Divergence Re-Emergence: Opportunities In Regional Bond Markets

- The Fed delivered a 50bp rate cut to begin its easing cycle, and kept the emphasis on its employment mandate. Chair Powell is determined to prevent the labor market from softening further, which has encouraged the bond market to price in deep interest rate cuts though the end of next year. That said, our research suggests that monetary conditions were not as restrictive as feared, and that the U.S. economy will prove resilient and will not justify the amount of easing currently priced in.
- Conversely, current rate expectations are justified in the euro area and Canada, due to their relatively weaker economic conditions. In fact, there is a case for both bond markets to front-load easing. This sets up for an opportunity to play a divergence within regional fixed income markets.
- Specifically, we believe U.S. Treasurys are set to underperform their euro area and Canadian counterparts. We recently added a spread trade favoring 5-year German Bunds versus U.S. Treasurys to the **MRB *TradeBook***. We believe this can roll up the curve as well in the 10-year segment as expectations for U.S. economic growth and monetary repricing are at extremes. We also expect more front-loaded easing in Canada by Q1 of next year.

Expectations for Fed rate cuts are too aggressive given that the U.S. economy continues to expand at a solid pace. At this point, there are more appealing opportunities to bet on front-loading and/or increased rate cut expectations for the ECB and BoC, which both have a better economic case for providing them. In turn, conditions are setting up for cross-market divergence in fixed income markets.

The Fed's dovish pivot is overdone given the durability of the economy

Fed’s Dovish Pivot Is Fully Priced

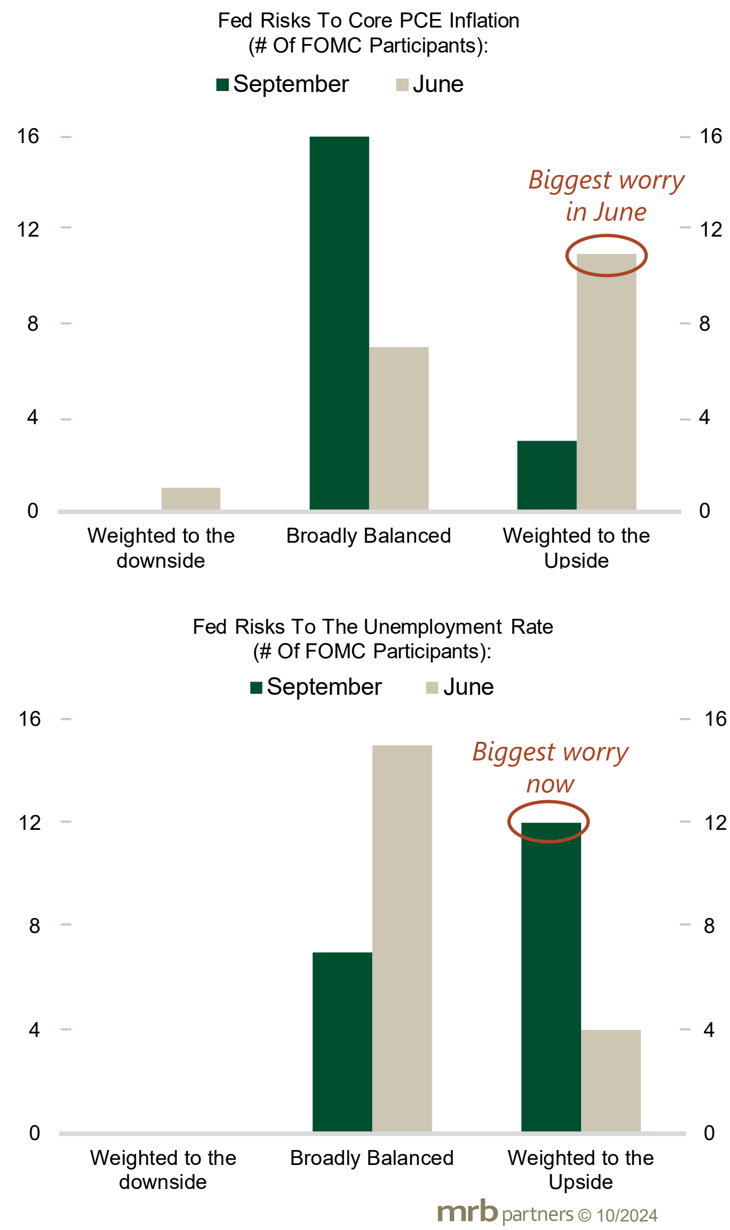
The Fed began its easing cycle with a 50bp cut and a clear emphasis on the employment component of its dual mandate, determined to stem further slowing. The FOMC formalized this with the majority of participants now seeing balanced risks around inflation, but upside risks to the unemployment rate (**chart 1**). At the same time, Fed Chair Powell indicated at the July FOMC press conference and his Jackson Hole speech that there is no tolerance for any additional softness in labor markets. This has provided a clear message to investors that the central bank will curtail the risk of the job market weakening more than desired.

Against this backdrop, the Fed is effectively committing to deliver at least 100bps of total easing by the end of this year. Bond investors view this as a minimum because the Fed has already shown a willingness to deliver a 50bp cut and could do so again, especially if the upcoming nonfarm payroll report shows softness and a tick up in the unemployment rate.

That said, MRB's research has highlighted that there is limited evidence that monetary conditions have been acting as a drag for the U.S. economy. The rise in the unemployment rate is largely driven by a sharp increase in immigration which is boosting the labor force and not due to sizable job cuts or weakness in final demand[1]. This is consistent with accelerating corporate profits and historically wide margins.

In short, Fed rate cuts are economically unnecessary, but are coming anyways. In turn, this will sow the seeds of a policy mistake by being too accommodative, given our higher estimate of the nominal neutral policy rate of around 4.5%[2]) and already resilient above-potential U.S. economic growth. The latter will also encourage consumer price inflation to hold well above the Fed's 2% target[3]. Our expectation is that this policy error will be a key theme that unfolds in 2025.

Chart 1 Concerns Of FOMC Members Have Shifted From Inflation To Unemployment



Investment Strategy: The Fed's dovish pivot is now fully priced, i.e. the policy rate projected to fall to 2.9% which forecasts a full unwind of "restrictive" policy. Deep rate cuts are likely to remain in the curve in the near run as the Fed delivers further easing, but expectations for a continuation of this

Too many Fed rate cuts expected for 2025

[1] **MRB:** "*U.S. Labor Market: Less Bearish Than It Appears*", August 9, 2024 and **MRB:** "*U.S.: Don't Fret About Rising Unemployment*", July 18, 2024

[2] **MRB:** "*U.S. Fed: The Makings Of Another Dovish Error*", September 19, 2024 and **MRB:** "*The Impact Of A Higher Neutral Fed Funds Rate*", July 17, 2024

[3] **MRB**: "*Weekly Macro Strategy – A Particularly Unusual Cycle*", September 13, 2024, **MRB**: "*U.S. Inflation: What Will Be The Underlying Run Rate?*", June 5, 2024 and **MRB**: "*An Inflation Problem Is Brewing*", June 3, 2021

trend throughout 2025 are misplaced given that the U.S. economic expansion is likely to continue grow at a healthy pace and inflation will prove sticky above the central bank's target. We are below benchmark duration and recently added a short position on the U.S. 10-year Treasury[4]. Friday's nonfarm payrolls report is a risk for this position, given the heightened importance the Fed has placed on this data release, albeit a firmer print could also solidify the bottom in yields.

Short U.S. Treasurys

Room To Price A Greater Dovish Pivot At The ECB And BoC

Same here bro

We do not disagree with the total amount of ECB rate cuts priced into the front-end of the curve (roughly 150bps of additional easing by the end of 2025). However, there is

Table 1 **Comments From ECB Members Signal A Bias To Cut More Aggressively**

Date	Official	Comment
Sep-20-24	**Rehn**	The ECB has a clear easing direction for its monetary policy, ***with pace and scope dependent on fresh economic data and analysis***
Sep-20-24	**de Guindos**	It's true to say that in December, we will have more information than in October. ***But we have left the door totally open.*** We want to maintain our optionality, and that will depend on the evolution of the data
Sep-19-24	**Panetta**	The reduction of ECB interest rates can be accelerated in the coming months
Sep-19-24	**Knot**	I'm more or less fine with market expectations of further cuts....following the current path we're on is a path that gives us two-sided optionality
Sep-19-24	**Centeno**	Given the position in which we are today, in the monetary policy cycle, ***we have really to minimize the risk of undershooting, because that's the main risk...I don't think five weeks is a short period of time***
Sep-18-24	**Nagel**	Depending on the incoming data, the time intervals between the potential steps may vary...we now need to show that we have enough staying power
Sep-17-24	**Simkus**	The likelihood of an October rate cut is very small
Sep-16-24	**Lane**	A gradual approach to dialing back restrictiveness will be appropriate if the incoming data are in line with the baseline projection. At the same time, ***we should retain optionality about the speed of an adjustment***

[4] **MRB:** "*Absolute Return Strategy – Extending Goldilocks*", September 26, 2024

room for the ECB to up the ante on dovish rhetoric in the near run, especially given the persistent disappointment of the regional economy over the past two years, building slack. We acknowledge that the ECB may be considerably less eager than Fed Chair Powell in committing to a more explicit dovish policy path, but commentary from centralist board members like Tim Lane suggest a desire to increase the pace of rate cuts (**table 1**, previous page). Indeed, this is already starting to be seen in the bond market, with the euro area 1-year, 1-year forward rate peeling away from its U.S. counterpart (**chart 2**).

Chart 2 Early Signs Of Divergence In Forward Markets?

* Source: Bloomberg

For much of this year, the ECB has suggested the theme of gradualism when it comes to policy easing and we acknowledge that the ECB could remain stubborn in its rhetoric. However, ongoing sluggishness in the economy and slightly faster easing in inflation pressures (including the latest flash readings of regional inflation numbers) should prompt the ECB to cut at its upcoming meeting.

The slump in global manufacturing and lack of a vibrant upswing in trade has materially undermined the German economy. At the same time, euro area consumers in aggregate remain in a funk, which has left the economic expansion uninspiring. On the more encouraging side, the lack of imbalances, very strong household balance sheets, and ample excess savings have curtailed contractionary forces, leaving the economy more consistent with an eventual firming rather than faltering. Also, there is no evidence that monetary conditions are contributing to the economic weakness within the region.

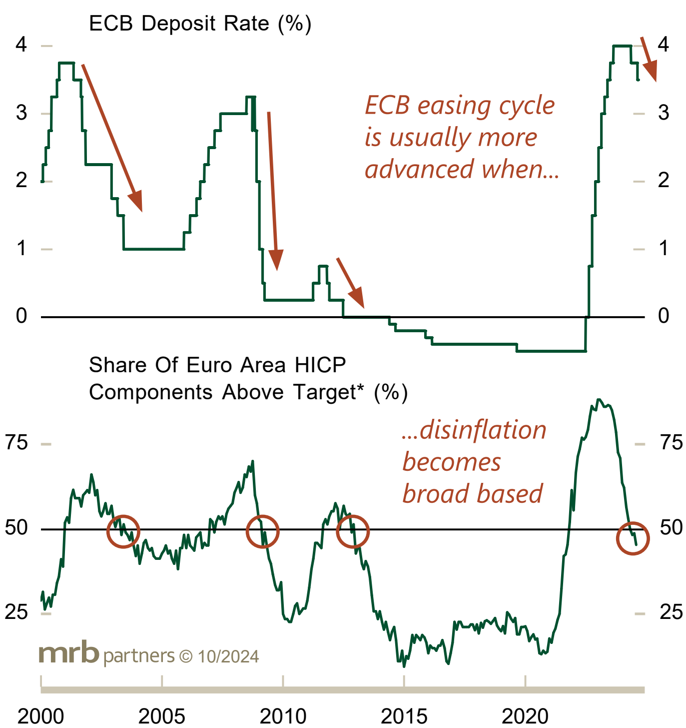
The ECB and BoC have a better economic case to validate expected rate cuts…

…the bond market may even bring these forward and/or price more

Nonetheless, two years of below-potential growth has created some slack within the economy. A diffusion index of HICP variables shows that the breadth of inflation is now moving in the ECB's favor, with more than half now below 2% (**chart 3**). When this has happened in the past, the ECB has typically been much further ahead in its easing cycle. The latest euro area PMIs also point to softer employment growth, which could encourage the ECB to move faster in its easing cycle (**chart 4**).

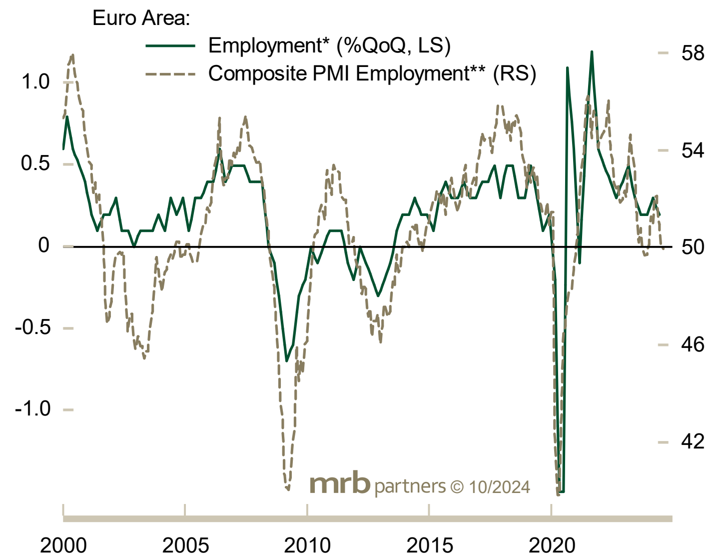
It is worth noting that real 10-year bond yields have also risen in the euro area by as much as in the U.S. since the global tightening cycle began in 2022 (**chart 5**). While

Chart 3 **The ECB Has Room To Cut**



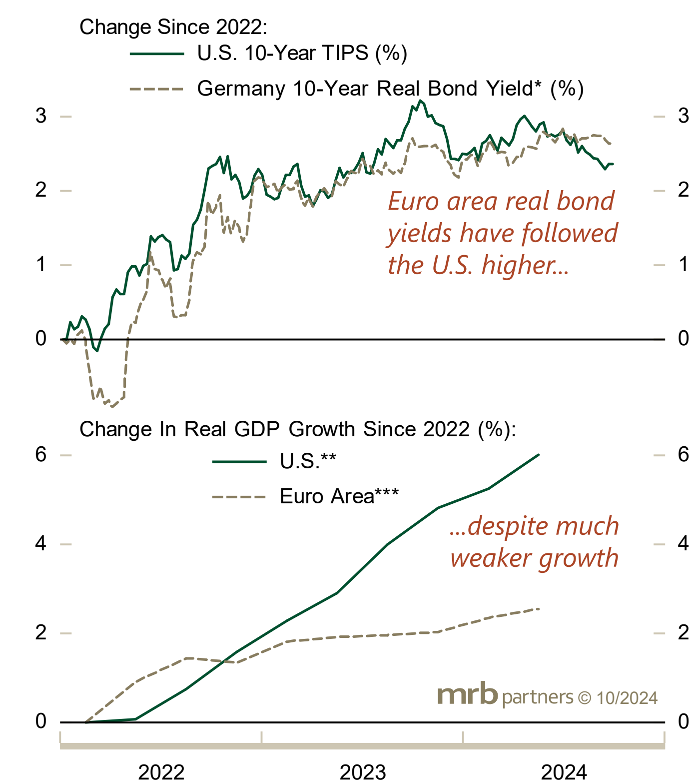
* Source: ECB & MRB calculations
Note: Diffusion calculated on over 400 line items

Chart 4 **Business Confidence Signals Soft Euro Area Employment Ahead**



* Truncated below -1.5%; source: Eurostat
** Truncated below 40; source: Markit Economics

Chart 5 **Euro Area Bonds Have Tracked U.S. Treasurys (So Far)**



* Source: Macrobond Financial AB
** Source: U.S. Bureau of Economic Analysis
*** Source: Eurostat

there is a spillover effect from U.S. real bond yields, we find it unjustified given that the euro area economy has materially underperformed the U.S. This suggests that German real Bund yields may be due to adjust even lower relative to U.S. Treasurys.

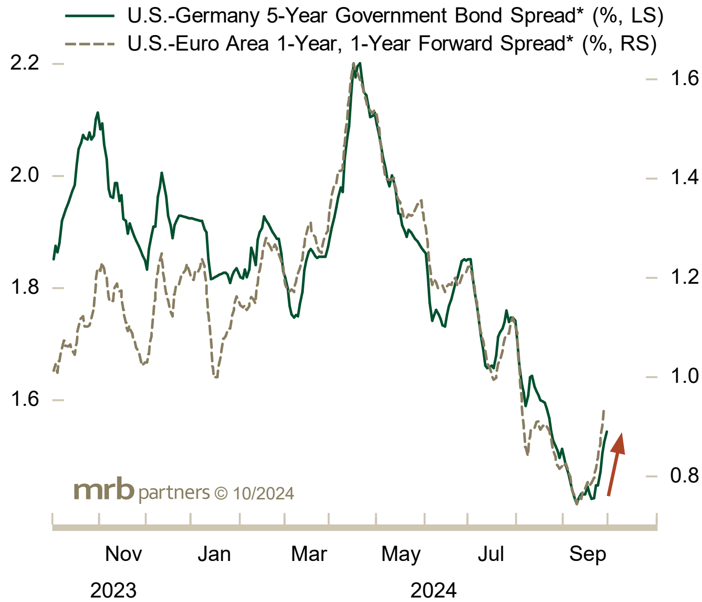
Investment Strategy: We believe the cumulative amount of expected ECB rate cuts in the curve is reasonable, but there is a non-trivial risk that the bond market brings forward rate cuts and/or prices in a greater easing cycle given the growth dichotomy with the U.S. Thus, we added a long position in 5-year German Bunds versus U.S. Treasurys in last week **MRB *Absolute Return Strategy***[5]. This spread trade already has support from diverging relative growth expectations (**chart 6**) and should benefit as the ECB continues its dovish pivot relative to the Fed (**chart 7**).

[5] **MRB:** "*Absolute Return Strategy – Extending Goldilocks*", September 26, 2024

Chart 6 **Relative Growth Expectations Should Also Cause Spreads To Widen**

* Smoothed
** Forecast revisions; source: JPM

Chart 7 **German Bunds Should Outperform As Relative Policy Expectations Shift**

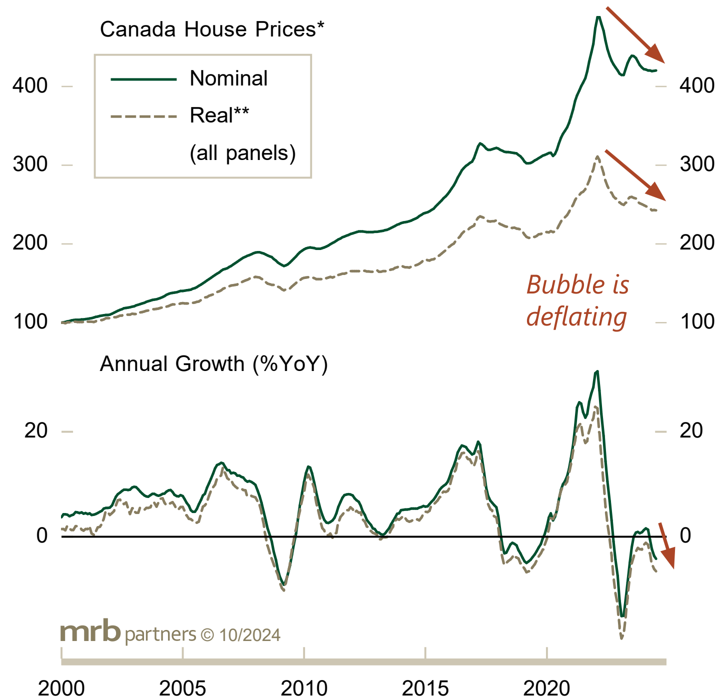


* Smoothed

There is also a case for the BoC to accelerate its pace of rate cuts, causing the bond market to bring forward expected rate cuts. Recent commentary from the BoC has been heavily focused on downside risks for economic growth and building slack within the economy. In a September 24th speech, Governor Macklem noted that more easing needs to be provided to ensure growth – which has fallen below the BoC's forecast made in July – picks up enough to prevent an undershooting of the 2% inflation target.

MRB has consistently warned that the Canadian economy is structurally vulnerable due to a housing bubble (**chart 8**) and excessive household leverage[6] (**chart 9**). Already, there have been a record number of homeowners struggling to make mortgage payments, causing banks to extend the maturity of mortgages or classify them as negative amortization. These nonperforming loans have

Chart 8 **Canadian Home Prices Continue To Weaken**



* Source: Canadian Real Estate Association; Teranet / National Bank
** Deflated by CPI
Note: Panel 1 is rebased

[6] MRB: "*Webinar – Canada's Housing Crisis & Impact For Investors*", January 17, 2023 and
MRB: "*Canada Housing: Sliding Down The Slippery Slope Of Hope*", September 8, 2023

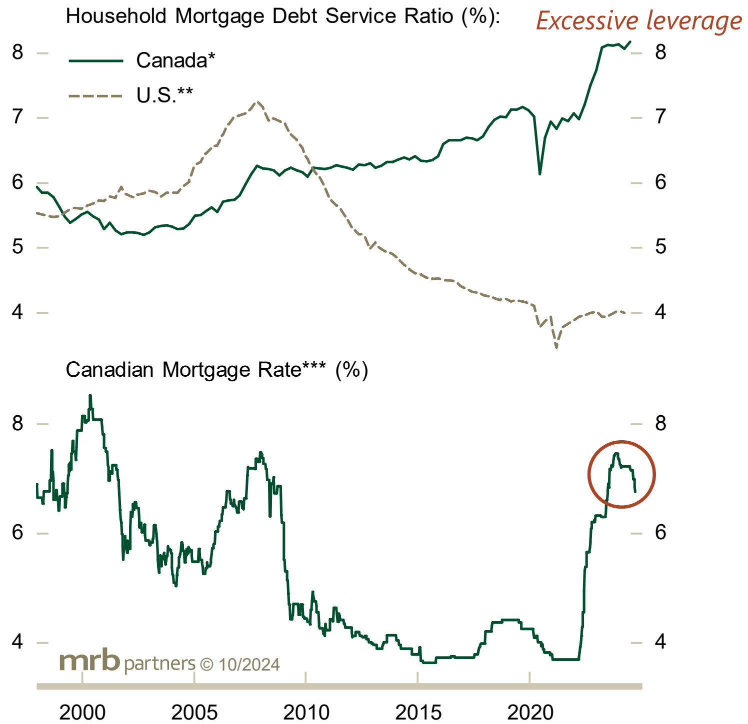
left the Canadian financial system and economy more vulnerable than banks or policymakers are acknowledging. With an ongoing heavy mortgage refi wave this year and next (**chart 10**), there will be growing pressure – and an incentive – for the BoC to frontload rate cuts.

Investment Strategy: There is room for BoC rate cut expectations to be brought forward and/or increased. Indeed, the BoC may aim to hit the mid-point of its nominal neutral range of 2.75% by early next year. This should keep Corra-SOFR spreads biased to widen further and favor a steepening of forward curves beyond terminal rate pricing (i.e. 1-year, 1-year forward versus 5-year, 5-years forward swaps). Likewise, we are overweight Canadian bonds (hedged for currency exposure) within the **MRB *Asset Allocation Strategy***[7].

Mazen Issa
Strategist, Fixed Income

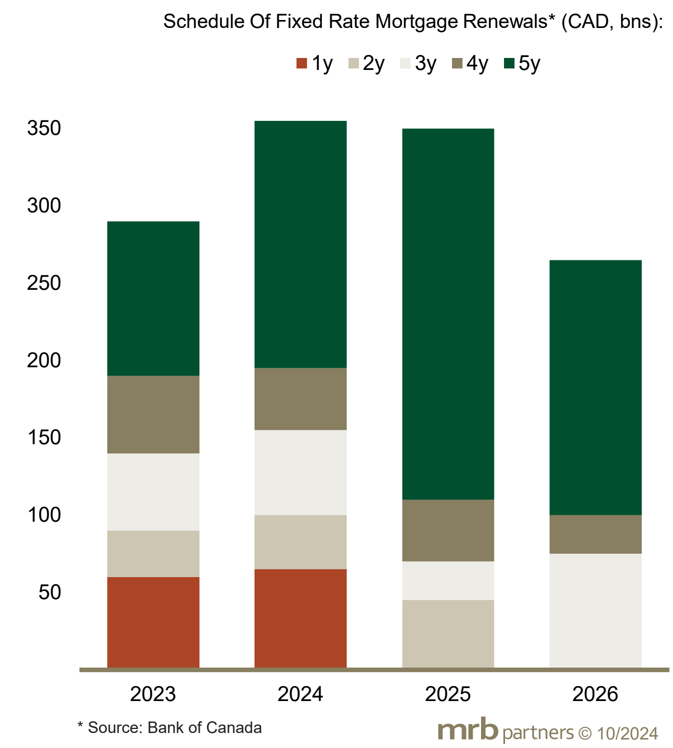
[7] Note that the next **MRB *Asset Allocation Strategy*** report will be published Friday.

Chart 9 **The BoC Has To Be Proactive To Avoid A Deleveraging Cycle**



* Source: Statistics Canada
** Source: U.S. Federal Reserve
*** Average of the conventional 1-, 3-, and 5-year mortgage rate; source: Bank of Canada

Chart 10 **Canadian Mortgage Debt: Ongoing Refinancing Wave Ahead**



* Source: Bank of Canada

mrb partners © 10/2024

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - Macro Research Board is an independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

MRB Research Coverage

- Weekly Macro Strategy
- Global Macro & Investment Themes
- Global Asset Allocation
- Absolute Return Strategy
- U.S. & Developed Market Strategy
- China & Emerging Market Strategy
- Regional Equity Strategy
- U.S. Equity Sectors Strategy
- Global Fixed Income Strategy
- Foreign Exchange Strategy
- Commodity Strategy
- Webcasts & Live Events