Trump 2.0: What It Means For The Fixed Income Market

- An apparent Republican sweep will provide the Trump Administration with ample flexibility to push forward with major policy changes, but will also increase macro uncertainty. This reinforces our expectation for higher U.S. Treasury yields and a greater term premium. Stay below benchmark duration, underweight government bonds and short U.S. Treasurys.
- The bond market is also significantly underpricing inflation risks. Stay overweight inflation protection and go long U.S. CPI swaps.
- Bond investors are likely to continue shifting from earlier expectations of deep Fed rate cuts in 2025 to only a few cuts, and then to anticipating an extended pause. We recommend shorting the June SOFR contract (M5) to capture this trend. If Trump again puts intense pressure on Fed Chair Powell to cut rates, the bond market is unlikely to respond favorably this time around, leading to a much steeper yield curve. Continue to bet on a bear steepening.
- Divergences between U.S. Treasurys and other developed bond markets will persist, particularly versus the euro area. We remain overweight German bonds versus U.S. Treasurys, and continue to bet on a wider spread between these markets.
- The Bank of Japan will need to become more hawkish to discourage a rebuilding of carry trades and stem yen depreciation. Bond investors are underpricing the likelihood for a normalization of 25 bps per meeting in the coming year. Stay underweight Japanese government bonds and add a short position on 10-year JGBs.

Now that the U.S. election has passed and an apparent Red sweep has taken place, the outlook for Treasurys is likely to shift substantially. We believe Trump's re-election will solidify a core MRB theme that the U.S. Treasury term premium will head higher[1]. As we previously outlined, the key factors that will push up the term premium include expectations for sustainably higher inflation and policy rates, larger debt/deficit trends as well as increased uncertainty around these factors. The latter will be amplified by policies that are dramatic and generally inflationary, yet conflict in terms of both pro-growth

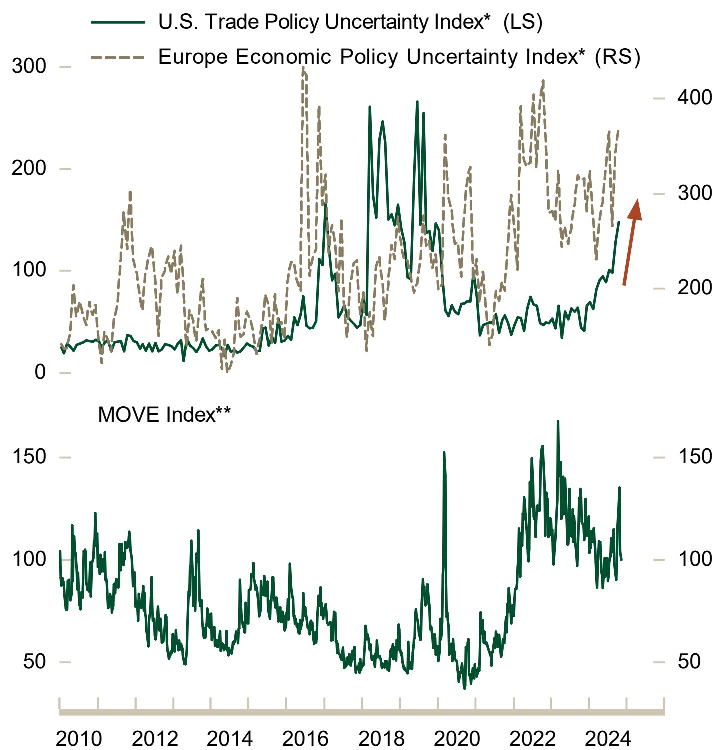
Trump will fatten economic tail risks and increase the U.S. Treasury term premium

[1] The term premium is the compensation that investors require for bearing the risk that interest rates may change materially over the life of the bond.
MRB "***The Return Of The Term Premium***", October 31, 2024

(tax cuts and deregulation) and anti-growth (tariffs and curtailed immigration/deportations).

In short, the next Trump Administration will materially fatten the economic tail risks and raise policy uncertainty more generally[2] (**chart 1**). While Trump's policies could soften once in office, they will encourage a much higher U.S. Treasury term premium and inflation expectations, which will impact U.S. and regional bond strategy.

Chart 1 More Trump Uncertainty Begets More Bond Volatility



* Source: Economic Policy Uncertainty
** Source: BofA

Economic Growth & Inflation Risk Are Bond Bearish

Trump is inheriting a very strong economy, which has expanded well above its long-term potential rate over the past two years, and has solid support underneath household spending (including healthy balance sheets, durable employment and strong wage growth). Higher-frequency data is also pointing to ongoing strength, rather than weakness, in the economy.

This resilience is encouraging but pro-growth policies, including tax cuts and deregulation, could further strengthen economic activity and push inflation higher (bearish for U.S. Treasurys), as well as come at the expense of much wider budget deficits (also bearish).

Alternatively, the strong economy provides Trump with ample flexibility to front-load tariffs and/or curb immigration, which are both stagflationary policies, and dramatically heighten economic and bond market uncertainty. While the economic growth drag may be supportive for U.S. Treasurys, higher inflation, greater budget deficits, and heightened economic uncertainty are likely to push up long-dated bond yields.

Trump is inheriting a very strong economy which provides ample policy flexibility

During his first term, President Trump led with pro-growth policies (Tax Cuts and Jobs Act) which provided an economic boost in 2017 (**chart 2**). This petered out in 2018 when the trade war began, leading to a marked deterioration in global exports, the ISM manufacturing index and eventually the U.S. and global stock market, until the President pulled back in fear of triggering a U.S. recession and losing the election[2]. Bonds rallied from mid-2018 because the economy was deteriorating and the Fed was forced to reverse course and signal rate cuts.

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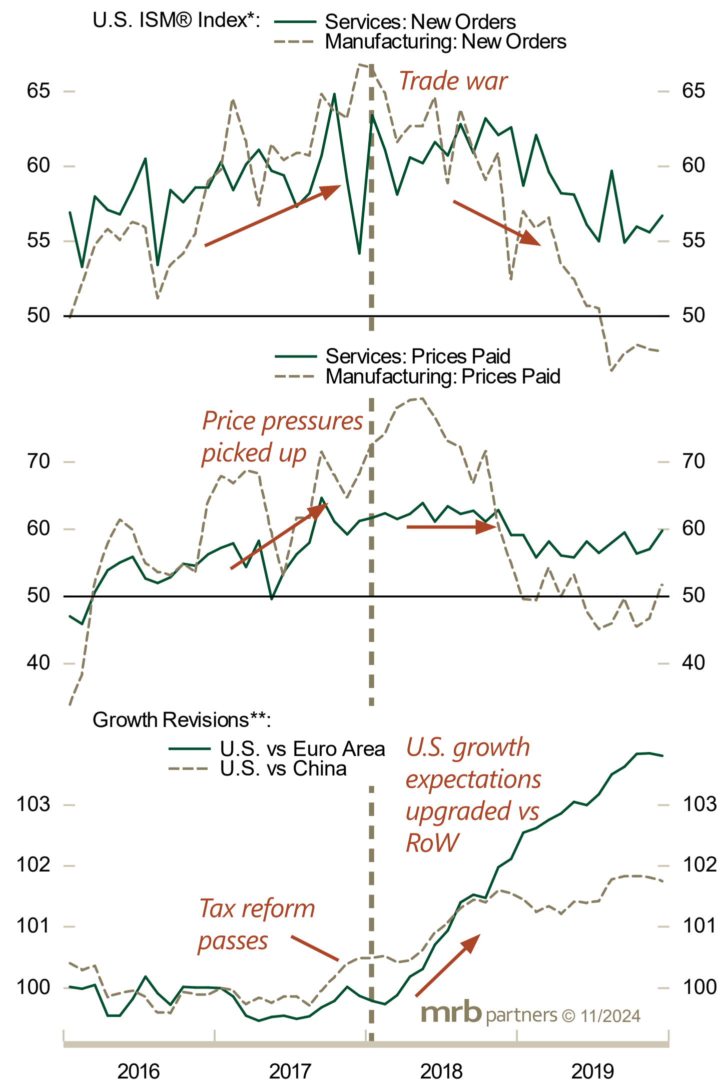
[2] **MRB *Weekly Macro Strategy*** "***Beware The Fat Tails***", November 8, 2024

However, CPI inflation is more elevated and entrenched this time around. Proposed tariffs will more directly impact consumer prices. Also, the next trade war is likely to be comingled with fiscal stimulus, rather than separated (as occurred in the late-2010s). This nets out to decent growth, even greater inflation, larger deficits, and heightened uncertainty (bearish for U.S. Treasurys), albeit the ultimate endpoint could very well be a recession via higher borrowing costs and much reduced trade.

It is worth stressing the material difference in the inflation dynamics between the late-2010s and now, which is grossly underappreciated by bond investors (**chart 3**). The secular disinflationary drags that created a prolonged low inflation era of near-2% core PCE inflation had only faded just prior to the first Trump Administration[3]. Note that our research suggests that these ***secular*** drags may have lowered inflation by a percentage point, which means (in the absence of these drags) the underlying trend in inflation is now likely over 3%. Also, ***cyclical*** forces will keep CPI inflation hotter now, particularly service sector inflation, with the economy expanding above trend and characterized by excess demand, with insufficient spare capacity manifested in a historically tight labor market and relatively high wage growth. This is before new inflationary policies are added.

Chart 2 **Activity Front-Loaded Prior To Tariffs**



* Source: Institute for Supply Management
** Rebased to January 2017 = 100; source: JP Morgan
Note: Vertical line denotes implementation of tariffs

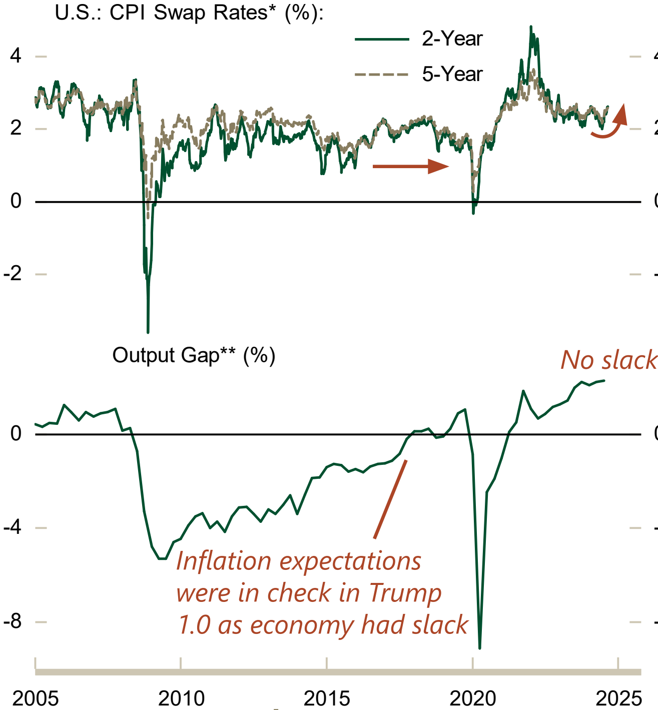
From a shorter-term perspective, U.S. Treasurys are oversold, and some consolidation is probable. However, the incoming data is likely to keep support underneath bond ***yields***. As we have noted previously, U.S. economic data historically surprises to the upside in the final quarter of the year[4]. So far, the upside surprises have been much stronger than in the past (**chart 4**), and we expect this to continue in response to a post-Hurricane bounce in employment data and activity (**chart 5**). Also, the year-over-year consumer

Inflation is sticky and most of Trump's policies will add to price pressures

[3] 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.

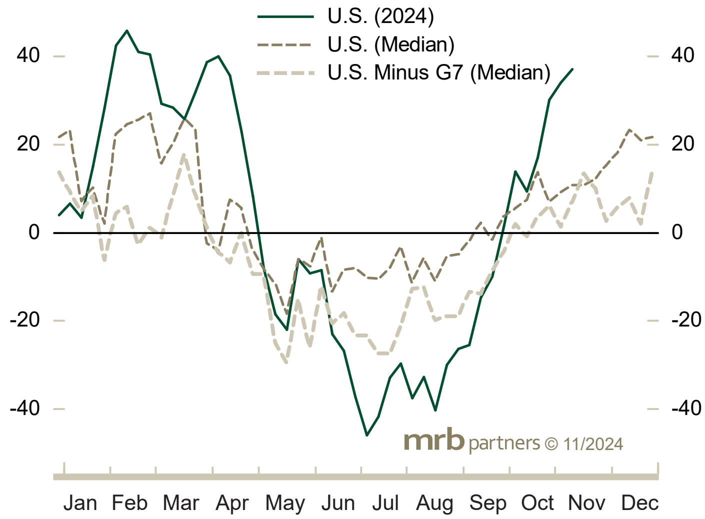
[4] **MRB** "***U.S. Treasurys: Reality Bites Again***", October 9, 2024

Chart 3 Market Is Too Sanguine On Inflation Risks



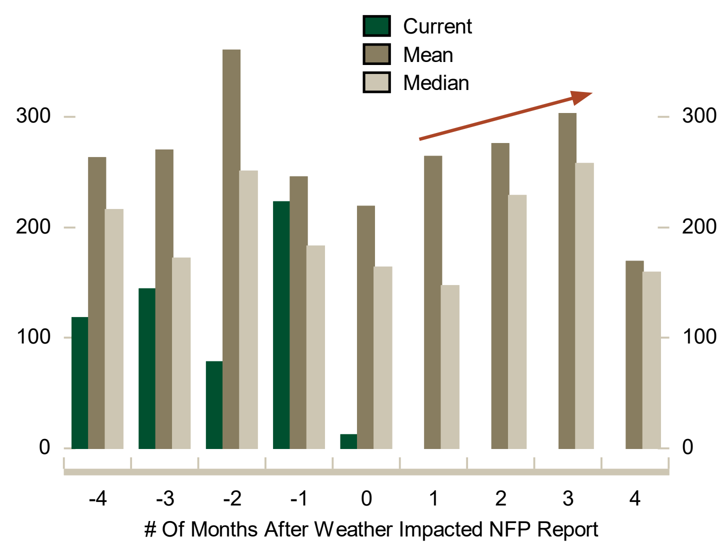
* Source: Bloomberg mrb partners © 11/2024
** Current GDP relative to potential GDP; source: Congressional Budget Office

Chart 4 U.S. Economy: Keeping With Seasonal Outperformance



* Source: Citi
Note: Median over the last 20 years

Chart 5 Jobs Tend To Bounce Back After Natural Disasters



* Includes Katrina, Sandy, Irma, Michael, Ida. Excluded Ike since part of 2008 job declines/recession; source: U.S. Bureau of Labor Statistics mrb partners © 11/2024

price inflation data should firm, due to base effects from the dip in 2023 Q4.

The Fed Is Making A Policy Mistake

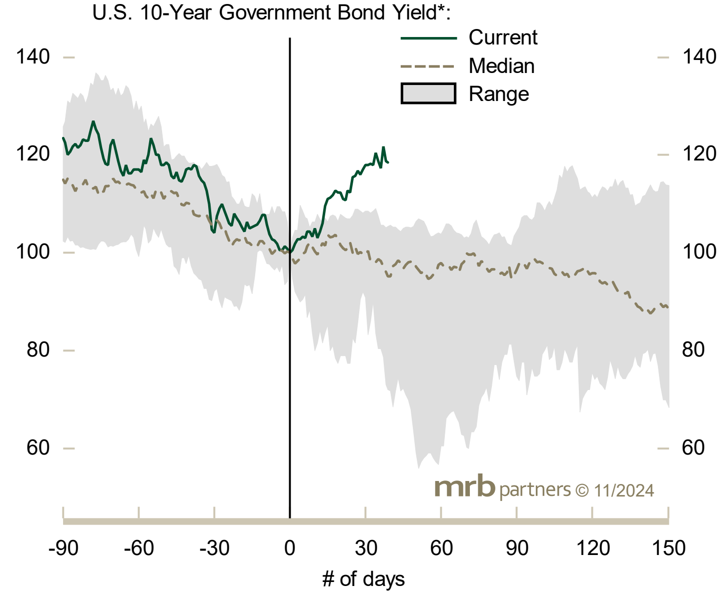
The economic trend has major ramifications for Fed policy. Prior to the election, MRB's research has repeatedly pointed to a much higher nominal neutral fed funds rate of 4.5% or higher[5]. There was no credible recession threat prior to the Fed's pivot in October 2023, and we consider rate cuts a dovish mistake that has reinforced a "no landing" outcome (i.e. continued above-potential economic growth), and created intermediate-term upside risks for inflation. Our view has been that stronger growth and elevated inflation would prevent the Fed from validating expectations for

[5] MRB "*The Impact of a Higher Neutral Fed Funds Rate*", July 17, 2024

deep rate cuts in 2025[6]. Considering the election results, additional fiscal stimulus and inflationary policies should increase the risk of an extended pause in the Fed's easing cycle. We believe that market will shift further to this view over the next few months.

The major caveat for the Fed pausing beyond the near term, is that Trump's business and political career has been based on excessive leverage, which makes him extremely favorable to lower interest rates. Indeed, President Trump was extremely aggressive with Fed Chair Powell during his first Administration, publicly threatening to replace him if he did not cut interest rates (the Fed ultimately cut, albeit it had an economic case to do so in response to damage created by the Trade War).

Chart 6 10-Year Treasury Yields Buck The Typical Fed Easing Cycle Trend



* Rebased to first Fed rate cut since 1995=100; source: Bloomberg

Trump has already floated ideas to replace Powell early with someone even more dovish (although the President does not have that authority). In turn, there is a risk that the Fed gets pressured into an even larger dovish mistake by continuing to cut. However, this would cause a bond market riot (and yields have already deviated from the typical outcome from Fed policy, **chart 6**), especially if investors viewed Fed bending as boosting economic growth and increasing inflation risks, along with heightened uncertainty about the Fed's independence[7].

The U.S. Treasury Term Premium Will Increase

The Fed dramatically underestimated its neutral policy rate and is now making a dovish mistake

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 to near 2%, which will also put upward pressure on their assessment of the level of the fed funds rate over the long haul (**chart 7**). In addition, massive and persistent federal budget deficits, along with the inflationary consequences of increased isolationism, and the heightened uncertainty of these policies, will add further upward pressure on the term premium.

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

[7] MRB*:* "*U.S. Post-Election Discussion: Q & A With MRB*", November 6, 2024

Wider U.S. Vs DM Bond Spreads

Trump's policies could lead to a further widening of spreads of U.S. Treasurys versus other develop bond markets, particularly Germany. The U.S. already has a material growth advantage (albeit already largely appreciated by investors) and will more aggressively use fiscal stimulus than other nations, which could provide a further boost to relative growth and inflation, while leading to much wider federal budget deficits (all are comparatively bearish for U.S. Treasurys). At the same time, investors are likely to perceive tariffs as relatively detrimental for Chinese and the euro area consumers.

Chart 7 The Term & Inflation Premia Are Underpriced

* D'Amico, Kim & Wei (DKW) No-Arbitrage Term Structure Model; smoothed; source: Federal Reserve
** Advanced 18 months
*** Difference between core CPI and GDP growth on 2-year basis; advanced 18 months; sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics

A major caveat is that U.S. tax cuts and deregulation benefit corporate profits, but with a considerably diluted impact on GDP growth, since these items are not currently curbing business hiring and expansion plans. Also, the recent move by the German Chancellor Scholz to dissolve the current government and call for a snap election could ultimately lead to greater fiscal stimulus, helping to lift the sick member of the euro area[8]. Moreover, steep U.S. tariffs on Chinese imports would significantly crimp U.S. household discretionary spending and could ultimately, and ironically, act as a drag on the U.S. economy. Nonetheless, the initial reaction of investors toward Trump's policies will likely be to bet on stronger relative growth and higher inflation in the U.S.

U.S. Treasury yields will continue to rise relative to other DM markets

Investment Strategy

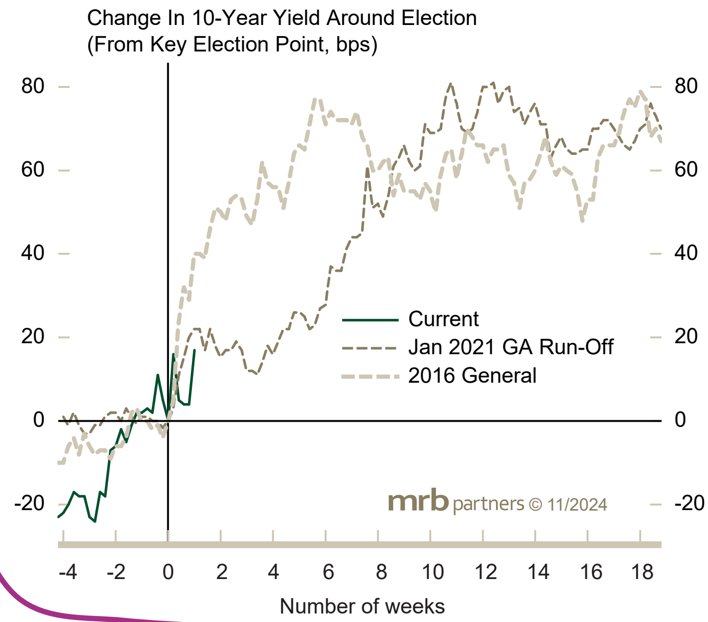
- **Short U.S. Treasurys:** U.S. Treasury yields have risen sharply since the Fed began its easing cycle, consistent with MRB's view that the first rate cut would mark a "sell on the news" event for Treasurys[6]. We also warned that the policies and risk premium associated with the U.S. election would provide a further lift to Treasury yields (**chart 8**). Indeed, our short position on the benchmark 10-year U.S. Treasury has generated 5%, and further gains loom as yields will eventually retest their 5% cyclical high. We remain underweight U.S. Treasurys (currency hedged) within a global fixed-

[8] **MRB** "*Euro Area Member Divergences Provide Opportunities*", October 23, 2024
MRB "*Euro Area Economy: Under Pressure, But More Resilient Than Perceived*", November 7, 2024

income portfolio and are positioned for a bear steepening of the yield curve.

❍ **Bet On A Fed Pause:** As much as Trump has lobbied for lower rates, his policies are at the very least stagflationary. Our view is that the Fed was already making a dovish mistake by cutting rates, and the central bank's recent statement removed the reference to having "confidence" in achieving its inflation target. The Fed will need to be attentive to fiscal risks and may need time to evaluate policy impacts. The recent rise in U.S. Treasury yields alongside Fed easing is a warning that the central bank could lose control over the long end of the curve if it ignores upside economic growth and inflation risks. For now, we expect the investors to continue to unwind their expectations for rate cuts in 2025 and eventually move towards pricing in a prolonged pause next year. We recommend shorting the June SOFR contract (M5) to express this view.

Chart 8 **Will Yields Follow Path Of Trump 1.0?**



Powell already spoke about this and explained why in the Nov press conf

❍ **Buy U.S. Inflation Protection:** We believe inflation premia is underpriced in the bond market. Investors are misplaced in expecting consumer price inflation to (eventually) return to the low inflation era prior to the pandemic. The 2-year CPI swap rate has already moved somewhat higher since the election, but further upside looms. We believe the market is also structurally underpricing inflation risks further out the curve. In turn, we remain overweight inflation protected securities. We also recommend betting on a higher U.S. 5-year CPI swap rate to capture ***cyclical*** inflation risks, as well as the 5-year, 5 year forward CPI swap rate to bet on investors slowly revising up their ***structural*** inflation views.

Stay short or underweight U.S. Treasurys and bet on higher inflation expectations and a bear steepening of the yield curve

❍ **Expect Elevated And Episodic Bond Volatility:** We expect bond volatility to remain more elevated than in the 2010s, given the new economic and political environment that will require bond investors to adjust their expectations to an era of more elevated inflation, a higher neutral Fed funds rate, and much larger government debt. Until this capitulation process has been completed, bond volatility is likely to remain elevated. Nonetheless, there will be periodic tactical opportunities to trade the extremes in bond volatility. Indeed, we currently have a ***tactical*** short U.S. position in the MOVE index within the **MRB *TradeBook*** which has generated 17% since the election, and we will take this opportunity to tighten the stop to protect 12% of the current gains.

- **Short U.S. Treasurys Vs German Bonds:** Trump 2.0 is likely to further exacerbate the divide in policy rates between the U.S. and other developed markets. We warned after the Fed cut 50 bps in September that it would encourage other central banks to frontload easing. Thus far, this has panned out, benefiting our underweight allocation to U.S. Treasurys (currency hedged) relative to all other developed bond markets (excluding Japan). Likewise, we have a long position in 5-year German bonds versus Treasurys (with a total return gain of 2.6%) and we will tighten stops to a spread of 190 bps. Indeed, our proprietary model that adjusts for growth and monetary policy expectations still points to significant outperformance of German bonds relative to Treasurys (**chart 9**).

- **Short 10-Year JGBs:** With investor expectations shifting in favor of higher U.S. growth and less Fed rate cuts, the Bank of Japan (BoJ) will need to become more hawkish and normalize policy faster to prevent a rebuilding of yen carry trades and excessive yen weakness. We recently argued for being underweight Japanese government bonds (currency hedged) within a global fixed-income portfolio and estimate that the 10-year JGB yield should rise closer to 1.5%[9] (**chart 10**). While the BoJ will want to manage the updrift in yields to slow unwanted volatility, we believe the central bank can now hike in 25 bp increments, and as soon as its December meeting. This is not currently priced into the bond market.

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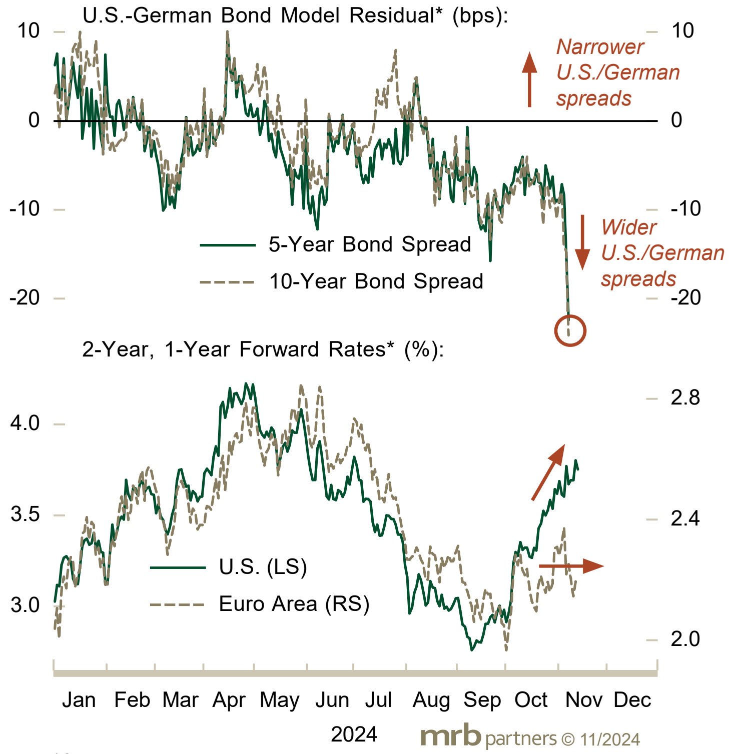
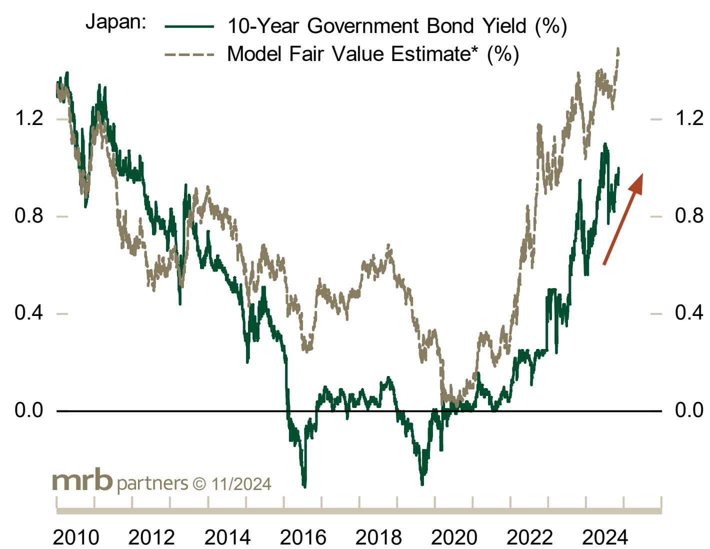
Philip Colmar | Partner, Global Strategy

Chart 9 **More Room For U.S./German Bond Spreads To Widen**



* Source: Bloomberg and MRB calculations

Chart 10 **BoJ Will Become More Hawkish And Push JGB Yields Higher**



* Based on financial market variables; sources: Bloomberg, Japan Cabinet Office

9 MRB "*Bank of Japan: Hawk In Dove's Clothing*", October 31, 2024

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