

US: A milestone, a short squeeze and a Q1 conundrum

The 10-year Treasury yield has finally hit 3% after four years, the dollar rally is showing all the hallmarks of a short squeeze, European companies might be scaling back some of their more aggressive dollar hedges and we still expect the Fed to hike three times this year with a further two, possibly three in 2019

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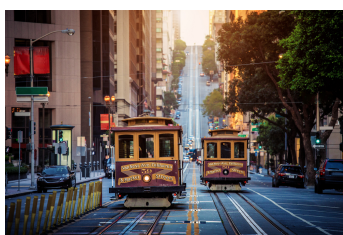
By Padhraic Garvey, CFA



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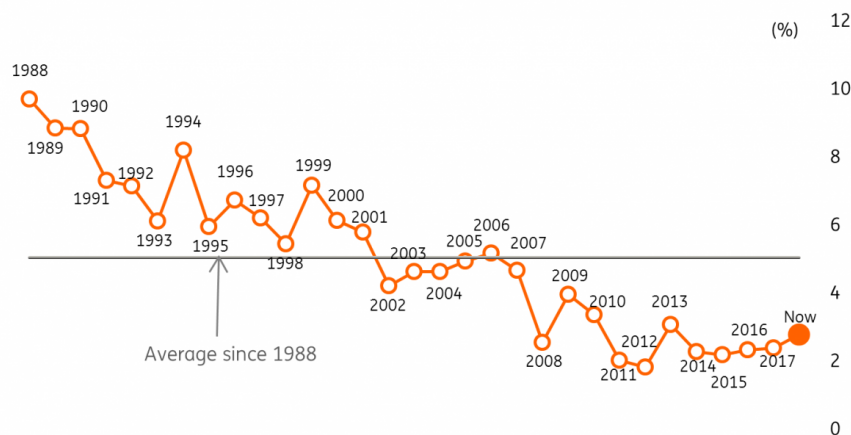
Source: Shutterstock

Getting a good steer on the US 10yr Treasury yield is important, for a few reasons.

It is the global benchmark market rate; movements in it cause reverberations across rates and bond markets extending from core rates to corporates and emerging markets. Crucially, it also provides a long-term nose for where the Fed funds rate may eventually converge towards (compensated by term premium). So, it matters.

The big question is, has the 10yr rate peaked? We're not convinced it has. Currently, 2.98%, we expect it to cross 3% perhaps within the next few weeks, with fundamentals, positioning and technicals as the key drivers. We employ our model for interest rates, to get an unbiased handle on a fair valuation of market rates.

The US 10-year rates since 1988 – still well below its historical average



Source: Bloomberg, ING estimates

What our model says?

We start by deciding where the neutral rate should be. Not an easy task, as it changes over time, and the average 10yr rate in the past 30 years at 4.85% is significantly different from current levels (some 200bp below average). We address this through the simple assumption that the US economy at the very least is a zero real rate economy, as Janet Yellen has attested. If that is the case, then the neutral rate must be flat to core inflation, and we expect core inflation to settle in the 2% area or slightly above.

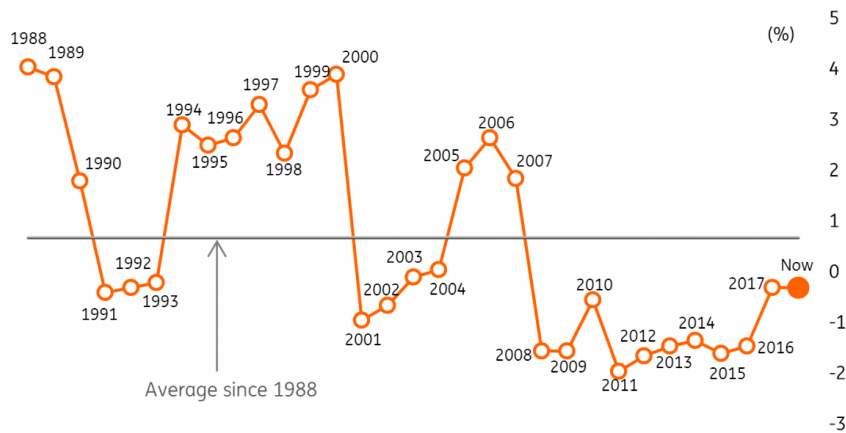
The next thing to do is assess how far we should be deviating from this rate. To do this we look at how a selection of macro variables deviate from normality, and we translate that into a deviation from normality for market rates both based on historical distributions when normally distributed. Long story short, we find that a weighted average of current macro data points to a basis point deviation of +130bp, i.e. market rates should be some 130bp above normal based off contemporaneous inputs. So, with the neutral rate at 2%, we add 130bp to this to give 3.3%. That is then a target fair value for market rates; code for the US 10yr rate.

For the past six to nine months the model has been consistently pointing to an outcome in the range of 2.9% to 3.4% with most of the outcomes in the 3.2% to 3.4% area. At the extremes of this distribution, there is support for the 10yr holding at sub-3%, but the bulk of the distribution points squarely to a break above 3%.

The caveats to consider

This model is based on current macro data and is agnostic to how we got to where we are and is also ignorant of where we are going. It is just based on where we are right now and doesn't know for example that Donald Trump is the US president. So there is a layer of judgement that is required.

US Fed funds rate less core inflation – real rate still low and negative



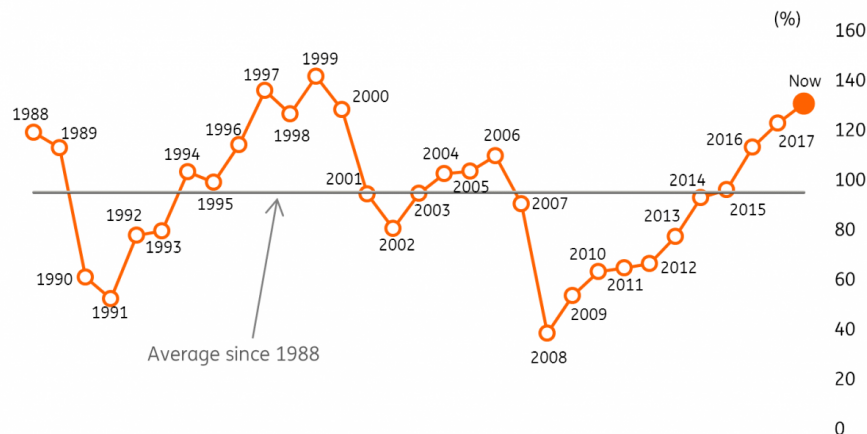
Source: Bloomberg, ING estimates

Also, there is dynamism to take into account. For example, if core inflation were to drift up to 2.5%, that adds 50bp to the central outcome, as it immediately pushes up the neutral rate. The same goes for other macro variable moves. And we've side-stepped the debate as to whether the US is a positive real rate economy or not. If it is a positive real rate economy, that also places upward pressure on the neutral rate. Janet Yellen, for example, has asserted that the US economy will be a 1% real rate economy in the medium term – that immediately brings 3% into play as a future neutral rate.

There is also an important technical issue to consider – the unwinding of quantitative easing (QE). Throughout the third and fourth quarter this year we will move to a point where for the first time in five to seven years central banks will no longer be net buyers of government bonds as the QE is reversed, driven by the (gradual) unwinding of the Fed's balance sheet. The Fed started to effectively de-print money late last year and will continue to do so through the coming five years at least; a persistent removal of support that had been in place through the years of aggressive central banks bond buying. Remember, even if we had a few weak macro datasets the quantitative tapering (QT) process continues relentlessly – an ongoing factor that places upward pressure on market rates.

But in fact, US fundamentals remain very robust. Consumer confidence is literally going off the charts, the last labour report had a jobs growth of 200k in excess of replacement, and survey evidence points to wage inflation ultimately heading towards 3.5%. While holes can and have been picked in aspects of the macro story, the fact remains that there is solidity in play in 2018 at least and well into 2019. We'd assert that the recession risk in the coming 18 months is very low but beyond that things, as always, become a bit fuzzy.

US consumer confidence – as high as it has ever been



Source: Bloomberg, ING estimates

This brings us nicely to key medium term considerations

One argument for not breaking above 3% is the likelihood that the US economy could slow, let's say starting in 2020 as prior rises in the Fed funds rate begin to bite. This could occur against a backdrop where the fiscal deficit could be threatening a 5% handle as tax reform hits government revenues. And this added to a growing shortage of savings in the private sector could coincide with the deficit on the balance of payments heading towards a similar big figure. Therein lies the genesis of an imbalance that could well pre-empt a growth recession, likely necessitating eventual mild Fed cuts say from 2021.

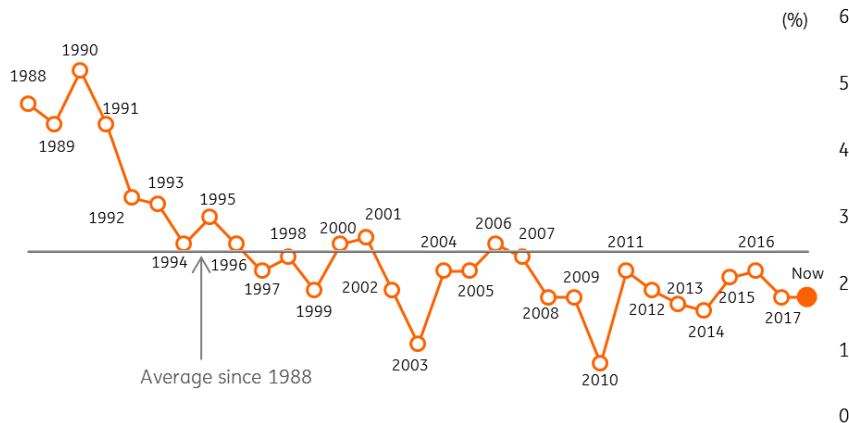
Related to the long term, another item to consider is the long bond (30yr) yield. In days gone by this was the benchmark of the US yield curve, and still garners respect as a back-end anchor for the US curve. The point here is the long bond yield currently sits at 3.15%. By virtue of its tenor, the long bond yield has an ultra-long nose and is suggesting that US rates should not be getting much above 3%. We'd be having a very clear conversation on the logic of the 10yr breaking above 3% if the long bond yield was at 4% for example. Not as straight-forward where it currently is; accepted.

The counter-argument, however, is that fundamentals are just too bubbly to be ignored, plus the wage inflation/core inflation upside trajectory looks increasingly persuasive. That's where our judgment lands. We are not convinced that the bond market sell-off is over. The long bond yield conundrum is more likely to be squared with the 10/30yr segment inverting at some point later in 2018. An inversion on the 2/10yr segment is less likely in 2018, reflecting a minimal imminent recession risk.

Market positioning is also an important input when it comes to timing and extent of the move. Around the turn of the year the flows data that we track show investors selling long end funds and buying short end funds, in other words they were shortening the duration and positioning for higher rates. That has calmed since, which in part explains why a subsequent break higher in the 10yr yield has not occurred, yet.

We expect this to change, likely to be bullied there by persistently firm fundamentals in the coming quarters. Chicken and egg kind of a situation, but all converging on a likely break above 3%.

US core inflation – still well below historical average at 2.5%



Source: Bloomberg, ING estimates

But how high and for how long beyond that?

There is no firm evidence that the 10yr yield should break higher than 3.5%. We find that a material rise in core inflation to 2.5% would be required to make this happen. So not improbable, but not our base view. Hence the notion that the 10yr rate should settle somewhere between 3% to 3.5%. Our point estimate is 3.4%, which also helps project the prognosis that any break above 3% would be sustained for at least a few quarters.

To get above 3% in the first place, there needs to be a market discount where imminent inflation risks trump medium-term growth recession risks. And by the way, we see the Fed funds rate heading towards a terminal value towards 3% on similar reasoning. The end game, in fact, sees the curve flattening out completely with the three handle heavily in play.

Having marked these, subsequent rates moves would indeed then be lower.

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USD: Return of the king or just a breather from a crowded short trade

The sharp 2% bounceback in the broad US dollar index has raised some eyebrows and led to questions whether this is a new trend. But FX positioning data shows this has all the hallmarks of being another short USD squeeze - which has historically been short-lived



Key messages: Crowded FX positions unwind

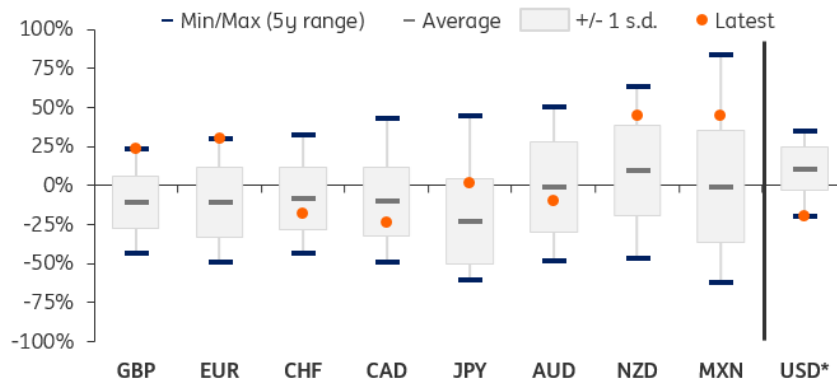
- The sharp 2% bounceback in the broad USD (BBDXY) index over the past week has raised questions over whether this is the end of the dollar bear trend - or whether this is merely a pause as investors take stock of what the next big narrative in global markets will be. We believe it's a classic case of the latter - not least given that we've had a strange week or so of low Trumpian noise, while the extremely crowded positioning in G10 FX markets also lends itself to a bit of a breather in the medium-term USD downtrend.
- When looking at G10 FX price action, we note that there is a clear link between positioning and year-to-date performance (yes it's not rocket science!). As the second graphic below shows, those currencies that have had the largest bullish positioning adjustments in 2018 (Sterling, New Zealand dollar, Japanese yen, Euro and Mexican peso) have also been the clear outperformers this year. Equally, the currencies with the biggest net long positions as of mid-April (MXN, NZD and GBP)

have also been the ones that have sold-off the most against the USD over the past week. The clear link between FX positioning & performance means that the 2% USD rally has the hallmarks of being nothing more than a short squeeze - fuelled by (1) local factors (weak data for GBP and NZD; presidential election risks for MXN) and (2) a lack of impetus in the recent drivers for USD weakness.

- The EUR is a slight anomaly here in that its weakness this week hasn't been as pronounced as its long positioning would suggest - though we chalk this down to (1) some focus on this week's ECB meeting and (2) the fact that EUR long positioning has been a function of growing bullish sentiment amongst real money investors - who are happy to play the 'long game'. For more see our [April ECB Meeting Crib Sheet](#).
- A sharp squeeze in short USD positions is not surprising given the lack of further impetus in the array of weak USD drivers - namely US political uncertainty (stemming from either trade or geopolitical risks), a sell-off in relatively expensive US assets or a strong Rest of the World growth story. Equally, it seems that initial dawning of more structural forces like the rising US twin deficit - and the administration's implicit weak USD policy - has already taken place. These structural narratives may require something (maybe a policy announcement or tweet) to once again become active - though we do believe that they will continue to exert downward pressure on an overvalued US dollar over the coming quarters.
- Looking at previous occasions when we've seen a similar sharp squeeze in short USD positioning, we note that the follow-through into USD spot price action has been fairly short-lived. On average the BBDXY index has been 1.1% higher after two weeks - after which there is no clear pattern to which direction the USD will take. If we take the most recent episode - October 2017 - as a precedent, then we could see the USD remain at these elevated levels for around three-four weeks - before the next wave of weakness kicks in. But given the high degree of uncertainty around US trade and foreign policy, we're aware that we may be only one tweet away from this coming much sooner.

ING FX Positioning Dashboard | Taking a breather from crowded positions

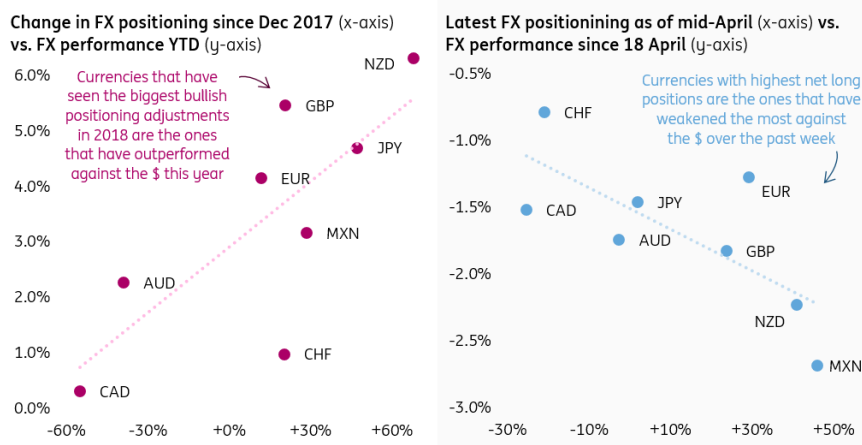
Speculative positioning (% of open interest)



Currency (USD base)	Week Change	Latest net positioning	YTD Change	Weekly Signal	Monthly Sentiment
NZD	+4%	+45%	+68%	Bullish	Bullish
CHF	+3%	-18%	+20%	Bullish	Bearish
CAD	+2%	-24%	-55%	Neutral	Bearish
EUR	+1%	+30%	+12%	Neutral	Bullish
USD	+0%	-19%	-12%	Bullish	Bearish
JPY	-0%	+2%	+47%	Neutral	Bullish
GBP	-0%	+23%	+21%	Neutral	Bullish
AUD	-8%	-10%	-39%	Neutral	Bearish

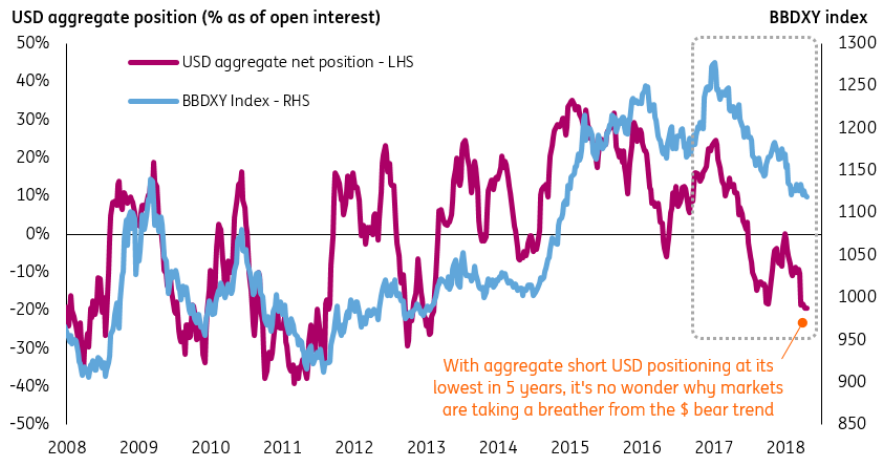
*Note: Aggregate USD positioning. Source: CFTC, Bloomberg, ING as of 17 Apr 2017 (data reported with a lag)

USD rebound screams of positioning adjustment more than anything else...

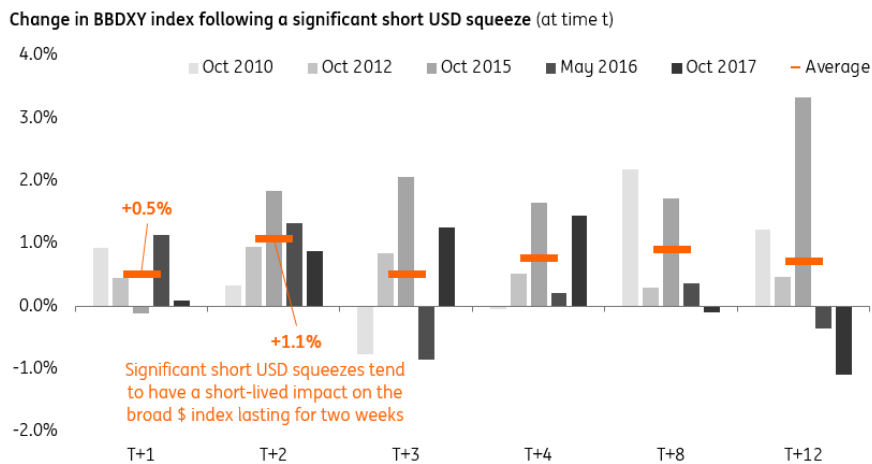


Source: CFTC, Bloomberg, ING estimates

USD bear trend since 2017 coincides with a sharp positioning adjustment



USD rebounds during past short squeezes have been short-lived and shallow



Source: ING estimates, Bloomberg, CFTC. Note: Time period (t) is weekly

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US GDP: The Q1 conundrum

US GDP readings for the first quarter are by far the weakest in any given year. Given our 2.4% forecast for 1Q18, this trend suggests 2018 will be fantastic



Source: Shutterstock

1.5pp How much lower growth is in a typical Q1 versus other quarters

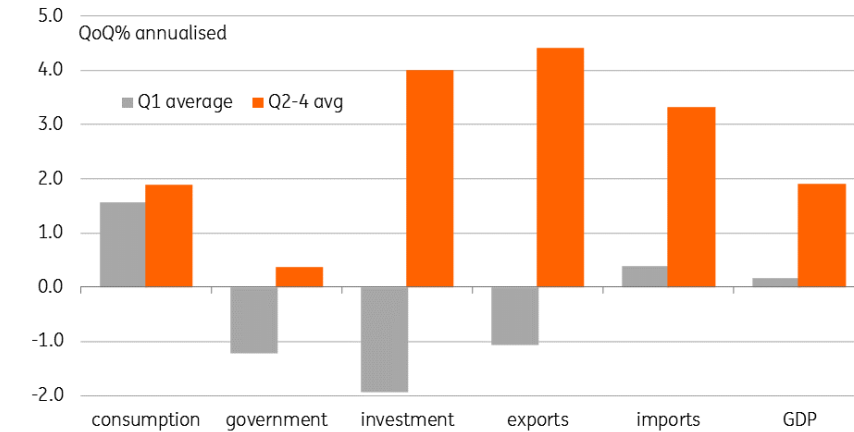
What's wrong with Q1?

As with most economic data, GDP is also seasonally adjusted to take account of the influence of things such as predictable weather patterns, school term dates or national holidays. For example, severe weather in the winter means construction work grinds to a halt while consumer spending typically gets a lift in the build-up to Christmas. Economists prefer to try and eliminate these patterns to make it easier to observe the "true" underlying cyclical trend.

Yet, looking at quarterly GDP growth rates, there is a clear pattern of underperformance in the first quarter of a year. Going back over 30 years, we find the average quarter on quarter (QoQ) annualised growth rate for a Q1 is 1.7% versus 3.2% for Q2 and 2.5% each for Q3 and Q4. Since the start of the financial crisis, the problem seems to have worsened with Q1 averaging 0.17% versus

2.4% for Q2, 1.9% for Q3 and 1.4% for Q4. Seasonal adjustment means Q1 growth should not be consistently different from any other quarter, so there is clearly some "residual seasonality".

Q1 annualised GDP growth versus Q2, Q3 and Q4 (2008-2017)



Source: Macrobond, ING

Why is it so much weaker?

The obvious point is that there is clearly a problem between Q1 and Q2.

If we have 1.7% growth in Q1 and 3.2% in Q2 that gives a first-half average of 2.5% - the same as the typical growth rates seen in the third and fourth quarter. Problem solved.

However, statisticians continue to debate the reasoning for this. Weather disruption has been severe in recent years with several winter storms right at the beginning of many years, but we can't categorically prove that weather is influencing data more than it has in the past. Some argue that weather may be impacting data in different ways due to changes in the structure of the economy.

Going back over 30 years, we find the average QoQ annualised growth rate for Q1 is 1.7% versus 3.2% for Q2 and 2.5% each for Q3 and Q4. And the problems seems to have worsened since the start of the financial crisis

It is possible that changing economic behaviours may be playing a part, although the ever-growing use of technology and online spending should more likely smooth spending behaviour rather than increase its volatility. There have also been suggestions about problems with price deflators and the quality adjustment factors that go into them (computers may not be getting much cheaper these days, but you are getting more for your money in terms of processing power).

Unfortunately, changes to statistical calculations don't seem to have helped resolve the situation.

Looking at the components of GDP over the past 10 years, there appears to be particular problems within investment, which has averaged -1.9% in Q1 versus +4% in each of the other quarters and

exports which has averaged growth of -1.1% in the first quarter versus 4.4% in the other three quarters. Other components exhibit evidence of residual seasonality with consumer spending averaging around 0.3 percentage points less growth in Q1 versus other quarters while for government spending it is 1.6pp and for imports it is 1.7pp. Inventories also seem to be run down more in Q1 than other quarters.

The trend looks set to continue

In terms of the specifics of this Friday's report, we look for GDP growth to slow to 2.4% while the consensus is a little lower, predicting 2% (both outcomes would be below the 4Q trailing average).

As is usual with this advanced reading for GDP, there is a broad range of views in the market. The Bloomberg consensus is spread from +1.3% to +2.8% and adding to the uncertainty; various regional Federal Reserve Banks publish "Nowcast" figures based on the monthly economic data flow. The New York Fed's model suggests 2.9%, the Atlanta Fed's model says 2.0% while the St Louis Fed says it will be around 3.5%, implying that there is a strong chance of a market moving number when we actually get the data publication on Friday.

Our view, however, is that weakness will be led by domestic demand. 4Q17 activity was boosted by post-hurricane rebuilding and the replacement of damaged/lost home and business equipment, which won't have been repeated. However, net trade should make a positive contribution thanks to the dollar weakness and a strengthening global economy while inventories are likely to be rebuilt after being sharply run down in 4Q17. Nonetheless, a 2% growth rate for a Q1 is still very good by historical standards and if the pattern of the weakest quarter for growth continues, this suggests 2018 will be a very good year.

Good news for 2018!

Our full year 2018 growth forecasts is 3%, and a rebound in the second quarter would set us up nicely for this. Retail sales rebounded in March, suggesting the domestic economy has regained some momentum while confidence is strong and the jobs market is robust, which is contributing to higher wages. Tax cuts will also be supporting spending while a rebound in asset prices following 1Q volatility is helpful.

Meanwhile, the dollar's weakness means that exporters are in a competitive position that allows the US to really benefit from the upturn in global demand. As such we are provisionally forecasting 2Q GDP at around 3.5%. With inflation pressures starting to become more evident, this will help keep the Fed on course to hike interest rates three more times in 2018.

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FX: Are corporates reconsidering US dollar hedges?

With US dollar hedging costs high, EUR/USD closer to fair value and the ECB story on hold, European corporates may be reconsidering their high hedge ratios on USD receivables

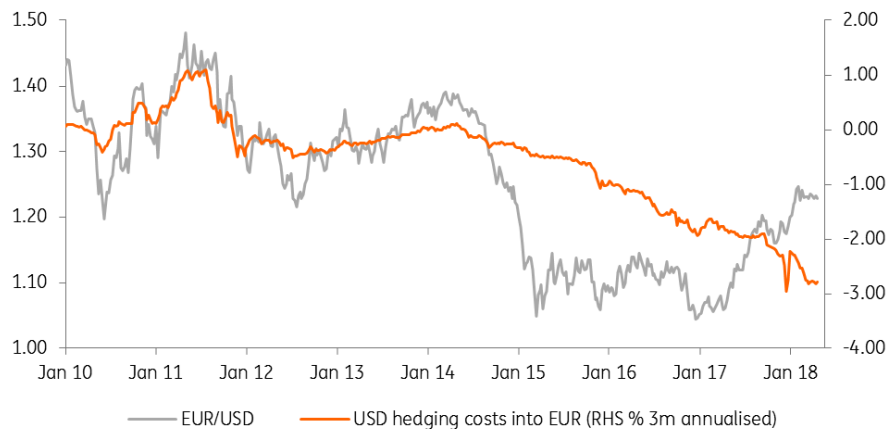


Corporates less convinced about a big dollar decline?

We may be a little premature in discussing this topic, but in speaking to some customers we are getting a sense that high US dollar hedge ratios are being reconsidered. In other words, corporates are possibly becoming less convinced about a further large dollar decline and, where hedging mandates allow, over coming months could be scaling back some of their more aggressive USD hedging.

While most corporate FX hedging decisions do sit within clear mandates, there is typically a little room for discretion. For example, when EUR/USD was below 1.10 in late 2016 and early 2017, larger European corporates typically held the view that the USD was overvalued (most fair value readings were in the 1.25 area) and that hedge ratios on expected USD receivables should be higher, e.g. closer to the top end of the 50-100% range and should cover longer tenors. Here, treasurers made special requests from the board to extend the horizon for USD hedging.

The cost of hedging



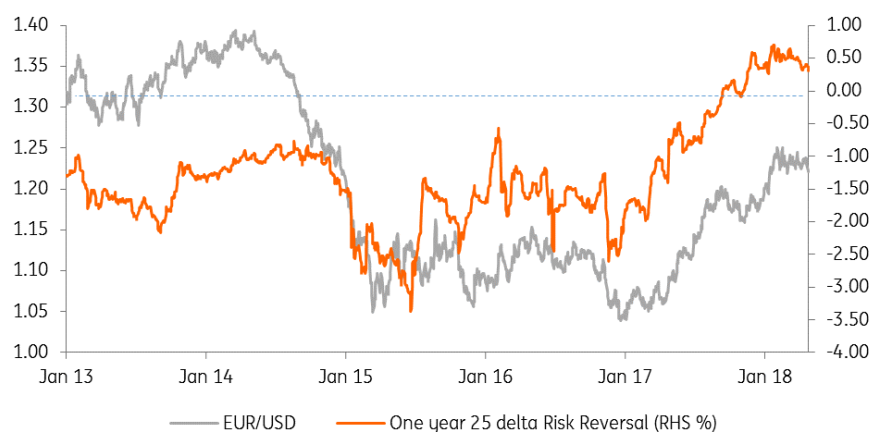
It now costs near 3% p.a to hedge USD into EUR

With EUR/USD a lot closer to fair value and now USD hedging costs near 3%, we get a sense that corporates may be starting to reconsider whether they roll those aggressive USD hedges – or perhaps cut those USD hedge ratios a little. Even a rolling three-month USD hedge into EUR costs close to 3.00% annualised – questioning whether corporate treasuries are right to be paying away 3% of their hard-won USD receivables.

We doubt that there is a magic number – e.g. 3% – where USD hedging costs become prohibitively expensive. But we would say that the EUR/USD bull story does need feeding – be it Trump's protectionist policies which embody a need for a weaker dollar or some fresh news from the ECB that the end of QE is on track and that the 1Q18 slowdown has not altered the ECB outlook.

EUR/USD One Year Risk Reversal

The cost of buying a 25 delta EUR call over an equivalent EUR put



FX option market could give us clues on corporate behaviour

We also think it's worth watching the 12-month EUR/USD risk reversal in the FX option market. This reflects the cost (in %) market players are prepared to pay for a EUR call option over an equivalent

put option. Corporates typically dominate this segment of the FX options market. As the chart above shows, the cost of a EUR call relative to a EUR put has been rising significantly since last summer. Recent stability in this risk reversal has gone hand-in-hand with EUR/USD consolidation in the spot FX market. But any decline in this risk reversal – perhaps below 0% – could be a sign that corporates were indeed reassessing their medium-term USD outlook.

As for our views – we’re convinced EUR/USD will be a lot higher over the next two to three years on the back of: a) US twin deficits and a late cycle economy and b) portfolio flows returning to the Eurozone as the ECB winds down its QE programme. We think any move below 1.20 will be relatively short-lived this quarter and retain a 1.30 year-end forecast.

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US: Are we heading to recession?

The US yield curve keeps getting flatter with growing concern it could turn negative. Such a development preceeded all nine recessions since 1955. How worried should we be?

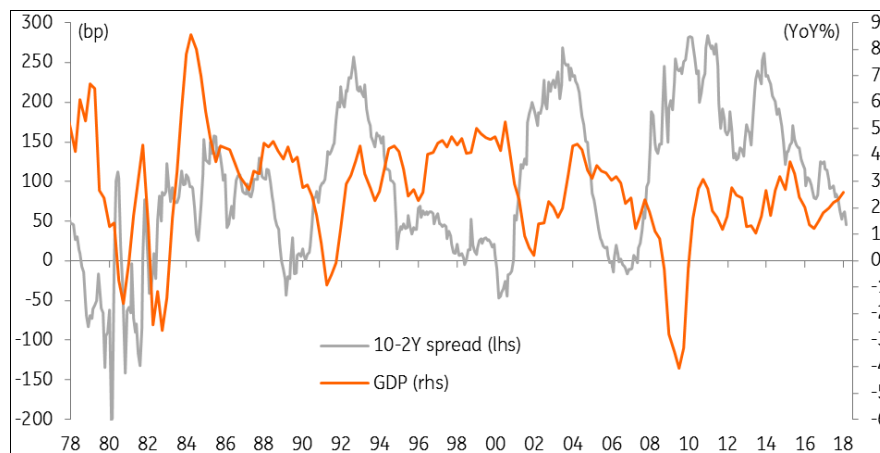


Source: Shutterstock

Yield curves and the economic cycle

The US yield curve is currently the flattest it has been for a decade. With the Fed looking set to hike rates another three times this year a growing number of voices are warning we could soon see the yield curve actually invert, meaning it is cheaper for the government to borrow over ten years that it is over 2 years. This is a huge story. When the yield curve has inverted previously it's been an early warning signal of impending doom - the US has typically fallen into recession within 2 years.

The US yield curve and GDP growth



Source: Macrobond

That said, it is important to remember that this is a guide, not a rule. In 1998 when we saw a very temporary shallow inversion following the Asia/Russia/LTCM crises, a swift Fed response meant the economy powered on and the yield curve quickly normalised with a positive slope.

Nonetheless, even in a relatively benign situation such as then, an inverted yield curve would signal bond market nervousness that could trigger a broader switch towards safe-havens and provide some respite for the beleaguered dollar.

Why invert?

Yield curves typically steepen ahead of a central bank tightening cycle as the market anticipates higher interest rates and then flatten as the central bank actually raises short-term rates. This is the process we are seeing right now. But if it continues and the curve inverts, history would suggest there are two main scenarios that we face:

1. The concerning one: The market believes the Federal Reserve is making a policy mistake by raising short-term interest rates too aggressively. This prompts an economic downturn that requires corrective action later on and is bad news for risk assets.
2. The more benign one (ie, 1998): The economy and inflation pressures aren't as strong as the Fed believes and we will see those anticipated Fed rate hikes priced out, lowering shorter dated yields, which prompts a re-steepening the yield curve. This is less damaging for risk assets.

The Fed divided

Over the past couple of days we have heard several Fed officials offering their perspective. As you would expect, there are a range of views.

St. Louis Fed President James Bullard (a noted dove) suggests we could see a negative yield curve within the next six months if the Fed pushes ahead too aggressively with rate hikes. He advocates a "wait and see" approach to monetary policy, believing that there is little inflation threat in the economy. It's important to remember he doesn't get to vote on Fed decisions this year.

San Francisco Fed President (from June NY Fed president) John Williams admits that an inverted yield curve has in the past been a “powerful signal of recessions”, but he doesn’t “see the signs yet of an inverted yield curve”. He believes that there is more of an inflation threat than Bullard, which will mean longer dated bond yields will move higher, but that the curve will continue to flatten – “it’s totally normal” in his view.

Fed Governor Quarles agreed yesterday, saying “I’m not viewing the current flattening of the yield curve as a particular signal towards pending recession”. Like Williams, he believes the longer end of the bond market is lagging behind and will respond.

Inversion avoided... for now

We have more sympathy with the views of Williams and Quarles than we do for Bullard’s at this stage. We remain upbeat on the US economic prospects. Domestic demand is strong, supported by strong jobs market, rising house prices and an expansionary fiscal policy driven primarily by significant tax cuts. At the same time the US dollar’s depreciation means that exporters are in a competitive position to benefit from the upturn in the global economy. If in addition President Trump can make progress on infrastructure investment this could help extend the US economic cycle.

Meanwhile, consumer price inflation is broadly in line with the Fed’s 2% target. Given the tight labour market, we find it quite easy to envisage wage growth rising above 3.5% YoY later this year. With energy prices and import prices picking up again there is the possibility headline CPI rises towards 3%.

In this environment of robust growth and rising inflation we forecast the Fed raising rates three more times this year with a further two, possibly three likely for 2019. This would take the Fed funds rate up to around 3%.

We also see upward pressure on longer dated yields. For reasons already stated, we think that the bond market is under-pricing the threat of higher US inflation - consensus estimates suggest inflation will be benignly rise fractionally above 2% before settling at that level for the next few years.

Then there is the Federal deficit, which is set to hit \$1 trillion dollars next year or 5% of GDP. This requires a massive increase in government debt issuance, much of which is likely to be in the form of longer dated treasuries, at a time when the Federal Reserve is running down its vast balance sheet. This change in the supply/demand mix could provide upside impetus for longer dated bond yields.

As such we see 10Y yields rising towards 3.5% and a Fed funds terminal rate of around 3.25-3.50%. But the Fed does not get anywhere near that this year. Hence the probability of inversion is low for 2018.

But we acknowledge the risks

The US economy is undoubtedly late cycle – we are in the midst of the second longest US economic expansion since the end of World War Two and debt levels are clearly on the rise. Consequently the response to higher interest rates is somewhat uncertain, but this is one of the reasons why the Fed continues to emphasise its “gradual” approach to policy tightening.

Add in the fear of an escalation of protectionist policies that could de-rail the positive global and US growth story and we acknowledge there is some justification for bond market nervousness that could lead to an inversion.

That said, it is important to remember that a negative yield curve doesn't mean recession is inevitable. Obviously, the US will eventually experience recession again, but for the next couple of years we remain upbeat with the global growths story while a competitive dollar and ongoing fiscal stimulus and infrastructure spending can help prolong the economic cycle.

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