U.S. Desk Strategy
Macro2Market

July 7, 2021
ISSUE #2

The Taper Road Map: Paved on strong US job growth & risky assets?

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The late 2Q into early 3Q price action has served as a stark reminder that US rates, especially long-term rates, can and will at times trade in a different zip code from "fundamentals". A combo of investors re-thinking the sustainability of aggregate demand while embracing that near-term inflation is likely transitory (a view we have had even before this latest bond bull run) along with a likely closing down of duration shorts, has led to a pulling forward of the historically favorable summer seasonals.

There's still scope for l/t rates to explore slightly lower levels over the course of Q3 (as a lot of damage has been done to chart formations), but the majority of the rally has run its course, in our view. However this view is linked to growth not relapsing, but more importantly, that there isn't any major downdraft in risky assets. If stocks wobble and turn south that will push back taper plans and lead to even lower rates.

TAPERING SCENARIOS (pg 2)

From the early onset we have been of the view that the Fed can be creative when thinking about how to both announce and structure tapering of its bond purchases. And as mentioned in our first report we were of the view that the risk was the Fed starts tapering earlier too. That said we do not expect an exact repeat of the 2014 experience. We believe the Fed will want to maintain as much flexibility as possible and its options open (especially on UST purchases which can be changed in multi-stages). Given the sort of uneven economic recovery we have been having, as well as because risky markets have become so linked to not stop liquidity injections, at a minimum this suggests the simplest thing to do first is taper its MBS purchases.

RATES FORECAST (pg 3)

Since our last update in late May, 10yr Treasuries have rallied roughly 25 basis points (bps) and 30yr rates have declined by more than 30 bps. Meanwhile 2s have climbed 8 bps (and in the intra-period were up 14bps in total). 5s also saw higher rates since our last update, breaking above 90bps before coming back down with the overall rates rally to basically unchanged in levels from our last M2M report.

In our initial launch piece, and ahead of the June FOMC meeting, and contrary to consensus views that the curve would keep steepening, we actually boosted our 2-year and 5-year rates. The rationale back then was if either growth delivers and/or inflation remains sticky, the Fed would not stay on hold forever. In this latest update we still feel comfortable with our new 2s and 5s levels as we head into a tapering event sometime later this year (which would then open up the door for hikes in short rates). Yet for 10s and 30s we've again lowered forecasts an average of 12.5bps.

In general our macro views on long-term rates are usually more bullish leaning than bearish given a whole host of structural features that have been depressing l/t rates for years. Yet even with our minor tweak lower in rates in 10s and 30s, we are still about 20bps higher than what's implied in forward rates (therefore we believe the whole curve will eventually do a U-turn higher in the fall, around the taper news).

For the record, by the same metric we are still more bullish versus consensus as our rates path is about 25-40bps lower than estimates aggregated by Bloomberg. If the economy surprises to the upside I'll change our views, but I still believe the peak in activity is behind us as we settle back down to trend growth in the quarters ahead. Please see the last page for our forecasts versus the markets and the consensus.

1. The Road Ahead

With stocks hitting a series of all-time highs, with US inflation data showing signs of peaking in 2Q21 all while the economy is going through reopen mode, one of the hardest markets to reconcile has been the US bond market, especially USTs. For those following our work will recognize that we have been constructive long-term USTs and ended up not being bullish enough. Overall the 2Q into 3Q price action has served as a stark reminder that US rates, especially long-term rates, can and will at times trade in a different zip code from what many assume would be the so-called “correct fair-value level” given the current economic fundamentals.

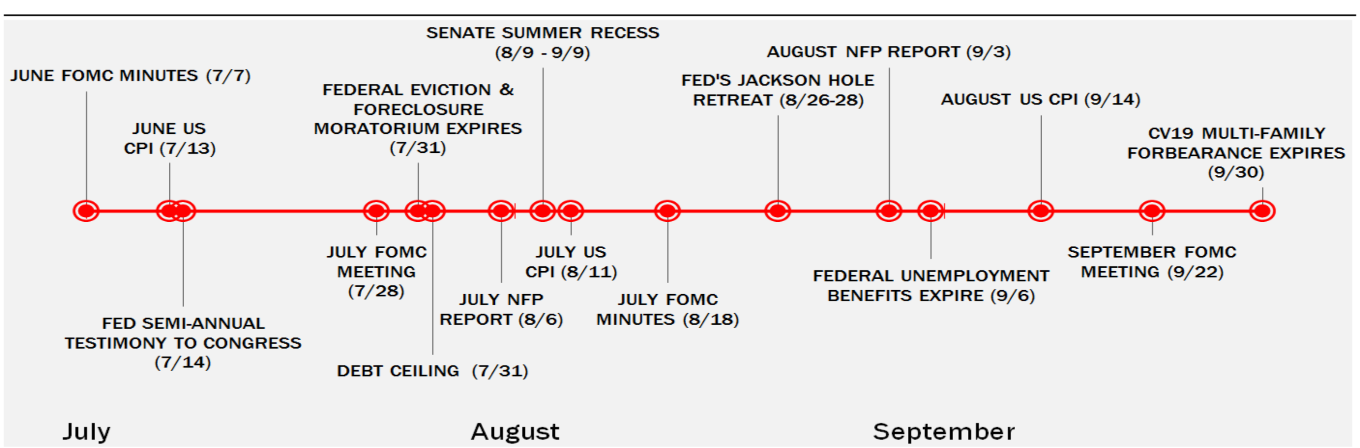
For starters, long-term rates have remained capped to the Fed’s long-run dot of 2.5%. Second long-term rates are discounting the forward path well beyond a few weeks/months of higher inflation and record level growth. In addition it’s now becoming clearer for markets that as vibrant as the US economy is, and even with demand overwhelming supply chains and inventory, it’s not going to be sustainable at this run rate. And besides, if one is bullish the economy, the rates most sensitive to such shifts is the belly and then the front-end, not the long-end. Third, not only is economic data in the process of peaking so too is the entire fiscal and Fed stimulus support. Yes, we likely get an infrastructure plan, but it will be a fraction of initial levels, in our view and it will be spread out over years (versus the big boosts that the economy has gotten hooked to over the last 15 months). Fourth, and this applies for overall fixed income, being short when funding rates are pinned near zero, the carry costs are just too much too handle. Lastly, the other item to monitor always and track closely is positioning setup during market inflections as that can only exacerbate the moves.

Key Events in 3Q21: The roadmap to taper and then higher rates (again) later on in 2H21?

- *Fed News:* First we will get the June FOMC minutes which should shed some light if they’ve become less dovish or really wanted to convey a hawkish pivot. We also might learn more about their taper plans (see next page for our views). Further afield there are a number of Fed events this summer that will all serve as opportunities to pave the path towards tapering. The next FOMC meeting will not include dots updates but it can be used to flesh out their tapering plans. Similarly at Jackson Hole there could be speeches on how central banks will need to prepare for the exits sometime soon. If everything lines up, (i.e. a series of strong NFPs plus stable-to-rising stocks), such a roadmap could lead to a September taper announcement.
- *US Government:* In addition to the standard suite of UST auctions and the August refunding (8/4) there are a series of self-imposed deadlines ahead. First is the debt ceiling set for 7/31. There are a number of CV19 related programs that are also set to expire over the quarter, with the enhanced unemployment benefits the big one (happening around Labor Day no less).
- *US Data:* We will get 2 more NFPs (the July and August report) and three more CPI updates (June, July and August) before the September FOMC meeting. Ideally the next two NFP reports need to come in or beat what we saw at the June release (closer to 1 million new monthly jobs) for markets, and more importantly the Fed, to feel comfortable with the idea of setting up for a September taper announcement. Although we are of the view that CPI will continue to take second place versus NFP, so long as CPI does not become all of a sudden volatile, then the taper path will remain dictated by NFP data. That said at some point the transitory items in the inflation data should start to reverse their recent upward trends and then the focus will shift towards rent prices impact on the owners’ equivalent rent component of the CPI basket, but that is more a Q4 thing.

Bottom-line, as we explore on the next page, the conditions could be right for the Fed’s tapering news in the coming months. The tapering event plus continued evidence of the economy returning back to steady activity should start to stabilize rates later on in Q3 and then result in a U-turn higher in rates towards the end of the year (as seen in our forecasts at the end of this document). However such a view is linked to growth not relapsing, but more importantly, that there isn’t any downdrafts in risky assets space.

US Macro Timeline: The path towards tapering needs to be paved with strong NFPs and stable-to-rising stock markets



Source: MUFG US Macro Strategy

2. Exploring Potential FOMC Tapering Scenarios

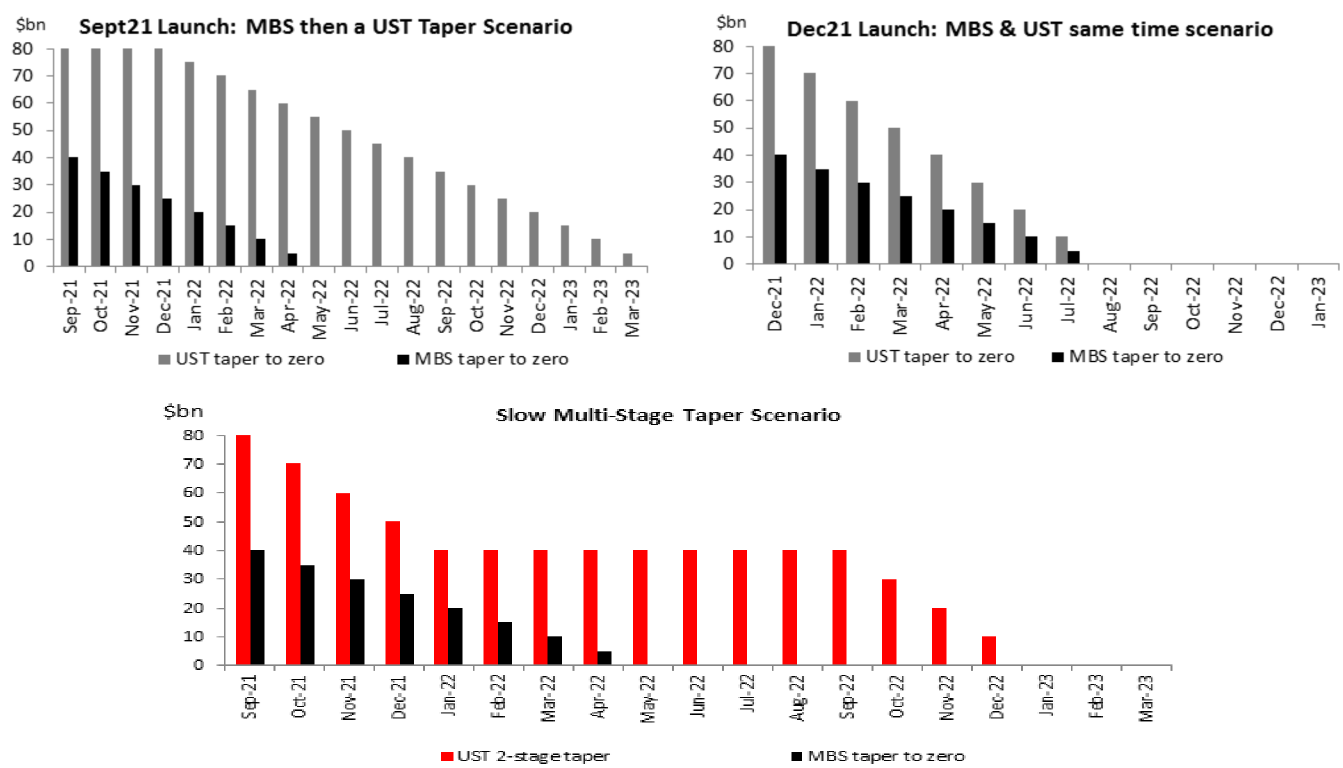
The Fed in our view has been easing well beyond what is needed and this has led to liquidity spilling into financial assets more so than the real economy. The record usage of the reverse repo program (RRP) is kind of proof positive of that. In many ways the Fed now is conducting a version of "sterilized QE" because as quickly as it's easing in the bond market, each new incremental liquidity injection is being turned around and mopped up in the money market space versus sitting at the banks. Net, they need to taper because market functioning has returned, especially in mortgages, but also because the system doesn't need open-ended QE.

As a recap the Fed last tapered a QE program back in 2014. However as you may recall, initially there was a market tantrum in the prior year, so the Fed spent over 6 months in 2013 trying to set it up and launch it. Eventually they went with tapering both MBS and UST purchases at the same time, reducing purchases at each meeting by $5bn in each asset class until they got to zero. Shortly after embarking on tapering the Fed also strengthened its forward guidance on interest rates (linking lift-off in rates to the unemployment rate) which further helped anchor rates while they were tapering. Long-term rates on balance rallied in 2014.

There are many permutations of what's listed below, but here are some ways the Fed can launch and structure its tapering plans:

- A 2014 repeat?: If the Fed decides to start tapering both QE programs, it could do so by $5bn each. However our view is that UST purchases are now even more critical for general market functioning (especially in a world of super-sized deficits) vs '14. Meanwhile with the housing market on the verge of overheating, the Fed could taper MBS as there is plenty of cloud cover.
- Staggered Taper: So our base-case is that the MBS purchasing pace are reduced first by $5bn, and as highlighted in the prior page, so long as the data and stocks perform, it would be launched in September and start in October (left chart below). And then at the December meeting they would announce that the tapering of UST purchases by $5bn would start in January.
- Delayed Taper: If jobs growth does not accelerate in Q3 and/or stocks were to suffer a setback (verging on a 10% correction) it's likely the Fed would delay its tapering plans to the December meeting. This would also allow them to see more data (which we expect would capture even further job growth gains post school reopenings). If they delay but economic activity remains solid, they could taper both USTs and MBS at the same time with USTs at a quicker pace too (right chart below).
- Multi-Stage Taper: Another possibility is that UST purchases could start at the same time as MBS but at some point in the tapering process be put on hold. MBS would continue to taper down to zero but the Fed could stop tapering USTs purchases mid-way if the economy slows and/or there were any signs of stresses forming in the Treasury market (bottom chart below).

Tapering Scenarios: Expecting a staggered taper (with MBS first) but risk of a multi-stage taper scenario also possible



Source: MUFG US Macro Strategy

3. MUFG US Rates Forecast

(versus the market and consensus)

Tenor	Estimates	Spot Rate	Fed L/T Dot	3q21	4q21	1q22	2q22	3q22	4q22	1q23	2q23	3q23	Yield Path
2yr	MUFG Midpt (A)			0.25	0.375	0.5	0.5	0.625	0.625	0.875	0.875	1.125	
	Mkt Imp Fwds (B)			0.3	0.38	0.48	0.59	0.69	0.79	0.9	1	1.11	
	BB Consensus (C)	0.26	2.5	0.25	0.31	0.38	0.46	0.55	0.65	0.74	0.85	0.95	
	A-B Spread			(5)	(1)	2	(9)	(6)	(17)	(3)	(13)	1	
	A-C Spread			0	7	12	4	8	(3)	14	3	18	
	C-B Spread			(5)	(7)	(10)	(13)	(14)	(14)	(16)	(15)	(16)	
5yr	MUFG Midpt (A)			1	1.125	1.125	1.25	1.375	1.375	1.625	1.625	1.625	
	Mkt Imp Fwds (B)			0.89	0.97	1.06	1.15	1.24	1.33	1.42	1.51	1.57	
	BB Consensus (C)	0.91	2.5	0.99	1.05	1.12	1.18	1.26	1.36	1.41	1.51	1.58	
	A-B Spread			11	16	6	10	14	4	21	12	5	
	A-C Spread			1	8	0	7	12	1	22	12	4	
	C-B Spread			10	8	6	3	2	3	(1)	0	1	
10yr*	MUFG Midpt (A)			1.5	1.75	1.75	1.75	1.875	1.875	2	2	2	
	Mkt Imp Fwds (B)			1.43	1.49	1.54	1.59	1.64	1.68	1.73	1.77	1.82	
	BB Consensus (C)	1.5	2.5	1.79	1.88	1.95	2.02	2.08	2.17	2.25	2.35	2.42	
	A-B Spread			7	26	21	16	24	20	27	23	18	
	A-C Spread			(29)	(13)	(20)	(27)	(21)	(30)	(25)	(35)	(42)	
	C-B Spread			36	39	41	43	44	49	52	58	60	
30yr	MUFG Midpt (A)			2.125	2.25	2.375	2.375	2.375	2.375	2.375	2.375	2.375	
	Mkt Imp Fwds (B)			2.04	2.06	2.08	2.1	2.13	2.15	2.16	2.18	2.2	
	BB Consensus (C)	2.11	2.5	2.45	2.53	2.58	2.65	2.71	2.77	2.85	2.96	3	
	A-B Spread			9	19	30	28	25	23	22	20	18	
	A-C Spread			(33)	(28)	(21)	(28)	(34)	(40)	(48)	(59)	(63)	
	C-B Spread			41	47	50	55	58	62	69	78	80	

*Note: The forecast 10yr yield range for the current quarter is 1.25-1.75%, for the fourth quarter the 10yr yield range estimate is 1.50-2.00%

The A-B Spread measures MUFG forecasts relative to what is priced into the implied rates in the forward US rates market…

The A-C Spread measures MUFG forecasts relative to consensus data as captured by the latest data on Bloomberg BYFC…

The C-B Spread measures Bloomberg consensus data relative to what is priced into the implied rates in the forward US rates market…

Source: MUFG US Macro Strategy

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