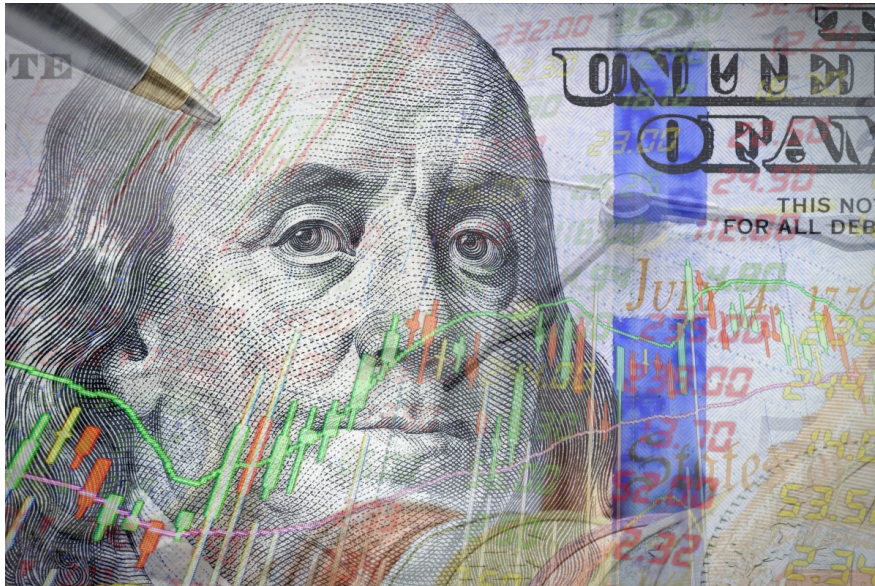


A bond bear market made in America

Confidence may be down, but the US economy continues to spend and make things practically as normal. The market is discounting less rate cuts ahead in consequence. Market rates have no business going below 4% unless something breaks. They have every right to head for 4.5%. A remarkable made-in-America bond sell-off despite material external weakness



The US economy continues to refuse to lie down – a key driver of long rates

At the beginning of 2023 marketing budgets were cut, in anticipation of a period of hunkering down. US CEO confidence had already nose-dived as 2023 approached, as had business confidence. A recession was coming. Job cuts were not fast-forwarded, as a lingering legacy of the pandemic years was a difficulty in getting people in the first place. The re-opening flop out of China added to the poor background noise, and many European economies entered technical state of recession. Yet here we are. No imminent US recession. And instead, the US 30yr bond yield has hit 4.4%, and looks to be in a mood to push on higher. And that as the Fed has seemingly peaked. So many contradictions.

Even as survey evidence tanked in the US, basically since mid-2022, activity has held up. Include

here retail sales, production and jobs. The important stuff. Meanwhile, significant falls in inflation readings has allowed the Federal Reserve to pause with rate hikes. They won't admit it yet, but they've probably peaked. Some aspects of the economy has been hit along the way, like activity in the housing market, the mini-crisis in the small banks in March as Silicon Valley Bank (SVB) went down, and post-pandemic paring back in the tech sector. But overall things have just about held together. The unemployment rate is still at sub-4%.

The post-SVB saw a material wipe out of rate cut expectations, as the economy popped

We had an important moment as SVB went down. The following number of weeks saw the build of a sizeable rate cut discount. The narrative was that something had finally broken, and the Fed would soon find itself cutting rates aggressively. The market discount for the funds rate by 2025 collapsed to the 2.5% area. That provided a clear run-way for the 10yr Treasury yield to fall, and it did, to about 3.3%. But crucially, the market then slowly morphed from worry and towards the realization that this chink was not going to take anything down. The market moved into a risk-on mode, credit spreads tightened, equities rallied, and high yield credit outperformed. The market discount for a recession disappeared.

For market rates that was a crucial period, as it resulted in that prior discount for the funds rate to get to 2.5% backing up to a discount that barely broke below 4%. And that's where we are now. Basically it tells us that the Fed, when it gets around to cutting, will get the funds rate not much lower than 4%. This technically places a floor on market rates. Market rates can of course go below 4%, but that would be an overshoot that would need to unwind. In fact a simple frequently used model for the 10yr Treasury yield is to take the future fed funds rate extreme and add a 30bp term premium to this. Based off that alone, the US 10yr Treasury at 4.3% is in fact bang on fair value.

With the Fed not discounted to get below 4%, the 10yr has every right to trade above that

This is crucial to understanding why US market rates have risen of late. Basically the market has downsized the extent of future cuts as the economy is just not lying down. Importantly, upward pressure on market rates has been in longer tenors, not shorter ones. The shorter tenors are standing pat as the Fed is likely done, and that is coming from the significant easing in inflation data. The result is calmness on the front end, while longer tenor rates rise. This acts to put the curve into a dis-inversion mode. It's an unusual one, as typically when the Fed peaks, longer tenor rates would tend to fall. Here, even as the Fed peaks, that peak risks becoming more structural in nature.

The latter point brings in the fiscal outlook for the US. Bear in mind that the congressional budgetary office has the US debt/GDP ratio approaching 200% by 2050 on unchanged policies. That paints a picture of ongoing elevated fiscal deficits (currently in the 5% of GDP area, or higher), and that typically would correlate with market rates being forced higher, all other things being equal. Higher market rates than usual into the future reflects issuance pressure, more Treasuries for any given level of demand. The US Treasury has been pushing up issuance requirements of late, pushing this extra issuance story into the investor mindset. When the last 30yr auction tailed badly, the subsequent 10bp uplift in market rates was quite the eye-opener.

It's also clear that the recent up-move in Treasury yields has been "Made in America". The

Treasury – Bund spread has widened, illustrating that Treasuries are pulling Bund yields higher. The same obtains for the Treasury spread to Japanese Government Bonds (JGBs), supporting our view that the raise of the cap on 10yr JGBs was an ancillary development and not a driving force behind the up-move in Treasury yields, especially as spreads between Treasuries and JGBs have also been re-widening of late.

The US 10yr at 4.5% would not be an overshoot. It's in fact medium-term fair based off the current market discount

So where does all this leave us? It leaves us in a resumed bear market in core bond markets. But it's a mild one though, so far. It was a real bond bear market last year as the Fed started to hike rates, and market rates rose significantly. Also, the spectrum of returns across all bond markets and right out the credit curve continues to show higher beta product outperforming. High yield has done best. This is the clearest discount for no material recession ahead, as low default rates are backed out of this. But there are potential issues to be concerned with. The longer that market rates remain under elevation pressure the greater is the span of players that will find themselves having to re-fund liabilities. That can bite hard in the end.

There are too many headwinds out there for the US economy not to experience some form of recession. And typically when we have that mystical break in something it causes the market discount for rate cuts to ratchet higher, and that in turn provides room for longer tenor rates to fall, significantly. We have that happening in 2024. But with one important caveat – when the Fed subsequently bottoms, there should be a positive aspect on the curve. Simplistically we should see at least a 50bp spread between the funds rate and the 10yr Treasury yield. It can be higher. But should really be no lower. If the funds rate bottoms at 4%, that pitches the 10yr at 4.5%.

Our view? The funds rate actually bottoms at closer to 3% (pressure builds and there is a break), which provides more room for market rates to subsequently fall. But based off the current market discount. It's still for now pointing up for yields. That dominates our thinking, until something actually breaks.

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