



United States

Rates
Gov. Bonds & Swaps
Rates Volatility

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US Overview

- There are plenty of minefields out there but none are likely to dominate what we still think for now is a powerful rationale that warrants the current term structure. Long rates are well defined by low to negative term premium and a low terminal Funds rate. While we still see plenty of reasons why the Fed struggles to lift off making it as hard as it always has been to make money on shorting front rates to say a 3 month forward horizon.
- There are reasonable risk reward trades that we like including using bullish rate views to buy cheap risk on protection e.g. on SPX. We also for choice rather receive the market than pay it based on term premium staying very negative (Europe) but also the risk of some softer US data. This would favor curve caps and some relief steepening. Volatility should be higher in the front end relative to the back end.
- The round out for 2014 GDP data was fascinating because like Rip Van Winkle after 5 years of would be accelerating recovery, we realize that there has been no acceleration - for five years! A rock solid dullness of sub 4 percent nominal growth. And everyone is so afraid of inflation! More importantly it clearly justifies the low terminal funds rate that the market is pricing as it leaves as many questions unanswered in terms of productivity and profits especially.
- We look at the potential for Japanese financial sector demand for overseas securities to pick up in 2015 and conclude there is up to \$200 billion to come based on dollar yen moving to 130 and recent sensitivities of asset allocation decisions as well as pre-announced pension asset reallocations.
- Historically, consistent bullish flattening of 10s30s has increased the probability of falling CPI y/y inflation over the subsequent six months. Bull flattening was pervasive enough to suggest an elevated risk of falling inflation following November, December, and January, and the indicator is hovering around "true" levels at present.
- The median bond fund manager will likely finish the first quarter being close to flat to the benchmark. Our excess returns model and SMRA survey responses show that portfolio managers have reduced their exposure to corporate bonds and increased allocation into Treasuries.

Still Play the Range

Markets seem choppy without a lot of direction. Investors in general seem more occupied with long Eurostoxx, Nikkei and the still the dollar although since the Fed, the "handover" of dollar strength from Europe led to Fed led is undermining. In rates while everyone "wants" higher rates, we are of the view that the market isn't going anywhere and the range should continue to be traded. Our bias is still to buy dips rather than sell rallies. We also think investors should be more convinced not to short the front end. It didn't help you in the rally and it probably won't help you in a rangy market. This suggests carry trades and curve caps are more attractive now than before, relative to outright duration plays.