Economics

# DBS Focus

# US Rates: Late Cycle

Group Research

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- After five years of normalization, US monetary policy settings are close to neutral
- Aside from the already telegraphed slower pace of rate hikes, balance sheet reduction is likely to slow or stop
- The market has turned too pessimistic (pricing in a cut for 2019) and we think this should be faded
- Keeping in mind that we are in the late cycle, duration risks may turn more attractive once sentiment stabilises and yields drift higher

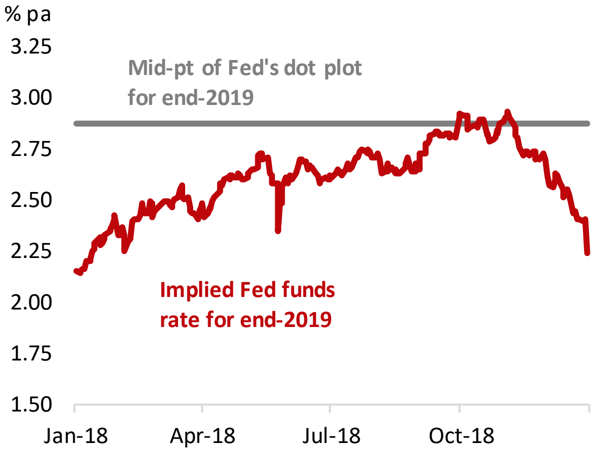
## Late Cycle

**The psyche of late cycle trading will be appropriate** for handling USD rates in 2019. The Fed has been embarking on policy normalisation over the past five years and **rate hikes will probably conclude sometime this year**. To recap, since early 2015, the Fed's balance sheet has shrunk by close to USD 500bn (the balance sheet size is currently about USD 4tn) while the Fed funds rate has increased by a cumulative 225bps (upper bound currently at 2.50%). While the strong labour market suggests that further hikes are in needed, **policy settings are probably close to neutral.** Moreover, **risk taking sentiment has deteriorated** due in part to the perceived autopilot twin tightening (rate hikes and balance sheet run-off) that has been taking place.

**2019 is likely to prove volatile even if the Fed dials down the pace of tightening.** The Fed has indirectly addressed market volatility and emphasized that policy making would be much more cautious going forward. We suspect that the pace of balance sheet reduction would slow (or even stop) relatively soon. This could be a more palatable way to sooth sentiment without adjusting short-term policy rates. Accordingly, we see two ways to navigate this difficult backdrop – **fading the extreme pessimism and taking duration risk when levels become more attractive.**

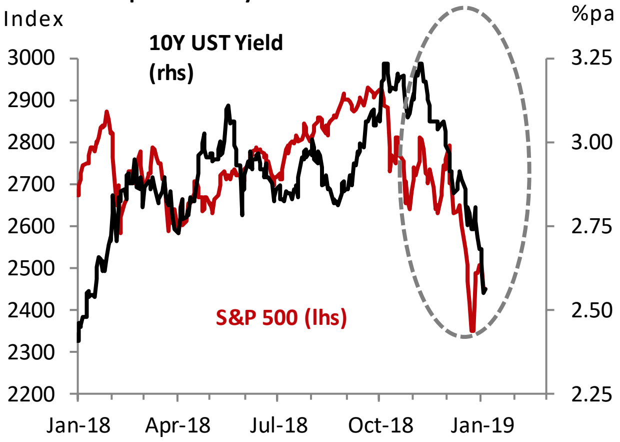
The selloff in US equities has been brutal with the S&P 500 down by close to 20% since end-September. Credit spreads (IG and HY) have also widened significantly. Unfortunately, the start of the year heralded declines across major stock indices before a bounce last Friday. We think that **USD rates are facing distortions to the downside amid risk aversion** and may have become unhinged from still-strong fundamentals. Notably, the market was pricing in an implied Fed funds rate of 2.93% in early November, but this figure has since dropped to 2.34%, pointing to a chance of a rate cut over the coming

**The market has turned too pessimistic**




Source: Bloomberg, CEIC, DBS

**Awaiting better levels before going long duration as risk aversion keeps 10Y UST yields low**

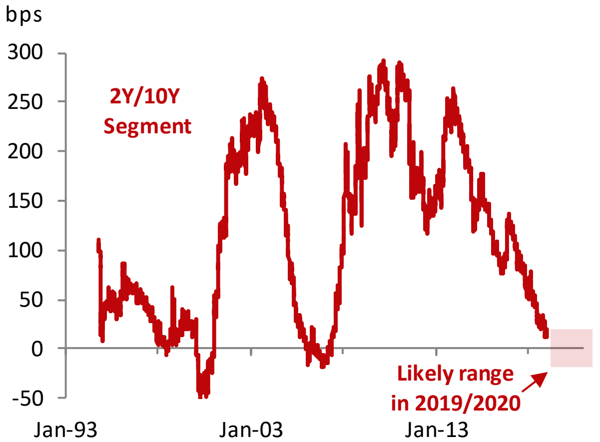



Source: Bloomberg

year. Once risk aversion wanes somewhat (when the VIX drops below 15), the market would price a Fed hold or 1-2 rate hikes again. The key risk to our outlook is a marked deterioration in the US economy, prompting the Fed to reverse course in 2019. **Fading the extreme negativity in the markets by selling the Dec-2019 Fed funds futures (selling Eurodollar futures or paying 1Y USD IRS are also possible) appears to be a good risk-to-reward play.**

We think **longer-tenor US Treasuries would be attractive as a medium-term play**. On the macro front, a US slowdown appears inevitable over the coming two years (DBSf: 2.5% in 2019 and 1.5% in 2020). This suggests that the Fed would be on an extended pause in 2020 and may herald looser monetary policy down the line. Locking in fixed rate returns at appropriate levels could pay off. To be sure, some segments of the UST curve have jumped the recession gun with the 2Y/3Y, 2Y/5Y segments of the curve showing signs of inversion over the past few weeks. That said, the more closely watched 2Y/10Y segment is still some 20bps away from inversion.

**2Y/10Y segment of UST curve to flatten/invert over the coming quarters**




Source: Bloomberg

**We think 10Y USTs are attractive at 3% and less so at 2.50%**. Yields are depressed at the time of writing (10Y UST yields are at 2.67% even after Friday's bounce) but we suspect that in the absence of risk aversion, 10Y yields could drift towards 3%. The key risk to our long-duration view would a resurgence in growth/inflation expectations and/or a loss of confidence in USD assets. In both cases, 10Y yields could push significantly above 3%.

Lastly, **we still see the UST curve (2Y/10Y) flattening over the course of the year,** tracing out familiar routes taken in past cycles. However, with just 20bps separating the two tenors, taking a curve view appears less interesting than taking a long-duration view when levels become more attractive.

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**Sources**: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).