

## US: Extremes

Hitting 1.5% for the 10yr Treasury is a big deal. Last year, many had debated whether we could even get above 1%. It now looks like 2% is the new 1%. Part of the reason for the rise in long yields is they are unprotected by the Fed's easy policy, which in turn is pushing short rates ever lower. Risk assets are in the mix too, inversely related to bond yields, but also getting fed by excess liquidity. Expect more volatility



### Big moves under big pressure - Long rates stretch higher and short rates head lower

It's not often we get moves like we've seen in US rates in recent weeks, as both ends of the curve gets stretched in quite a dramatic fashion.

The backstory here is twofold. First, a good news story on recovery, largely driven by the US - an outsized spurt in growth and inflation is practically guaranteed for 2021, and in an accelerated manner. A sense of post-pandemic euphoria will be part of this in the second half the year.

Second, a decent chunk of the kudos for the positive outlook is attributed to the official sector, and the Federal Reserve remains fully engaged with a monetary policy stance that is in full-on easing mode. In fact it remains remarkably loose - zero rates, "practically guaranteed" for the next year or so, and an ongoing \$120bn of bond buying per month.

The latter is important. It injects liquidity directly into the system. It's big too. Remember when the Fed announced its last taper of bond buying in late 2013, it was doing lower volumes, of \$85bn per month.

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Fed bond buying also encourages investor to buy out the credit curve, as recipients of cash reinvest in other, typically more risky, product. In other words, the Fed buying program not just injects liquidity, but also encourages risk-taking, which in turn supports credit markets. Its not the driver of tight credit spread, but it helps.

These are all interconnected, and there is a clear transmission to higher long end rates here too, as the reflation story gains in credibility. But the front end is where it it is all brewing, where there is catch-all evidence of a very easy monetary stance.

## **Crazy stuff going on on the front end, as rates look to dive even lower**

There are also growing implications for the front end of the curve. In recent days, overnight SOFR (secured overnight financing rate) has been in the 1bp to 3bp area, having drifted down from around 10bp at the turn of the year. This is dangerously close to zero, and indeed to negative rates.

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*SOFR is not the Fed's policy rate of course, and it does not have an official mandate to control it. But still a move into negative territory would not be ideal, as some could argue that the front end has gone rogue.*

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The drivers on the front end are an exceptional excess of supply of liquidity. Added to that, the US Treasury has made clear that they have an ambition to spend down a chunk of the \$1.7trn sitting on the Fed's balance sheet. It got there through aggressive T-bill issuance through 2020 as a Covid buffer was built. The thing is, a spend of this effectively pushes it into the supply side of the liquidity equation, as it adds to banks reserves, and pushes down on ultra short month market rates.

While the Fed's effective funds rate is holding in the 7bp area, there could well be pressure for that to edge lower against this backdrop. That would be uncomfortable for the Fed, as it currently operates under a floor to ceiling range of zero to 25bp for the fed funds rate.

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What the Fed could do is hike the rate it pays on excess reserves, or even the rate it pays on repo, all in an effort to keep the funds rate comfortably above zero, and ideally to coax front end rates generally away from zero, noting that market repo rates are already printing negative in the -10bp area.

The other way to tempt front end rates higher could be to mop it up through bills issuance. However, the Treasury has an ambition to reduce T-bill as a proportion of debt from over 25% currently, down towards 20% (it was at around 15%). In fact, collateral for repo falls as a consequence too, which can place downward pressure on SOFR (which is effectively a compilation of repo rates). Note that repo can also be curbed as higher bank reserves act to stretch assets to equity ratios.

## Long end rates are being driven by reflation with a significant inflation tail

The juxtaposition between this and what is happening on the longer end of the curve is quite stark. But they are also related. Exceptionally easy monetary policy is pushing ultra front end rates lower, while at the same time it leaves longer tenor rates very exposed to inflation risks. The worst enemy of the fixed income investor is inflation, as it erodes the real value of future fixed coupon and principal payments. Holders of long dated bonds feel quite vulnerable here, as the Fed is offering minimal protection against that risk.

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The rapid rise in long dated Treasury yields should be contextualized against this backdrop. Higher rates reflect the risk that the reflation theme morphs into an untamed inflation rise. The accelerated move higher that saw the 10yr briefly touch 1.6% was the culmination of a dramatic move above 1.3% in a matter of days, and only a couple of weeks from a brief threat to test below 1%. Flows show a clear reduction in duration strategy in bond space, and the acceleration higher in rates also reflected futures selling by mortgage backed players (hedging reduced refinancing as rates remained on a rising journey).

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There has also been a notable rise in real yields. Not an area that is looked at much outside of fixed income, but it is important. A few weeks back the 10yr real yield was -1.1% (effectively the 10yr yield minus an inflation expectation). It is now at -65bp. That's a huge move in real space.

But look at where it is now; still deep in negative territory. If the reflection theme is the real deal, then long tenor real rates should not be negative.

This in fact provides upside potential, say targeting a return to a zero real yield for the 10yr, which translates into the 2% area as an objective in for the conventional 10yr yield. That's still some way from where we are now. Near-term wobbles on risk assets will obstruct such a move. But if this is a true reflationary process that takes us well clear from the prior deflationary tail risk, then we should be mid-cycle on a rising yields trend.

Yesterday was a down day for risk assets. That tells us very little, as we get those from time to time. But a down day today would add to the angst, making for a pervious Monday. To be seen. In any event, we are likely on a journey here toward even higher rates. The dramatic cheapening of the 5yr to the curve is a technical signal that this has indeed morphed into a bear market for bonds. This is not a bad thing, as it is evidence of recovery from Covid despair. In that sense it is something we should really embrace.

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