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Sujet traité : Quoi faire avec les bons du Trésor? / What To Do With Treasury Bonds?

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GLOBAL STRATEGY

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What To Do With Treasury Bonds?

In This Report

Are 10-year Treasury yields at 3.9% too high, or too low? How restrictive is current monetary policy, or is it restrictive at all? These are hugely important questions for obvious reasons. However, there is no agreement on where the "resting spot" should be for both the long and short end of the curve.

Many strategists and economists, including former Treasury Secretary Lawrence Summers, argue that the neutral rate could be as high as where the current policy rate is, or even higher. They believe that steady-state inflation ultimately will be much higher than 2%.

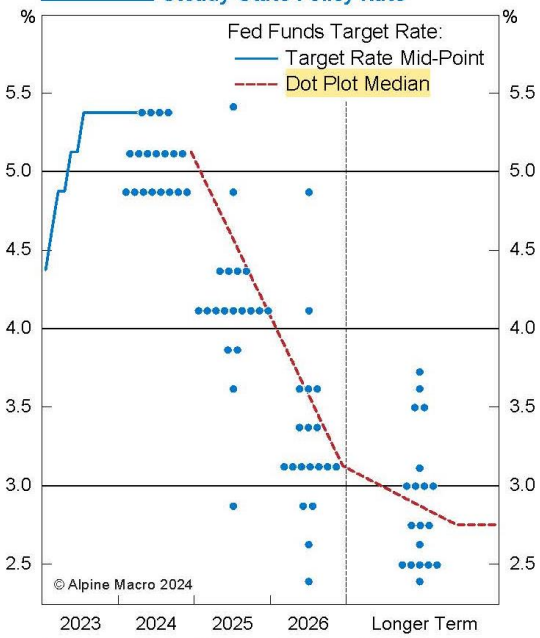
We have always held the view that the 2021 surge in prices was primarily driven by supply disruptions, and that inflation would inevitably fall as the world economy regained its post-pandemic composure – regardless of whether the Federal Reserve tightened policy or not.

Although inflation has indeed fallen sharply, disagreement over the equilibrium interest rate remains as big as ever. With the bond market becoming increasingly volatile, the need to know where the resting spot is for bond yields has only increased.

The Fed Projection: Does It Make Sense?

A good starting point is the Fed's dot plots (Chart 1). Fed policymakers seem to suggest that the equilibrium policy rate should be around 3% by 2026, with a "long-term" projection at 2.8%.

Chart 1 FOMC's Projection Of Steady-State Policy Rate



Note: Blue dots are FOMC members' projections from 06/12/2024 meeting

Fed policymakers have not explained their rationale behind these projections, but usually steady-state interest rates consist of steady-state growth and long-term inflation. As a rule of thumb, nominal interest rates should be roughly in line with nominal GDP.

The Fed's 2.8% "terminal rate" assumption does not seem to be consistent with nominal growth. Prior to the pandemic crisis, for example, real GDP growth averaged 2.3% between 2010 and early 2020, while core inflation during this period averaged 1.6%. Nominal GDP growth for that decade was 4% on average.

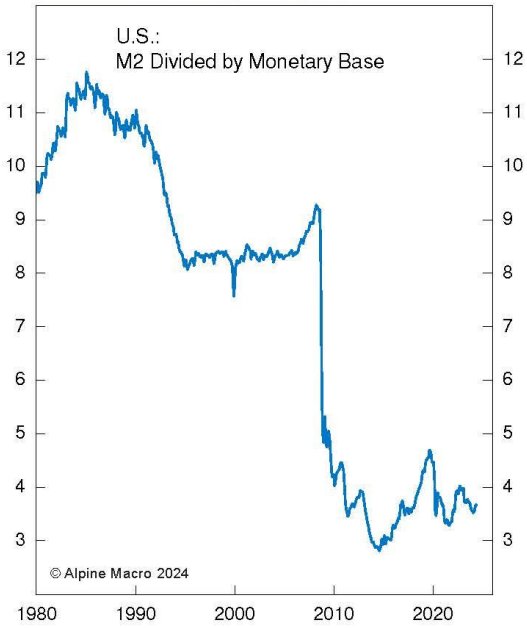
Therefore, the 2.8% "terminal rate" is not consistent with average past performance unless the Fed believes that steady-state growth will drop to below 1% or that the U.S. economy continues to face similar problems as it did in the 2010s.

It is worth remembering that 10-year Treasury bond yields fluctuated at around 2.4% in the 2010s, with highs at around 3% and lows at 1.5%, even though nominal economic growth was 4% for the decade.

Meanwhile, short rates stayed at zero from 2009 to 2016, climbed to 2.5% between 2018 and 2019, and collapsed back to zero in 2020. For the entire 2010s, short rates averaged at 0.73%. In other words, neither long bond yields nor the short end of the curve was remotely close to nominal GDP growth last decade.

Clearly, with the Fed's "dot plots" converging to 3% for 2026 and falling to 2.8% afterwards, policymakers believe that interest rates will neither return to pre-pandemic norms nor converge to nominal GDP growth. The interesting question is, do these numbers make sense?

Chart 2 The 2008 Collapse In Money Multiplier



"Pre-Pandemic Norm"

From what we know today, the high-income economies were stuck in a "liquidity trap" after the 2008 Global Financial Crisis, when liquidity preference became infinite, forcing G7 central banks to chop rates to zero to prevent monetary contraction.

This type of situation arises when households prefer saving to spending, while businesses are reluctant to invest. Essentially, a "liquidity trap" describes a condition where the money multiplier collapses (Chart 2) and money demand turns horizontal – all stemming from savings chronically exceeding desired investment.

Under these conditions, the equilibrium real rate of interest, also called R*, needs to be very low to keep savings versus investment in balance. When excess savings become large and chronic, the R* turns negative to clear the savings imbalance, or the economy must deflate and/or contract.

Throughout the 2010s, the real fed funds rate averaged -0.85%, while 10-year TIPS yields averaged 0.47%. Even with the real rate of interest having turned vastly negative at the short end, the U.S. economy was still under constant threat of price deflation, as evidenced by the persistent inflation undershoot against the 2% target.

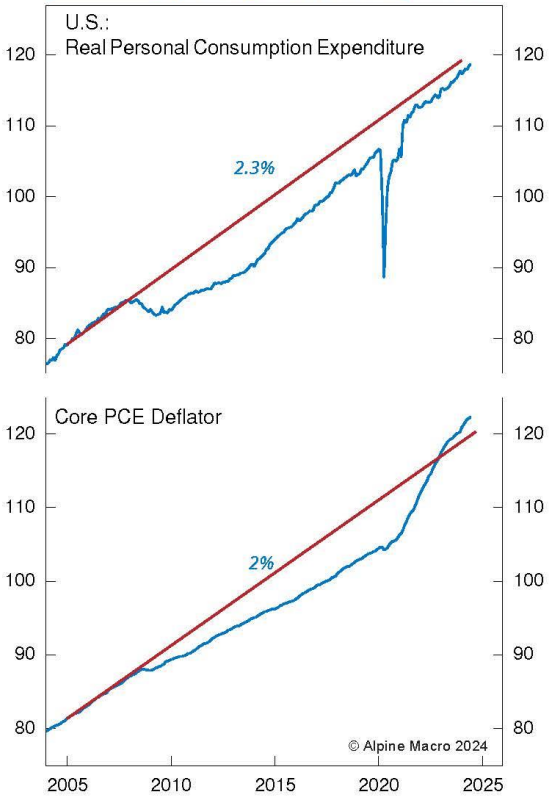
The key culprit behind the "liquidity trap" was that U.S. households were under enormous pressure to deleverage their balance sheets as a result of the 2008 housing crisis. In plain English, most households wanted to save more and spend less in order to pay down their debt.

Such a deleveraging effort implies a loss of consumer demand, an effort that, if sustained, makes the implied loss permanent. **Chart 3** shows just how big the permanent loss of consumer spending was as a result of the sustained deleveraging. At the other side of the equation, capital investment stayed very weak throughout the 2010s.

An additional factor that contributed to the ultra-low-rate environment was the emerging savings glut as a result of China's investment boom coming to an end in 2010, while Europe also sank into a "liquidity trap" with price levels on the verge of a general decline.

The threat of deflation was so serious that the European Central Bank and the Bank of Japan

Chart 3 **Permanent Loss Of Consumer Spending Vs Deflationary Threat**



eventually drove nominal interest rates to negative in 2014 and 2016, respectively, both unprecedented in their perspective history. The combined savings glut from Asia and Europe flooded the U.S. financial markets (**Chart 4**), further pushing down interest rates but driving up the dollar.

It is difficult to precisely quantify the impact of foreign inflows on the overall levels of interest rates in the U.S., but we estimate that cheap foreign savings may have compressed long bond yields by at least 50 basis points, if not more.

Chart 4 Global Savings Glut Has Benefited U.S. Bonds

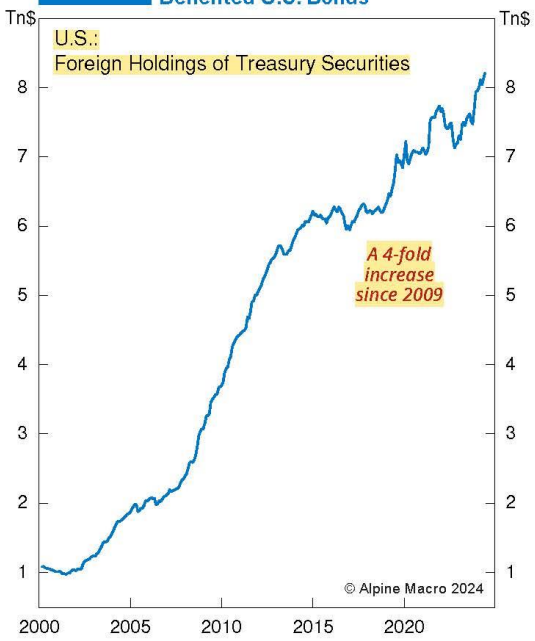
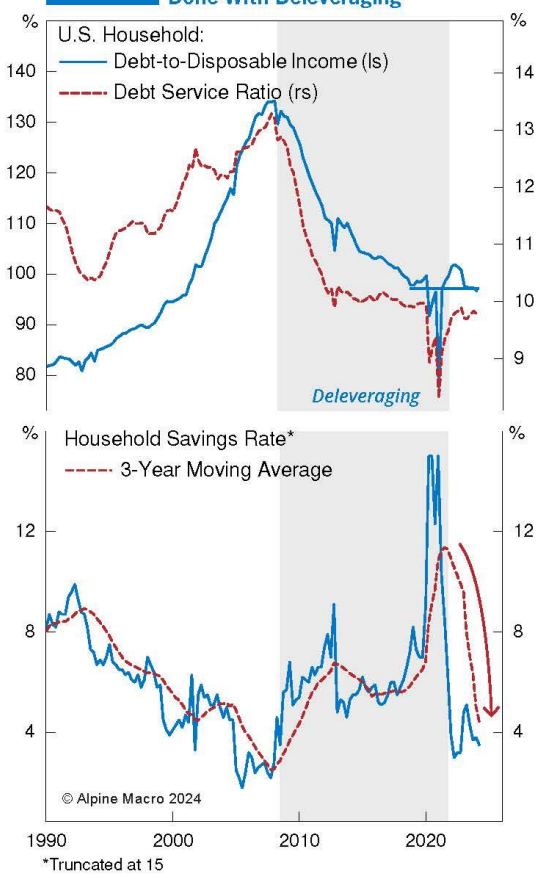


Chart 5 U.S. Households: Done With Deleveraging



What Has Changed?

The Covid-19 pandemic crisis was a five-sigma shock that brought about some enormous changes to the underlying global economy. By and large, there have been three major shifts in the U.S. economy.

The first is that the household sector is no longer preoccupied by deleveraging. The unprecedented $5 trillion in income transfers during the 2020 pandemic crisis helped households clear a large chunk of their debt. Importantly, this happened on top of a decade-long deleveraging process.

Today, the U.S. household debt-to-disposable income ratio stands at 97%, a near 40-point decline from 2008 levels, while debt service costs stand at 9.8% of disposable income, a record low in pre-pandemic history despite very high interest rates (Chart 5). It is worth noting that households' net worth has soared by $50 trillion since 2020 (Chart 6). As a mirror image, households' total liabilities as a share of net worth have dropped to their lowest levels ever. All of this has worked towards reducing the savings rate while boosting consumer spending.

Chart 6 Soaring Household Net Worth Reduces The Incentive To Save

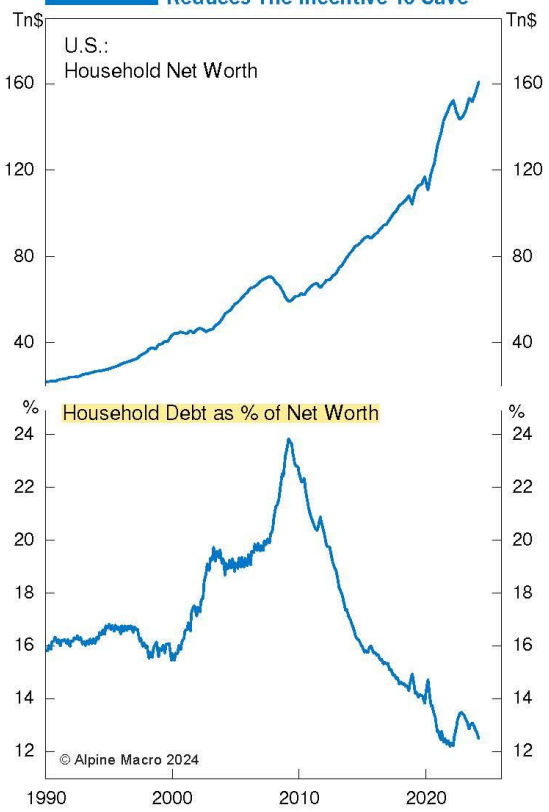
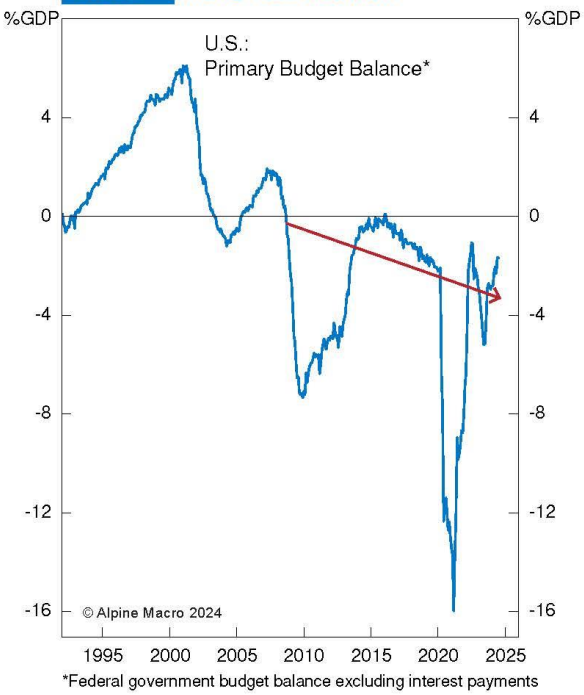


Chart 7 Rising Fiscal Activism



The second major shift is rising fiscal activism (Chart 7). The Trump tax cuts in 2017 and the Biden administration's investment programs were all enacted at a time when the U.S. economy was expanding at a reasonably strong clip.

This runs against the notion that fiscal policy should always be counter-cyclical. In fact, surprising economic strength last year against high and rising interest rates was largely the result of rising fiscal stimulus.

The key point is that the U.S. government seems to be more inclined to using fiscal policy as a tool to boost growth and gain political popularity, although the GOP tends to do so *via* cutting taxes while the Democrats are more willing to spend. Either case could add to GDP growth and possibly real bond yields.

Lastly, the U.S. could be on the cusp of another major upturn in labor productivity driven by a wide range of innovations, particularly the rapid applications of AI. At present, it is difficult to pin down what AI will do to each industry, but from 1995 to 2010, the internet revolution boosted labor productivity

Chart 8 U.S. Labor Productivity: Then Versus Now

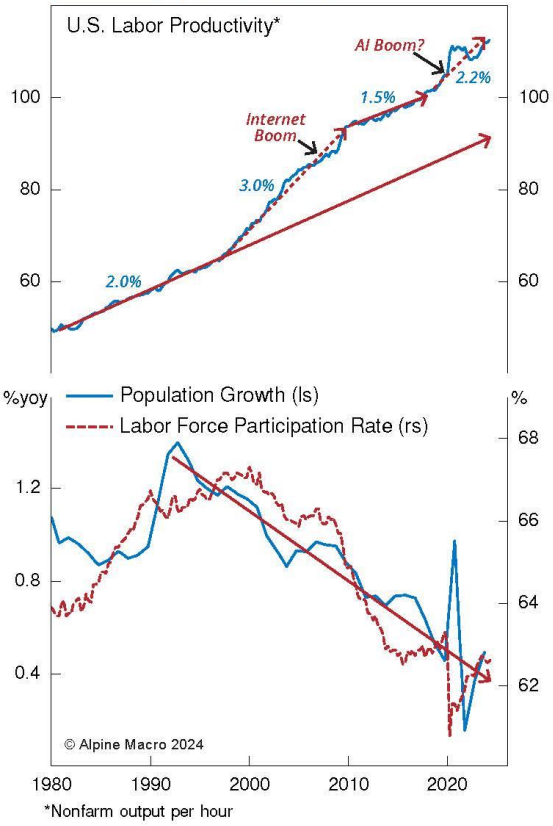
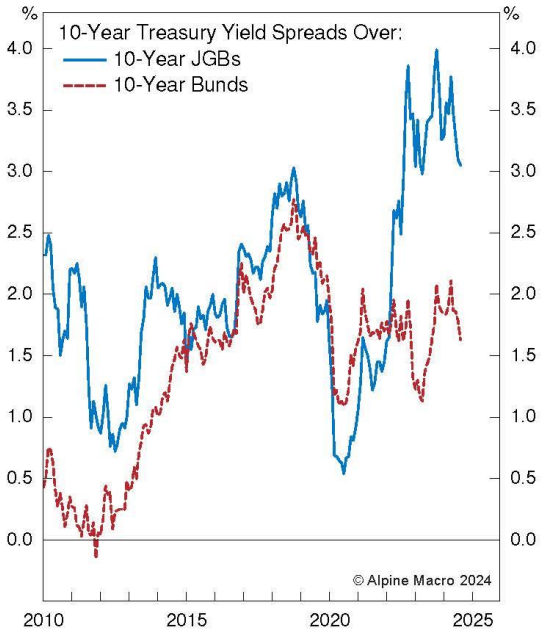


Chart 9 U.S. Treasurys Remain Attractive



by 1 percentage points a year (Chart 8). It is not impossible that AI will do the same for the next decade or so.

The key point is that there are two opposing forces at work: demographic trends and a lower labor participation rate are working to reduce growth potential, while a wider application of AI could bring about a surge in labor productivity leading to higher growth. The net result is hard to ascertain at this moment.

Last decade, labor productivity generated 1.5% growth a year, while the labor force added another 0.6% to GDP growth. Going forward, even if U.S. labor force growth drops to zero, GDP growth can still be sustained at 2% or even higher if labor productivity growth accelerates to 2% or higher.

Of course, it is entirely possible that real growth drops to 1.5%, with 0% labor force growth and labor productivity growth staying at 1.5% a year. Again, there is no way to know with any degree of precision which outcome will prevail.

Furthermore, it usually takes a long time for the full impact of new technologies to show up in labor productivity growth. This means that in the short term, the steady-state growth rate may still be around 1.8-2.0%.

Finally, what has not changed is the global savings equation. China's economy is being suffocated by an explosion of excess savings as a result of the fallout in real estate, while Europe continues to move along a low-growth path. The problem of excess savings remains very acute, particularly inside the Chinese economy.

Chart 9 shows that the yield spread between the U.S. and Japan is the highest since 2005. German bunds and U.S. Treasury spreads are also at a lofty 170 basis points. Therefore, both Europe and Japan will continue to be key sources of excess savings for financial markets in the U.S.

The only difference is that China is re-deploying its excess savings by investing in the developing world rather than in Treasury bonds (Chart 10). So far, however, we cannot find a direct correlation between China's divesting effort and Treasury bond yields, so it is hard to know whether China's divestment has contributed to the rise in overall interest rates in the U.S.

So What?

In a nutshell, U.S. domestic savings will be less than during pre-pandemic times, and real growth could be similar but with higher productivity growth. Excess overseas savings will remain plentiful, even though the U.S. will lose China as a key investor in U.S. Treasurys.

All of this means that steady-state real interest rates, both at the short and long ends of the curve, should be higher than what prevailed in the 2010s and more in line with real economic growth.

Chart 10 China Has Reduced Its Holding Of U.S. Bonds

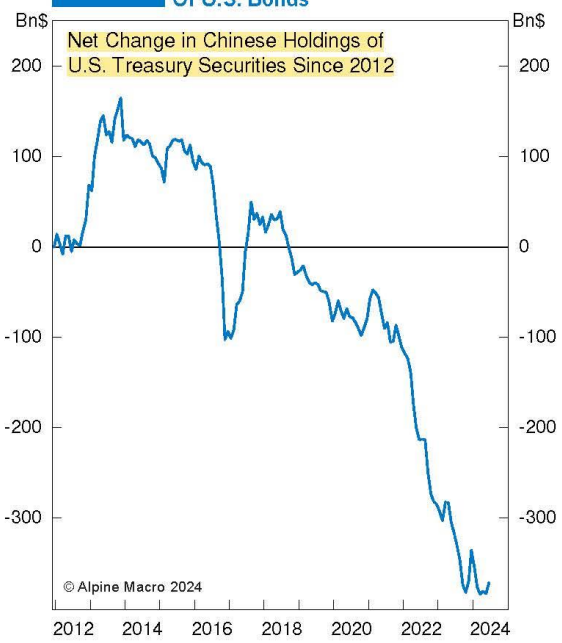
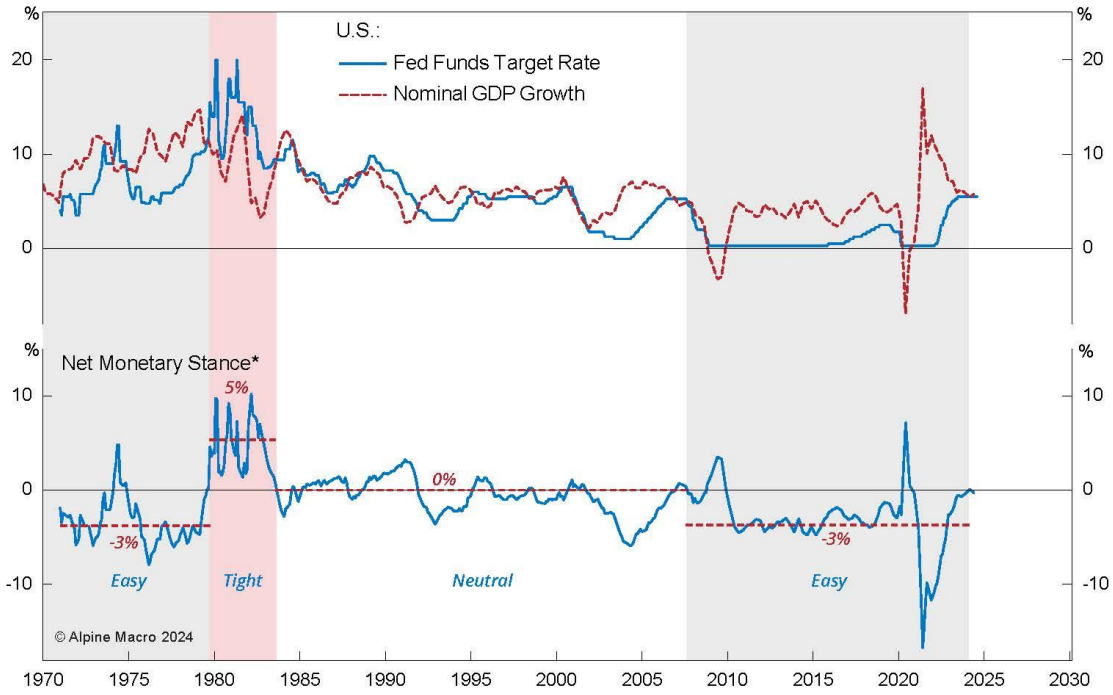


Chart 11 provides another interesting perspective. It compares the nominal fed funds rate with U.S. nominal GDP growth: whenever the fed funds rate is higher than GDP growth, Fed policy is restrictive, and *vice versa*.

By this yardstick, a large portion of the rate hikes since 2022 should be considered as rate normalization, and that policy is only slightly restrictive today. However, the chart also highlights the need for the Fed to drop rates because falling inflation (and therefore nominal GDP growth) will make the current policy rate increasingly restrictive.

On balance, it seems that the steady-state Fed policy rate would be around 4.0% if the U.S. were

Chart 11 Fed Policy Rate Versus U.S. Nominal GDP: How Tight Is Monetary Policy?



*Fed funds target rate minus nominal GDP growth

a closed system, but inflows of foreign savings will likely compress the steady-state rate to 3.5%.

If so, the long end of the curve should be around 3.7-3.8%, assuming the term premium is small and at around 20-30 basis points. Our bond model also says the fair value for 10-year Treasury yields is at 3.7% (Chart 12).

Of course, if the AI boom indeed leads to a surge in labor productivity in the future, inflation could drop to levels lower than the Fed's 2% target, say, to 1.5%, while real growth goes to 2% or even higher. In this case, the stock market would boom, while bond yields may still stay at around 4%.

If the "resting spot" for the long end of the curve indeed is 3.7-3.8%, investors should go long duration if bond yields are above that level, stay at the benchmark duration when yields are nearing their steady-state, but go short duration if yields fall far below the "resting spot". This is why we cut our bond duration call to neutral from overweight on August 5 when 10-year Treasury yields dropped to 3.7%.

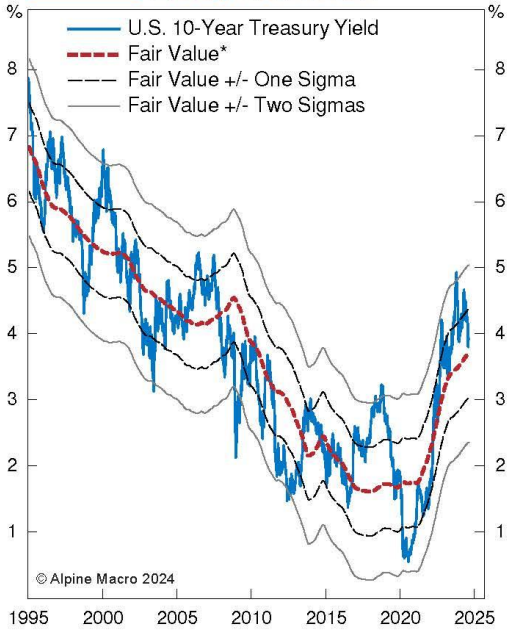
Of course, 10-year Treasury yields could collapse to 2% or even lower if the economy falls into a recession, but our bet is that the U.S. economy will not contract in the foreseeable future.

Housekeeping

- We are reinstating our long position in Nikkei 225, unhedged. The Japanese equity market will continue to benefit from easy money and an undervalued currency.
- Our long Russell 2000 position was stopped out with a 6.3% profit. We treat the recent setback in small caps as an opportunity to re-enter the trade, as we still believe the bull market will broaden as the Fed drops rates.
- Investors should add a long position in U.S. Financials (ETF: IYF). The yield curve is dis-inverting and loan initiations are improving. Credit delinquency is under control and lower rates will help banks.

Chen Zhao
Chief Global Strategist

Chart 12 Fair Value For 10-Year Treasury Yields At 3.7%



*Based on trends of inflation, short-term interest rates and the long-term natural rate of unemployment

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long 10-Year German Bunds/ Short 10-Year JGBs[1]	08/07/2023	2.6%/0.62%	Rolling -1%	08/05/2024	2.13%/0.69%	6.4%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	51.2	-	-	16.9%
Long Russell 2000 (ETF: IWM) (**RE-OPEN**)[2]	01/08/2024	196.73	208	08/05/2024	208	6.3%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	11.6%
Long S&P 500 Energy (ETF: XLE)[3]	03/25/2024	93.26	88	08/05/2024	88	-4.9%
Long Nikkei 225 Unhedged (**RE-OPEN**)[4]	05/06/2024	38,835	35,000	08/05/2024	35,000	-9.9%
Long Long-Dated Treasury Bonds (ETF: TLT)	06/10/2024	90.98	95	-	-	7.9%
Long U.S. Financials (ETF: IYF)[5]	08/19/2024	-	-	-	-	-

Note: P&L is calculated using daily closing prices.
[1] Our rolling stop for Long 10-Year German Bunds/Short 10-Year JGBs was triggered on 08/05/2024 with a profit of 6.4%.
[2] Our Long Russell 2000 (ETF: IWM) trade was stopped out on 08/05/2024 with a profit of 6.3% and **we are re-opening the trade.**
[3] Our Long S&P 500 Energy (ETF: XLE) trade was stopped out on 08/05/2024 at a loss of 4.9%.
[4] Our Long Nikkei 225 Unhedged trade was stopped out on 08/05/2024 at a loss of 9.9% and **we are re-opening the trade.**
[5] We are initiating a Long U.S. Financials (ETF: IYF) trade.