SECULAR STAGNATION *TRUMPED*
US RATES GEARING UP

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While the new US administration reforms are underway, US real rates remain depressed, pricing-in little growth acceleration

- Inflation expectations have paced-up, accounting for most of the recent tightening
- 10-year yields are still 110bps below the Golden rule command i.e. nominal growth

Potential on both inflation and growth; plus a Fed to remain behind the curve

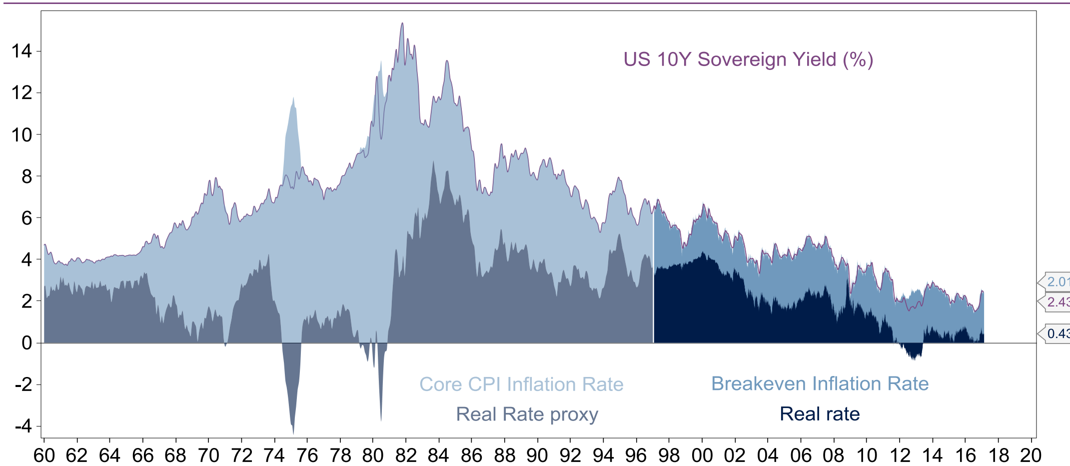
- Wage pressures and protectionist reforms could support breakevens towards 2.5%
- Growth inducing reforms in the making are spearheaded by sentiment and capex
- With the 3 Fed 25bps hikes we expect in 2017, the US policy rate will remain 200bps below what a Taylor rule suggests

US yield risk tilted to the upside

- 50% probability of 3% yield scenario under conservative consensus forecasts
- 40% probability of 4% yield in case of activity accelerating smoothly
- 10% probability of 1.5% yield outcome in case of global crisis

Despite US Treasuries safe-haven feature, with an 80bps tightening potential, and the debt ceiling brinksmanship looming large, we recommend holding an underweight position on 10-year bonds

Secular stagnation still priced-in US rates... so far



Source: Bloomberg, Macrobond, Lyxor AM

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TIME TO CALL THE END OF THE SECULAR STAGNATION ERA?

Trumponomics could leave secular stagnation in the dust

The new US administration reform agenda aims at jump-starting an economy that records full employment but low productivity growth. Monetary orthodoxy in the 80s closed the page of the 70s *stagflation*; the financial crisis turned the page of the *great moderation* in 2007; are we on the eve of seeing *secular stagnation* become a theme of the past?

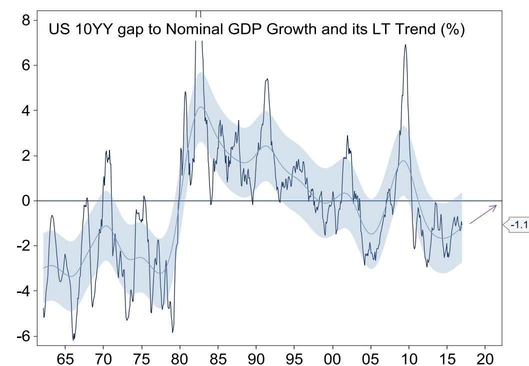
Weak growth currently priced in

The Golden rule tells us that US Treasury long term yields should reflect nominal growth. Today's 10-year yield at 2.4% should hence be compared with a Q4 2016 GDP growth of 3.5% year-over-year (1.9% in real terms, plus 1.6% price index inflation).

The 110bps gap is a reflection of long term expectations that accommodative policies that pressure yields lower may remain in place. Those expectations bear on the assumption that frail growth dynamics shall in particular justify dovish monetary conditions to extend.

Netting inflation breakevens from nominal yields delivers the same message: real yields hardly reach 43bps, their average level since 2009 and the Fed's QE inception. On the other hand, market 10-year inflation expectations have recently inflected on the back of recovered oil prices.

US yields activity accommodative… for now



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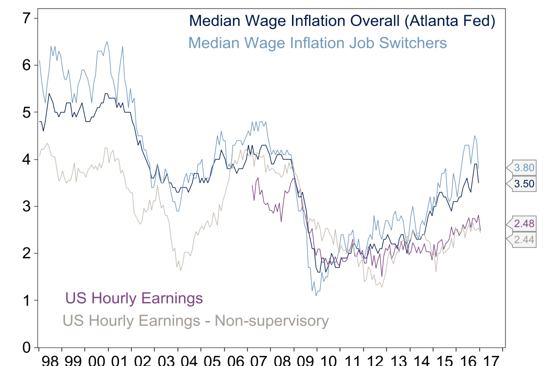
US wages brewing



Source: Macrobond, Lyxor AM

BY YEAR-END, US 10Y YIELD TO EXCEED 3%

Inflation expectations should still progress

Two key new ingredients have been added since our last inflation publication[1] that focused on the buoyant US rental price inflation (at +3.5% yoy) and the looming oil base effect.

First, with full employment reached, wage pressures are accelerating, as visible in median wages gaining 3.5% this past year. This measure properly corrects distortions induced by the recent massive job creations at the entry of the skill & income spectrum. Second, President Trump's fiscally active and protectionist platform should boost price pressures. Details on implemented measures are awaited, yet, determination and intention are unambiguous.

Eventually, although the USD appreciation should temper the latter factors, we expect the 10Y breakeven rate to progressively move toward the upper end of his historical range at 2.5%.

Growth expectations ought to continue being revised higher

Analysts have started to review their US growth forecasts after the November elections amidst the oil and gas sector rebalancing. Although at first consumers' and companies' confidence accelerated without tangible new policy ground, macro leading indicators (eg PMIs, orders) have

[1] *"Inflation, oil base effects to lift US prints, breakevens look cheap". Lyxor Investment Strategy (May 2016)*

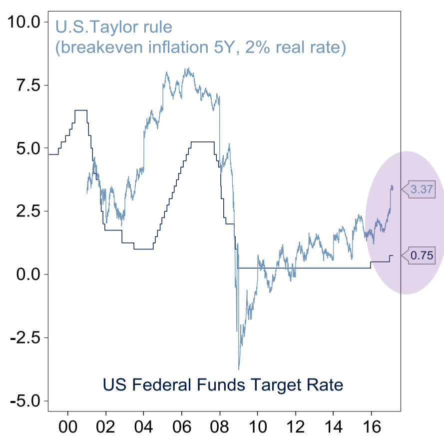
since started to indicate that activity is already picking up, ahead of reforms' implementation. We expect the current 2.3% Bloomberg consensus growth expectation to progress towards 2.5%.

Fed should reduce accommodation, while keeping the UST slope steep

The Fed has achieved its inflation and employment mandates while a massive fiscal push is now looming. Clarity on the fiscal package together with the coming nomination of new more hawkish FOMC members should prompt the Fed to follow the Dots path. We expect 3 rate hikes in 2017.

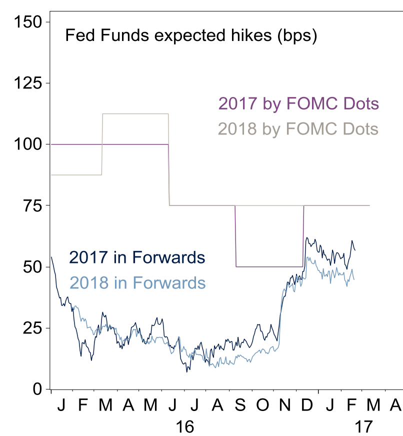
As the Taylor rule today recommends a 3.4% O/N rate, this year's tightening will anyhow leave monetary policy accommodative, so that the US yield curve should not flatten aggressively.

Taylor rule recommends 10 rate hikes!



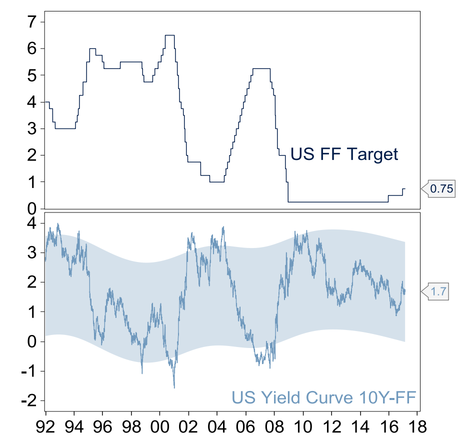
Source: Bloomberg, Macrobond, Lyxor AM

We see 3 rate hikes in 2017



Source: Bloomberg, Macrobond, Lyxor AM

Upside potential on O/N rate and Slope



Source: Macrobond, Lyxor AM

US YIELD RISKS TILTED TO THE UPSIDE!

[50% probability] of 3% scenario

Bloomberg consensus survey has 2017 real growth at +2.3% and PCE inflation at +1.9%. Under these conservative assumptions, today's 1.1% gap between nominal growth and nominal yields would justify that 10Y yields close the year at 3.1%. Reasoning through the yield curve and combining funding rates at 1.5% (after 3 hikes) with the current slope of 1.7%, we find that US Treasury yields should hit 3.2%. We put a 50% probability to yields hovering around 3%.

[40% probability] of 4% scenario

We factor-in our growth and inflation forecasts of +2.5% and +2% respectively and assume that the gap between 10Y yields and nominal GDP narrows towards its historical average. In this case, the Golden rule points to yields at 4%. Similarly, with funding rates at 1.5%, and economic activity accelerating robustly, monetary policy would end up much behind the curve. A steepening towards 2.5% would seem perfectly within reason, hence supporting a 4% yield outcome.

[10% probability] of 1.5% scenario

We attach a 10% probability to a worst case scenario that would include faltering macro dynamics (sudden activity stop), Fed policy mistake (over-tightening) and global risk-off scares (possibly stemming from Europe or China). We believe that UST yields could then plunge back to their historical lows near 1.5%.

DEBT CEILING RISKS ADD TO OUR CAUTIOUS STANCE ON UST

Our probability weighted scenarios bring us to defend a December-end 3.25% yield forecast, to which the looming debt ceiling brinksmanship could add large upside risks. US Treasuries remain more than ever the only carry-providing safe haven, which tempers our negative view. We recommend a slight underweight position on US government bonds.

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