but for an average of the KW and DKW term premiums. For inflation, we found that a 24-month compounded growth rate of core CPI, advanced 18 months, works reasonably well in capturing the underlying trend in the term premium. In other words, investors base their expectations of future inflation (18-months ahead) on the recent (24-month) observed history of CPI.

That said, it is notable that the ACM term premium held above this inflation measure for many years after inflation peaked in the early-1980s, which reflected persistent fears of bond vigilantes that inflation would revive. By the mid-2010s (after the deflation shock of the Global Financial Crisis), the term premium trended well below this measure of inflation, reflecting the bond zealot's adoption of the secular stagnation narrative.

Even now, investors remain overly complacent regarding inflation, expecting that all roads will ultimately lead back to a stable inflation rate near 2%, according to the CPI swap market[7] (**chart 4**). However, our research has shown that the low inflation era of near-2% PCE inflation (or the equivalent 2.5% CPI inflation) prior to the pandemic was the result of multiple ***secular*** disinflationary forces[8]. These forces 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 economies (which are two major sources of global demand and tend to set global prices).

Chart 4 Investors Are Too Complacent On Inflation Risks



* Source: Bloomberg

While difficult to estimate, these ***secular*** disinflationary forces may have dragged core CPI inflation rates down by about one percentage point during the 2000s and 2010s in the U.S. economy. If so, then the underlying or steady-state core inflation rate is now likely to be just over 3% rather than near 2% under the assumption that these secular disinflationary drags are much less intense. At the same time, ***cyclical*** forces suggest that inflation could run ***above*** these levels over the next year, given that the U.S. economy continues to expand at a rate above its long-run potential and the output gap is decisively positive (**chart 5**). This comes at a point when the disinflation from pandemic-related supply distortions has already run its course, as reflected in already depressed goods CPI inflation.

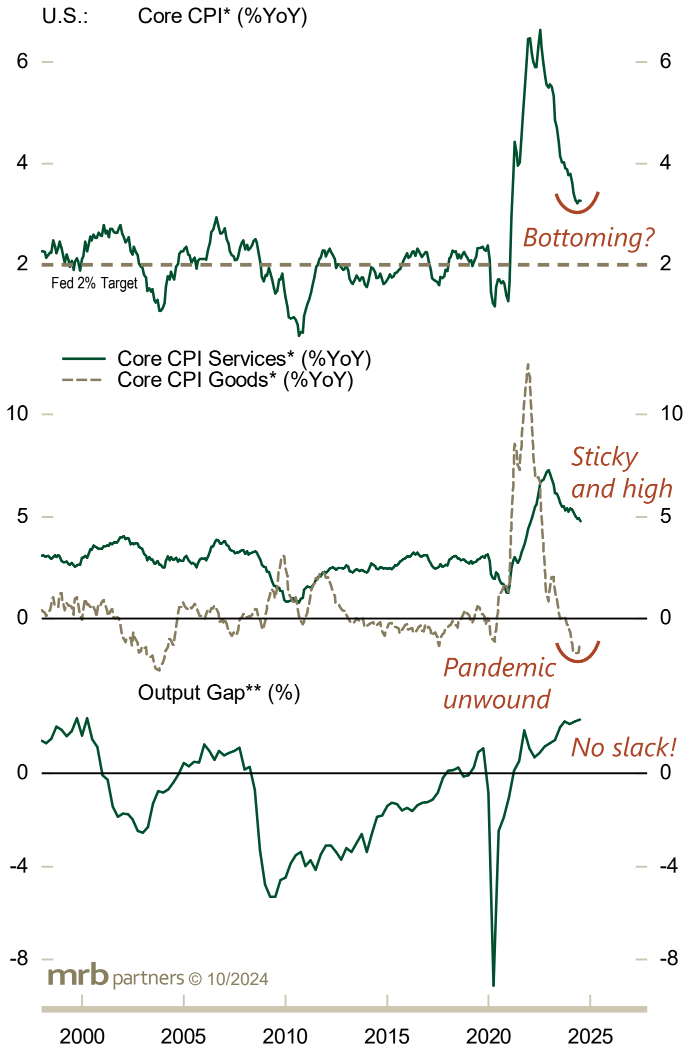
The underlying run-rate of CPI inflation is now over 3% in the absence of previous secular disinflationary drags...

...and cyclical forces point to higher-than-trend inflation

In short, the underlying run-rate of U.S. consumer price inflation is higher than bond investors (and the Fed) expect. As this is progressively realized, it should lift inflation expectations and inflation uncertainty, which will put upward pressure on the term premium and U.S. Treasury yields. It will also lift the expected path of the fed funds rate (see below).

8 Note that annual core CPI inflation has run on average almost 50 bps above core PCE inflation over the past four decades, so a 2.5% CPI swap rate is consistent with expectations that the Fed will achieve its 2% core PCE inflation target.

Chart 5 **U.S. Inflation Will Trend Above 3%**

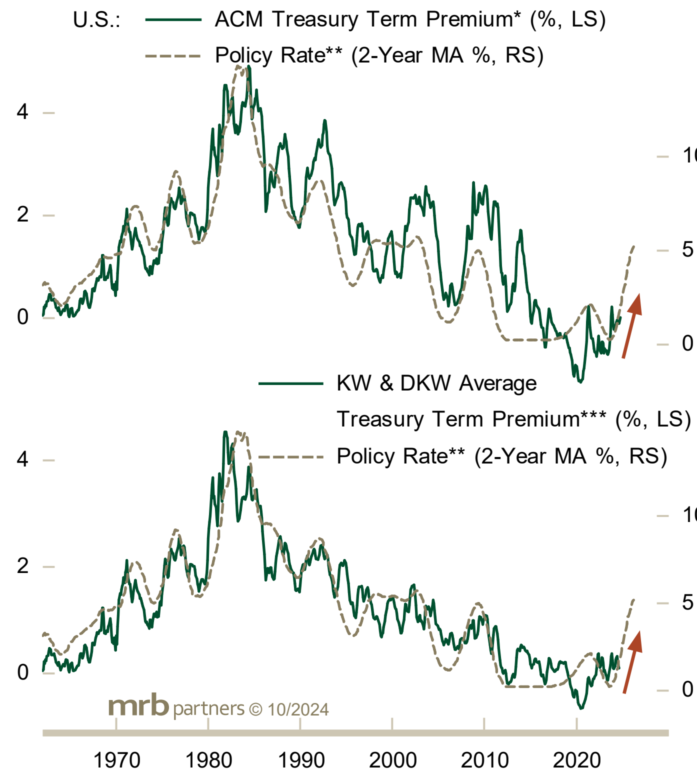


* Core excludes food & energy; source: U.S. Bureau of Labor Statistics
** Current GDP relative to potential GDP; source: Congressional Budget Office

Outlook For Fed Funds Rate

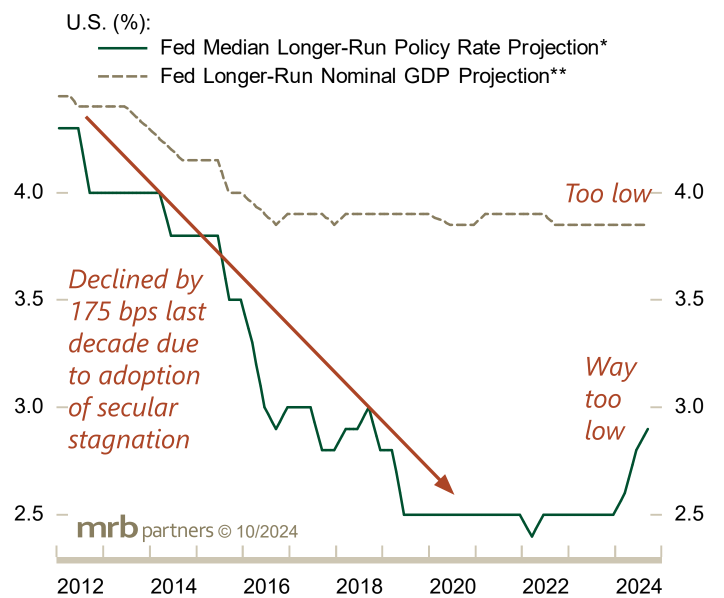
Term premium estimates are heavily influenced by expectations of future Fed policy rates and the uncertainty associated with these estimates. The outlook for policy rates (in inflation adjusted terms, or the so-called R-Star) is often considered separate from the term premium. However, the two overlap. **Chart 6** shows that a 24-month moving average of the Fed funds rate, advanced 18 months, helps explain the major swings in the term premium estimates over the past 60 years.

Chart 6 **The Term Premium Is Influenced By The Trend In Policy Rates**



* Smoothed; source: New York Federal Reserve
** Advanced 18 months
*** Smoothed; back data is ACM term premium; sources: Federal Reserve, New York Federal Reserve

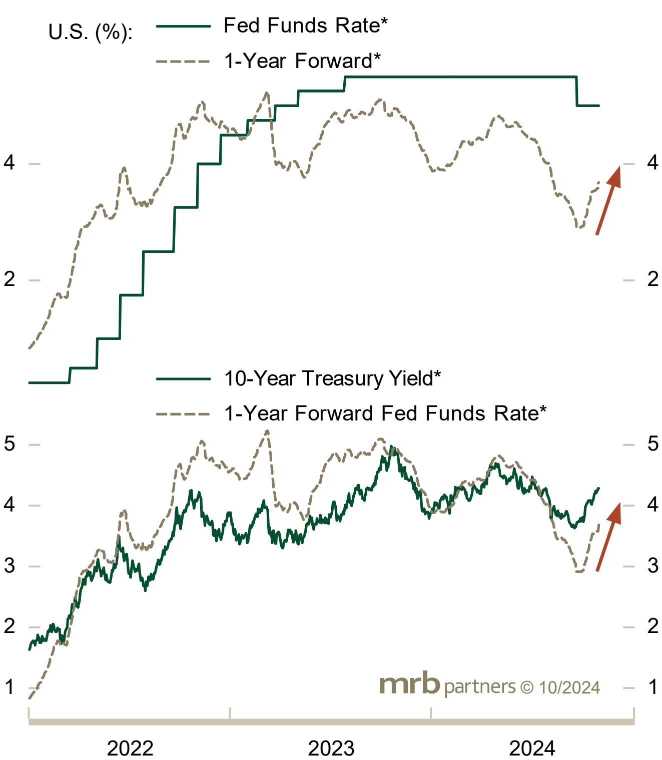
Chart 7 **The Fed's Neutral Policy Rate Is Higher Than Expected**



* Source: Federal Reserve
** Midpoint of central tendency plus 2% inflation; median omitted for shorter forecast history

The reason for the overlap is that the Fed worked hard at rebuilding credibility after the surge in inflation during the 1960s-1970s, and then progressively adopted "increased transparency" and "data dependency" to dramatically reduce policy-related uncertainty for investors. During the 2000s and 2010s, the Fed also began shifting to a structurally dovish bias, which has since become extreme and biased rates lower. The Fed also began publishing a long-run estimate of its neutral policy rate[9], which provided greater clarity for investors over the longer-term outlook. However, by the mid-2010s, the Fed suppressed longer-dated bond yields by dramatically lowering its neutral estimate relative to the central bank's forecast of nominal GDP, with the latter also being reduced meaningfully (**chart 7**, previous page). Indeed, greater transparency by the central bank, a strong dovish bias, and the purposeful decoupling of interest rates from the economy, crushed the term premium over the past decade.

Chart 8 Bond Market Priced In Too Many Fed Rate Cuts



* Source: Bloomberg

Our far-from-the-consensus view is that the U.S. economy is much less interest rate sensitive than perceived and that the long-run neutral policy rate is 4.5% or higher[10]. In turn, the Fed's new easing campaign will be cut short by a solid economy and inflation that bottoms well above the central bank's target. Expectations for deep Fed rate cuts for 2025 will unwind further (**chart 8**). This will also increase the level, as well as the uncertainty, of future policy rates, which should progressively lift the term premium for the benchmark 10-year Treasury, contributing to higher bond yields. In other words, ***we expect a gradual unwinding of the distortions that depressed bond yields last decade***.

An ongoing rise in the neutral fed funds rate estimate will push the term premium higher

U.S. Treasury Supply

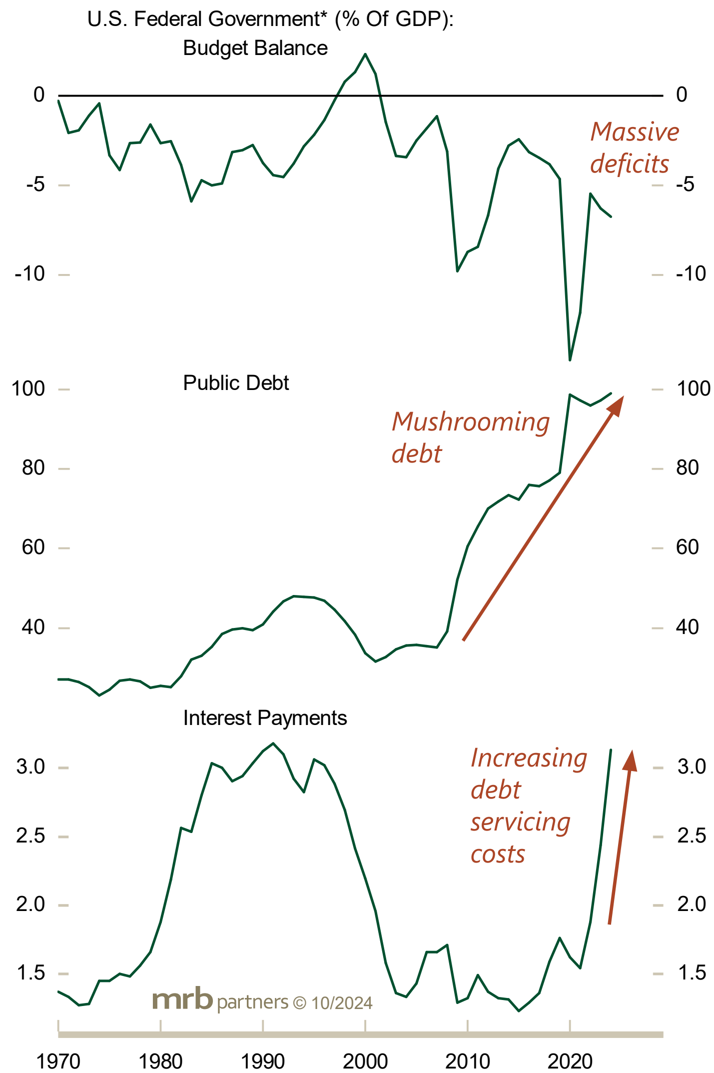
Concerns regarding structurally higher fiscal deficits and shifts in the Fed's balance sheet generally show up in the term premium. Historically, U.S. Treasury supply plays

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

[10] 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

a minor role in determining bond yields as cyclical growth, inflation and monetary policy dominate the trend. However, the massive and seemingly open-ended increase in government debt (as a percent of GDP), along with higher borrowing costs, suggest that supply could play a much larger role in the years ahead by adding additional upward pressure on the term premium for U.S. Treasurys.

Chart 9 U.S. Federal Government: Alarming Debt Trends



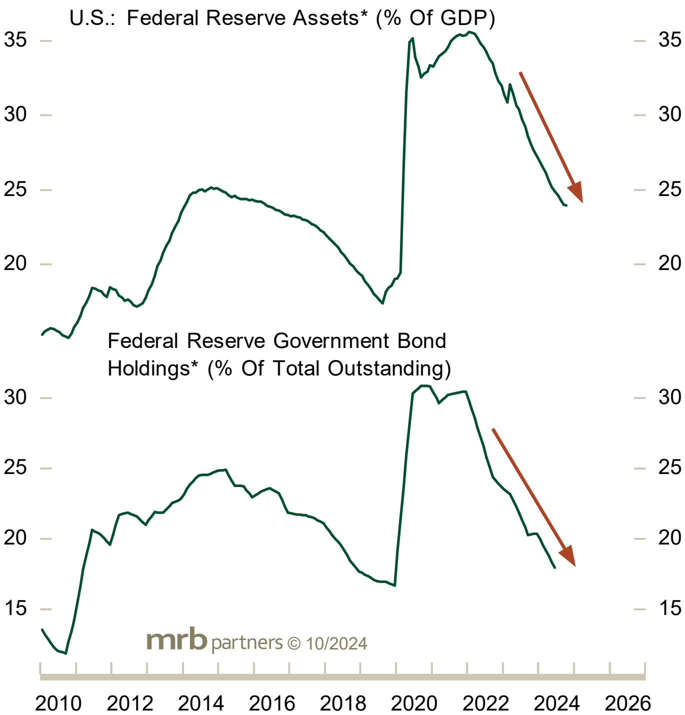
* Includes 2024 projection; source: Congressional Budget Office

While there were significant fluctuations in the U.S. federal government budget deficit in the post-WWII period, the deficit mushroomed in response to the Global Financial Crisis (GFC, **chart 9**). The GFC required a bailout of the U.S. banking sector and stimulus to offset a deleveraging household sector, leading to a dramatic widening of the budget deficit to 10% of GDP. In the years following, the U.S. federal budget deficit narrowed (but never fully closed) until 2016 when it began widening anew, and eventually mushroomed during the pandemic to a whopping 15% of GDP.

There has been some improvement in the U.S. federal budget deficit over the past four years, but it continues to run at an unsustainable pace of more than 6% of U.S. GDP, despite a strong economy (for long-run fiscal stability, governments should run surpluses during expansion phases, and deficits only when the economy is in recession). Worse yet, policy proposals from both major parties suggest that the deficit could widen much further regardless of next week's election outcome. Although a Harris win with a split Congress may help limit spending (unless there is a grand deal that benefits both Democrat and Republican spending objectives), although a series of debt ceiling battles beginning in early-2025 could increase the term premium due to uncertainty. All of this comes at a point when higher interest rates and rising debt servicing costs will make it progressively more challenging to service the massive government debt and contributing to a wider deficit.

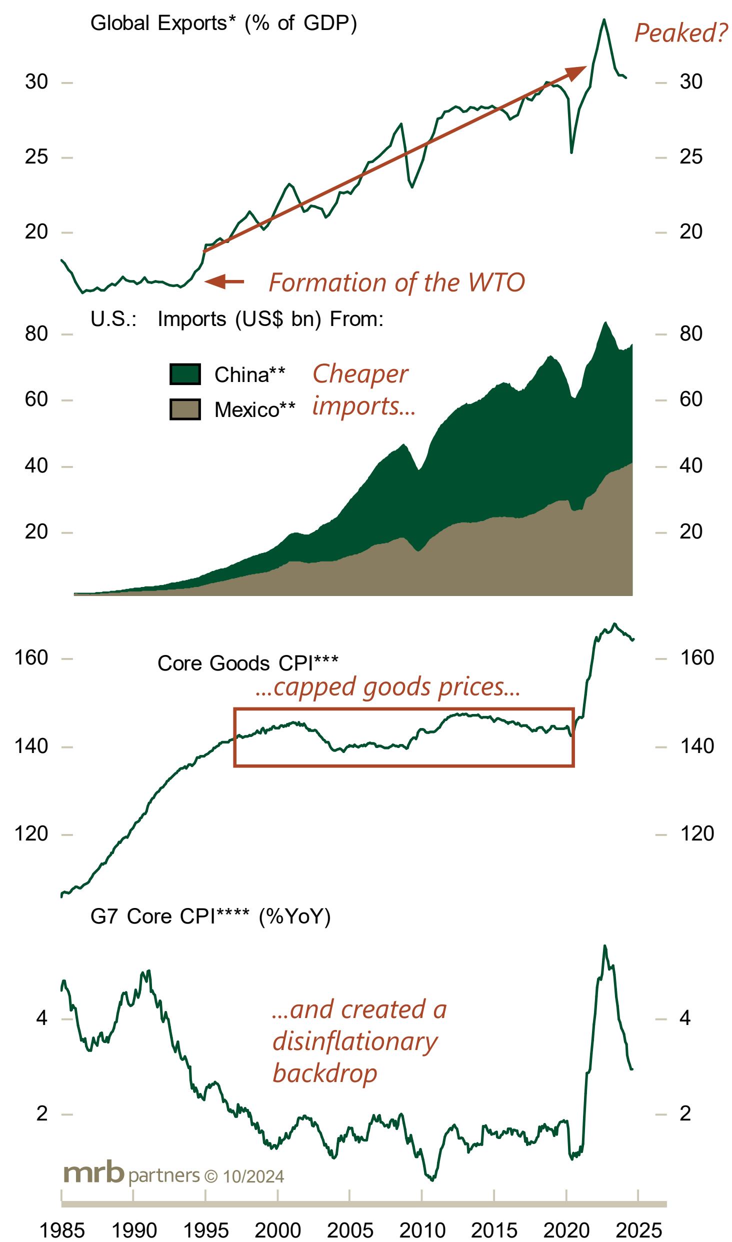
Mushrooming government deficits will eventually matter

Chart 10 Central Bank Demand For Bonds Is Fading



* Source: U.S. Federal Reserve

Chart 11 Has Globalization (And Disinflation) Peaked?



* Source: OECD
** Smoothed; sources: U.S. Census Bureau; U.S. Bureau of Economic Analysis
*** Excludes energy and food; source: U.S. Bureau of Labor Statistics
**** Excludes energy and food; source: OECD

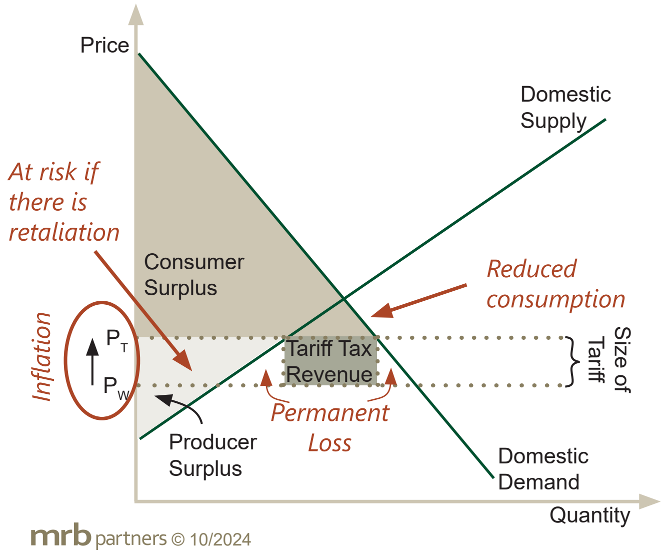
At some point, central bank demand for Treasurys has also diminished (**chart 10**). The Fed held around 30% of all outstanding Treasurys earlier this decade (as part of its quantitative easing program), which has now slipped to around 18%. In short, we expect investors to progressively begin to worry about open-ended government spending, whether the government will breach its debt limit, and if supply will outstrip demand, especially if inflation expectations are rising at that same time. All of this points to a higher term premium on U.S. Treasurys.

Protectionist Risk

There is a substantial difference in the policy platforms of the major parties in the approaching U.S. election. However, one area where they overlap is their desire to pursue protectionism in the form of tariffs on goods from China and/or other major trading partners, on-shoring and other trade restrictions. Promoting protectionist policies and taking a hard line with China is now viewed to be a winning strategy among voters, and both political parties are eager to promote such policies.

Politicians are primarily focused on tariffs, which are stagflationary regardless of how these policies are sold to the public[11] (**chart 11**, previous page). Consumer prices will rise, and meaningfully at major retailers, while consumption would be pared back in response to tariffs adding an inflation "tax" on discretionary incomes. The profitability of domestic businesses will be curbed by higher input costs, lower domestic demand, and potentially lower foreign demand if other countries retaliate on U.S. exports, as seems highly likely (based on the trade war episode in the late-2010s).

Chart 12 **Imposing Tariffs Is Stagflationary And Risks Retaliation**



The U.S. federal government will collect some tax revenue from tariffs, but it will take much more than this to fill in the hole from the private sector losses due to protectionist policies[12] (**chart 12**). Thus, if the federal government opts to cut personal income taxes to offset the economic drags from higher tariffs (as is currently proposed by Trump), it will blow an even larger hole in the budget deficit. This would be a bad outcome for U.S. Treasurys, since offsetting the economic drags or "stagnation" component of "stagflation", would leave the economy more inflationary and with increased U.S. Treasury supply.

Tariffs are stagflationary and add to uncertainty...

In short, protectionist policies are a recipe for an increased term premium and higher bond yields. At a minimum, uncertainty will increase meaningfully as tariffs are debated and acted upon. Any efforts by the Fed to anchor policy rates would merely reinforce the inflationary tilt of the economy (and significantly steepen the yield curve).

...not a good combination for financial assets

Final Word: *Most macro forces point to a meaningful rise in the term premium over the next year and possibly beyond. Much of the rise will be driven by investors questioning their entrenched view that inflation will return sustainably near 2%, which will also put upward pressure on their assessment of the level of the fed funds rate over the long haul. The caveat is that the 1980s and 1990s showed that the capitulation to a new secular inflation reality can happen slowly over many years[13]. If so, then the upward adjustment in the term premium will be gradual/choppy, but risks will remain skewed to the upside.*

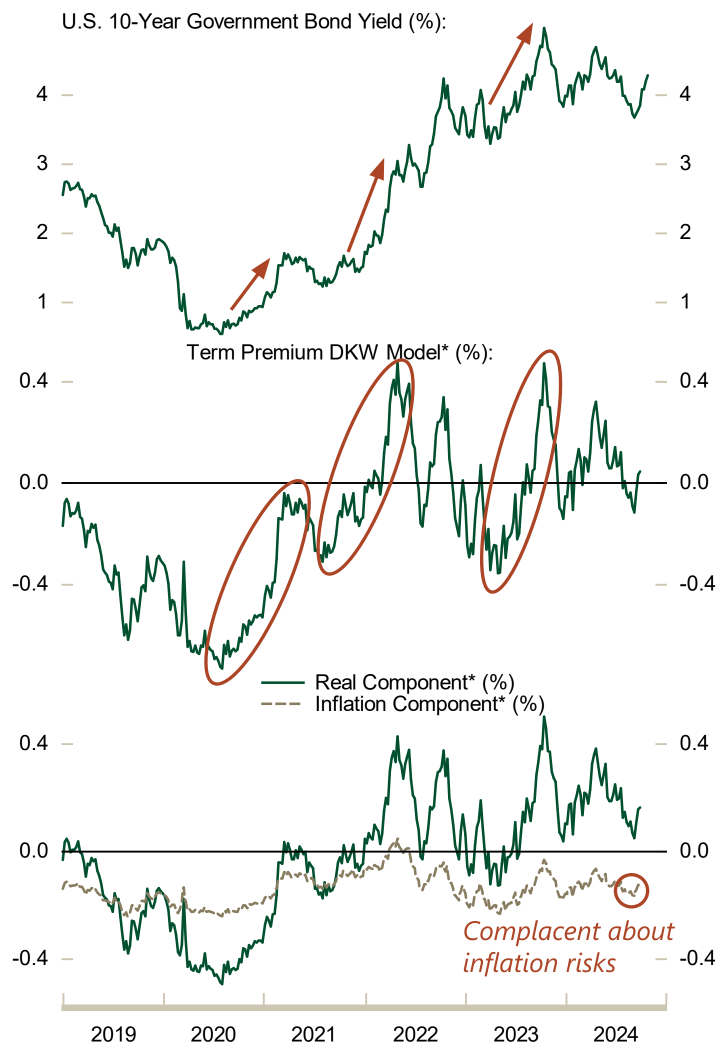
[11] **MRB:** "*The Impact Of A Higher Neutral Fed Funds Rate*", July 17, 2024

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

[13] **MRB:** "*Webcast – Protectionism: A Dangerous And Losing Trade*", September 4, 2024

In addition, massive and persistent budget deficits, and potential funding challenges by the federal government, along with the inflationary consequences of increased protectionism will add further upward pressure on the term premium.

Chart 13 The Term Premium Has Already Impacted The 10-Year Treasury Yield This Decade



* D'Amico, Kim & Wei (DKW) No-Arbitrage Term Structure Model; source: U.S. Federal Reserve

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Term Premium & U.S. Treasurys This Decade

Chart 13 shows the DKW estimate of the term premium, which we use for this part of the analysis since it also provides a breakdown of the real and inflation components. According to this measure, there have been three meaningful increases in the term premium for the benchmark 10-year Treasury since 2020 that contributed to bouts of higher bond yields:

- The first was a 70 bps jump in the term premium from July 2020 to March 2021 in response to the massive fiscal policy support aimed at reflating activity from the pandemic fallout, and ultimately helped trigger the spike in consumer price inflation[14].

- The second was an 80 bps increase in the term premium from July 2021 to April 2022, when the bond market begrudgingly accepted that the "transitory narrative" for growth and inflation was misplaced, and the Fed would need to hike interest rates meaningfully[15]. This ended the prolonged era of near zero percent interest rates.

[14] **MRB:** "***The Fed & U.S. Treasurys: Mirroring The 1980s***", February 1, 2024

[15] **MRB:** "***The Fed & U.S. Treasurys: Mirroring The 1980s***", February 1, 2024

[15] **MRB:**"***Are We Headed For Deflation Or Inflation?***", July 13, 2020 and **MRB:**"***An Inflation Problem Is Brewing***", June 3, 2021

[16] **MRB:** "***Stuck In A Moment (The 2010s)***", August 5, 2021, **MRB:** "***Asset Allocation Strategy – Moderating From Boom To Still Solid***", October 1, 2021 and **MRB:** "***The End Of "Transitory"***", October 21, 2021

- The third was a 80 bps jump in the term premium from May to October 2023 as the consensus realized it was wrong in betting on a U.S. recession and began revising up their assessment for the economy and the neutral fed funds rate[16].

- What is noteworthy is that according to the DKW model, the inflation component of the term premium rose from July 2020 to April 2022 but subsequently dropped back into negative territory, to levels only mildly above its historical lows. This implies that bond investors are convinced that the spike in consumer price inflation was indeed a one-off event, and that inflation will now return to a low and very stable range. We disagree[17].

Final Word: *The term premium has experienced three brief but substantial (70-80 bps) increases this decade, which has provided a material lift to U.S. Treasury yields. That said, decomposing the term premium reveals that bond investors remain overly complacent regarding the outlook for inflation (consistent with the CPI swap market), which is in sharp contrast with the conclusions from our research. This sets the stage for a potential major surprise heading forward, and room for another meaningful upward adjustment in both the term premium and yield of the benchmark U.S. 10-year Treasury.*

The term premium could increase by a percentage point or more

Indeed, we expect another meaningful rise in the term premium of at least those experienced earlier this decade (70-80 bps) if not much larger. We also expect the upward adjustment in the term premium to be sustained on a multi-year basis. As a reference, the term premium averaged roughly 1.2% during the 2000s and 1.8% during the 1990s, albeit with considerable volatility.

Investment Strategy

- **Bonds:** We expect the benchmark 10-year yield to ***eventually*** retest its October 2023 high of roughly 5%, albeit driven by different factors than a year ago. Fed rate cuts provide a drag on higher government bond yields, but this can be more than offset by a rise in inflation expectations and the term premium. The **MRB *TradeBook*** currently

[17] **MRB:** "*Webinar: Our No-Recession, Non-Consensus U.S. View Explained*", January 31, 2023,
MRB: "*Absolute Return Strategy: Investors Misinterpret The Cycle Yet Again*", February 10, 2023,
MRB: "*Challenging The U.S. Recession View (Part I)*", May 9, 2023, "*(Part II)*", May 11, 2023

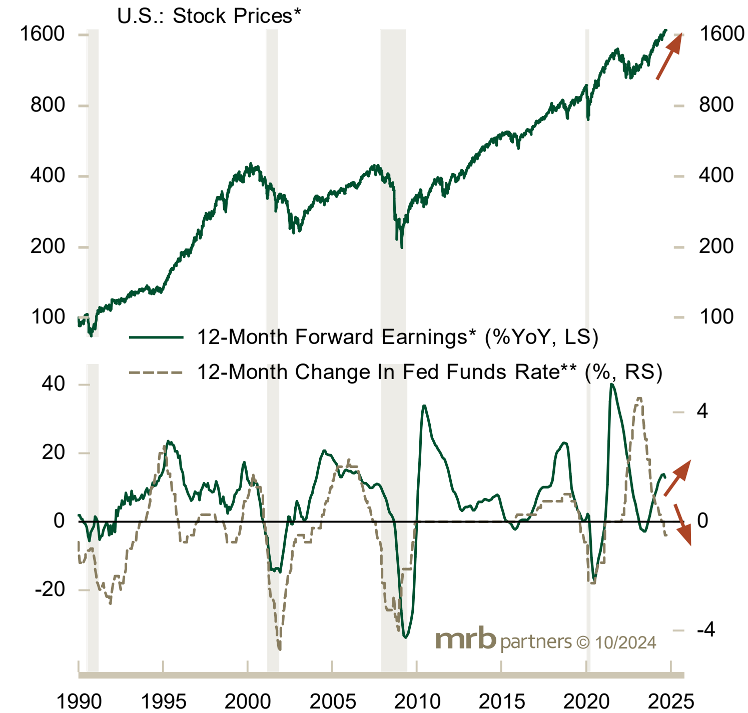
has a short recommendation on the 10-year U.S. Treasury (up 4%), but with a stop to protect the profits. We also have a short position on 5-year U.S. Treasurys versus German bonds (up 2%). Finally, we recommend being below benchmark duration and underweight U.S. government bonds within the **MRB *Asset Allocation Strategy***[18].

❍ **Equities:** The Fed is currently cutting policy rates at a time when corporate earnings are strong and improving, which is exceptionally abnormal and thus supportive for equities (and credit) (**chart 14**). Effectively, the central bank is adding to the (non-empty) punchbowl, which is supportive of risk-on ***provided*** bond yields do not rise substantially and spoil the party[19]. Since 2020, equities have been able to advance despite higher bond yields until the latter breaks into uncharted territory (i.e. new highs), at which point equity multiples compress (**chart 15**). If this pattern holds, U.S. (and global) stocks will next run into trouble when the benchmark U.S. 10-year Treasury yield pushes above 5%. While this is not imminent, we expect it will eventually occur and caution that the price/earnings multiple for the S&P 500 is now 20% above its October 2023 levels. For now, the **MRB *TradeBook*** has a pro-growth bias, with long positions in global equities (up 2%) and U.S. high-yield corporate bonds (up 23%), albeit with stops to protect profits. Within a multi-asset portfolio (in the **MRB *Asset Allocation Strategy)***, we are neutral

[18] **MRB:** "***U.S. Inflation: What Will Be The Underlying Run Rate?***", June 5, 2024, **MRB:** "***When Will Inflation Steer The Fed Again?***", September 12, 2024

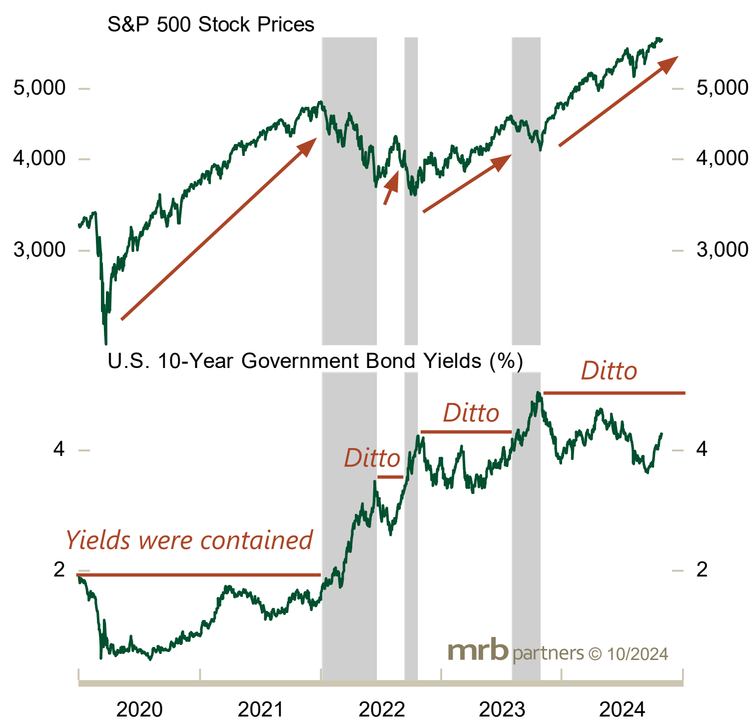
[19] Note that the next MRB Asset Allocation Strategy report will be published Friday

Chart 14 **The Fed Doesn't Typically Cut As Earnings Accelerate**



* Local currency; smoothed; rebased; source: MSCI
** Source: Bloomberg
Note: Shaded for NBER-designated U.S. recessions; panel 1 shown in log scale

Chart 15 **Equities Rally Until Bond Yields Break To New Highs**

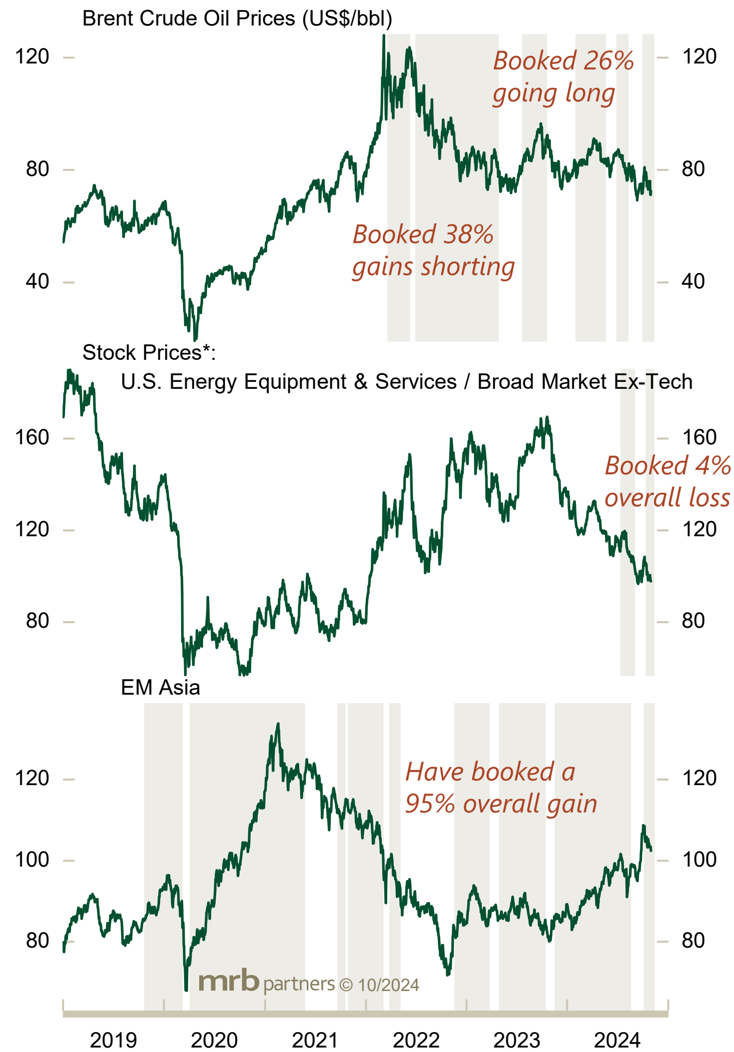


Note: Shaded for the equity sell-off

on equities, but overweight stocks versus bonds (and overweight cash).

❍ **Defensive Hedges:** We have been far more constructive than the consensus on the outlook for the U.S. economy and risk assets because the aggregate cost of capital is still too low to be threatening. However, we are not dogmatic in our view and if bond yields rise sharply (and/or a growth disrupting trade war erupts), we will shift from a pro-growth to a defensive stance. As a starting point, there are stops on all beta positions in the **MRB *TradeBook***. We also have a stop-short on U.S. growth stocks, as well as stop-buys on VIX futures, U.S. health care stocks versus the broad market, and the Japanese yen (see page 2).

Chart 16 MRB *TradeBook*: Closed Positions



* U.S. dollars; source: MSCI
Note: Total return rebased to 100 at initiation of trade; shading denotes when MRB previously held trade

MRB *TradeBook* Housekeeping

The stops were breached on three of our recommendations in the **MRB *TradeBook*** this week, causing us to close the positions (**chart 16**):

❍ **Long U.S. Energy Equipment And Services Vs U.S. Broad Market Ex-Technology:** The exit point on long U.S. energy equipment and services versus the broad U.S. market was triggered this week at its entry level. The outlook for energy prices over the next 6-12 months remains modestly positive on the back of resilient global growth. We still believe this pair trade has considerable upside potential, but we will honor the stop and move it to the *Shadow Trades* with a 4% trailing stop-buy.

We closed three positions

❍ **Long Brent Oil:** This long crude oil position was stopped out this week with a 2% gain (note that we have previously booked a 38% gain on oil prices on the short side and 24% on the long side in the aftermath of the pandemic). While worries in the Middle East have eased as of late, better-than-expected global growth conditions should support energy prices in the months ahead. In turn, we are moving this position to our *Shadow Trades* with a 4% trailing stop-buy.

- **Long EM Asia Equities:** Our long EM Asian equity position was also stopped out this week with a 4% gain. While we are honoring this stop, macro forces remain constructive for EM equities. Chief among these is the acceleration of EM earnings (and relative to DM earnings), driven by stronger domestic growth momentum and recovering export demand. Still, for now, we are moving this position to our *Shadow Trades* with a 4% trailing stop-buy.

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