BNY

iFlow

SHORT THOUGHTS

July 2, 2024

Where to for Yields: The Fed, France, and Trump

Weaker Data vs. Political Realities

- It's not clear to us that increasing probabilities of a Fed rate cut will continue to drive 10y yields
- This had been the case until the French elections and the US Presidential debate
- A France/Trump premium appears to be pricing itself into bonds

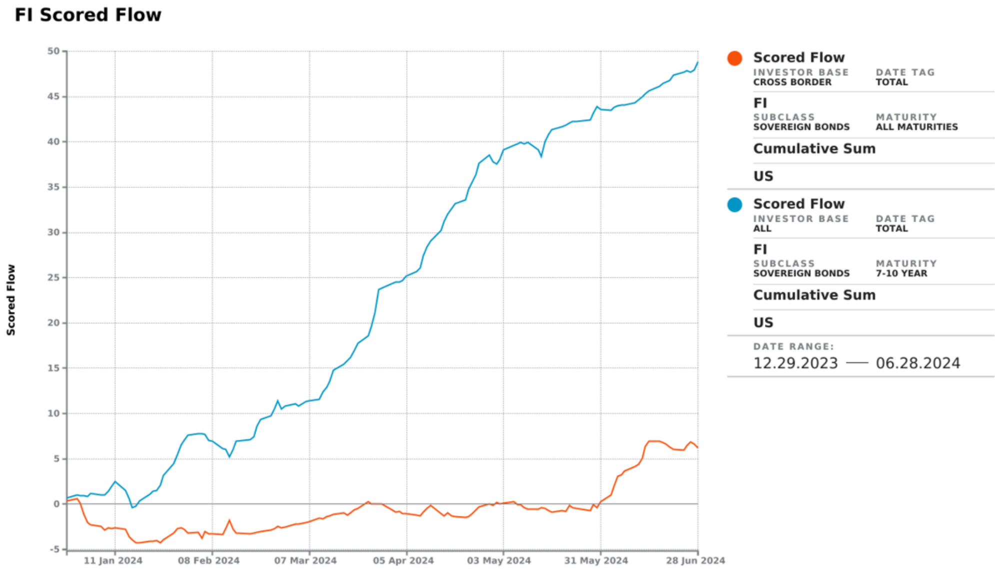
Prepare for an Interesting Summer in Bonds

What has happened – and what could happen in the near future – to bond yields is ambiguous. We admit that we were gearing up last week to advocate for unequivocally bullish prognosis over the course of the summer. However, events of the last few days and market reactions have made us more skeptical than we had been. In this note, we'll try to dissect the drivers of recent moves. We conclude that our faith in lower yields going forward has been eroded and we wouldn't be surprised to see a continuation of the very recent moves higher in yields and a bear steepening.

After last Thursday's debate, we feel the probability of Trump election victory has risen. While we are reluctant to quantify this probability, we note that betting markets post-debate have seen a substantial gap open in favor of Trump. Biden's odds of victory before the debate were around 35%. They have since plummeted to below 20%. We feel that recent increases in yields have reflected this opening gap between the two candidates.

Before we go further on the above point, we should first consider the bullish bond case. Two considerations were behind this view. The first (and still relevant) argument comes from iFlow. We have argued in the past (see here) that demand for long dated bonds is inexorably positive. The chart below reinforces that view. The blue line is total cumulative flow for the 7-10y sector of the Treasury curve. Over the past 12 months, we see sustained bond buying at this maturity. The duration grab that we have been writing about is obvious. At the same time, cross-border demand has picked up after having been flat (or at times, negative). Since the beginning of June, we have seen a return to bond buying from abroad.

Strong Demand for Long Duration

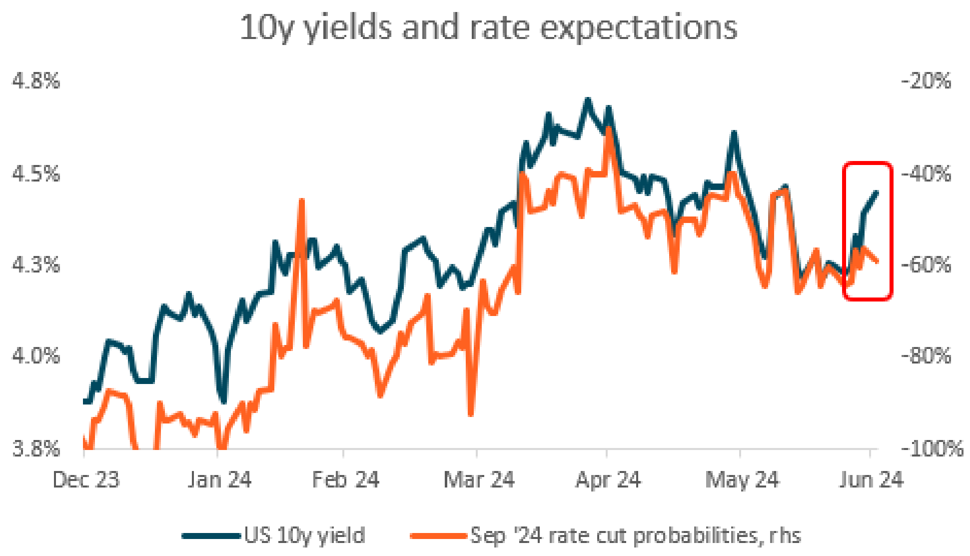


Source: BNY Mellon Markets, iFlow

In addition to the demand story, rate expectations had been playing a part in the bullish view up until now. The chart below tells a simple story. We plot the yield on the 10y note (blue line) versus the market-implied rate cut probabilities for the September meeting (orange line). As expectations for rate cuts wax and wane, the yield on the 10y has moved almost in lockstep. Until the last few days, that is.

We are expecting a September rate cut, as we think inflation – especially the all-important services component – will behave better over the next few months. Furthermore, we see the data softening in the real economy. On Monday, we published a note on these developments (see here) and reiterated our September call. If this were the whole story, we would have expected the market to increase the odds of a rate cut, pushing the implied probability lower and taking yields – supported by strong demand for bonds as discussed above – with it. However, in recent days there has been a clear break in the correlation between yields and rates expectations, as indicated by the red rectangle. The relationship no longer holds – at least for now.

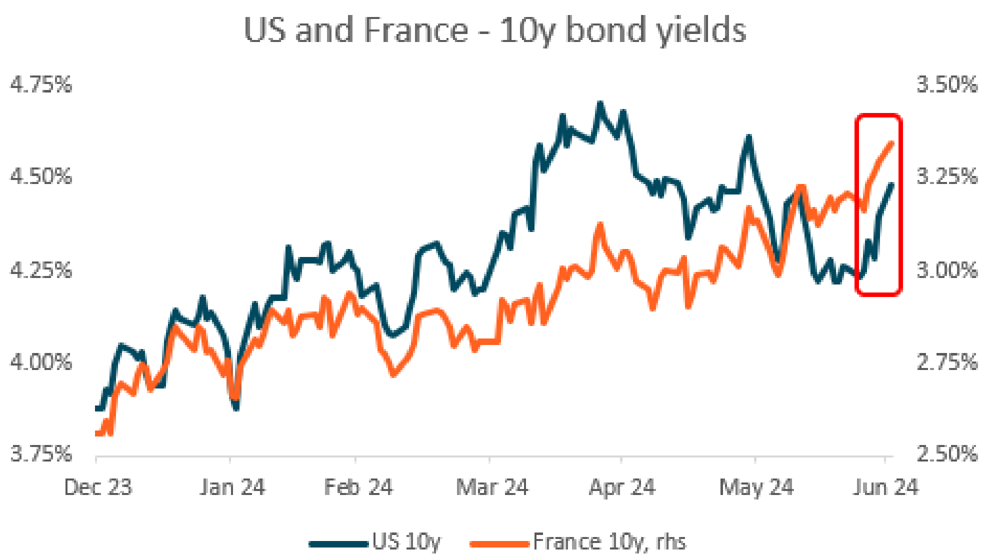
Yields Had Been Following Rate Expectations



Source: BNY Mellon Markets, Bloomberg

One argument for higher yields despite increasing odds of a rate cut in September is that US yields had been moving in sympathy with French OATs (i.e., French sovereign bonds). The move higher in OAT yields has reflected increased concerns that either the populist left or populist right would emerge in control of Parliament after the second round next Sunday (more likely the right, after first-round voting over the weekend reflected the pre-election polls). This would, the market fears, increase public spending and erode fiscal stability. Long-term US sovereign debt dynamics are also increasingly being seen as unsustainable, so the co-movement between the two markets is understandable.

French Sympathizer



Source: BNY Mellon Markets, Bloomberg

We also infer that a risk premium for USTs is being reflected on the increasing likelihood of a Trump victory in November. The market looks to be pricing in inflationary effects of proposed tariffs and a reversal of favorable immigration policies, as well as a potential further fiscal deterioration as a result of deep tax cuts.

How high can yields go, especially if the economic data continue to deteriorate and FOMC cuts appear increasingly likely (as is our view)? We may have to wait for another weak set of data – possibly as early as this coming Friday's nonfarm payrolls release, to really understand how much the Trump premium dominates the economic and rates outlook. Monday's somewhat weaker ISM manufacturing survey didn't dent the selloff in USTs, but it was a very small miss relative to consensus expectations.

As we argued in Monday's *Macro Morning Briefing*, we do view the economy as slowing, and the likelihood of a September rate cut as increasing. But for the past few days at least, and likely over the next few days, it looks as if the path of yields will be higher. If even weaker data does emerge, and yields don't head lower, we'll know that the bear steepening is sustainable.

Disclaimer & Disclosures

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