ALPINEMACRO
A Unique Mind On The Markets

U.S. BOND STRATEGY

November 7, 2024

Higher Yields But Lower Bond Volatility?

- Post election, investors are facing higher rates but potentially lower implied bond vol.
- Elevated policy uncertainty should calm down over time.
- Declining inflation should also allow the MOVE index to normalize.
- These trends favor Agency MBS, but could be headwinds for ABS and non-Agency CMBS.
- To play a possible MOVE/VIX convergence, go long IG versus HY Corporates.

Implied bond volatility has retreated and the 10-year yield has shifted down in the days following the election spike. Investors are perhaps coming to the conclusion that some of Trump's pre-election policy proposals will be scaled back, even with a GOP sweep. It may also reflect trade unwinding and a "buy the rumor, sell the fact" market reaction.

Our *Geopolitical Strategy* service made the case that, while the second Trump administration will aim to cut taxes, trim regulation and raise tariffs, it will be more cautious than feared:[1]

- First, the incoming administration will aim to maintain market and economic stability. For Trump, market performance has long been a measure of his own governing success, so he is unlikely to enact policies that would significantly disrupt markets and growth.
- Second, the Trump team understands that governments overseeing inflation spikes court political defeat. Rising food prices contributed to the political downfalls of incumbent administrations in the U.K., France, and the U.S.
- Trump's economic team will likely be Wall Street-friendly and more economically orthodox than expected, with a Reagan-like, *laissez-faire* approach – except with an emphasis on higher tariffs and on U.S. reindustrialization. Most of Trump's economic advisors are at least somewhat concerned about the deficit.
- Lastly, Trump is unlikely to interfere with the Fed, or try to limit its independence.

1 Alpine Macro *Geopolitical Strategy* "United States: Trump's Comeback – Brace for Headlines, Expect Policy Surprises" (November 7, 2024).

Bond and equity implied volatility both followed the usual post-presidential election pattern and fell sharply in recent days (**Chart 1**). Nonetheless, the MOVE index is still elevated in absolute terms and versus the VIX (**Chart 2**).

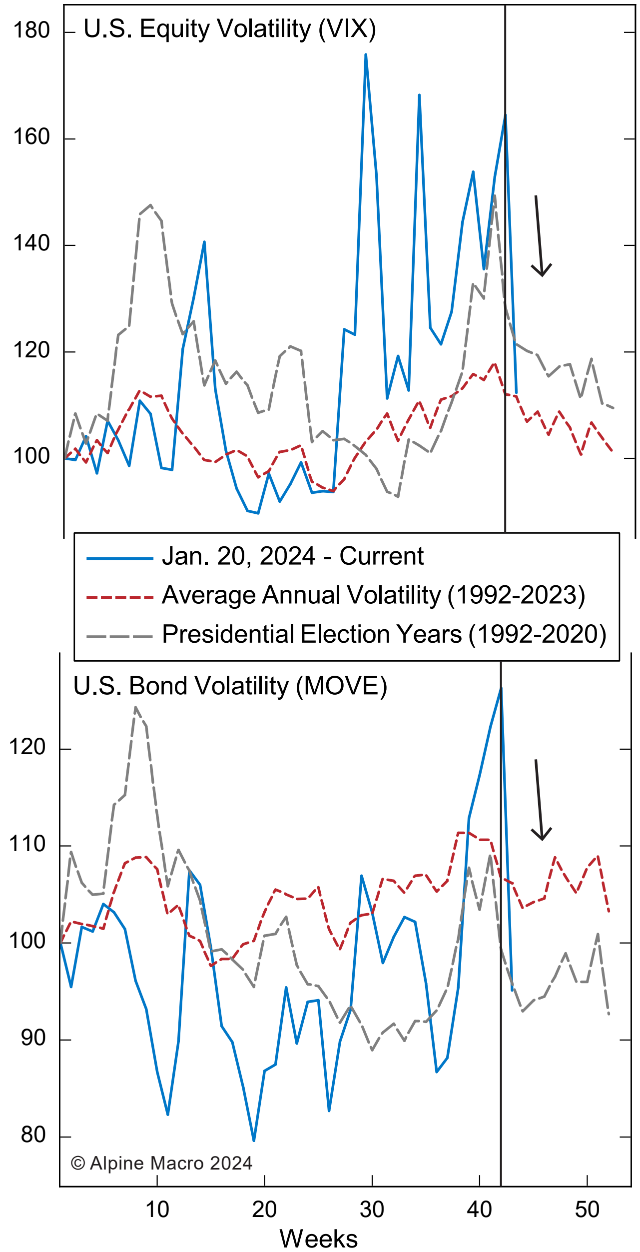
Bond vol is driven mainly by trends in uncertainty regarding the macro and policy outlooks. One way to measure this type of uncertainty is by using the dispersion of forecasts among analysts in the Survey of Professional Forecasters from the Federal Reserve Bank of Philadelphia (FRB).

For a range of macro variables, the FRB survey provides the difference between the 75th and 25th percentiles for quarterly forecasts from time T to T+4. We took an average of these time periods to obtain a summary statistic of dispersion for a handful of variables shown in **Chart 3**.

Unsurprisingly, the MOVE index is highly correlated with T-bill and 10-year Treasury yield forecast dispersion measures. But the key force driving the underlying process is macro uncertainty – the forecast dispersion for real growth and, especially, core inflation.

The wave of inflation following the pandemic undoubtedly created a lot of uncertainty about how quickly it would come down and how much policy tightness would be required (**Chart 4**). This uncertainty fed directly into higher implied rate and bond volatility.

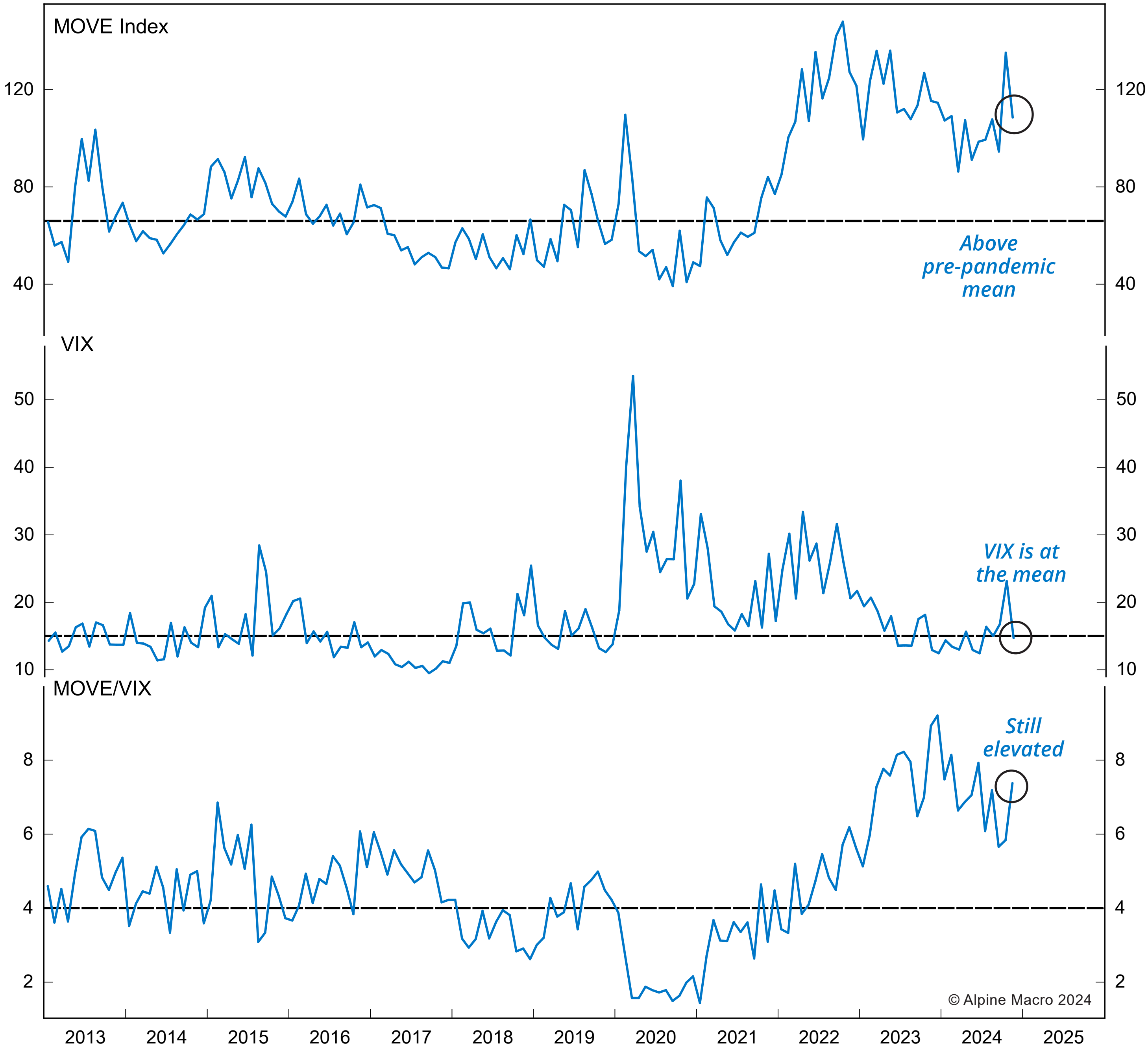
Chart 1 **Volatility Declines Post-Election**



Note: Presidential election years are calculated from Jan 20 of the election year to Jan 20 of the next year, using Presidential inauguration date as year-markers, with values rebased to 100 on Jan 20.

Uncertainty about the inflation outlook is moderating according to the core PCE inflation dispersion index, as inflation shifts closer to 2%. This makes sense. Inflation tends to be more stable in low-inflation environments, making it easier to forecast. The MOVE index is trending down as a result, although with a lag. Disinflation is also driving a downtrend in the MOVE index relative to the VIX.

Chart 2 Implied Bond Volatility Is Still Elevated



Note: Horizontal dotted line denotes long-term average; source: ICE BofAML, CBOE

The Republican sweep in Washington has clearly boosted ***policy*** uncertainty in a wide range of areas. The timing and extent of forthcoming policy changes are very much "up in the air". Our geopolitical team will of course be monitoring the situation closely in the coming days and weeks. We obviously cannot rule out bouts of bond market volatility related to the policy backdrop.

Chart 3 Macro Uncertainty Drives Rate & Bond Vol

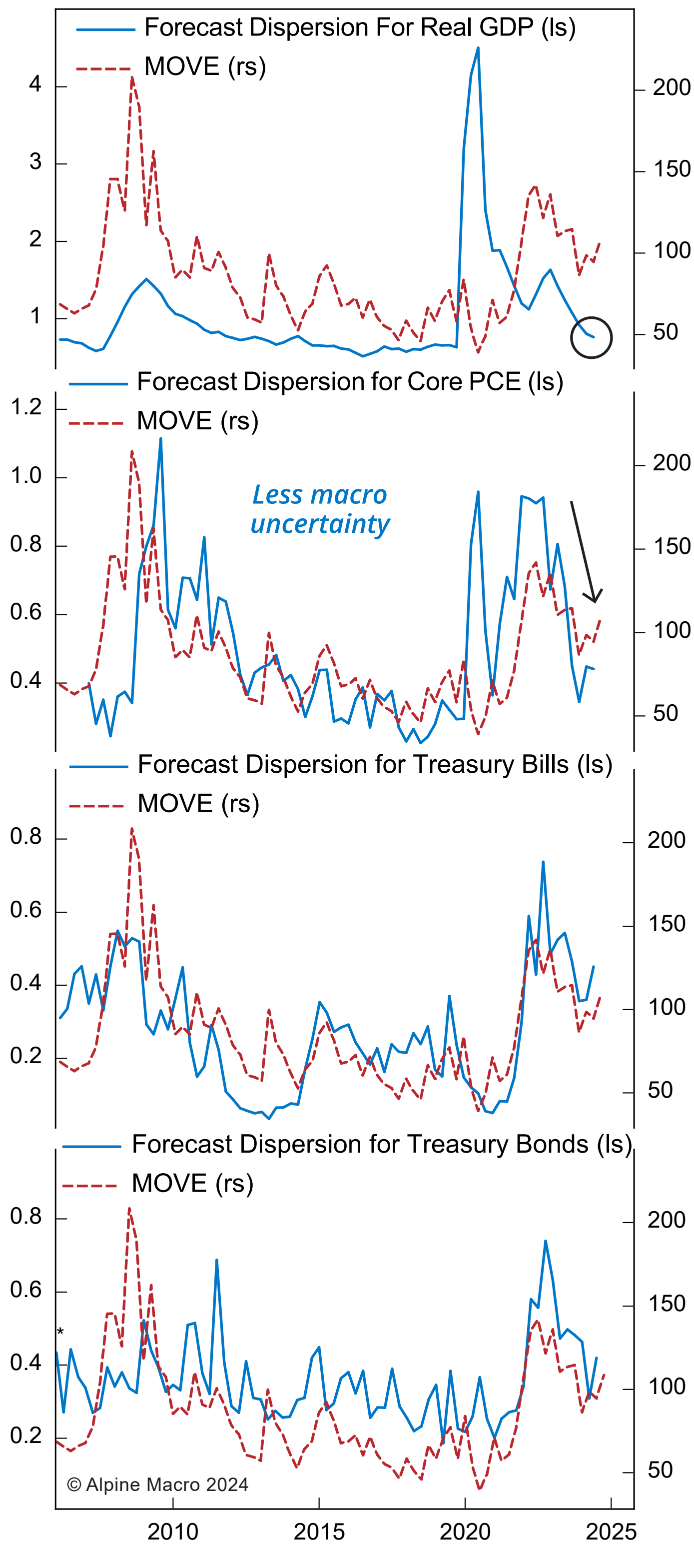


Chart 4 MOVE Has Downside Potential

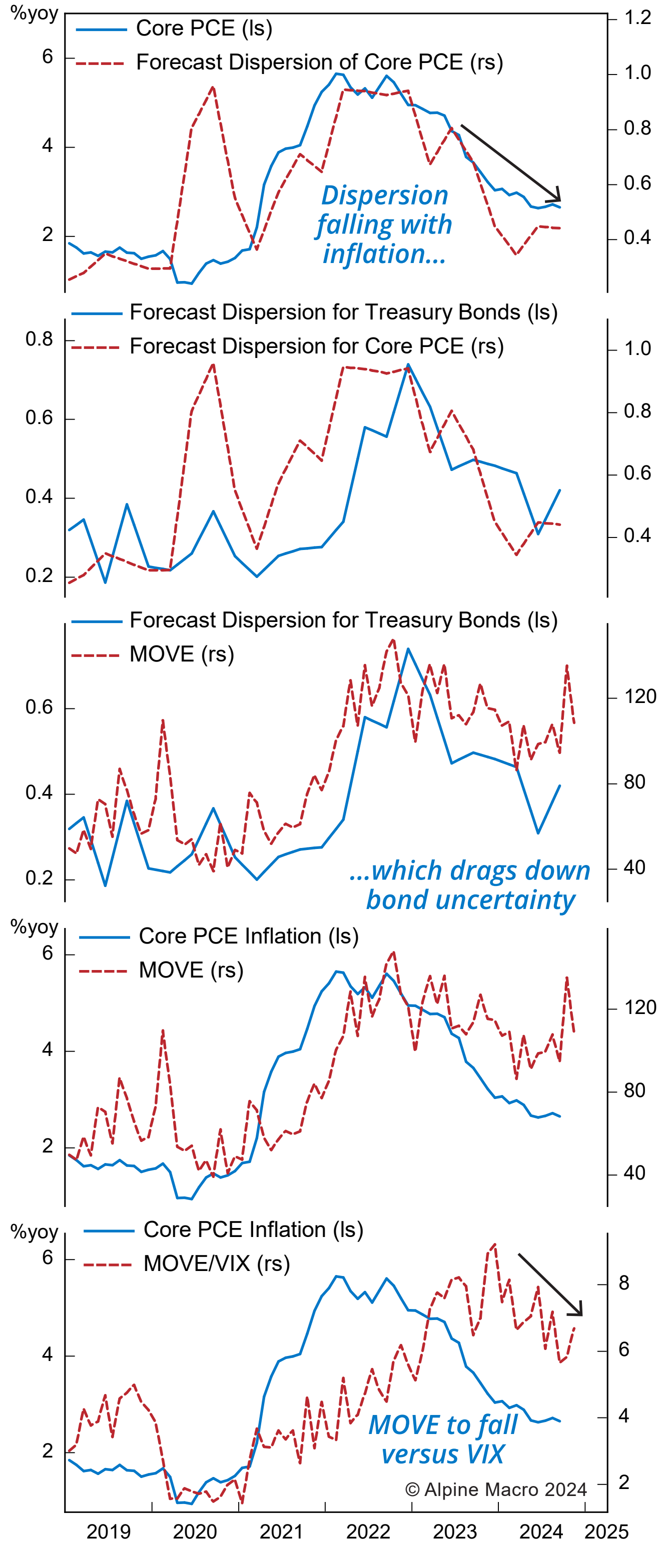
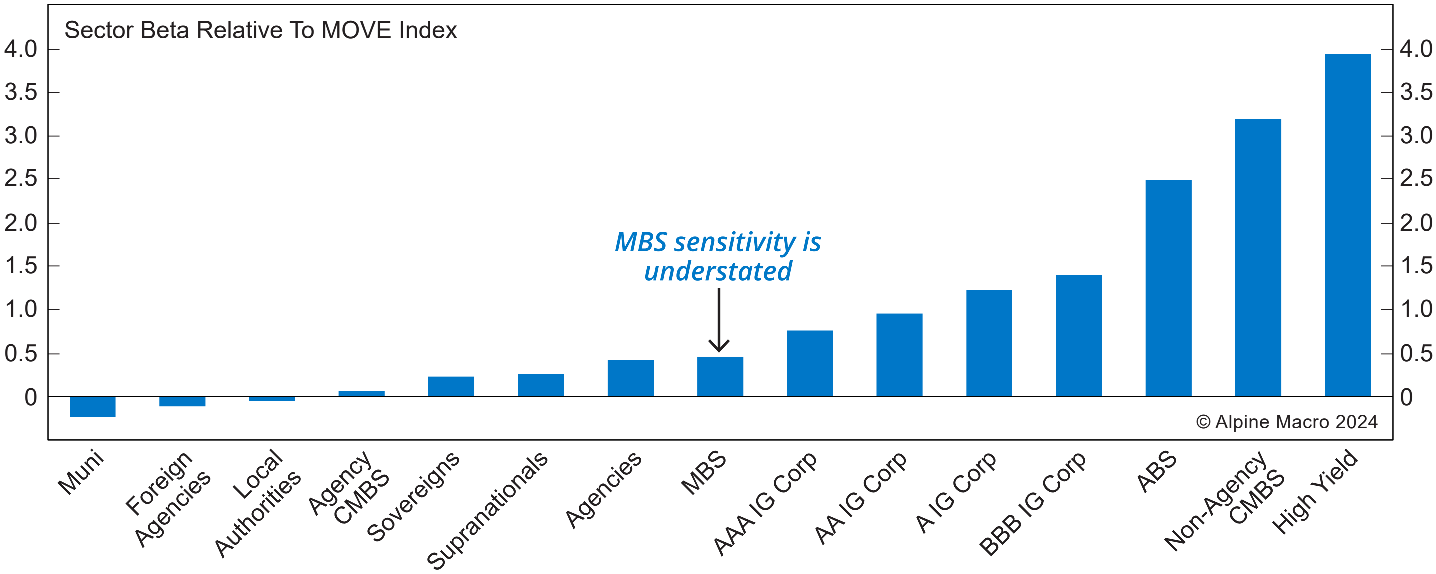


Chart 5 Sector Sensitivity Versus MOVE Index



That said, we think that the inflationary impact of forthcoming border measures and tariff activity will ultimately be modest. We are still confident that underlying U.S. inflation remains in a downtrend. The October CPI report showed that the deceleration in shelter inflation remains intact, if frustratingly slow. Core inflation excluding shelter has already reached 2%. An eventual return of the overall core inflation rate to the 2% target would go a long way in terms of allowing bond volatility to shift back into its pre-pandemic range.

Chart 5 shows that spreads in the Corporate, ABS and non-Agency CMBS sectors are most sensitive to shifts in the MOVE index.

Higher Rates And Lower Vol

In last week's report[2], we discussed the reasons behind Alpine Macro's view that equilibrium interest rates have increased. These reasons included a stronger supply-side backdrop, along with a "crowding out" effect of sustained government budget deficits.

The key implication is that we do not see much scope for a major Treasury rally because the Fed will be limited in how much it can cut rates in this cycle. The Fed may not even be able to ratify current market expectations for about 100 basis points of additional rate cuts over the next year. The new administration is bound to add some fiscal stimulus at a time when the economy is humming along just fine.

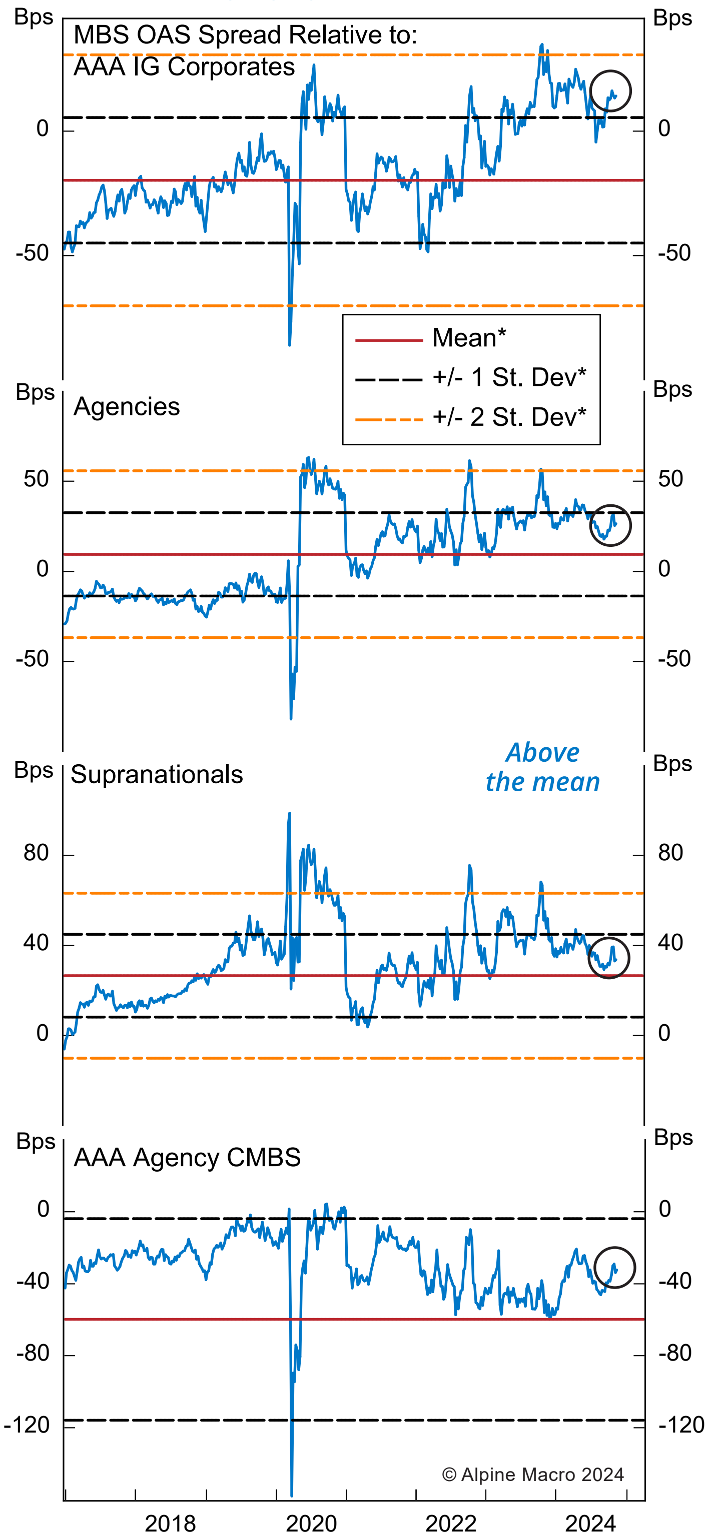
This means that, while bond volatility has some downside potential, borrowers can expect less rate relief than was previously hoped. This has important implications for some fixed-income sectors.

Sector Implications

We will provide a more detailed analysis by sector in our 2025 *U.S. Bond Outlook*, to be published next month. However, below are our initial thoughts:

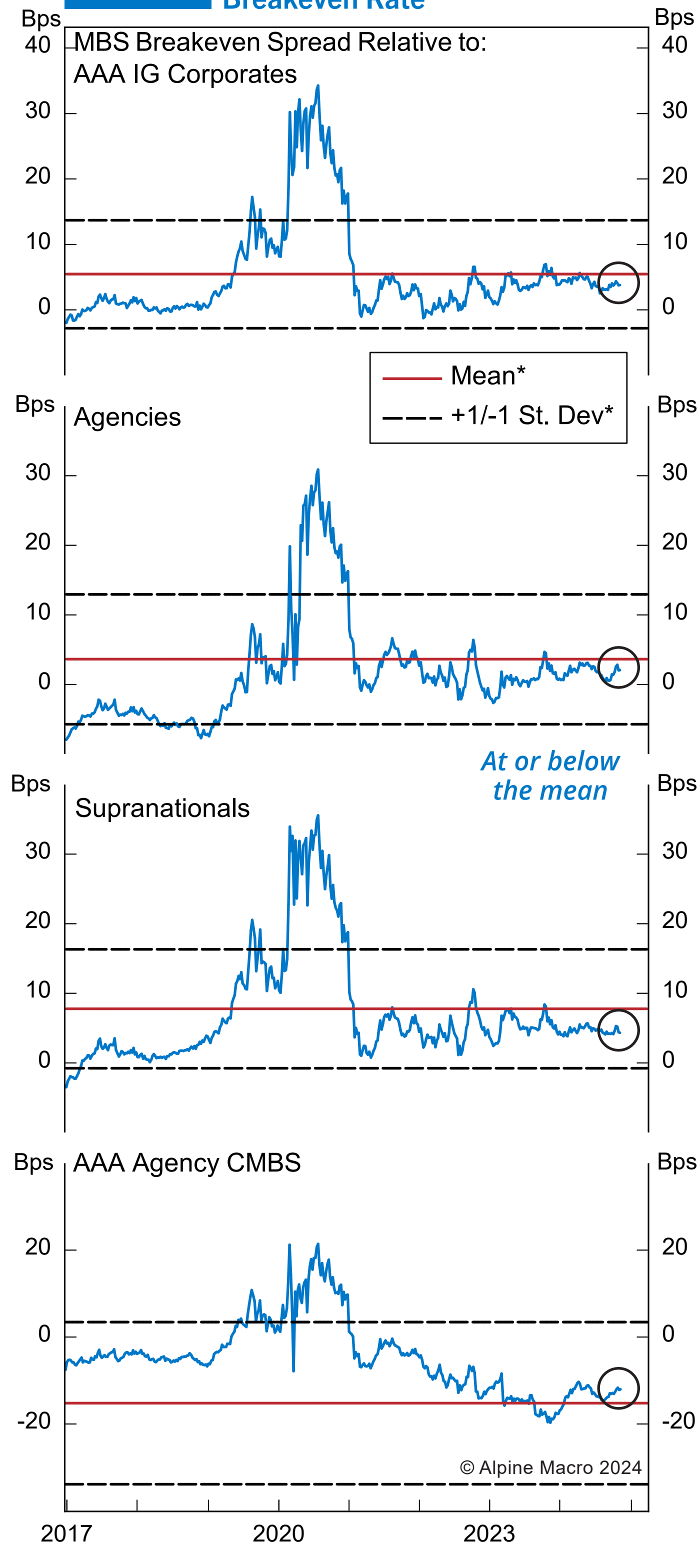
2 Alpine Macro *U.S. Bond Strategy* "Election Outcome: Riot Point Ahead For Treasurys?" (November 7, 2024).

Chart 6 MBS: Cheap Based On OAS...



*Excludes GFC values from calculation
Source: Bloomberg Finance L.P.

Chart 7 ...But Less So Based On Breakeven Rate



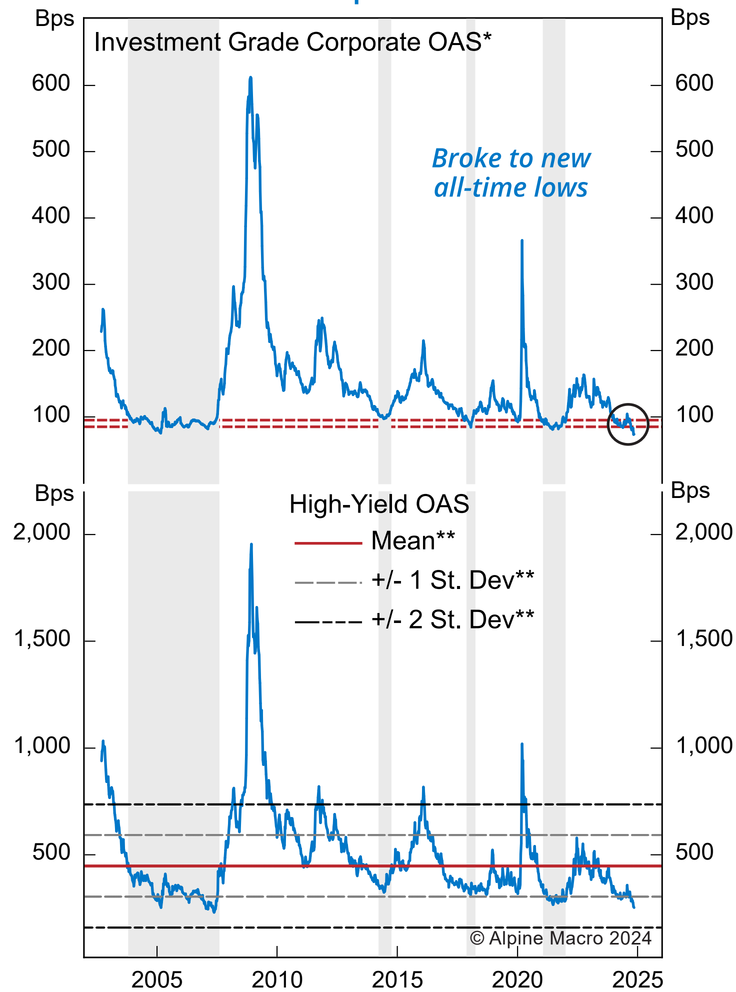
*Excludes GFC values from calculation
Source: Bloomberg Finance L.P.

- **MBS** relative performance should improve on the back of lower bond volatility, limited new supply and increasing demand from the banking sector. MBS is in the middle of the pack in terms of OAS sensitivity to the MOVE index, but changes in OAS do not translate directly into excess returns as it does with other fixed-income sectors. Mortgage pass-through returns would benefit in relative terms from a drop in bond volatility by more than **Chart 5** implies. Moreover, MBS still appears to be cheap versus other high-quality sectors on an OAS basis, although relative value is roughly neutral in terms of spread breakevens (**Charts 6** and **7**).

- **Asset-Backed Securities** should also benefit from lower bond volatility. However, we are becoming more cautious on consumer credit. Delinquencies have been on the rise as lower-income households struggle with high interest payments. Government handouts led to "FICO score inflation" during the pandemic, which appears to have allowed some borrowers to take on debt that they cannot afford. This applies to both credit cards and autos. Asset pools have so far been paying down faster than delinquencies are rising, which is good for ABS investors. However, the tide may be turning, at a time when borrowers cannot expect much in the way of rate relief.

- **Non-Agency CMBS:** Many properties continue to struggle with poor rent and revenue prospects. Lenders have been willing to "extend and pretend" in the hope that lower interest rates would arrive and allow refinancing at a rate that is more commensurate with the rental income of the underlying property. However, rate relief looks less likely now and lenders cannot wait forever. We are re-evaluating our overweight allocation to this sector, but do not recommend any changes this week.

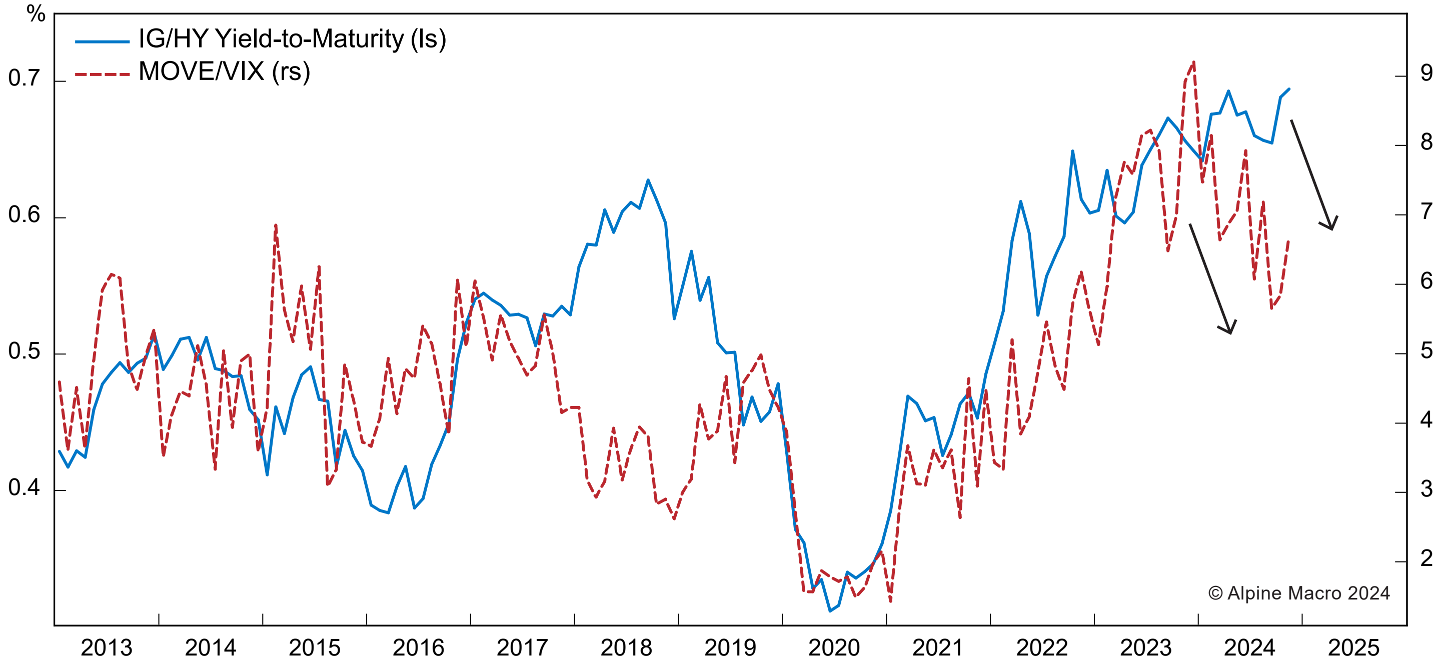
Chart 8 A Bubble Forming In IG Corporates?



*Horizontal red lines denote secular low range
**GFC excluded from calculation; source: Bloomberg Finance L.P.
Note: Shaded area denotes periods of secular low corporate spreads

- **Corporates:** Both IG and HY Corporate bonds are sensitive to bond volatility, although IG is more sensitive to the MOVE index, while HY is more highly correlated with equity volatility. That said, valuation precludes an upgrade at this time. The Bloomberg Barclays IG index shows that the OAS has dropped to 74 basis points, breaking below

Chart 9 Favor IG To HY As A Trade



the 85-95 basis point range that has been a level of resistance since 2000 (**Chart 8**). HY OAS is closing in on all-time lows. The prospect of lower corporate taxes, continuing robust profit growth and rising equity prices (providing corporate bonds with more equity cushion) are all undoubtedly positive. However, the market is looking pretty bubbly. Moreover, the refinancing wall now appears more ominous, which is particularly problematic for sub investment-grade issuers. The tightening in CCC-rated spreads looks way overdone.

For investors that wish to trade a decline in the MOVE, both in absolute terms and relative to equity volatility, consider the following:

- Long MBS versus Treasurys or versus IG corporates.
- Long the IG Corporate index versus HY. **Chart 9** highlights that the IG/HY yield ratio is correlated with the ratio of the MOVE to the VIX index. Both appear to be high by historical standards and have plenty of room to move lower.

Bottom Line: We remain at benchmark on duration for now, but would consider going long if the bond selloff proceeds much further or inflation begins to surprise to the downside. The election has lifted economic growth prospects to some extent, but the good news is discounted in risky spreads, especially in Corporates. The disinflation trend is still in place, which should allow implied bond volatility to continue to trend lower over time. We will re-evaluate our sector recommended weightings in next month's *2025 U.S. Bond Outlook*.

Mark McClellan
Chief U.S. Bond Strategist

FINALLY SOMEONE THAT AGREES

Alpine Macro U.S. Bond Allocation (Duration: At Benchmark)

1-5 Scale; 3 Represents Benchmark	Allocation Score	Comments
Treasurys	2	
Spread Product	4	
Spread Product Composition:		
IG Corporates	3	Avoid AAA; favor upper-end of BBB
High-Yield	3	
Agency CMBS	5	
Non-Agency CMBS	4	Favor AAA
Government-Related	4	Favor Local Authorities and Agencies
ABS	4	Favor up-in-quality, favor sub-prime autos
Agency MBS	4	
Municipals	4	Favor highly-rated taxables in the belly, and BBB non-taxables at the long end

Note: The allocation score presents Alpine Macro's recommended weighting relative to benchmark. It is based on a five-point scale, with "1" being "maximum underweight", and "5" being "maximum overweight". A benchmark weighting is represented by "3". The underweights and overweights across bond sectors notionally sum to the overall recommendation for spread product versus Treasurys. Our benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index, augmented with High-Yield Corporates and Municipal bonds.

Historical Returns

	Excess Return to Treasurys (Bps)			Total Return (Bps)			Option Adjusted Spread (Bps)				
	Past 5 Days	Past Month	YTD	Past 5 Days	Past Month	YTD	Latest	Past 5-Day Change	Past Month Change	YTD Change	Duration
Barclays Aggregate	20	12	104	-58	-141	192	32	-3	-2	-12	6.1
Treasury Index				-73	-145	94	0	0	0	0	5.8
IG Corporate	52	53	314	-37	-119	346	74	-7	-7	-31	6.9
AAA	44	-2	194	-89	-214	27	27	-4	1	-15	10.1
AA	45	28	203	-58	-152	182	37	-6	-3	-16	8.0
A	47	39	273	-42	-132	308	61	-7	-5	-30	6.9
BBB	59	70	371	-28	-102	414	92	-8	-9	-35	6.7
High-Yield	88	140	617	53	61	909	253	-26	-41	-98	3.0
BB	81	114	457	43	27	725	149	-23	-31	-72	3.3
B	90	142	522	60	74	829	236	-30	-49	-101	2.8
CCC	104	233	1241	71	155	1570	533	-29	-101	-297	2.9
ABS	8	27	124	-20	-28	431	50	-3	-9	-17	2.7
Government Related	29	19	112	-38	-118	238	43	-3	-2	-7	5.3
Domestic Agency	3	4	36	-33	-70	288	10	0	-2	-7	3.2
Foreign Agency	6	7	70	-37	-92	296	20	-1	-1	-9	3.6
Sovereign	106	39	265	-5	-164	197	115	-11	-5	-14	8.4
Local Authorities	24	50	187	-76	-146	164	58	-2	-4	-16	7.6
Supranationals	1	-1	29	-44	-109	256	8	0	0	-4	3.7
MBS	22	-10	71	-56	-163	183	41	-3	1	-9	6.0
CMBS	14	20	235	-38	-111	413	88	-3	-4	-38	4.1
Non-Agency	19	32	357	-27	-84	570	140	-4	-7	-63	3.7
Agency	8	9	114	-50	-137	257	38	-2	-1	-11	4.5
Municipals*	102	154	0	24	-33	143	-79	-17	-26	-11	6.2

*YTW used instead of OAS

Detailed U.S. Bond Allocation

	Allocation Score	Yield			Duration			Weight		
	PF	PF* (%)	BM* (%)	Exposure (Bps)	PF*	BM*	Exposure	PF* (%)	BM* (%)	Exposure (Bps)
U.S. Bond Strategy		4.9	4.9	4	6.2	6.2	0.0	100.0	100.0	0.0
Treasurys	2	4.4	4.4	3	7.3	6.3	1.0	30.1	39.8	-9.7
Spread Product	4	5.1	5.1	-5	5.8	6.2	-0.4	69.9	60.2	9.7
Corporate	3	5.4	5.5	-6	5.5	6.5	-1.0	25.9	25.8	0.1
Investment Grade	3	5.1	5.2	-7	6.0	7.2	-1.2	21.9	21.8	0.1
AAA	1	4.8	4.8	0	11.0	11.0	0.0	0.1	0.3	-0.1
AA	3	4.8	4.9	-10	6.4	8.1	-1.6	1.7	1.6	0.0
A	3	5.0	5.1	-7	5.9	7.2	-1.2	9.7	9.6	0.1
BBB	3	5.3	5.4	-8	5.8	6.9	-1.1	10.4	10.3	0.1
High Yield	3	7.0	7.0	0	3.0	3.0	0.0	4.0	4.0	0.0
BB	3	6.1	6.1	0	3.3	3.3	0.0	2.1	2.0	0.0
B	3	7.1	7.1	0	2.8	2.8	0.0	1.4	1.4	0.0
CCC	3	10.0	10.0	0	2.9	2.9	0.0	0.5	0.5	0.0
Government Related	4	4.9	4.9	5	5.9	5.4	0.5	4.1	3.9	0.2
Agency	4	4.7	4.6	7	3.7	3.2	0.5	0.8	0.6	0.2
Foreign Agency	3	4.6	4.6	7	4.1	3.6	0.5	0.6	0.6	0.0
Local Authorities	5	5.1	5.1	8	8.7	7.6	1.1	1.0	0.6	0.3
Sovereign	3	5.7	5.6	9	9.6	8.4	1.2	0.9	0.9	0.0
Supranationals	2	4.5	4.4	7	4.2	3.7	0.5	0.8	1.1	-0.3
Securitized	4	5.1	5.1	0	5.9	5.9	0.0	33.6	25.6	8.1
Agency CMBS	5	4.7	4.7	0	4.5	4.5	0.0	1.1	0.7	0.4
Non-Agency CMBS	4	5.8	5.8	0	3.7	3.7	0.0	0.9	0.7	0.2
ABS	4	4.9	4.9	0	2.7	2.7	0.0	0.5	0.4	0.1
Agency MBS	4	5.1	5.1	0	6.0	6.0	0.0	31.2	23.8	7.4
Municipals	4	3.6	3.6	0	6.2	6.2	0.0	6.3	5.0	1.3

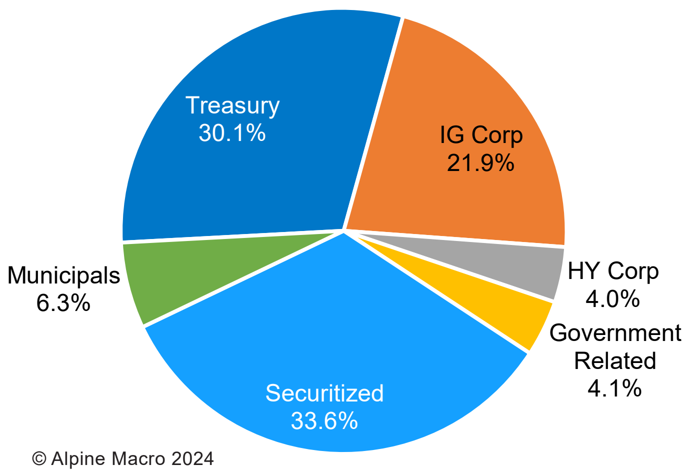
*PF = Portfolio; BM = Benchmark
Source: Bloomberg Finance L.P.
Note: Our methodology incorporates a restriction that the maximum deviation from the benchmark weight is 50%. However, due to the adding-up constraint, the actual weight shown in the table can deviate by slightly more than 50% at times.

Detailed U.S. Bond Allocation

	Contribution to Duration (CTD)			Contribution to Yield (CTY)		
	PF*	BM*	Exposure	PF* ()	BM* ()	Exposure
U.S. Bond Strategy	6.2	6.2	0.0	4.9	4.9	4
Treasurys	2.2	2.5	-0.3	1.3	1.8	-42
Spread Product	4.0	3.7	0.3	3.6	3.1	46
Corporate	1.4	1.7	-0.3	1.4	1.4	-1
Investment Grade	1.3	1.6	-0.3	1.1	1.1	-1
AAA	0.0	0.0	0.0	0.0	0.0	-1
AA	0.1	0.1	0.0	0.1	0.1	0
A	0.6	0.7	-0.1	0.5	0.5	0
BBB	0.6	0.7	-0.1	0.6	0.6	0
High Yield	0.1	0.1	0.0	0.3	0.3	0
BB	0.1	0.1	0.0	0.1	0.1	0
B	0.0	0.0	0.0	0.1	0.1	0
CCC	0.0	0.0	0.0	0.1	0.1	0
Government Related	0.2	0.2	0.0	0.2	0.2	1
Agency	0.0	0.0	0.0	0.0	0.0	1
Foreign Agency	0.0	0.0	0.0	0.0	0.0	0
Local Authorities	0.1	0.0	0.0	0.1	0.0	2
Sovereign	0.1	0.1	0.0	0.1	0.1	0
Supranationals	0.0	0.0	0.0	0.0	0.0	-1
Securitized	2.0	1.5	0.5	1.7	1.3	41
Agency CMBS	0.0	0.0	0.0	0.1	0.0	2
Non-Agency CMBS	0.0	0.0	0.0	0.0	0.0	1
ABS	0.0	0.0	0.0	0.0	0.0	1
Agency MBS	1.9	1.4	0.4	1.6	1.2	38
Municipals	0.4	0.3	0.1	0.2	0.2	5

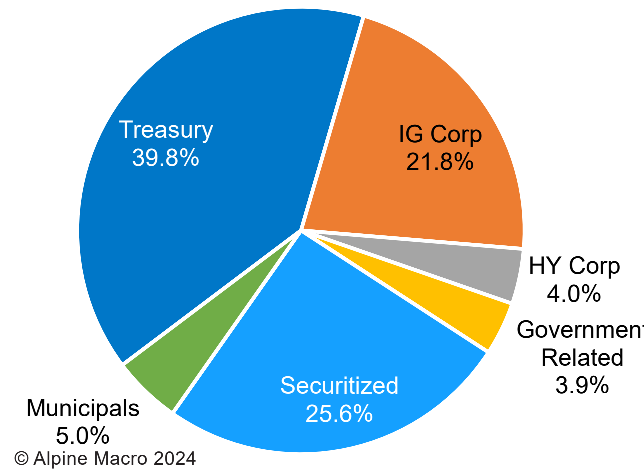
*PF = Portfolio; BM = Benchmark
Source: Bloomberg Finance L.P.
Note: Our methodology incorporates a restriction that the maximum deviation from the benchmark weight is 50%. However, due to the adding-up constraint, the actual weight shown in the table can deviate by slightly more than 50% at times.

Portfolio Exposure



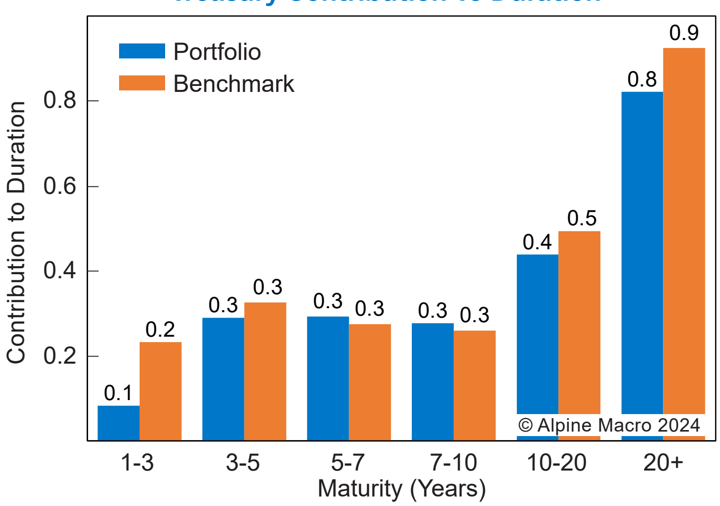
Source: Bloomberg Finance L.P.

Benchmark Exposure

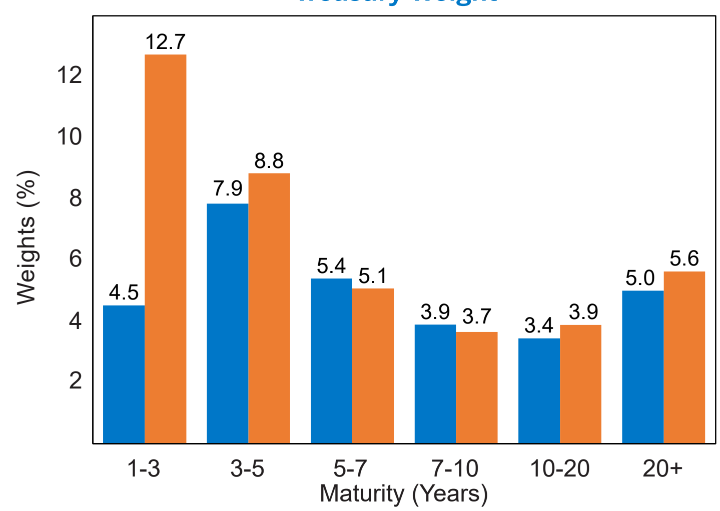


Source: Bloomberg Finance L.P.

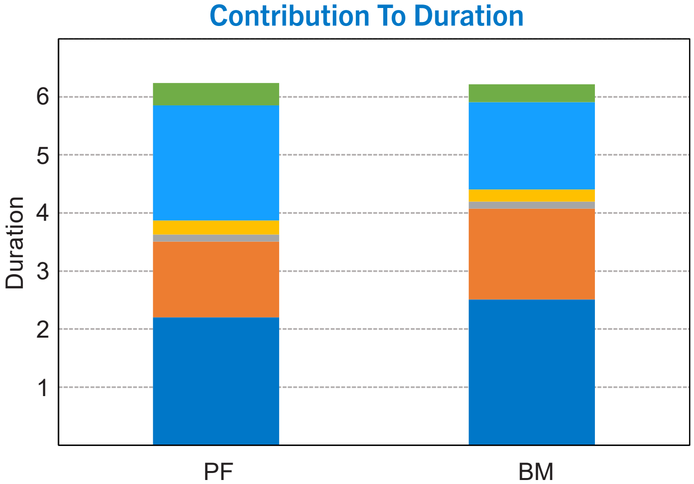
Treasury Contribution To Duration



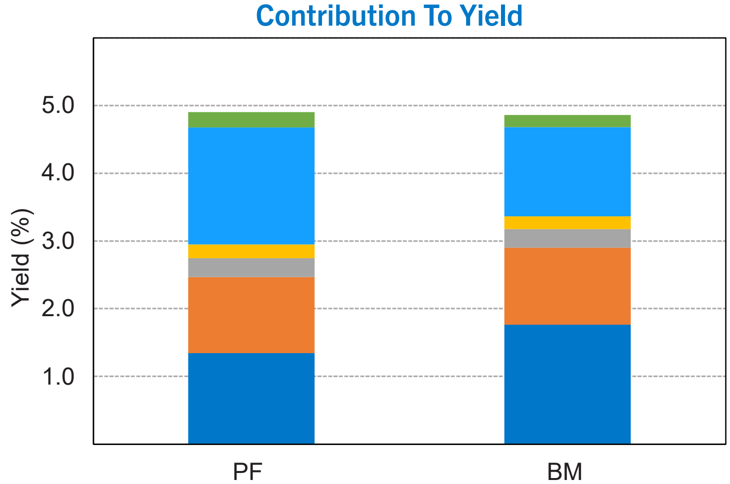
Treasury Weight



Contribution To Duration



Contribution To Yield



Treasury IG Corp HY Corp Government Related Securitized Municipals

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