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For Treasuries and the Dollar, History Rhymes

Using the 2016 to 2018 period as a roadmap for 2021

Starting three weeks ago, in our piece Goldilocks and the Three Bears, we began a shift to an increasingly bearish stance on sovereign bonds in the UK, US, and Europe. We see higher sovereign yields in each region, but across all three we have slightly different expressions.

- Two weeks ago we actively went short US 5yr notes (at 0.80%, along with some other expressions). Having in addition to recommending shorts in 5s at 0.80%, we recommended paying 2y2y at 0.85% and short 5s on the 2s5s10s butterfly at -10bps (having just missed our -15bp entry the week before).
- In the UK, we have been bearish for most of this year. We are focusing shorts on 10yr yields and via paying 2y1y SONIA.
- In the Euro-area, Head of European Rates Strategy Giles Gale wrote about The end of the bund supercycle, a title that pretty much says it all. We are most bearish the long end and in addition to outright shorts we think 10s30s can steepen further (a long held view).

In this note, we discuss our preference for shorts in the belly of the US curve and how price action through the end of the post-GFC Fed easing cycle (2013 – 2018) has influenced our thinking on US rates, as well as the USD. It looks increasingly clear that, despite Powell's ultra-dovish insistence last week, the beginning of the end of the Fed's post-pandemic easing cycle is nigh. While recent price action, particularly in 1Q 2021, has clear similarities to the 2013 taper tantrum, we think the 2016 to 2018 period is a better analogy for 2Q 2021 and beyond. This argues for shorts in the belly and a flattening bias for the UST curve. On the USD, the wider global growth context (in this case, a positive one) and speed of any bearish UST / flattening move are critical to assessing how higher yields may impact the USD.

As we discussed in this past weekend's Weekly Thematic Review, we think that the belly may prove more exposed than the long-end to market pricing in additional rate hikes into the near- but not immediate-term horizon. Regardless of if the Fed actually *delivers* hikes before 2023, we think the market *needs to price in* some greater probability that they may hike in that window. Further, we expect some stickiness with fresh pricing of Fed rate

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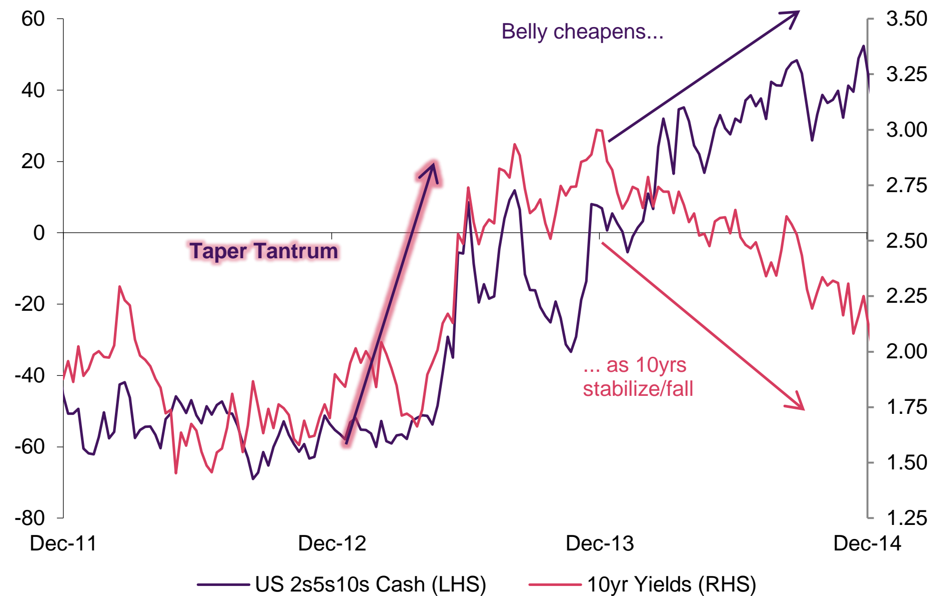
hikes – even if the Fed holds an ultra-dovish stance, we anticipate the market will roll that pricing forward over time, rather than simply price out the risk of future hikes.

This is not dissimilar to the post-2013 taper experience where once the long end sold off, the belly cheapened in anticipation of future hikes, despite the fact they were years away.

US 2s5s10s Cash Butterfly (bps), US 10yr Yields (%)

Source: Bloomberg, NWM



2016 to 2018 Is a Better Analogy for 2021 Because of the Fiscal Easing Cycle

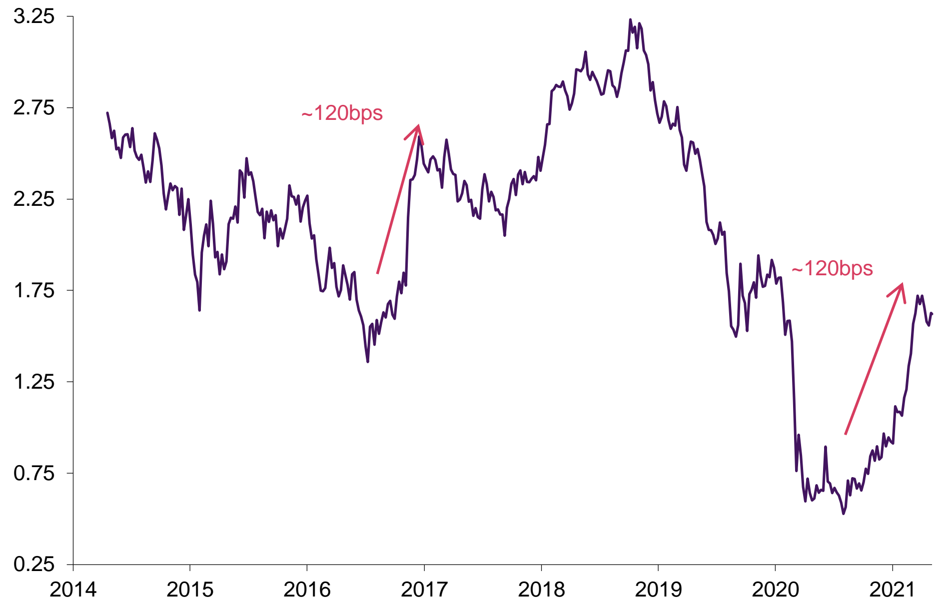
The fiscal impulse is arguably the strongest reason why 2016-2018, rather than 2013, is the better comparison point for Treasury markets today. The 2013 taper tantrum occurred against a backdrop of Tea Party anti-deficit activism, debt ceiling squabbles, and mandatory fiscal spending restraint forced by the sequester.

But the shift in growth expectations, and with it Fed expectations, in both 2016 and 2021 were strongly motivated by a decisive shift toward easier fiscal policy. In 2016, after the Republican sweep of government in the 2016 elections, 10yr yields rose 82bps, culminating what was a 123bp bear move that started the previous summer. With the Republican victory, forecasters became more optimistic on the US growth outlook based on expectations for deficit funded tax cuts and infrastructure spending, in addition to a more positive business environment that included a lighter regulatory touch.

In 2021, we have seen a 120bp rise in 10yr yields from last summer, on rising optimism for the growth outlook, this time based on an economic reopening from a pandemic, reinforced by large deficit funded spending plans via the various COVID rescue bills (and potentially more via infrastructure spending).

US 10yr Yields (%), Weekly

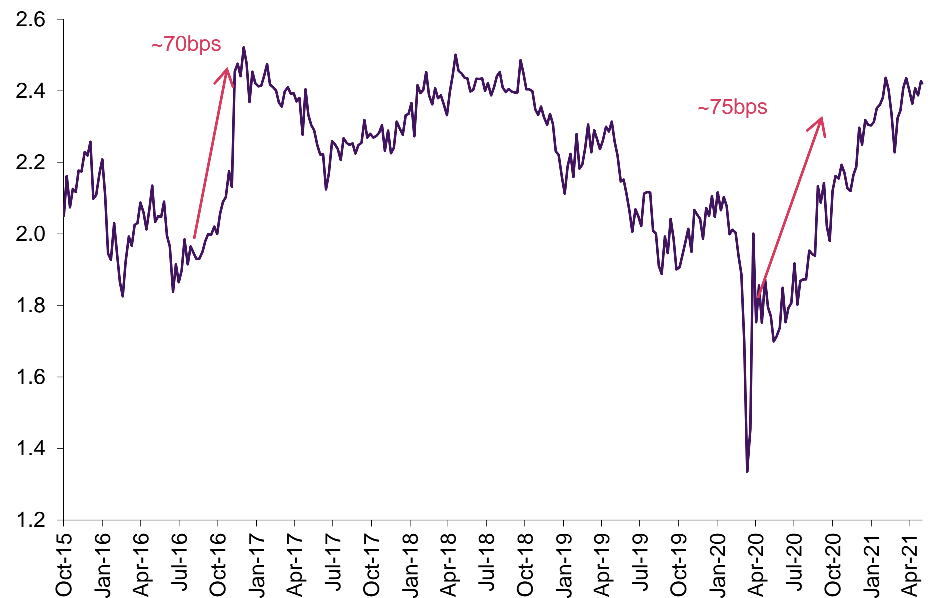
Source: Bloomberg, NWM



Interestingly, market inflation expectations in the aftermath of the 2016 US Presidential election rose by nearly exactly the same amount as they have risen from 2020-2021, excluding the immediate post-shutdown plunge in March 2020. *We do think that now the risk of future inflation is higher than in 2016*, but will return to that later.

US 5y5y Inflation Swap (%), Weekly

Source: Bloomberg, NWM

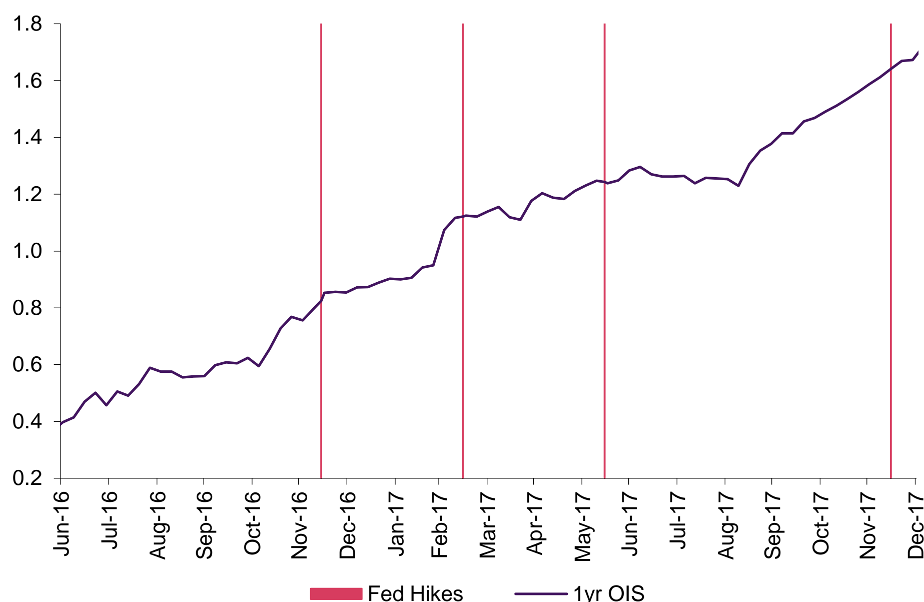


One significant difference between 2016 and 2021 is the Fed outlook – in 2016 the Fed was in fact (slowly) on the move. Even so, during the 2015-2018 rate hiking cycle, the

market was reluctant to price in much in the way of future hikes, which helps make the comparison to now more palatable. Graphically, you can see how 1y OIS in that period never priced in much in the way of future hikes, but drifted higher into meeting dates. The market reluctance was justified, in hindsight, by frequent pauses in the initial rate tightening cycle, especially early on. After a single hike in December 2015, the Fed took a year to raise rates again in December 2016. The Fed then raised rates in March and June 2017 by 25bps each before pausing again. Looking ahead, we see risk of the market pricing a more aggressive Fed as a feature of the end of the current easing cycle, given the strength of the recovery, the huge size of fiscal stimulus in the system, and the fears of inflation. It is this expected market pricing which in our view presents greater risks to the belly of the curve.

US 1y OIS (%), Weekly

Source: Bloomberg, NWM

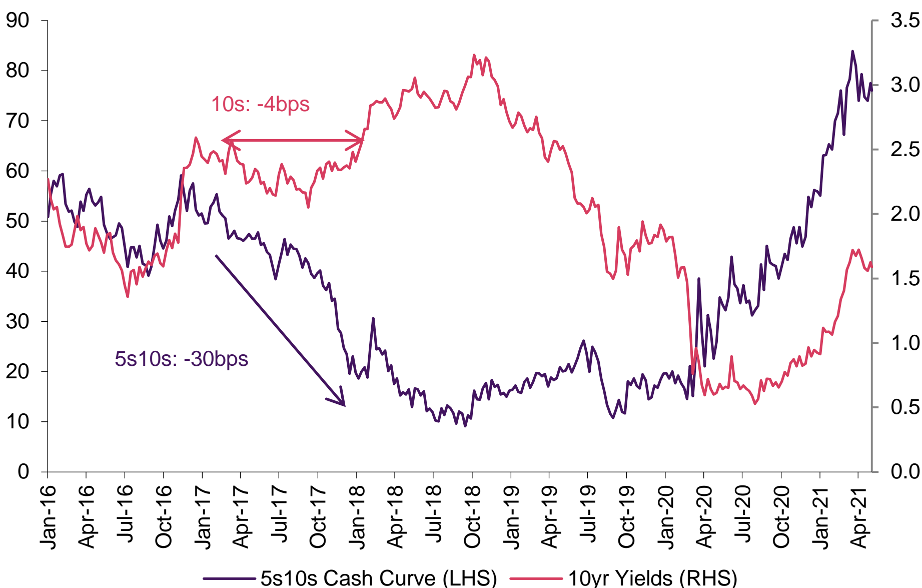


Where Are We Now? 2017. Ranges in Long End With a Flattening Bias / Short Belly

So where does that leave us now? We think currently we are going to be in a period similar to that of 2017. At the time, an initial surge in yields on expectations of higher growth and inflation after the 2016 Presidential election, US 10yr yields settled into a range, waiting to see if those expectations deserved to be validated. However, while 10yr yields over 2017 had a net change on the year of only -4bps, the 5s10s cash yield curve flattened ~30bps due primarily to upward pressure on the belly. In addition, the 2s5s10s butterfly in 2016 (and in 2013 for that matter) traded closer to 20-30bps, versus -10bps presently. Note, we do not think the history of 2017 will repeat, but we do think it will rhyme: *we do think 2021 will be on an accelerated timeline*, and not as long as 2017 (we are thinking more along the lines of ~6 months), given the strength of the current rebound and our belief high growth expectations will be verified by year-end (see Global Economic Quarterly | Rational Exuberance for our above-consensus global growth forecasts). **Given this, we are adding a 5s10s curve flattener to our basket of trades,** and expect the rates selloff to resume once this current consolidation period ends – after the 2017 pause, 10yr yields rose an additional ~90bps to their peak.

US 10yr Yields (%), US 5s10s Cash Curve (bps), Weekly

Source: Bloomberg, NWM



To be sure, 2017 and 2021 have some stark differences, as noted most obviously in 2017 the Fed did raise rates three times, something that almost certainly won't happen in 2021, but as also previously noted the market was reluctant even then to price in much more in the way of future hikes throughout 2017. Presently, by comparison, the market has ~4x 25bp rate hikes between now and the end of 2024, with the first full 25bps not priced until approximately mid-2023 despite a more explosive economic recovery, much greater fiscal stimulus, and also much greater uncertainty around the inflation outlook. We think these argue for a wider band of Fed hike probabilities compared to both the 2017 cycle and current market pricing.

Speaking of inflation, the issue of inflation is a medium term to our view: that we are underestimating the near term potential for inflation to stay high, past the next several months when higher prints are expected due to base effects. We see this as a risk to our view for we expect the Fed to stay on hold as long as they can to gain credibility around flexible average inflation targeting (FAIT), a desire to generate said inflation over a period of time, and given their new social approach to monetary policy. This could cause a curve steepening as the market builds in great inflation risk premium ("behind the curve"), against our view.

The other risk to our view is that US growth underwhelms versus the market's incredibly high (albeit justified) expectations for GDP growth in 2021 and beyond. A disappointment could manifest in several forms, but perhaps the most obvious near-term risks stems from a new Covid-19 variant emerging that is resistant to current vaccines, delaying or even reversing reopening. We think this scenario could bring with it additional steepening, as Fed tapering expectations are delayed indefinitely while expectations of another deficit-funded substantial Covid-19 relief stimulus package is priced in.

Arguably a related risk is Biden's recently announced infrastructure and social spending plans, though we are less worried here. These plans are very different than the American Rescue Plan, in that they have "pay-fors" and the stimulus from them will be spread out over as long as 10 years. In addition, we have some doubts that the entire $4tn in packages will be passed, with infrastructure possibly by the fall and the social bill perhaps

not until next year. While the risk to deficits / supply on Biden's infrastructure plan is undoubtedly on the upside (less revenue raisers and more spending), Biden's infrastructure push differs massively from the Covid-19 relief package in both the level of deficit funding and on timing of government expenditures.

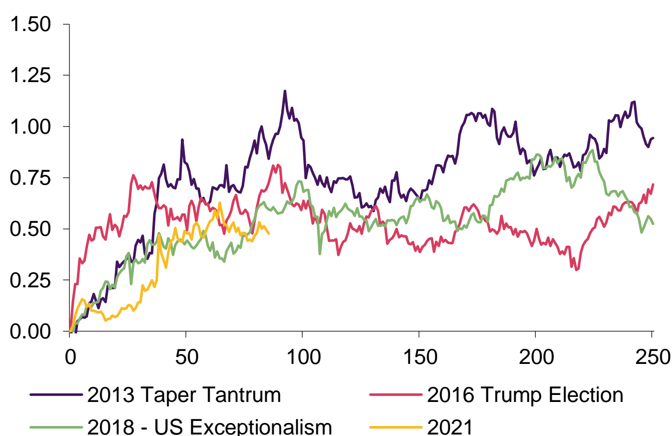
Global Growth Context of US Rate Move is Key for the USD

The path of US interest rates, both in absolute and relative terms, is critical for the outlook for the USD. As was quite apparent early in 2021, a rapid rise US yields, regardless of its exact driver, has significant carry-to-vol implications across the FX landscape, particularly for high-beta FX across emerging markets. Furthermore, the surge in US yields in early 2021 also reflected a shift in relative growth expectations across regions as the US has shifted from a likely laggard of the post-Covid-19 recovery to a strong leader, backed by fiscal stimulus. NWM economists now expect US economic outlook may exceed 9% y/y in 2021, though significant US outperformance we suspect is now more fully in the price.

A rise in US rates, particularly one that comes if the market pulls forward tightening expectations, is one that likely reads positive for the USD. But what is notable about USD price action during the course of the Fed's multi-year cycle shift from 2013 to 2018 was that USD price action was hardly consistent across the various instances of rising US 5yr yields. Below we present two charts showing price action in 5yr UST yields and the DXY (normalized) over four broad periods of market tightening – the 2013 taper tantrum, the post-Trump election / early tightening cycle of late 2016/early 2017, the later tightening cycle / post tax reform / trade war era we loosely call the "US exceptionalism" period through 2018, and today.

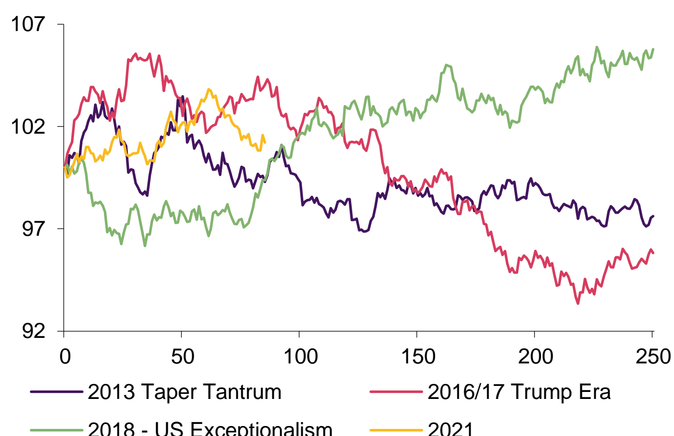
Change in US 5yr Yield over select periods of rising yields

Source: Bloomberg, NWM
2013 Taper Tantrum – 30 April 2013 = 0
2016 Trump Election – 8 November 2016 = 0
2018 US exceptionalism – 27 December 2017 = 0
2021 – 4 January 2021 = 0



Normalized change in DXY over select periods of higher yields

Source: Bloomberg, NWM
2013 Taper Tantrum – 30 April 2013 = 0
2016 Trump Election – 8 November 2016 = 0
2018 US exceptionalism – 27 December 2017 = 0
2021 – 4 January 2021 = 0



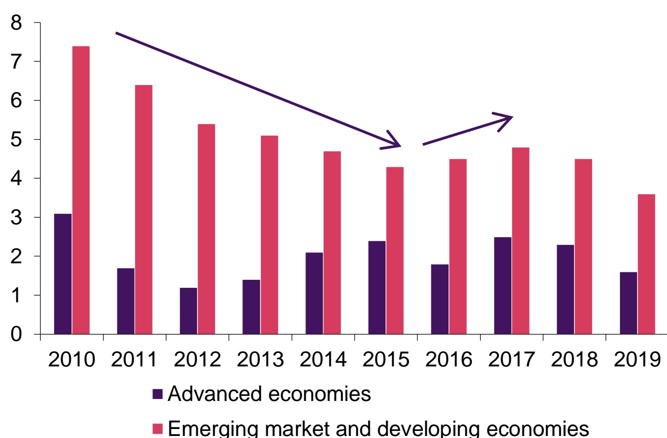
Not only is USD price action inconsistent across these periods of rising US 5yr yields in each case, but USD price action in 2017, the period we see as most analogous to today's US rates market, was quite poor despite persistent quarterly FOMC interest rate hikes. We think this is largely due to the strengthening global outlook alongside the stronger outlook for the US economy, which can certainly play out over the Covid-19 recovery. Looking back at GDP growth broadly over the past decade, 2016 and 2017 represented local peaks in GDP growth in emerging market economies after years of steadily

declining growth rates in the years following the GFC (see below). Suffice it to say, 2021 looks likely to meet that same standard – one in which US outperformance is seen alongside a rising global economic outlook.

Taken together, we are not anticipating a bear flattening in the US rates market to have a significant positive impact on the USD. Instead, we expect a strong global growth profile to continue to benefit risk and global growth sensitive assets at the detriment to the safe-haven USD. There are two major risks to this view – the first is that the global economic outlook *outside the US* falters while the US outlook remains strong. Perhaps the clearest risk on this front comes from Covid-19, given both variant risk as well as differentiated vaccination rates across developed and emerging economies.

GDP Growth – Advanced Economies vs. EM Economies. Rising EM economic growth was likely a key input into USD price action through rising yields in 2016/2017.

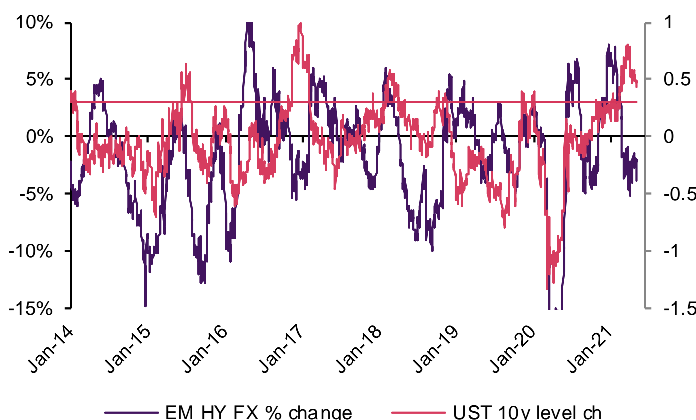
Source: IMF, NWM



A 30-50bp move in USTs (horizontal line) has been consistent with a peak in EMFX returns

Source: Bloomberg, NWM

3m changes. HY EM is an equal-weighted basket of INR, IDR RUB, TRY, ZAR, BRL, MXN, COP.



The second risk to this view undoubtedly relates to the speed of any rise in interest rates and the implications it has for global capital flows, particularly to EM. At the onset of 2021, our EM colleagues found that a 30-50bp move in the US 10yr yield over a 3m period, for example, was consistent with a peak in EMFX returns. A repeat of the early 2021 period, where a rapid move higher in US rates upends bullish risk positioning, is a risk to our outlook.

Against this macro and financial outlook, we continue to find selective opportunities in EMFX, especially where a) valuations to fundamentals (i.e., commodities) have reached multi-year highs, and b) carry-to-vol ratios have started to improve as inflation pressures have pushed central banks towards monetary policy normalization. In particular, we continue to favor high-beta expression through RUB & COP (here) and BRL (here) vs a dollar and euro basket, while retaining our defensive stance on MXN and INR. Again, our longs should offer more protection from the tightening of global financial conditions as long as commodities remain supported.

On the G10 side, we think long USD/JPY and USD/CHF are appropriate expressions of a potential strong global growth / higher US yield environment, and we are long both. But our portfolio is generally quite risk positive, and leans bearish on the USD – we continue to favor AUD/USD long, anticipating resilience coming from strong commodity prices. We are long GBP and SEK against the USD as well, seeing the latter as a high-beta expression of a recovery in the Euro-area.

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