

US Treasuries - bullish. But it's complicated

What's going on with inflation breakevens? Tariffs are supposed to push up prices, but breakevens have fallen. Not great as it points to macro malaise. Equities down too points to lower earnings. Lower bond yields gel with that, and we likely get more. But as we likely hit 4% inflation again in the months ahead, longer rates will be pressured back up again



We see yields heading lower for the next few months

Tariffs are supposed to push up prices, so why have inflation breakevens fallen then?

So-called "liberation day" caused many and varied market reactions. The most notable was the virtual collapse in equity valuations. While understandable, this was a tad strange, as the tariff announcements were not that deviant from what was expected. The 10% baseline was one that Donald Trump campaigned on, and 60% on China was another. And reciprocal tariffs were an overlay on top of that, much of which panned out as could be anticipated from existing trade deficits. So why the collapse? The only logical rationale is a belated downsizing to future earnings, with structural implications. In that sense, this is bad.

The quirky world of bond inflation breakevens did something that few could have predicted - they collapsed lower

Tariffs will place upward pressure on prices, so surely inflation breakevens should have shot higher. But they didn't. The 10yr inflation breakeven in fact fell, from 2.35% to 2.20%. That may not seem a lot, but it paints one potential troubling picture. For tariff-induced price hikes to result in a fall in inflation expectations there must be an assumption for an intermediate period of macro pain that manifests in dis-inflation as a second-round effect.

There is good and bad from the fall in inflation breakevens. The good is that it perhaps allows room for the Federal Reserve to cut quicker should the macro economy weaken in the coming months. The bad is it begins to paint a picture of macro malaise. It's too early to make that call. But we can't ignore what we are seeing. Thankfully, the fed funds strip paints a better picture. One where rates get cut, but don't have to go through the floor.

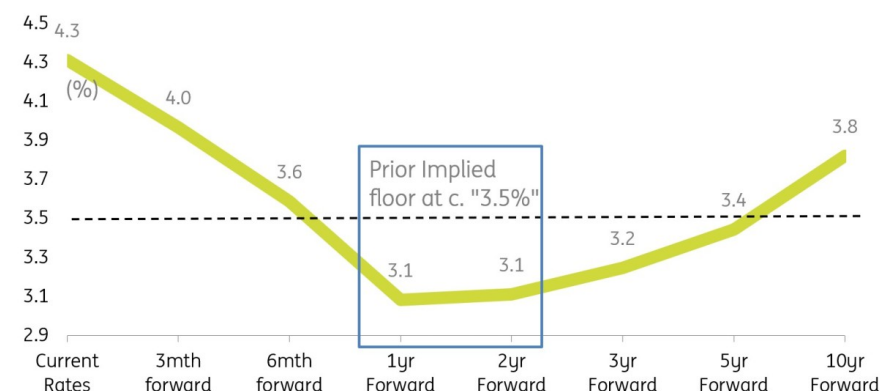
We noted a bullish tendency a month ago, but the gap lower in yield has taken us to a new dimension

About a month ago we set out our latest vision for US market rates. It's [here](#). We concluded with the following – “Right now, the knee-jerk should be bullish for Treasuries. We've also identified a floor, and how that floor could in fact shift lower”. Well, in the wake of 2 April (liberation day) that floor *has* shifted lower. Instead of flooring in the area of 3.5%, the 1mth SOFR rate is now discounted to floor at closer to 3%.

That 50bp gap lower has been echoed right out the curve. In effect the dominant reaction has been a gap lower in the entire curve, by some 40bp. The 2yr yield is now approaching 3.5%. The 10yr yield has done something similar, gapping down to sub-4%. The overall curve has steepened, but not by much. The question is where now?

The implied floor for the funds rate shifts down towards 3%

The chart shows the 1mth SOFR rate (proxy for funds rate) and the market forward discount



Source: Macrobond, ING estimates

The significant build in the rate cut discount now being confronted by Chair Powell's "persistent" risk for inflation

First, on the aforementioned “floor”. This is set by the market discount for the Fed funds rate, which we proxy by the 1mth SOFR rate. Currently, it’s discounted to get to about 3.1%. That equates to a full 100bp in rate cuts, and with a significant bias towards 125bp.

Important point – theoretically, getting to the 3% to 3.25% area for the funds rate is simply getting to a neutral valuation for the funds rate. And getting to a neutral valuation for the funds rate is not consistent with a damaging recession. It’s actually consistent with a much softer landing than risk assets seem to be fretting about

An important complicating factor here is inflation. We’re facing into a slowdown tendency for activity as a consequence of the tariff tit-for-tat. Hence the collapse in market rates. But at the same time, US inflation is very likely going to re-visit the 4% area again (tariff effect), within calendar year 2025. That alone is a clear negative for Treasuries. On top of that, Chair Powell in his first comments since “liberation day” has lobbed the word “persistent” into the conversation, as a risk for inflation. That places a clear constraint on the willingness to chop rates, as longer-term inflation needs to be anchored.

Growth angst for now is trumping the inflation risk from tariffs, hence the room for still lower yields

The risk is Chair Powell can’t cut by as much as he’d like to, for fear of morphing tariff-induced prices rises to a sustained inflationary tendency. In this scenario, the Fed gets the funds rate to neutral when in fact they would prefer to push it through neutral. Here, downward pressure is placed on the 10yr yield.

Such an outcome rationalises the 10yr yield dipping down to the 3.5% area, and is emerging as a likely outcome in the coming months

And especially as the Fed can’t pre-empt macro weakness, as the inflation risk has also been elevated. So we have an outcome where material activity weakness trumps price rise negativities for bonds’ valuations. Hence the drive for even lower yields.

If neutrality for the funds rate is the landing zone, at a certain

point there must be a tendency for the 10yr yield to edge back up again

Beyond that, it may take some time, but logic would suggest that landing at neutral and holding there as a floor would ultimately manifest in a re-steepening of the curve. And we'd then eye 4% as a logical area to aim for on the 10yr. Remember, we have the likelihood for a 4% inflation print in the works, plus a still elevated fiscal deficit and associated issuance pressure. These argue, ultimately, for a steeper curve.

The macro angst factor is now dominating, and hence the concession to a more bullish viewpoint for Treasuries, at least in the coming months.

The 10yr yield is now at 4%. It could dip to 3.5% through the second quarter

It could even go lower. But on the assumption for a more stable third into fourth quarter, the curve should be in a position to build back out again, with the 10yr getting to comfortably back above 4%. All assuming no big damaging recession; a case admittedly that still needs to be proven by events ahead.

Longer term, the curve will still need to steepen out from the back end, taking long rates back up again

Our impression right now is for a troubling second quarter, but then a mending process. That process could take a few quarters, but would still represent a recovery of sorts from the alternative risk of the type of abyss now being contemplated by the latest risk asset discount. In fact, there is even a scenario where we could latch on to our prior expectation for the 10yr yield to hit 5%. It centred on the inflation risk from tariffs dominating the activity hit, plus an ongoing fiscal mess manifesting in sustained issuance pressure. This has not gone away as a combination that could re-emerge. Forget that for now though, as yields head lower first and continue to do so for a number of months at the very least, unless something changes.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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