Macro Strategy

LET'S TWIST AGAIN

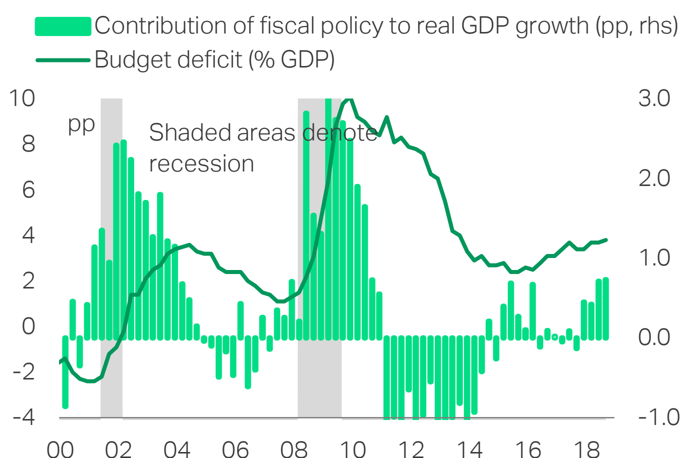
Oliver Brennan

- **Treasury issuance and term premium to raise long-term yields**
- **Slowing US growth momentum calls hiking cycle into question**
- **Yield curve set to untwist: we buy a 2s10s steepener**

Fiscal policy is supercharging US growth, for now. President Trump's stimulus is raising the US budget deficit to its highest non-recession level in the last 40 years. Unlike Bush's tax cuts in the early 2000s, this injection of stimulus is also having a positive impact on growth. The Hutchins Center Fiscal Impact measure tracks the government's contribution to GDP growth: it currently stands at 0.734%, the highest on record, outside times of recession, since this arm of the Brookings Institution started making calculations in 2000. And with the budget deficit forecast to widen to 4.8% of GDP over the next two years, the fiscal impact measure is likely to rise further.

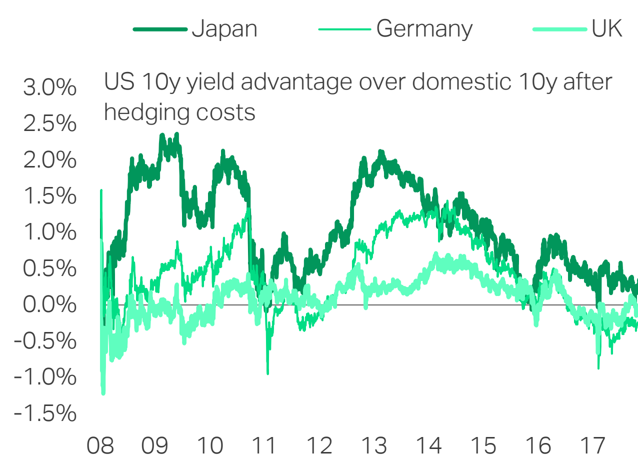
But all this comes at a cost. Greater supply needs to find the right clearing price to match demand. Real 10y yields have risen by more than 20bp since October; partly this is the result of a higher term premium, and partly it is necessary compensation for having to absorb more debt. In Global Financial Trends this week, Shweta Singh questions who is going to buy all the new Treasuries: EM reserve manager demand is shrinking and hedged yields for DM foreign investors are unattractive. And with even more issuance on the cards, the supply/demand equation is unlikely to remain static.

Rising budget deficit a floor under US growth



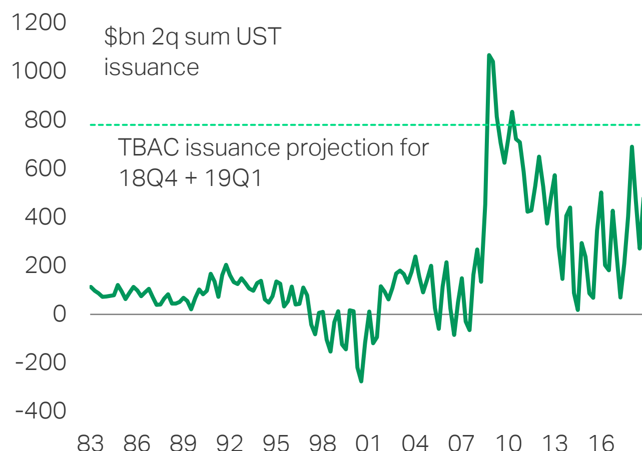
Source: Brookings, Bloomberg, TS Lombard

No incentive for foreigners to buy Treasurys



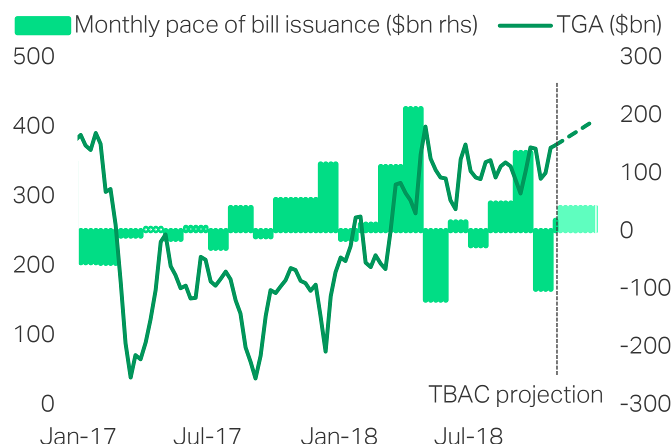
Source: Bloomberg, TS Lombard

Projected issuance dwarfs most of history



Source: TBAC, Treasury, TS Lombard

TGA and Bill issuance set to rise this quarter



Source: TBAC, Treasury, Bloomberg, TS Lombard

Record issuance forecast over next two quarters. In its most recent forecast published last week, the Treasury Borrowing Advisory Committee projects a total of $781bn of issuance over the next two quarters, which would be the largest ever except during the GFC. TBAC has tended to overestimate borrowing needs recently, but the direction of travel of the budget deficit suggests a flood of issuance over the next several months. This is likely to push the clearing price for bonds lower (and for yields higher) and also has consequences for money markets.

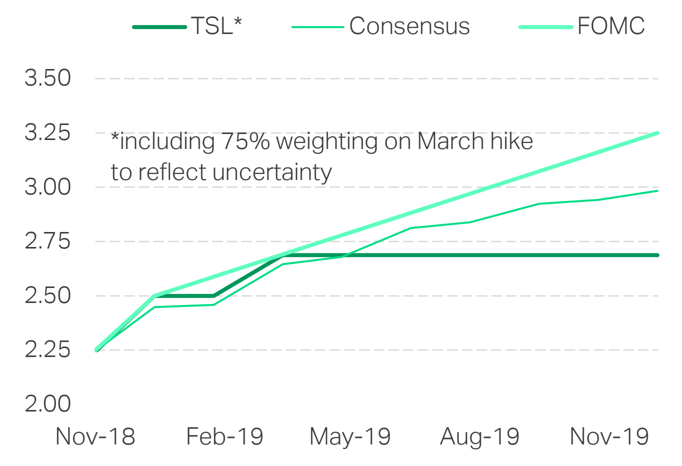
Bill issuance critical for money markets. In August we showed that Bill issuance had been key for money market liquidity. In Q1 the Treasury issued $333bn of Bills and parked $130bn of the proceeds in the Treasury General Account, its deposit account at the Fed, thereby withdrawing liquidity from the banking system. Bill issuance in Q3 was $82bn and the TGA rose by $40bn. TBAC recommends $100bn of net new Bill issuance in Q4 and in Q1 2019, and it expects the TGA balance to rise by $35bn to $410bn by the end of this quarter. In other words, the Treasury is likely to tighten money market liquidity again this quarter.

FOMC tweaking short-term rates to manage tightening liquidity. In a recent speech, FRBNY markets head Simon Potter described policy normalisation as 'proceeding smoothly', with no sign of stress in short-term rates - yet. Potter characterised the decision to peg IOER 5bp below the fed funds range ceiling as a technical adjustment to reduce the likelihood that the effective fed funds rate would trade above the target range. These tweaks are in effect a response to the tightening of liquidity brought about by the Treasury: in the money market the Fed has one eye on offsetting Treasury policy.

But the Fed and the Treasury are pulling in the same direction at the long end. With record stimulus in the pipeline, and Fed QT now running at $30bn of Treasuries per month (an order of magnitude less than the Treasury's issuance schedule, but not immaterial), both agencies are combining to push up longer-term yields. We highlighted how term premia were being squeezed in Decompression Sickness last month: the combined forces of Fed and ECB QE this decade have lowered the US term premium by over 100bp. This compression may not unwind in its entirety, but the directional risk to term premia is the same as that for real yields due to mounting supply: higher.

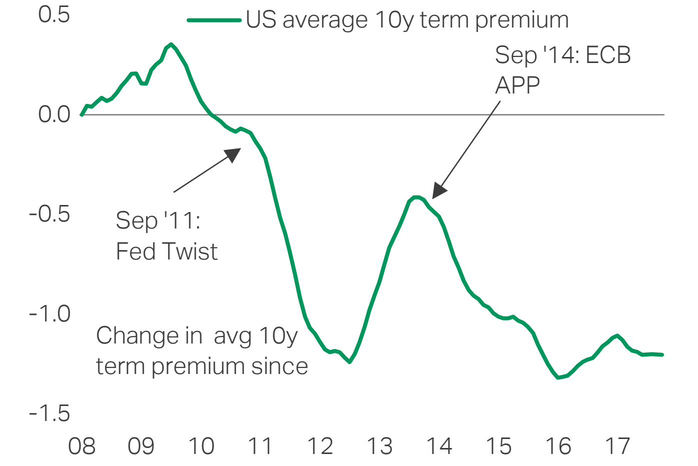
Meanwhile, four more Fed rate rises are no longer certain. As well as offsetting Treasury money market tightening, we reckon the FOMC will not deliver on the panel's dot plot forecast of four more rate hikes by the end of next year. We expect, at most, two more increases (in

We expect FOMC to pause early next year



Source: Bloomberg, FOMC, TS Lombard

US term premium to rise, taking 10y yield higher



Source: BIS, TS Lombard

December and in March) before a pause. We reckon the Powell Fed has a different reaction function to previous FOMCs, and once the policy rate is above neutral the committee will proceed cautiously, avoiding the past mistake of chasing inflation and inverting the yield curve.

Indeed, we see the declining share of capex in GDP growth as a sign of slowing momentum in activity which calls the March hike into question, even if the government's contribution to growth is likely to remain high. We do not expect a recession – fiscal stimulus will be a sufficient protection against that – but private sector growth is set to slow and, once Fed policy is above neutral, so will FOMC tightening.

Operation Untwist. Usually the yield curve steepens at the end of a tightening cycle once the policy rate is cut sharply. But we do not think this is the end of the cycle, and we do not expect policy rate cuts in the foreseeable future. Rather, this will be a different type of curve steepening as QT and the Treasury combine to push up long-term rates entirely independent of growth expectations, while inflation expectations likely remain anchored. We express this view through a 2s10s steepener: **we buy the 2s10s spread at 25bp and look for a move to 60bp, with a stop at 0bp** (we will know we are wrong if the curve inverts).

Model portfolio update

All our model portfolio positions lost money last week, combining for a -70bp loss, our worst week since June. In large part this was thanks to President Trump's tweets ahead of the mid-terms which suggested a trade deal with China could be close. The ensuing EM equity rally erased some of our MSCI EM/DM gains while the rise in risk currencies, added to stronger-than-expected Australian data and short positioning, helped boost AUD through key technical levels and stop out our EUR/AUD trade. And the fall in USD/CNH from 6.98 to 6.91 cut one-third off the premium on our USD/CNH digital call.

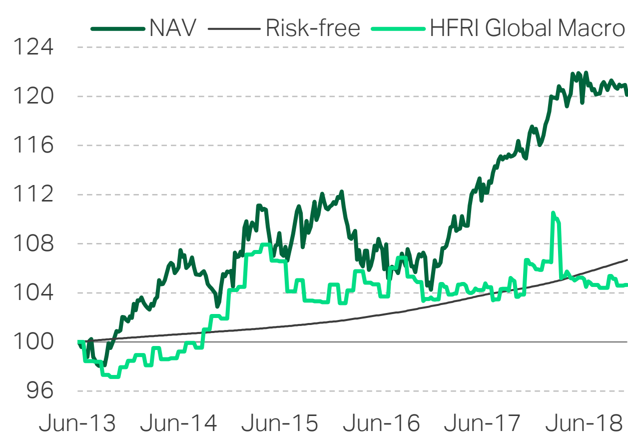
What's more, we missed the opportunity to buy GBP, having demonstrated the perfect conditions to do so in our Daily Note last Monday. But we hesitate to chase the currency here as the rally has been sparked and sustained by the UK government alone. A retracement could easily occur if the EU or Ireland dig in their heels or if Conservative rebels – of either the hard or soft Brexit variety – make a renewed push for further concessions.

Current trade recommendations

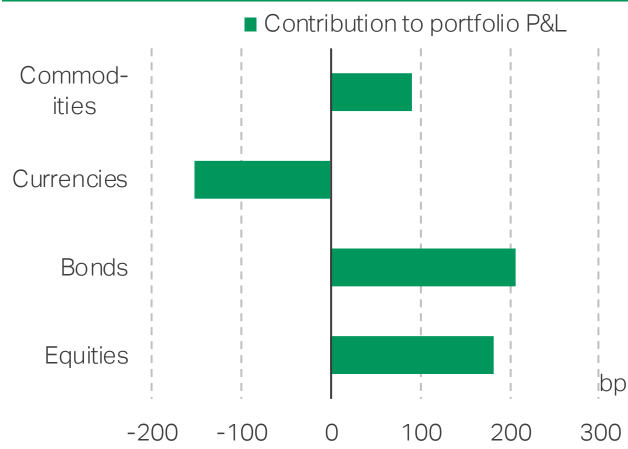
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global cycle								
	Short MSCI EM vs MSCI DM	01-Aug-18			4.3%		4%	Liquidity conditions to tighten again, and trade war risk still looming
	Long EUR/AUD**	26-Sep-18	1.6180	1.5900	-1.7%	1.67	1.59	Domestic headwinds, erosion of yield advantage to hurt AUD
Trading trade troubles								
	Long USD/CNH via 29-Mar 7.20 digi*	17-Oct-18	23.3%	14.5%	-8.8%			CNY likely to continue weakening to offset tariff risks
November seasonals								
	Long USD vs JPY and INR basket	24-Oct-18			-0.2%	1.8%	-1.8%	USD rallies in November, most significantly vs JPY and INR
Oil price normalization								
	Short Brent/WTI spread	19-Sep-18	$9.00	$10.25	-$1.25	$4.00	$11.50	Spread usually narrows post-hurricane as US exports return
Rebalance imbalance								
	Long Comm serv vs S&P	31-Oct-18			-1.8%			Investors lagging sectoral rebalancing, sector should outperform
Operation Untwist								
	Long US 2s10s steepener	**07-Nov-18**	**25bp**					**Fiscal deficit and term premium to raise long end rates vs hiking cycle pause**

Bold indicates new trades or changes made this week. *Includes cost of original Dec-18 expiry digi **Hit stop on 1-Nov

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	20.11%	4.65%
Annualized Return	**3.43%**	**0.84%**
2015	3.99%	-1.26%
2016	-4.89%	0.14%
2017	9.67%	2.47%
YTD	3.47%	-1.15%
MTD	-0.70%	
Volatility (ann.)	4.63%	3.99%
Sharpe ratio (12m)	**0.63**	**-0.24**
Sortino ratio (12m)	**1.96**	**-0.14**
Alpha (12m, vs HFRI)	7.43%	
Beta (12m, vs HFRI)	0.17	
Corr (12m, vs HFRI)	0.25	
Corr (12m,vs MSCI World)	0.34	
Corr (12m, vs JPM GBI)	0.12	
Max drawdown (12m)	-2.35%	-4.39%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 1y10y USD 2.9% payer (28-Nov-17)	152
Long WTI / short Brent (06-Oct-17)	86
Long OIH US equity (14-Feb-18)	82
Long Canada 10y / short USTs 10y (18-Oct-17)	74
Long WTI (14-Feb-18)	66
Worst	**Contrib. (bp)**
Long AUD/USD put (25-Oct-17)	-61
Short Brent /WTI spread (19-Sep-18)	-61
EUR/USD Call Spread (16-May-18)	-45
Long EUR / short AUD (03-Oct-18)	-38
Short CNY / long JPY (15-Aug-18)	-35

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