Rates

Desk Strategy

US Rates

July 22, 2021

US Rates Forecast: Stick with the cycle

The narrative has shifted from reflation to caution, but in a world of growing concerns, the US remains exceptional

Entering 2021, the reflation theme dominated markets, reinforced by faster than expected vaccinations and growing optimism on re-openings, growth and inflation. We ourselves were espousing this theme, with bear steepening views on US rates and longs in US inflation, as well as a generally positive outlook on risk.

As we look forward to the second half and beyond, despite a series of stronger than expected US inflation reports, reflation has been replaced with trepidation. Long yields have turned lower, on back of a Fed rhetoric shift towards a more balanced risk outlook, reassuring investors the monetary authority will not let inflation get out of control, as well as more recent concerns about peak growth (especially in Asia and specifically China) and worries that the Delta variant will force new restrictions. Thus the idea of a synchronized global recovery is on the retreat, replaced by a much more segmented outlook even if/once we move past recent worries surrounding the Delta variant.

Looking forward, within that more segmented outlook, we remain very optimistic on the US growth outlook, and this and our higher than consensus inflation forecasts will be a challenge for both the markets and the Fed in the second half. Thus we see higher yields, but as we initially laid out in For Treasuries and the Dollar, History Rhymes back on May 5th, we continue to see the bulk of the pressure for yields focused on the belly, with a continuing flattening on 5s10s and 5s30s, as is natural for this point in the cycle. While the rise of the Delta variant is a near term and significant risk, unless rising cases lead to significant growth in hospitalizations and thus wider restrictions, we think the current scare will be "transitory".

Growth, inflation, and the Fed

Before we lay out our updated rates forecast, we review our above consensus growth and inflation forecasts, and what that means for the Fed going forward. As seen in the

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table on the following page, we see double digit real GDP growth for Q2 (saar), with 8.5% in Q3 and 7.5% in Q4, putting 2021 GDP at +7.1% y/y. Additionally, for 2022, we do not see a substantial fall off in growth, with 2022 real GDP settling in at 5.4% y/y, though with the bulk of the strong growth early in the year. As for employment, we see the unemployment rate falling to 4.9% at the end of 2021, and continuing to fall towards 3.6% at the end of 2022.

US Forecast Summary

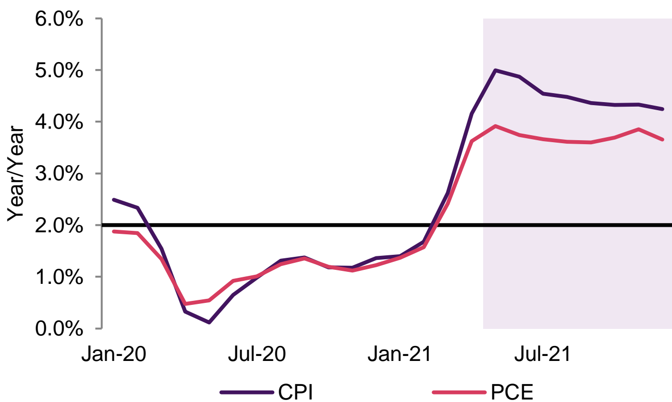
Source: BEA, BLS, FRB, NWM. *End of period

	% q/q, seasonally adjusted, annualised								% year/year		
	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	2020	2021	2022
Real GDP	6.4	10.5	8.5	7.5	6.4	2.0	2.3	2.0	-3.5	7.1	5.4
Household consumption	11.3	10.0	10.0	10.0	9.0	3.0	2.0	1.5	-3.9	8.8	6.8
Non-residential fixed investment	10.8	7.2	5.5	5.6	2.0	1.5	1.6	2.0	-4.0	8.3	3.3
Residential investment	12.7	-8.0	6.0	6.0	2.5	2.5	2.7	3.0	6.1	12.3	2.9
Government expenditure	5.7	3.1	2.5	1.8	1.8	1.8	1.8	1.8	1.1	1.8	2.0
Inventory investment (% pt)	-3.0	2.5	1.6	0.7	-0.5	-0.7	0.4	0.4	-0.7	0.7	0.3
Net exports (% pt)	-0.9	0.2	-1.1	-1.1	0.3	0.0	0.0	0.0	-0.1	-1.5	-0.3
Nominal GDP	11.0	13.0	10.5	8.0	8.2	3.7	4.1	3.8	-2.3	9.7	7.0
Unemployment Rate, % (average)	6.2	5.9	5.5	4.9	4.4	4.0	3.7	3.6	8.1	5.6	3.9
PCE inflation, % y/y	1.7	3.8	3.8	4.0	3.7	2.7	2.4	2.4	1.2	4.0	2.4
PCE core inflation, % y/y	1.5	3.3	3.2	3.4	3.3	2.4	2.3	2.4	1.4	3.4	2.4
Fed Funds Target Range, %*	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25

While our growth outlook is impressive, it is on the inflation side where we expect our stronger than consensus forecasts will be a challenge for both the markets and the Fed alike, and call into question the idea of “transitory” inflation, at least through the first quarter of 2022. As seen in the charts below, for both CPI and PCE inflation, and for both headline and core, we see inflation well over 3% y/y for the rest of the year, with 3%+ y/y core PCE inflation continuing into the first quarter of 2022, before settling down in the 2.3%-2.4% y/y range.

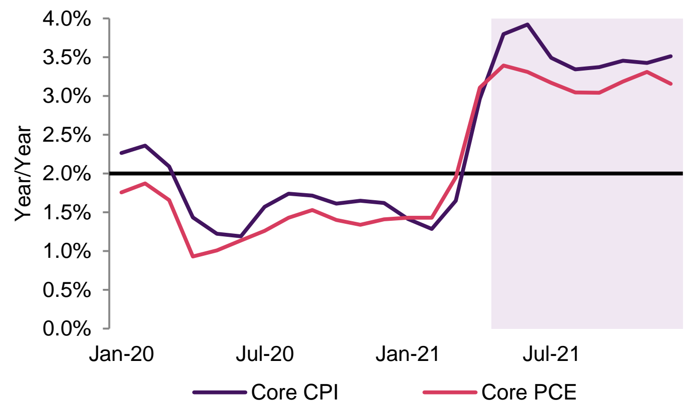
Headline Inflation: CPI vs PCE

Source: Bureau of Economic Analysis, Bureau of Labor Statistics and NatWest Markets



Core Inflation: CPI vs PCE

Source: Bureau of Economic Analysis, Bureau of Labor Statistics and NatWest Markets



While the above inflation scenario may lead to a difficult time for the markets and the Fed later this year, NWM Economics believes that with inflation falling back to ~2.3% by Q2,

the Fed will be able to resist pressure for tighter policy and, after taper beings in Q1 of 2022, the Fed will delay the first rate hike until September of 2023. This would support the Fed's goal of maximum employment, redefined as 'broad-based' and 'inclusive'. For full details of our US and global economic and policy outlook, see Monetary Policy – Loitering With Intent?

Our US Interest Rate Forecast

Below we present our updated modal US interest rate forecast, which we view as center points around band of potential outcomes exists, albeit one that this year we see the risks as skewed towards higher rates (more on this below).

2021 and 2022 US Rate Forecast (cash US Treasuries)

Source: Bloomberg, NatWest Markets

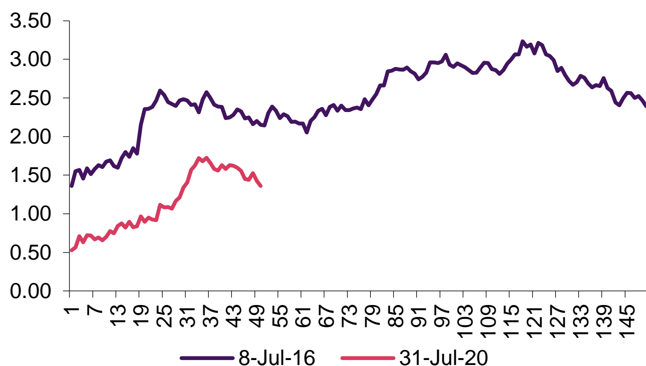
		2021		2022			
	Now	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
3m OIS	0.09	0.10	0.10	0.10	0.10	0.10	0.10
2s	0.21	0.40	0.50	0.70	0.85	1.00	1.25
5s	0.74	1.05	1.25	1.40	1.55	1.70	1.85
10s	1.29	1.50	1.65	1.80	1.90	2.05	2.15
30s	1.94	2.10	2.15	2.25	2.35	2.40	2.45
2s10s	109	110	115	110	105	105	90
5s10s	55	45	40	40	35	35	30
5s30s	120	105	90	85	80	70	60
10s30s	64	60	50	45	45	35	30

In addition to the economic assumptions discussed above, our base case reflects the following expectations:

- Despite the fact the Fed is moving towards tapering its current asset purchase program, we continue to believe that the current cycle will more closely reflect that of 2016-2018 versus 2013, a view we laid out in early May (again, see For Treasuries and the Dollar, History Rhymes). As the below charts show, over the course of the 2016-2018 period 10yr yields only changed 4bps over the course of 2017, but the curve flattened and the belly weakened. So far, 2021 is tracking that prior cycle nicely on several fronts. We broadly expect this to continue.

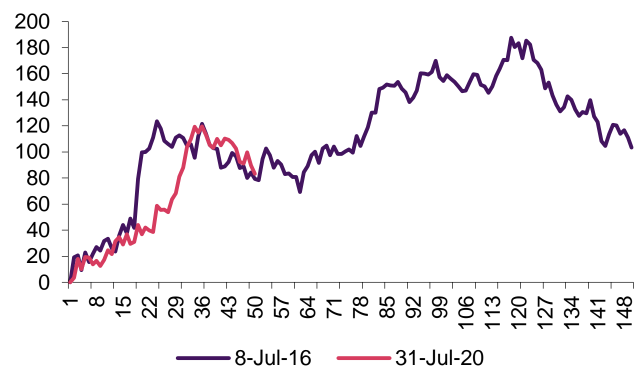
Recent history vs. 2016-2018 cycle, 10yr yields, from prior yield low (date indicated)

Source: Bloomberg, NatWest Markets



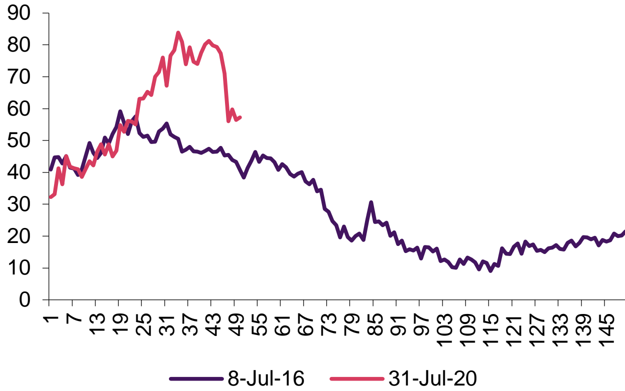
Recent history vs. 2016-2018 cycle, 10yr yields, cumulative change from prior yield low (date indicated)

Source: Bloomberg, NatWest Markets



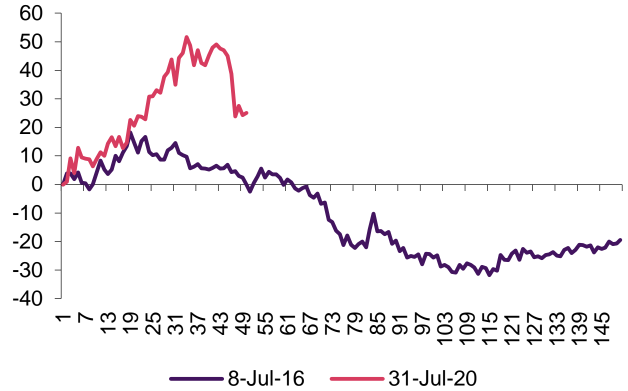
Recent history vs. 2016-2018 cycle, 5s10s curve, from prior yield low (date indicated)

Source: Bloomberg, NatWest Markets



Recent history vs. 2016-2018 cycle, 5s10s curve, cumulative change from prior yield low (date indicated)

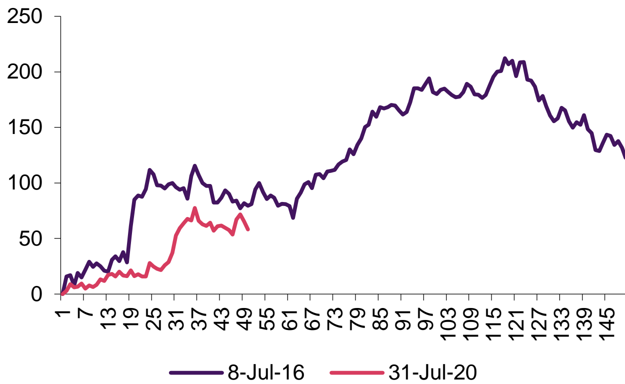
Source: Bloomberg, NatWest Markets



- Where we differ from the 2016-2018 experience is that while over the full year of 2017 benchmark 10yr yields changed only 4bps on net, we do see yields pressured higher on a faster timeline than the past experience, albeit led by the belly of the curve as the market increasingly prices in a Fed liftoff in future years (note: 2017 was also an exceptional year with 5 consecutive CPI prints surprising to the downside which compares to the current streak of 3 upside CPI surprises in 2021). We see this pressure on nominals due to consistently high and above target inflation over our current forecast horizon. This is somewhat similar to the post-taper 2013 environment where the market priced in increasing changes of rate hikes, and despite inaction from the Fed for several years, continued to just roll out that pricing as time went one.

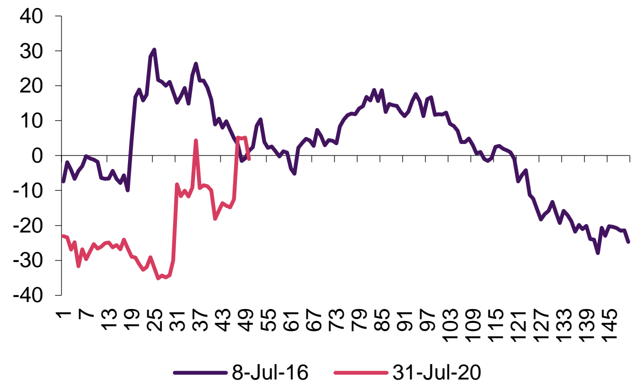
Recent history vs. 2016-2018 cycle, 5yr yields, cumulative change from prior yield low (date indicated)

Source: Bloomberg, NatWest Markets



Recent history vs. 2016-2018 cycle, 2s5s10s butterfly, from prior yield low (date indicated)

Source: Bloomberg, NatWest Markets



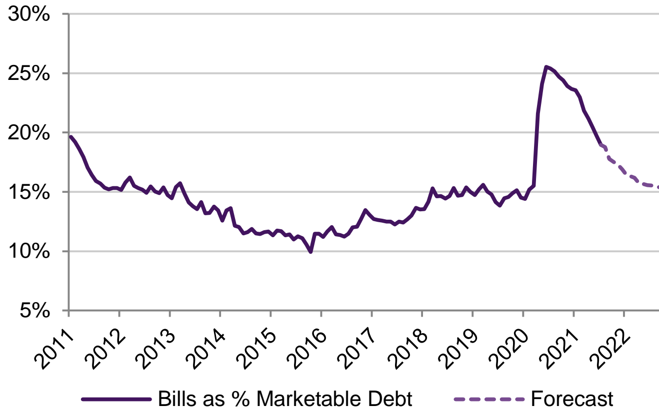
- Regarding the supply outlook, we expect Treasury to begin cutting coupon issuance at the November refunding, based on expectations of a $1.5tn deficit for FY22, and a long term post-Covid TGA balance of ~$500bn. While some uncertainties about additional fiscal stimulus packages and the pace of the recovery remain, from this early vantage point we have penciled in Treasury at the November refunding beginning with $2bn in cuts to 2s, 2yr FRNs, 3s, and 5s, $3bn in cuts to 7s and 10s,

and $2bn in cuts to 20s and 30s. It is possible Treasury may want to take a bit more out of 20s, given challenges to the issue since its arrival.

As for bills, we expect to see the recent trend of a decline in the outstanding stock to continue. As we head into the debt ceiling period, we do not think the Treasury will change coupon auction sizes, but rather cut bill auctions to remain within the debt limit boundaries – August/September could see an over $200bn reduction in net bills. However, going into next year, we think bills will stabilize near 15% of total marketable debt from the current ~20%.

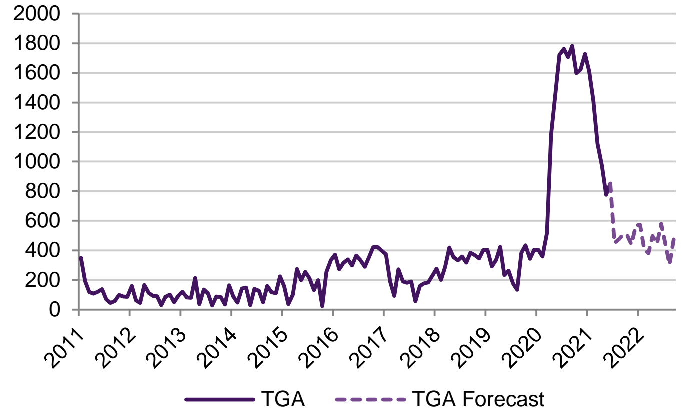
Bills as a % of Marketable Debt, NWM Forecast

Source: US Treasury, Federal Reserve, Bloomberg, NatWest Markets



Treasury General Account (TGA), NWM Forecast

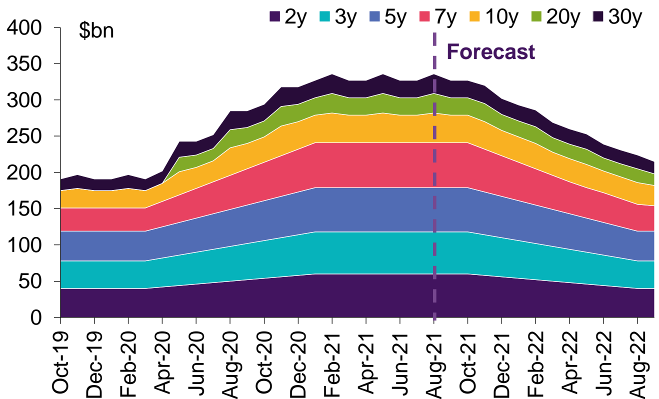
Source: US Treasury, Federal Reserve, Bloomberg, NatWest Markets



This is essentially an unwind of much of the Covid related ramp up in supply, but with a smoother exit path (we see further cuts to coupons extending through mid-2022). Recall in the supply ramp-up, Treasury increased the front end at a $2bn per month pace, but over the course of two refundings, 10yr initial auction sizes rose from $27bn to $38bn. We could see small cuts to TIPS as well, such as in the 5yr sector, but as of now we are leaving TIPS auction sizes unchanged in our baseline scenario. While these cuts are historically large, the impact purely from a supply-demand perspective is likely to be blunted to some degree by Fed tapering their asset purchases, though to what extent depends on the timing and pace of the reduction in purchases.

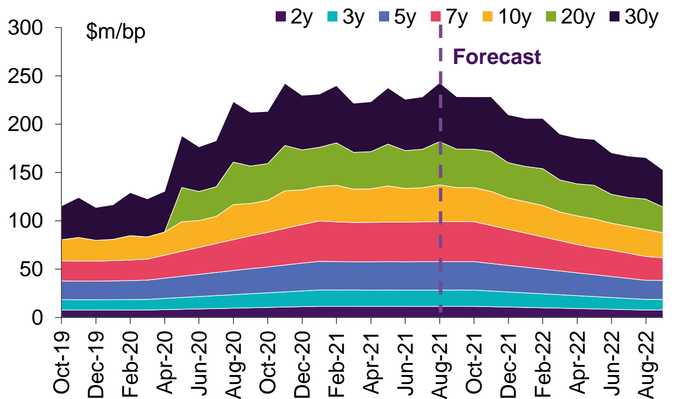
US Supply by Sector ($bn notional)

Source: US Treasury, Federal Reserve, Bloomberg, NatWest Markets



US Supply by Sector ($m/bp)

Source: US Treasury, Federal Reserve, Bloomberg, NatWest Markets



US inflation market – preference for the front-end

Turning from nominals to inflation, the June FOMC meeting has clearly divided the investor community with a substantial proportion expecting faster hikes that will ultimately slow down consumer prices. We believe this is the reasoning behind the 20bp decline in 30y US CPI swaps relative to the highs in June.

Tapering will unequivocally be negative for medium/long-term inflation expectations and being underweight long-end inflation seems to be the obvious trade. The challenge with this position is timing. Fed speakers quickly changed their tone following the June FOMC to prevent the market from over-pricing a premature tightening signal, which raising a clear risk to being underweight long-end inflation position: the widely expected tapering may materialize very slowly and much later than many anticipate.

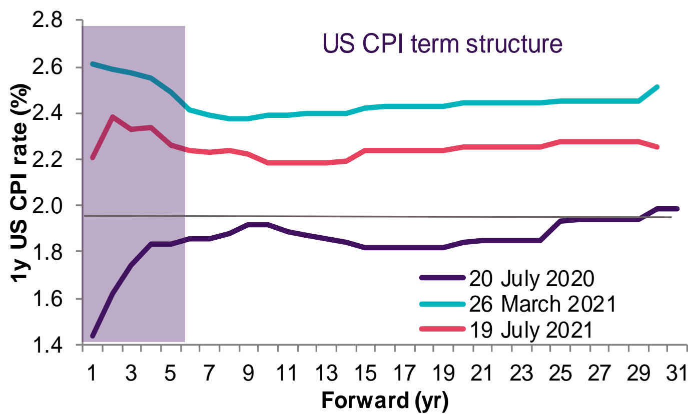
In the meantime, we believe that there is potential for front-end inflation swaps (2y) to widen and the recent drop in oil prices offers an attractive entry point to re-initiate longs (similar to the long 1y1y US CPI which we ran from November 2020 until April 2021).

The two charts below take a closer look at CPI swaps. The left chart shows changes across 1yFwd of the CPI term structure. The inversion at the front-end of the curve has moderated as all inflation forwards moved lower and the market seems to have embraced the view of “transitory inflation”.

Thus we want to use this opportunity to buy 2y US CPI swaps. We believe that there is still an asymmetry in the market with regards to CPI surprises. In our view, the potential risk is that inflation does not prove to be as transitory as many had expected which overall will flatten the entire CPI term structure. We prefer 2y CPI swaps to 1y1yFwd now as we want to benefit from any additional upside that will happen in the upcoming prints in 2021.

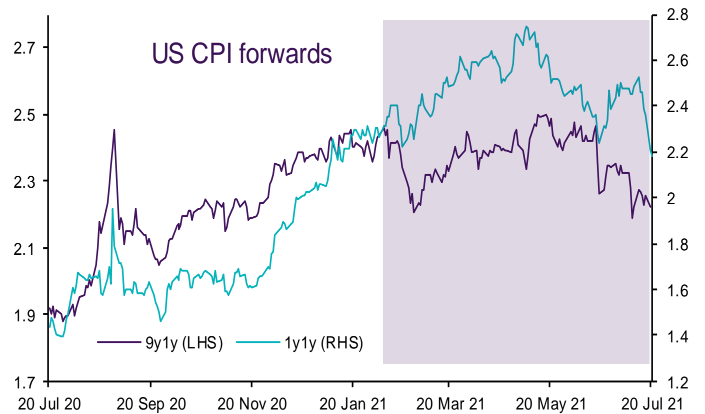
US CPI forwards

Source: NatWest Markets



Benefit from the recent cheapening at the front end

Source: Bloomberg, NatWest Markets



Recommendations

So on net, we hold the following recommendations previously initiated in May:

- Short 5yr yields from 0.80% targeting 1.30%, paid 2y2y OIS from 0.85% targeting 1.40%
- 5s10s flatteners from 78bps, targeting 25bps

- Short 5s on 2s5s10s butterfly from -10bps, targeting +20bps
- Long US 30s vs. Germany 30s from 200bps, targeting 150bps (combined view of flatter 5s30s and steeper EUR 10s30s)

And add:

- Long 2y US CPI swaps from 2.95%, targeting 3.2%

Notable risks to the outlook

As noted above, we see the risks to our forecast as biased to higher rates than our modal forecast, but downside risks exist as well. The main risks we see are:

- **Lower growth due to Delta variant (risk to lower yields):** This is the risk that the markets are currently applying an increasing probability to occurring. From our standpoint, we are optimistic on the growth outlook, but if the Delta variant or other variants lead to renewed lockdowns or restrictions, a subsequently lower growth outlook would further concern investors and the Fed, and reinforce that any near term inflation increases will be transitory. Given high vaccination rates, and low political appetite for lockdowns in the US (and on a state-by-state basis, arguably a greater reluctance in states that have the lower vaccination rates), we do not see this as a major risk, but we are watchful of increased hospitalizations and fatalities due to variants as a leading indicator. In addition, Delta or other future variants risk weighing on growth expectations globally more heavily than in the US, which in turn could still drive wider risk aversion to the benefit of USTs.
- **Persistently stronger than forecast inflation leads to faster taper/increased market pricing of Fed hikes (risk to higher yields; flatter curve):** Even in our modal forecast, we see only a modest pricing in of future hikes as market participants generally adhere to what we expect will be ongoing dovish Fed reaction to "transitory" inflation, even through the end of the year based on supply chain issues now that base effects have passed. In addition, the Fed clearly seeks to broaden employment gains across demographics, and will remain dovish in seeking to push the unemployment rate lower.

  However, sustained higher inflation, especially if it filters to market and public inflation expectations could shift the Fed to less accommodative policy more quickly than we expect. This leads to higher yields in the front end and belly, but mainly a flatter curve as the market may actually lower its long term growth forecasts and thud the terminal long term rate with a more reactive and anti-inflationary Fed.
- **Persistently stronger than forecast inflation leads to markets fearing a Fed behind the curve (risk to higher yields; steeper curve):** Similar to the above scenario, but instead of the Fed becoming more reactionary, it digs in its heels and continues to be extremely dovish in the face of higher than forecast inflation, elongating the taper timeline and pushing off forecast rate hikes. This in turn leads to renewed concerns about longer term inflation, leading to bear steepening of the yield curve.
- **Fed personnel changes (?):** Powell's term as Chair of the Fed ends in February 2022, and we expect trial balloons for his potential replacements to be unveiled late this summer or early this fall. Current leading contenders include Fed Governor Lael Brainard, Atlanta Fed President Raphael Bostic, and of course Chair Powell himself. While none should dramatically alter the current path of the Fed, we see Brainard as slightly more dovish than Powell, and Bostic as slightly more hawkish given recent

comments[1]. Of course other names may be floated, and soon, but we doubt the Biden administration would shock to a significantly more hawkish Fed chair nominee.

- **Fiscal Stimulus (higher yields):** The breakthrough in bipartisan stimulus talks increase the odds of fresh fiscal stimulus being passed in the near-term. There are plenty of pitfalls and sequencing concerns that need to be hashed out, but fresh fiscal stimulus could reinforce the US growth outlook. While we think fresh stimulus would put additional upward pressure on yields, the risk may favor flatter curves rather than steeper – unlike Covid stimulus packages, which were deficit financed, there is a much greater emphasis on financing and "pay-fors" in terms of the most recent infrastructure stimulus talks.

[1] In June, Bostic advocated for lifting rates in 2022 due to a faster than expected recovery from the pandemic (https://www.bloomberg.com/news/articles/2021-06-23/fed-s-bostic-sees-2022-rate-liftoff-taper-call-in-a-few-months)

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