# STAYING NEUTRAL ON US TREASURIES

## CALM WATERS MAY LIE AHEAD

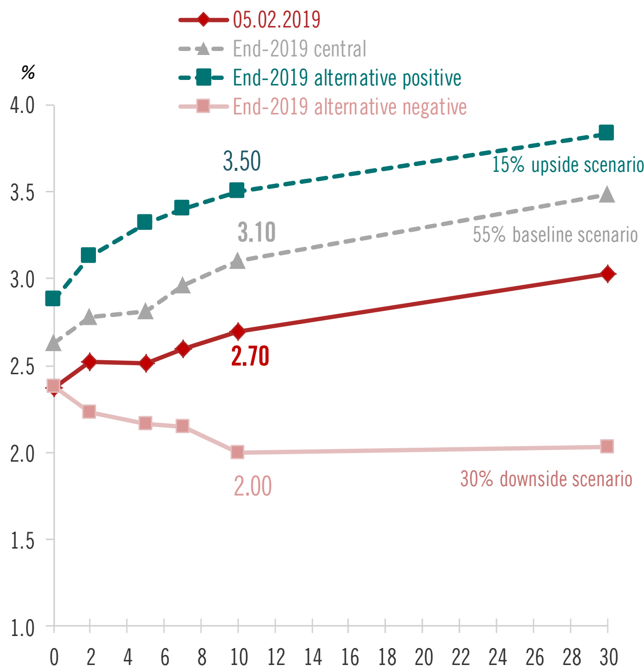
Author

LAURÉLINE CHATELAIN
lchatelain@pictet.com

## SUMMARY

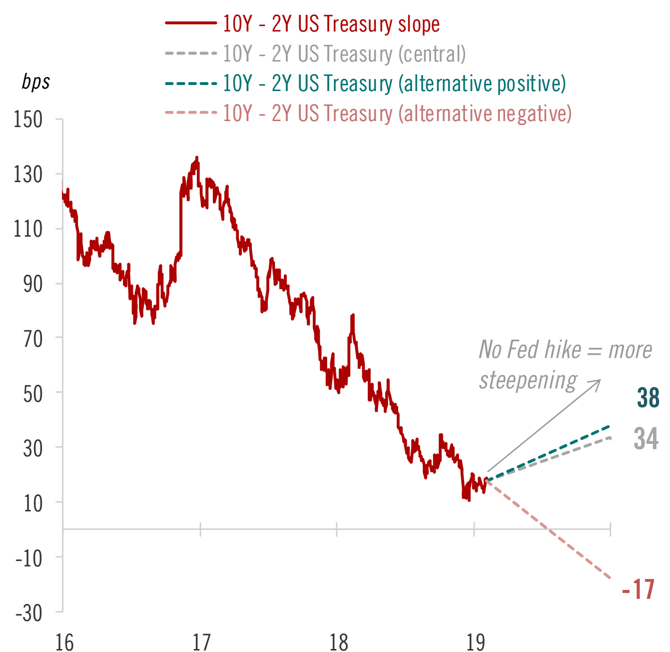

- Since our December note on the 2019 outlook for US Treasuries, the environment for US bonds has shifted dramatically. The 10-year US Treasury yield reached a low of 2.56% on 3 January, the day before Jay Powell, chairman of the US Federal Reserve (Fed), made a U-turn from a hawkish to a dovish stance. Taking note of this regime shift, we are revising our year-end target downward, from 3.4% to 3.1%. We expect the 10-year yield to move gradually up to 3.0% by mid-year, plateauing towards the end of 2019.
- In this central scenario, the Fed would pause its rate hiking cycle and the upward yield move would come mainly from rising inflation expectations due to a further oil price increase and an acceleration of US core inflation. Moreover, we foresee a revival of the term premium (i.e., a steepening of the US yield curve), brought on by a pause in Fed rate hikes, by continued Fed balance sheet shrinkage and by a rising supply of US Treasuries on the mid-to-long end of the curve.
- However, global recession risks have been rising and we are aware that the curve could invert, with the 10-year yield falling to 2.0% should this risk materialise (our negative scenario). For this reason, we are remaining neutral on US Treasuries in general, favouring the mid-part of the curve.


CHART 1: US TREASURY YIELD CURVE IN THREE SCENARIOS




Source: PWM - AA&MR, Bloomberg, 05.02.2019

CHART 2: US TREASURY YIELD CURVE SLOPE IN THREE SCENARIOS




Source: PWM - AA&MR, Bloomberg, 05.02.2019

# STAYING NEUTRAL ON US TREASURIES

## CALM WATERS MAY LIE AHEAD?

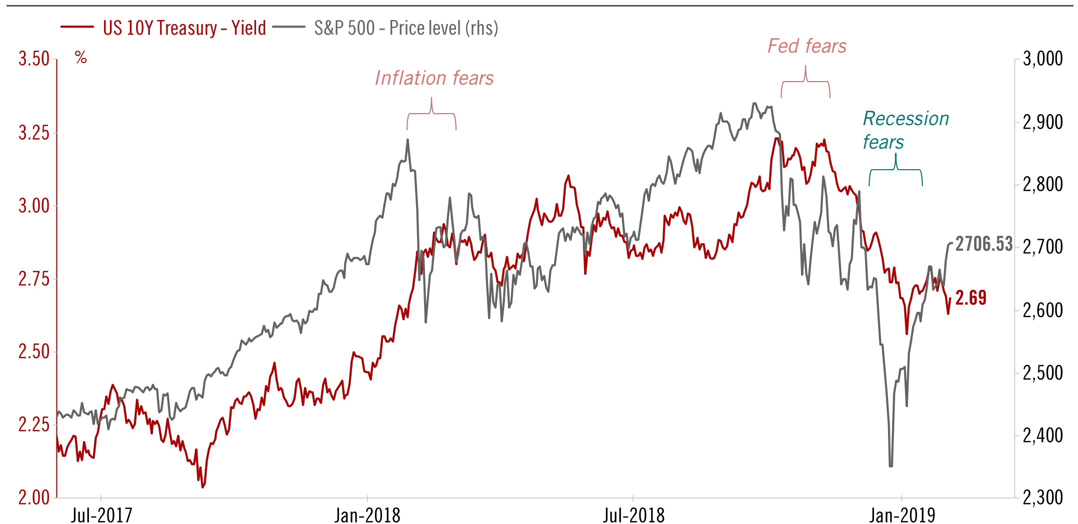
### Regime shift for US Treasuries

Since our note on the 2019 outlook for US Treasuries on 6 December 2018 (see here), the environment for US bonds has shifted dramatically. The 10-year US Treasury yield reached a low of 2.56% on 3 January, the day before Fed chairman Jay Powell made a U-turn from a hawkish to a dovish stance. This shift to dovishness was confirmed at the Fed meeting on 30 January, when Powell insisted that the Fed would be "patient" and data-dependant, thereby abandoning its tightening bias. Our US economist now expects only one final, symbolic rate hike in June, but risks of no rate hike are growing (see here). Taking note of this regime shift, we are revising our year-end target downward, from 3.4% to 3.1%. We expect the 10-year yield to move up gradually to 3.0% by mid-year, plateauing towards the end of 2019.

Underpinning this shift is the deterioration of the global, and to a more limited extent, the US economic outlook since Q4 of last year, as soft data nose dives, with the manufacturing PMIs (Purchasing Manager Index) in Germany, France, Italy and China dipping below the 50-level threshold. Of particular concern is Germany, an export-oriented economy that, among others, has suffered from the Chinese economic slowdown and new European auto regulations (see here).

Weaker incoming economic data and a hawkish Fed last October sparked a global equities sell-off on fears that the Fed would kill the US economic cycle by being too restrictive and that a (global) recession was imminent. In that context, 10-year US Treasuries finally played their safe-haven status, with the yield falling an impressive 67 basis points (bps) from the peak of 3.23% on 8 November to the low of 2.56% on 3 January. This was in stark contrast to their behaviour during the rest of 2018, as the protection status of long-term US Treasuries did not work when US equities sold-off on fears of rising inflation or of a more hawkish Fed (*see Chart 3*).

CHART 3: 10-YEAR US TREASURY YIELD AND THE S&P 500




*Source: PWM - AA&MR, Factset, 04.02.2019*



PICTET 1805

## From flattening to steepening

What does this regime shift mean for the direction of US Treasury yields in 2019? First, as the Fed pauses its hiking cycle (with one or even no further rate rises), the rise in short-term yields will not drive the 10-year yield up as it did since the end of 2017, meaning that further yield curve flattening would come from the 10-year yield falling further, rather than rising less than Fed funds rates. This is encompassed in our negative scenario (30% probability), in which signs of a US recession would appear this year, leading the US Treasury yield curve to price in Fed rate cuts and to a yield curve inversion. The 10-year yield would then fall to 2.0% and the two-year yield would move below the Fed funds rate, as is usually the case when market participants start to anticipate a recession (*see Chart 1 and 2 above*).

In our central scenario however (55% probability), the yield curve (10-year – two-year) would steepen from its current low level of 18 bps (on 5 February) to about 34 bps by year-end, with most of the steepening happening in H1. That scenario is based on a rise in inflation expectations and on a less negative term premium on the back of higher long-term Treasury issuance and a Fed tightening pause. In this case, the 10-year Treasury yield would rebound towards 3.0% in the summer, plateauing toward 3.1% by year-end (*see Chart 1 and 2 above*). This is the scenario that will be elaborated on in this note.

In our positive scenario, US growth would be sufficiently robust, with inflation accelerating as well, for the Fed to embark in a new round of tightening, pushing the 10-year yield up to 3.5% by year-end (*see Chart 1 and 2 above*).

## Rising inflation expectations

Looking first at inflation expectations, we expect the 10-year inflation breakeven yield to move higher due to an oil price rebound towards USD 60 per barrel (for the West Texas Intermediate (WTI)) and an acceleration of US core inflation (Personal Consumption Expenditures (PCE)) above the Fed's 2.0% target. Since the beginning of 2019, the rebound in the 10-year inflation breakeven yield has materialised, rising from the lows of 1.68% on 3 January to 1.87% on 5 February. However, this level remains too low, as it should hover around its long-term average of 2.1% when the US economy is late cycle with inflation and wage growth picking up. This was actually last year's average level as well.

Moreover, as explained above, a dovish Fed likely means that it will be less reactive to an acceleration of core PCE above its 2% target (we expect it to be 2.2% on average in 2019). Hence, the recent rise in inflation breakeven yields could continue and we expect the 10-year breakeven yield to reach 2.1% by mid-year. However, inflation expectations embedded in the 10-year Treasury yield have been closely correlated to the oil price, with a sharp drop usually signalling weakening demand and rising risks of a global recession. For this reason, the recent oil price rebound must also endure (*see Chart 4 and Chart 5*).

# STAYING NEUTRAL ON US TREASURIES

## CALM WATERS MAY LIE AHEAD?

CHART 4: US 10-YEAR TREASURY YIELD BREAKDOWN

Source: PWM - AA&MR, Bloomberg, 05.02.2019

CHART 5: US 10-YEAR INFLATION BREAKEVEN AND OIL PRICE

Source: PWM - AA&MR, Factset, 05.02.2029

### Term premium revival is on the table

A constant puzzle for bond investors is the negative term premium in the US, which stands at -0.64% for the 10-year Treasury yield. It has been pushed lower through the multiple rounds of quantitative easing (QE) by developed market central banks since the 2008 Financial Crisis. As these extraordinary measures came to an end, market participants expected it to rise again. However, it was pushed down again in early 2016 and in late 2018 due to 10-year Treasuries' safe-haven status as US risky assets sold off. President Trump's election sparked hope that reflationary policies, through his tax cuts, would lead to a steeper yield curve, but the Fed's tightening cycle pushed the term premium back into negative territory (as the US yield curve usually flattens when the Fed hikes rates) (*see Chart 6*).

Looking into 2019, we expect the US Treasury yield curve to steepen through higher long-term yields. In other words, we foresee a revival of the 10-year term premium. First, as the Fed pauses and the US economic cycle is preserved, the flattening pressure from tighter monetary policy should wane.

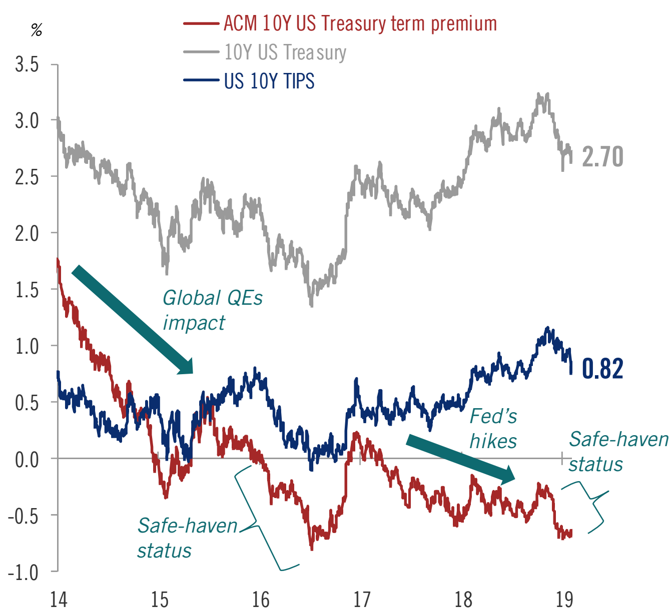
Second, even if the Powell hinted on 30 January that Fed members would discuss the Fed's balance sheet reduction in the upcoming meetings, we do not expect them to put it on hold until later in the year. This means a continuing shrinkage of US Treasuries holdings of about USD 30bn per month, which would amount to a reduction of at least USD 200bn in 2019, after USD 214bn last year.

# STAYING NEUTRAL ON US TREASURIES

## CALM WATERS MAY LIE AHEAD?

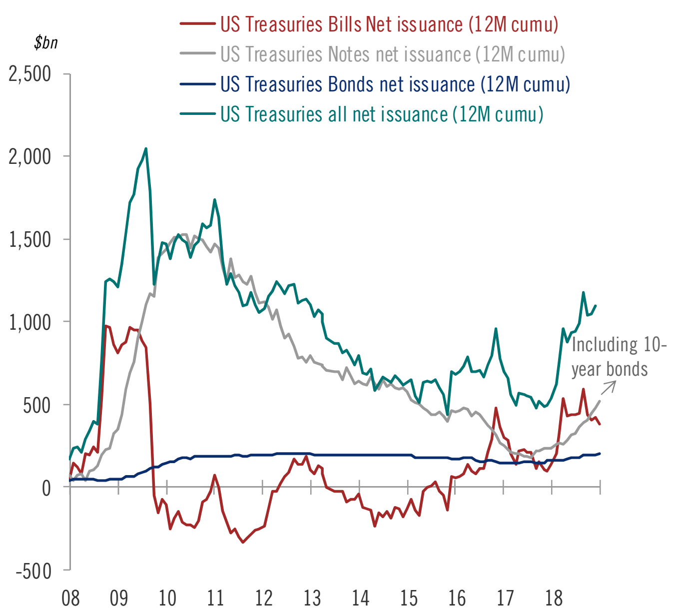
Lastly, the December 2017 tax cuts significantly increased US Treasury issuances, as they are "unfunded", pushing the US Federal government deficit deeper into negative territory to -3.9% of GDP in 2018. The 12-month cumulative net issuance of all US Treasuries reached USD 1,105bn at the end of last year, which is double what was reached in 2017. Interestingly, the bulk of issuance has come from Treasury Bills, given the US Treasury department seems to favour the "cheapest" part of the curve. However, as the yield curve became almost flat in H2 last year, the increase has switched to Notes issuances, which include 10-year Treasuries (*see Chart 7*). Therefore, we expect this increased supply on the mid-to-long-end of the Treasury curve to put upward pressure on long-term yields, thereby reviving the term premium. One has to bear in mind however, that higher Treasury yields have also attracted new marginal buyers. Specifically, US Households have bought about 60% of all net issuances in the three first quarters of last year, raising their total holdings from 9% to 14% of all Treasuries outstanding. Taking note of this, we only expect a moderate rise in 10-year yields to 3.1% by year-end.

CHART 6: US 10-YEAR TREASURY TERM PREMIUM* AND YIELDS




Source: PWM - AA&MR, Bloomberg, 05.02.2019
*ACM term premium from Adrien Crump & Moench estimates at the New York Fed

CHART 7: US TREASURIES NET ISSUANCE (12-MONTHS CUMULATIVE)




Source: PWM - AA&MR, SIFMA, 31.12.2018

### Conclusion

We expect the 10-year Treasury yield to move gradually up to 3.0% by mid-year, plateauing at 3.1% by the end of 2019. In this central scenario, the Fed would pause and the upward movement would mainly come from rising inflation expectations and from a revival of the term premium (i.e., from a steepening of the US yield curve). However, global recession risks are rising and we are aware that the curve could invert, with the 10-year yield falling to 2.0% should this risk materialise. For this reason, we are remaining neutral on US Treasuries in general, favouring the mid-part of the curve.

**DISCLAIMERS**

**Distributors:** Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2017.

**Distributors:** Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore, 10 Marina Blvd #22-01 Tower 2, Marina Bay Financial Centre, Singapore 018983 and Pictet & Cie (Europe) S.A., Hong Kong branch ("Pictet HK branch") in Hong Kong. The registered address of Pictet HK branch is 9/F, Chater House, 8 Connaught Road Central, Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard. Furthermore, BPCAL/Pictet HK branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved with transactions on such Investment.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to, and effectively assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK branch to update any of them. BPCAL/Pictet HK branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are believed to be from sources believed to be reliable, BPCAL/Pictet HK branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK branch.

**Singapore**

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL has obtained an exemption from the Monetary Authority of Singapore ("MAS") under section 100(2) of the Financial Advisers Act ("FAA") for the provision of financial advisory services to High Net Worth Individuals (as defined in the MAS Guidelines on Exemption for Specialised Units Serving High Net Worth Individuals FAA-G07) (the "Exemption") and is exempted from the requirements of sections 25, 27, 28 and 36 of the FAA, the MAS Notice on Recommendations on Investment Products (FAA-N16), MAS Notice on Appointment and Use of Introducers by Financial Advisers (FAA-N02), MAS Notice on Information to Clients and Product Information Disclosure (FAA-N03) and MAS Notice on Minimum Entry and Examination Requirements for Representatives of Licensed Financial Advisers and Exempt Financial Advisers (FAA-N13).

Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

**Hong Kong**

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK branch and any of its affiliates or related corporations to any prospectus or registration requirements.

Pictet & Cie (Europe) S.A. is incorporated in Luxembourg with limited liability. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: AQ515) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK branch in Hong Kong in respect of any matters arising from, or in connection with this document.

**Distributor:** Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c ); (ii) Arrange Deals in securities; (iii) Manage Securities ; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.