United States

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US rates: Reality bites despite delayed new tariffs

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The past months' escalation of the US-China trade war and increasing risks related to the unrest in Hong Kong mean that markets are rapidly moving towards our "major escalation" scenario for the US rates presented in May. While SEB's official Fed forecast remains unchanged for now, at the strategy desk we recommend positioning for lower market rates in anticipation of a series of rate cuts by the Fed. We recommend a zero cost swaptions strategy with buying USD 1y5y 1.30-1.00% receiver spread and selling 1.75% payer.

Delay to part of new tariffs

On Aug 1, the US administration announced 10% tariffs on USD 300bn of US imports from China set to apply from Sep 1 in addition to earlier 25% tariffs on about USD 250bn of imports. On Aug 13, the US administration surprisingly announced that some tariffs will be delayed to Dec 15 in order to facilitate the upcoming holiday shopping season. The postponement applies to goods like smartphones, laptops and toys. According to the WSJ, the value of imported goods exempted from tariffs was about USD 156bn in 2018.

Despite the now-announced delay, developments during the summer bring us near to our previously outlined "major escalation" scenario involving a series of Fed rate cuts and a substantial further decline in bond yields as the prolonged uncertainty bites on corporate sector confidence with increasing risks of repercussions for the household sector. Yesterday's statistics from Germany (negative q/q Q2 GDP) and China (weaker than expected industrial production and retail sales) demonstrate downside pressures on growth.

Furthermore, the 90 day exemption from a national security ban granted to Huawei and a number of other Chinese companies in May will expire on Aug 19.There is a risk that the exemption will not be extended, which could lead to a retaliation by China, hampering the risk appetite and putting pressure on rates.

Risks turning into reality

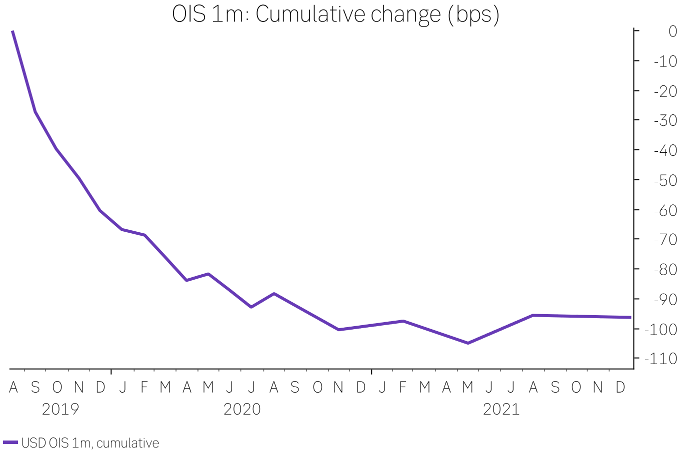
On May 21 we set out alternative scenarios for the US rates ("US-China trade war in stand-off until G20", here) that were further refined on Jun 7 (The Great Trade war: "Financial market implications", here). We concluded that in a "major escalation" scenario in which the trade war is not resolved in the foreseeable future and the US imposes 25% tariffs on all imports from China, the Fed would cut its fed funds target range to 1.25-1.50% by mid-2020. The US 2y and 10y yields would decline to 0.80% and 1.60%, respectively, by mid-2020. In the Jun 7 report, we stated that "…the current market pricing [US 10y yield at 2.08% at that time] still gives rise to attractive opportunities to strategically position for lower USD rates…". Since then, this scenario has unfolded very quickly with the 10y Treasury yield declining to around 1.60%.

On Jul 10, SEB's Fed forecast (here) was revised to involve two 25bps rate cuts, in July and December 2019. Our official forecast is another insurance cut in December but the risk picture is clearly shifting towards more aggressive and faster cuts, more in line with what we outlined in our previous "major escalation" scenario. With core inflation stable at or just above 2% since the beginning of the year and the Fed's favourite inflation measure, core PCE, about half a percentage point lower, the Fed should have room to continue to gradually adjust its policy rate somewhat to meet risks from trade turmoil and nervous financial markets.

Aggressive but not unrealistic

Markets are now pricing Fed rate cuts by 35bps for the September meeting, a total of 69bps by the end of this year and about 108bps by end-2020 (see Fig. 1 below). While the current pricing is relatively aggressive, it still falls short of what would likely need to be delivered in the case that a recession scenario materializes.

OIS 1m: Cumulative change (bps)



Source: Macrobond, SEB

Despite the announced delay to some tariffs, there remains a non-negligible risk of further escalation of the conflict over time. Furthermore, the recently sharpened tone from China increases the risk of tougher measures towards Hong Kong, which could further escalate the US-China tensions and make a trade deal even more difficult to achieve. And the longer it takes to find a trade resolution, the larger the potential damage to the economy.

Since we presented our trade war related risk scenarios, markets have moved even faster than we expected considering our 1.60% mid-2020 target for the 10y Treasury in a "major escalation" scenario, which assumed the US imposing 25% tariffs for all imports from China. Our economists are in the process of revising their views on the Fed, and at the strategy desk we think that a prolonged trade war will most likely motivate 75bps of fed funds cuts from the current level by mid-2020 with the next cut at the Sep 18 meeting. A further escalation with 25% tariffs on all imports from China could motivate the Fed to cut more.

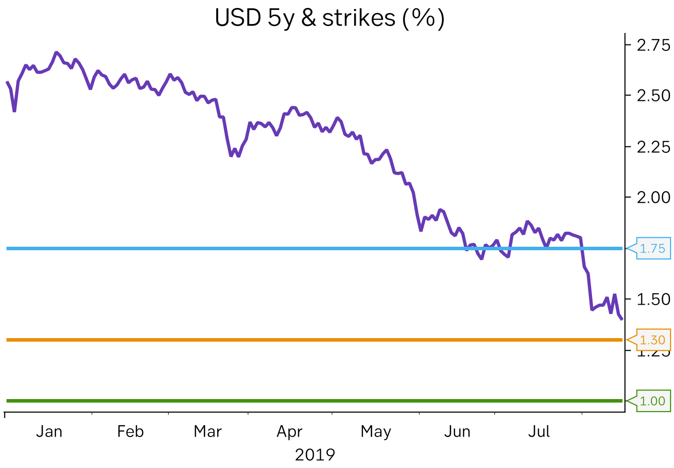
In the table below we show our current official forecast and our revised "major escalation" scenario targets for US rates. In a major escalation scenario, we now revise our mid-2020 target for the 10y Treasury yield from 1.60% to 1.30%. We also continue to expect the curve to steepen in such a scenario, but to a lesser extent than what we forecasted previously in May / June.

Position for lower USD rates

Altogether, we recommend positioning for further declines in US rates and regard the following swaptions strategy as very attractive to expressing this view:

Trade: Buy USD 1y5y 1.30-1.00% receiver spread, Sell USD 1y5y: 1.75% payer

- Premium: Zero cost
- With USD 100m notional per leg
- Greeks, 100mio notional / leg
  - Delta: USD -21k
  - Vega:USD -13k
  - 3m carry & roll: USD +100k
  - Max profit at expiry: USD 1,425k



Source: Bloomberg, SEB

In the "major escalation" scenario, we expect the USD 5y to trade clearly below 1.00% in 12 months' time. Even in a less aggressive rate cut scenario we expect the USD 5y to trade below 1.30%. If rates rise, the position will break even at the maturity as long as the USD 5y is below 1.80%, i.e. there is protection for an around 30bps increase of the USD 5y rate from its current spot level.

While we continue to see a long-term steepening position in the USD curve, we currently prefer expressing our dovish view via the directional swaptions position. Accordingly we close our existing USD 2y/10y curve steepener with 3y fwd start that was recommended on Jan 16("Strategic trade: Position for a steeper USD swap curve, Jan 16, here). The recent flattening of the 2y/10y curve has eaten up the previous profits of the position and we close the position with a loss of 8bps.

SEB official base scenario

- Current 25% US tariffs on imports from China will remain in place with the delayed 10% tariffs becoming effective on Dec 15

Financial markets

- Fed to cut 25bps in December, on hold thereafter
- Current market pricing of Fed expectations is stretched, resulting in a rebound in the short end of the curve
- Long end remains near current levels as markets remain concerned of the Fed falling behind the curve and increasing recession risks
- Risks are for long rates declining with the 2y/10y curve inverting substantially if the Fed does not deliver more than one rate cut during the autumn

US forecast	End-2019	Mid-2020
FF	1.75-2.00	1.75-2.00
2y (IRS)	1.65 (1.60)	1.60 (1.55)
5y (IRS)	1.55 (1.45)	1.50 (1.40)
10y (IRS)	1.70 (1.55)	1.70 (1.55)
2y/10y (IRS)	5 (-5)	10 (0)

Major escalation scenario

- Delayed tariffs will become effective in December and with no resolution found, 25% tariffs on all imports from China will be imposed in H1 2020

Financial markets

- Fed to implement a series of rate cuts taking the fed funds target range at least to 1.00-1.25% by mid-2020 with further rate cuts possible in H2 2020
- 10y yield declines to all-time lows in H1 2020
- Substantially steeper curve

US forecast	End-2019	Mid-2020
FF	1.50-1.75	1.00-1.25
2y (IRS)	1.30 (1.25)	0.70 (0.65)
5y (IRS)	1.20 (1.10)	0.85 (0.75)
10y (IRS)	1.40 (1.25)	1.30 (1.15)
2y/10y (IRS)	10 (0)	60 (50)