03 March 2021

Global Economics & Market Strategy

UST10YR Yields Will Rise in 1H21: Fixed Income Investors Don't Panic

- **We undertake a U-turn in our view on UST10YR yields to now forecast a rising yields path towards 1.70-1.75% by summer of 2021 before a fall to 1.38-1.42% in 2H21.**
- **As a result, longer dated US government bonds will continue to face adverse pressure in 1H21 before finding some support in 2H21.**
- **The silver lining is that some time in summer, we believe that the balance of risks is skewed towards the US Federal Reserve announcing some measures to stabilize longer dated government bond yields if the upward momentum in yields is too rapid in 2Q21.**

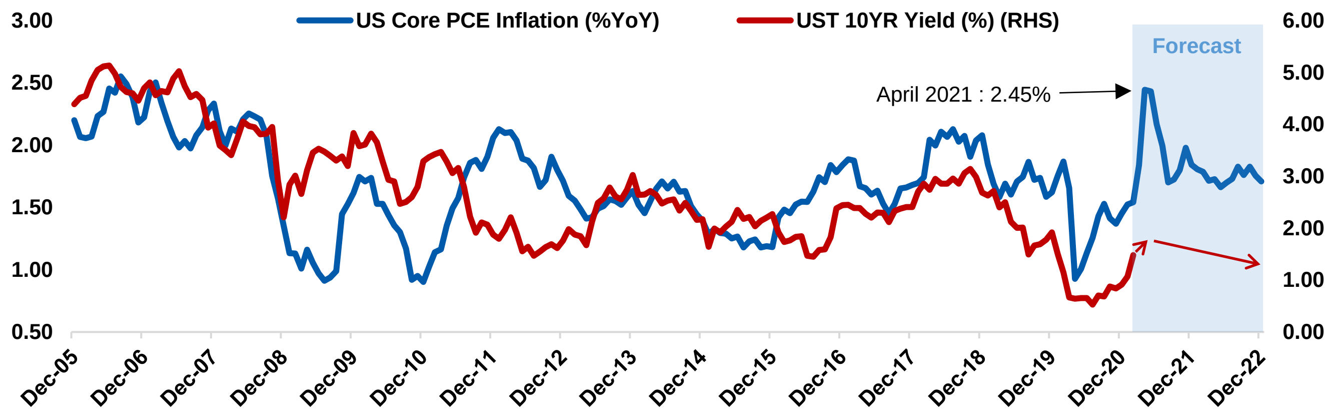
Group Chief Economist & Head, Market Research

Dr. Sailesh K. Jha
+603 9280 8880
dr.jha@rhbgroup.com

Head Rates & FX Strategy
Dr Suresh Rama CQF
+603 9280 8864
suresh.kumar.ramanathan@rhbgroup.com

Rates & FX Analyst
Amanyna Hanany Mohd Adnan
+603 9280 2172
amanyna.hanany.mohd@rhbgroup.com

Figure 1: Rising US core PCE inflation in 1H21 will propel UST10YR yields to 1.7 to 1.75% in 1H21



Source: Bloomberg, RHB Economics & Market Strategy

UST10YR Yields Up In 1H21 Then Down In 2H21

In our view the recent decline in US Treasury 10 Year (UST10YR) government bond yields is temporary. We believe UST10YR yields will rise to around 1.7% by summer before declining to around 1.4% in 2H21 (Figure 2). Relative to market expectations (as proxied by the futures market), we are more pessimistic on the H121 outlook for UST10YR yields but more constructive in 2H21.

The key challenge in 1H21 for global markets is that it digests the path of higher UST10YR yields we are forecasting (Figure 2) and prices it into various financial instruments from a trading and investing perspective.

The main catalysts for our change in view (Figure 2) to a rising UST10YR yields path from a falling yields path in 1H21 (as indicated in our December 2020 Global Outlook report) are the following:

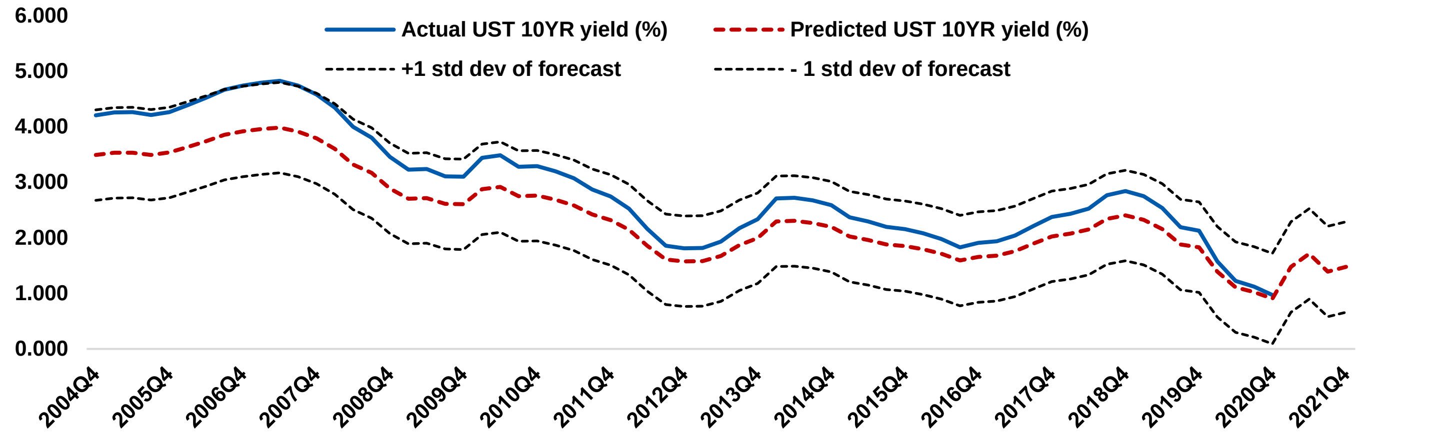
- Our econometric model results (Figure 3) are signalling a rising yields path in H121, where in the main inputs into our model are current US core PCE inflation and market inflation expectations.
- In addition, positioning in the UST10YR futures market hasn't turned net short yet (Figure 7). Funds flow data indicate that investors are already reducing positions in US long dated government bond holdings (Figure 8).
- We expect US core PCE inflation to surprise on the upside due to the low base effect of 2Q20 and a narrowing of the output gap on back of above trend US GDP growth in 1H21 before stabilizing in 2H21 as growth moderates to trend. The rise in core PCE inflation will generate higher UST10YR yields in 1H21.
- Although the pickup in US core CPI will be partially driven by base effects, we believe markets will react to these above consensus prints in 1H21 and reduce positions in UST10YR bonds along with perhaps some risky financial assets which are negatively correlated with long term interest rates.
- The silver lining is that some time in summer, if we are correct on our UST10YR yield forecasts along with our assessment that turbulence in some risky asset prices will pick-up in 1H21, the balance of risks is skewed towards global central banks such as the US Federal Reserve (FED) announcing some measures to stabilize longer dated government bond yields. These policy actions could materialize if the upward momentum of yields is too rapid in 2Q21.

Figure 2: RHB UST10YR Yield forecasts revised up since our…

	1Q21	2Q21	3Q21	4Q21
UST10YR Yield New (%)	**1.43-1.48**	**1.70-1.75**	**1.38-1.42**	**1.38-1.42**
UST10YR Yield Old (%)	0.85	0.70	0.85	0.95
UST10YR Futures (%)	**1.41**	**1.47**	**1.43**	N.A.
Bloomberg Consensus (%)	1.16	1.30	1.35	1.46

Source: Bloomberg, RHB Economics & Market Strategy

Figure 3: ...econometric model suggests UST10YR yields will continue to rise in 1H21 before dropping in 2H21



Source: RHB Economics & Market Strategy

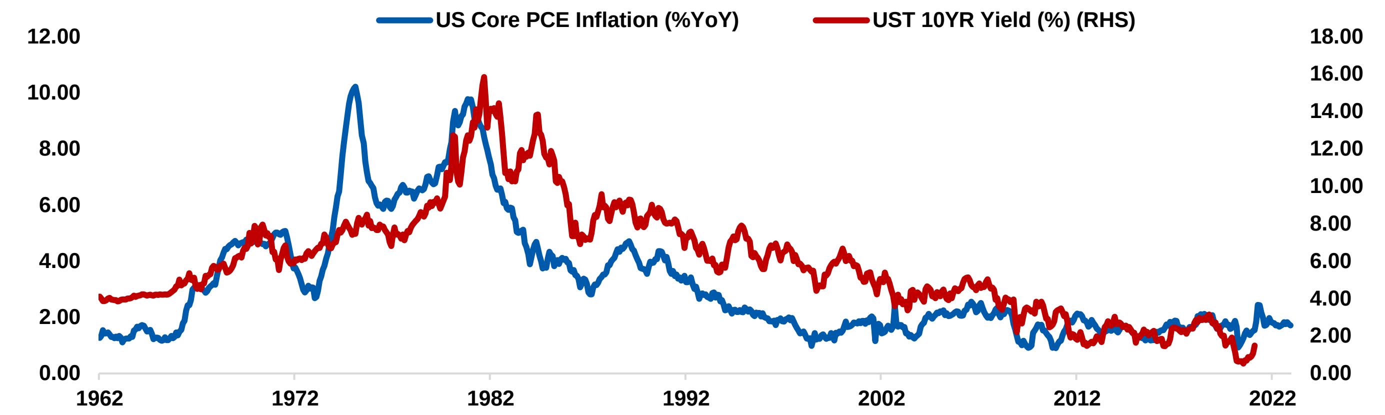
Over the last around 50 years, the empirical evidence suggests that rising UST10YR yields is broadly associated with higher US core PCE inflation prints (Figure 4). In 1H21 and 2H21, history will repeat itself, ie yields go up and then down. The main reason is that markets are usually incorrect on their assessment of core inflation dynamics in terms of the drivers and path over the next 3-6 months. The main reason being that, with the exception of some monthly prints on core inflation being contaminated by seasonal and base effects, on average the US output gap is the primary catalyst of core PCE inflation and this is not easy to forecast correctly (Figure 11 & 12).[1] However, it's not clear that when financial market participants trade fixed income products, is the output gap a critical input into their assessment of where long term bond yields are headed? Second, even if the output gap is an input into the trading strategy, which measure of the output gap is being utilized?

Note that in recent history, during the period September 2016 to April 2018 yields doubled to 3% (Figure 4) on back of above trend growth and the output gap narrowing significantly. Further back in history, the bull market of the mid to late 2000s culminated in UST10YR yields hitting 5% in May 2006. This was a period characterized by strong and above trend US and global growth accompanied by a significant narrowing of the output gap. Today, we are in a similar situation as in the mid to late 2000s as it applies to the macro outlook for 1H21. However, 2H21 is a very different story. In 2H21, we expect US GDP growth to slow and core PCE inflation to drop as well.

As a result, and taking into other factors such as potential central bank policy action, by the time summer arrives, opportunities to invest in longer dated US government bonds could present themselves. Note that the output gap is an unobservable variable in the sense that potential growth (as proxied by GDP, Industrial Production, etc…) needs to be estimated. As a result, forecast errors of the output gap could generate very different expectations among market participants of where UST10YR yields are headed. This is the situation currently. But as we traverse thru 1H21, these forecasts errors will fall as the market catches up with what's the reality of forward looking inflation versus what's noise. Once inflation expectations stabilize in the summer of 2021, 10YR bond yields could then start stabilizing.

[1] The output gap is defined as the difference between actual and potential growth of an economy.

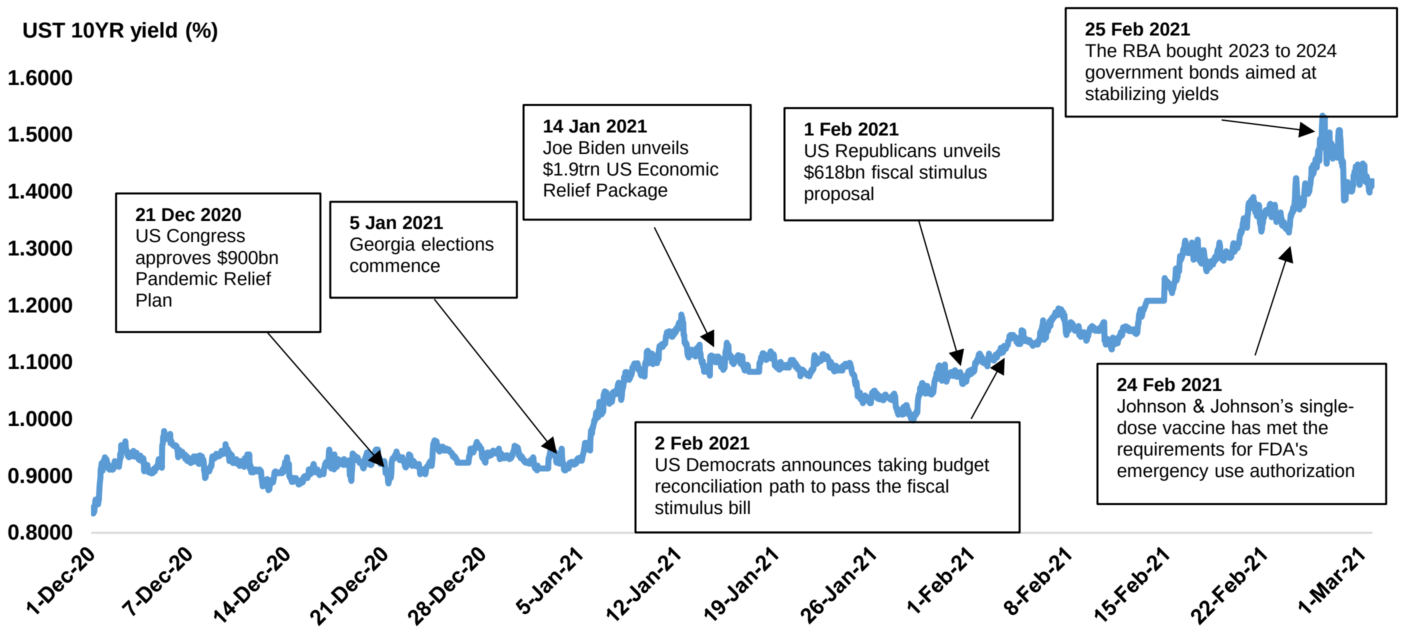
Figure 4: 60 years of evidence suggests that UST10YR yields rise as US Core PCE inflation rises, while…



Source: Bloomberg, RHB Economics & Market Strategy

Besides fundamental data points such as US core PCE inflation driving UST10YR yields higher, policy announcements and other news flow also impacts yields (Figure 5). On the policy side, over the next few months we expect the Biden administration to start raising expectations of passage of an infrastructure bill in the summer. In addition, news flow of an accelerated path of Covid-19 vaccine inoculations in the US could emerge in 1H21. These domestic event risks along with above consensus inflation and growth related data prints could drive UST10YR yields higher in 1H21.

Figure 5: …domestic and global policy announcements could impact yields as well



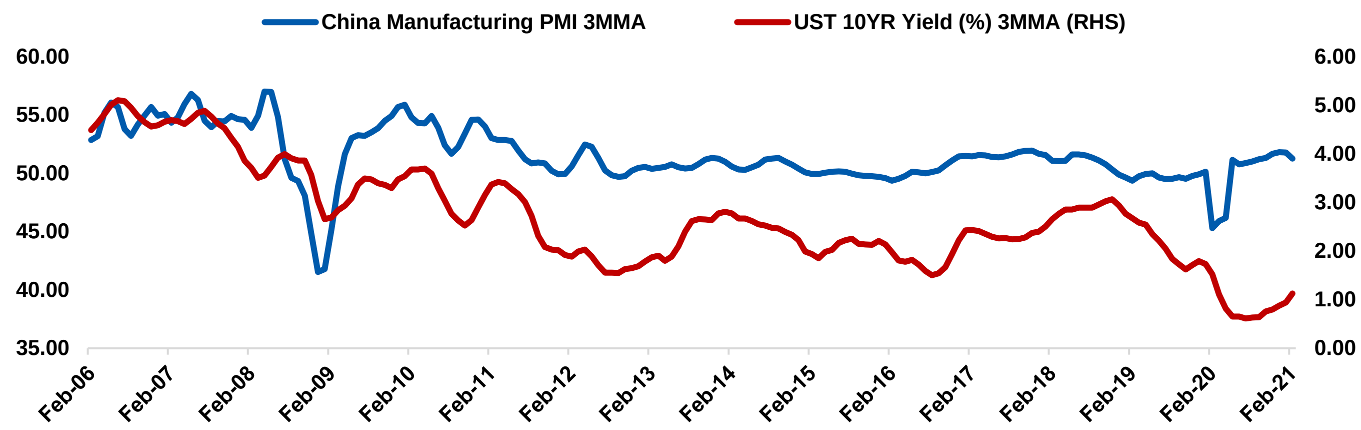
Source: Bloomberg, RHB Economics & Market Strategy

However, what will eventually temper the upward momentum of UST10YR yields is if intra-day trading ranges rise to 1.7-1.9% on a sustained basis in 2Q21, which would put 6 month ahead real yields at close to 0%. At this point of time and market environment, the balance of risks would be skewed towards the FED announcing some form of yield control measures. Moral suasion like what the European Central Bank (ECB) has been engaging in recently has limited sustained impact on yields. Policy action such as what the Reserve Bank of Australia (RBA) announced on February 25 to purchase additional bonds has an impact on global bond markets (Figure 5). What the FED will also be faced with in the summer is that the prospect of further fiscal stimulus in the form of infrastructure spending or other expansionary fiscal policy to be passed by the US Congress could take longer than anticipated.

At the same time UST10YR yields could potentially be approaching 0% on a sustained basis. At the start of the last business cycle which ensued from 1Q17 to 1Q19, real forward looking yields (as measured by the difference between UST10YR yields and US 2YR breakeven) was around 0.4%. To maintain GDP growth slightly above trend for a sustained period, a prolonged period of close to 0% real yields is necessary. Hence, we believe the aforementioned potential market and fiscal policy environment in the summer of 2021 could be unacceptable for the FED, as it would pose downside risks to growth and inflation in 2H21. As a result, the risks are skewed towards an announcement by the central bank of some form of yield control measures to stabilize longer dated government bond yields. Other risks faced by the FED during 2Q21 could be that the front end of the yield curve starts flattening at a fast pace as core PCE inflation surprises on the upside.

Besides domestic macro, policy, and news impacting UST10YR yields, global factors such as economic and market risks in China are important to track (Figure 6). In particular, China credit risks, further tightening of policy towards the property sector, geopolitical risks related to Hong Kong, and unexpected significant declines in the local stock and currency markets could impact the trajectory of UST10YR yields. Over the last around 10 years, we have noticed a disconnect between UST10YR yields and US core PCE inflation in 2016, where inflation rose but yields fell in 2016 (Figure 4). Part of this disconnect was fears of a hard landing in China in 2016. Other global factors such as the 2011-2012 European crisis partially caused UST10YR yields to fall significantly even though US core PCE inflation was rising for much of this period until mid-2012 (Figure 4).

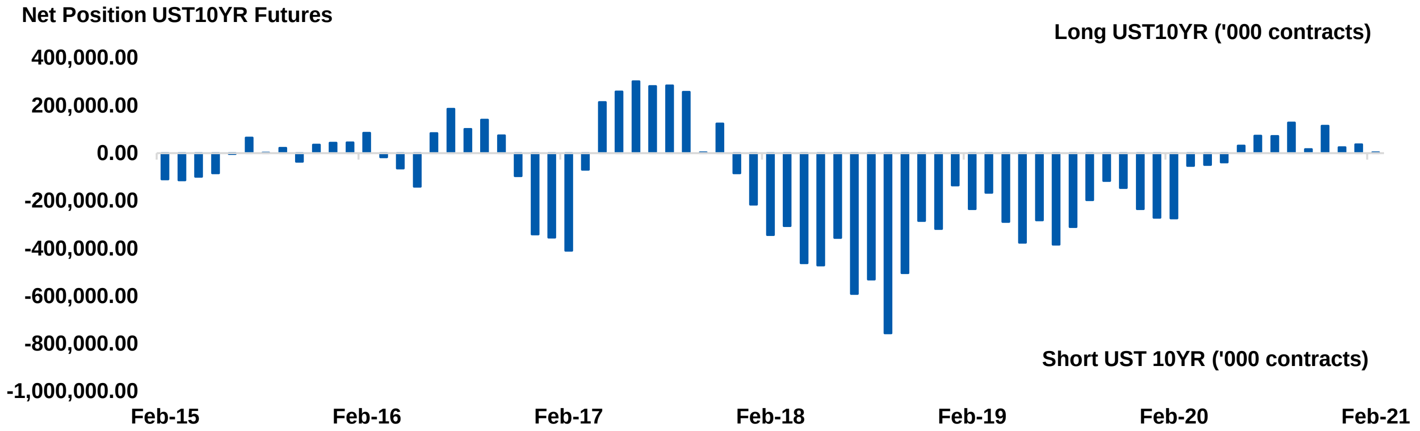
Figure 6: But in 2016 UST10YR yields fell despite US inflation rising due to China hard landing risks up



Source: Bloomberg, RHB Economics & Market Strategy

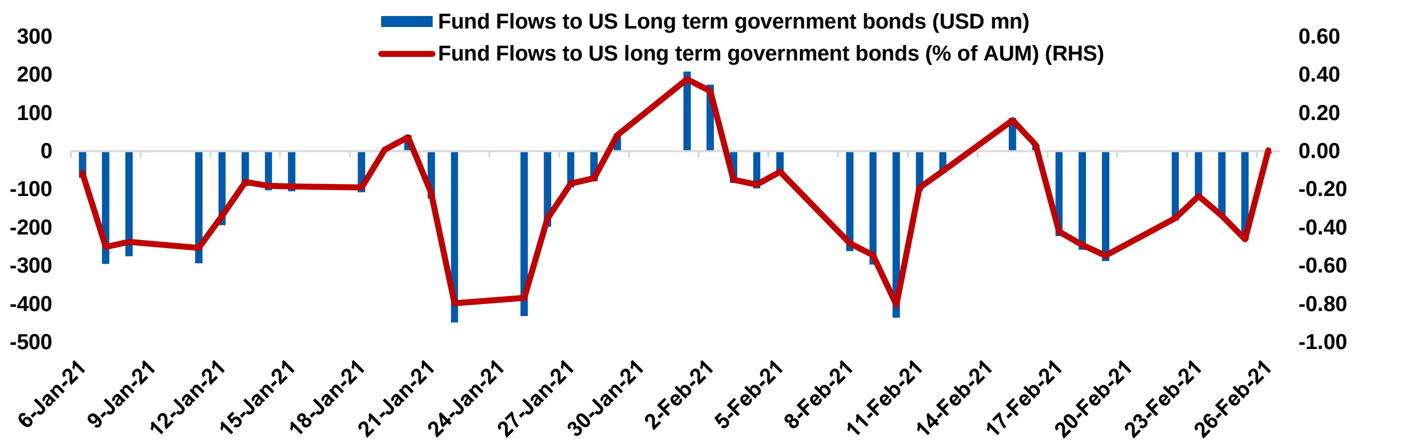
Having discussed the fundamental and policy back drop supporting our UST10YR yield forecasts for 2021, we examine the positioning and fund flows data. We conclude that the market isn't short just yet (Figure 7) and there is room for further net outflows from long dated US government bonds in 1H21 (Figure 8). From the UST10YR futures positioning data (Figure 5) we notice the market is basically flat in terms of positioning, hence any abrupt surprises on macro, policy, and news related events could induce net shorts to materialize. We believe these event risks, as discussed above, will ensue in 1H21 and thus cause a significant build-up of net short positions in the UST10YR futures market which will translate into rising yields in the UST10YR cash market. On the funds flow front, investments into long dated US government bonds (Figure 6) continue to decline and we haven't seen any sustained net inflows since early 2021. As a result, as is the case for our view on positioning turning net short in 1H21, we expect significant net outflows from longer dated US government bonds in 1H21.

Figure 7: Light positioning in UST10YR futures market suggests that abrupt changes in market sentiment could impact the direction of UST10YR yields in the cash market significantly



Source: Bloomberg, RHB Economics & Market Strategy
Last data point is as of Feb 2021, monthly commencing in January 2015, 3mma

Figure 8: While funds flow data suggest that net outflows from US long term government bonds is underway



Source: EPFR, RHB Economics & Market Strategy
Last data point is as of 26 Feb 2021, daily data commencing on 4 January, 2021. AUM represents assets under management.

2021 & 2022 Inflation and GDP Growth Forecasts Upgraded

We revise up our 2021 and 2022 US CPI inflation forecasts to 2.3%YoY and 2.2%, from 1.6% and 1.8%, respectively (Figure 9). For the first time, we present our US core PCE inflation forecasts (Figure 10), which is the main inflation measure that the FED and the market examines carefully. Our core PCE inflation forecasts are above consensus. However, unlike some in the market, we don't foresee a blow up of inflation in 2021 and 2022 even though M2 growth is currently on a steep upward trajectory (Figure 13).

Figure 9: RHB US CPI inflation forecasts revised up

	2020	2021f	2022f
CPI (%YoY, avg) New	1.2	2.3	2.2
CPI (%YoY, avg) Old	1.4	1.6	1.8
Bloomberg Consensus (%YoY, avg)	N.A.	2.2	2.1

Source: Bloomberg, RHB Economics & Market Strategy. Above refers to US CPI, urban, sa

Figure 10: RHB US core PCE inflation forecasts are above consensus estimates for 2021

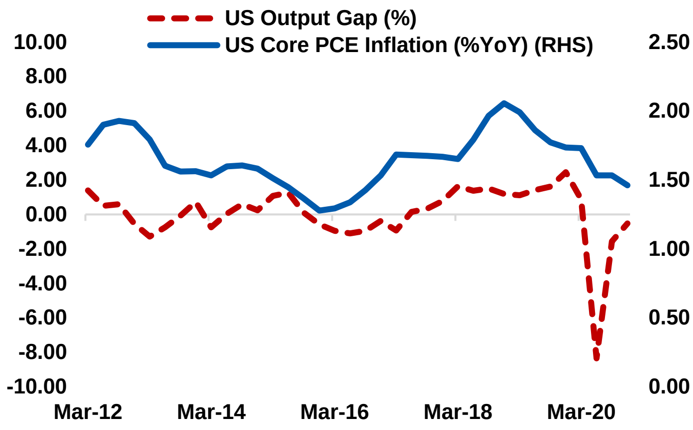
	4Q20	1Q21f	2Q21f	3Q21f	4Q21f	2022f
Core PCE Inflation (%YoY, avg)	1.40	1.63	2.34	1.80	1.87	1.75
Bloomberg Consensus (%YoY, avg)	1.40	1.50	2.10	1.70	1.80	1.90

Source: Bloomberg, RHB Economics & Market Strategy

In our view, the narrowing of the output gap will drive core PCE inflation to a peak of 2.45% YoY in April 2021 and close to the previous 14 years peak of 2.55% recorded in August 2006 (Figure 11 and 12). Above trend GDP growth in 1H21, which could be well above an average of 5% YoY, will likely cause the output gap to turn significantly positive from a negative reading posted in 4Q20. This will put upward pressure on core PCE inflation in1H21. In addition, the core PCE inflation prints will also be impacted by the low base effects of 2Q20.

As the US economy opens up, we are already noticing services inflation rising in sectors such as housing and health care. Looking forward, these sectors are likely to continue to propel core PCE inflation higher in 1H21 before stabilizing in 2H21 as the impact from fiscal stimulus stabilizes. In addition, as the incremental impact of fiscal stimulus abates in 2H21, we foresee demand side pressures dissipating.

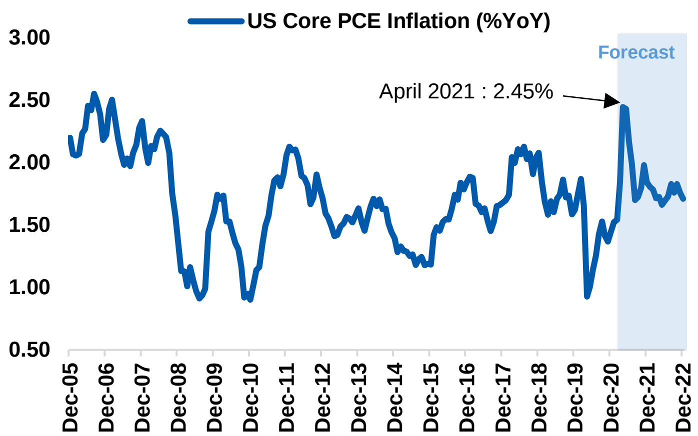
Figure 11: A further narrowing of the output gap…



Source: Bloomberg, RHB Economics & Market Strategy

A narrowing of the output gap means that actual growth is approaching potential growth.

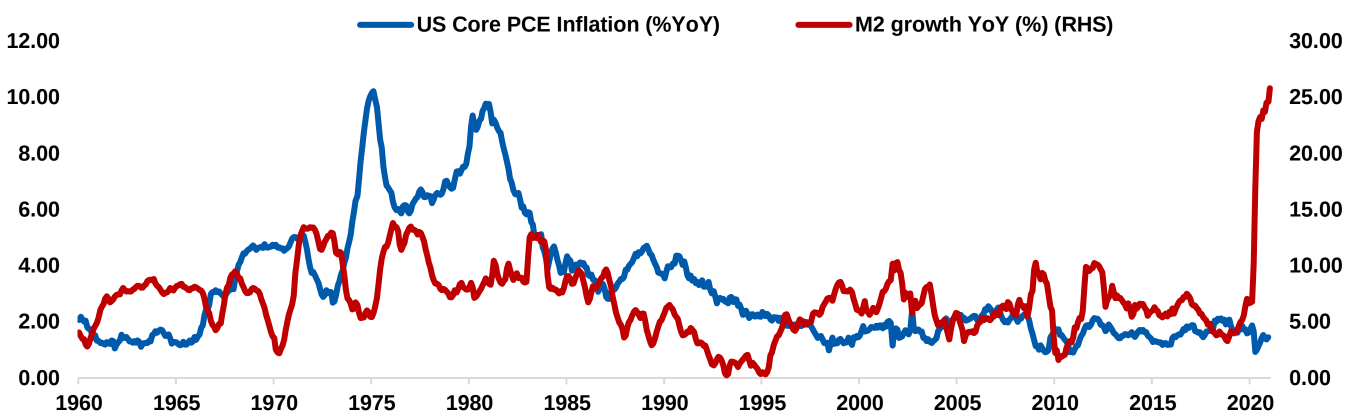
Figure 12: …will cause inflation to accelerate in 1H21



Source: Bloomberg, RHB Economics & Market Strategy

However, do note that we are not forecasting a scenario of wage price spiral dynamics filtering into aggregate price dynamics in 2021 or 2022. This is despite our view that fiscal stimulus induced rapid acceleration of M2 growth will persist for much of 2021 (Figure 13). Sixty years of evidence suggests that the link between M2 growth and core PCE inflation has weakened considerably since around 2005 (Figure 13). The experience so far since the FED and US government embarked on massive stimulus measures from 1Q20 onwards has been that core PCE inflation has been well behaved and we expect it to remain as such in 2021 and 2022. One of the main reasons is that slack in the labour market remains high as the pre-pandemic level of employment has yet to be reached and is unlikely to be attained in 2021 and for the better part of 2022. Improvements in labour market conditions tend to lag sustained growth accelerations by at least 1 year. It's unclear, beyond the next 2 to 3 quarters, whether growth will remain above trend or not. As a result, we don't foresee persistent demand side and wage price spiral dynamics pressures on core PCE inflation arising in 2021.

Figure 13: Despite massive fiscal and monetary stimulus, US core PCE inflation unlikely to explode in 2021



Source: Bloomberg, Federal Reserve Bank of St. Louis, RHB Economics & Market Strategy

M2 growth partially captures the impact of fiscal and monetary stimulus measures.

Having discussed our 2021 outlook for inflation, we now focus on the outlook for GDP growth. We remain below consensus estimates on our forecasts for 2021 and 2022 GDP growth despite our upward revisions (Figure 14). We foresee a rapid acceleration to above trend consumer spending in 1H21 before a deceleration to trend in 2H21 as the tail winds from the proposed passage of the USD1.5 to 1.9 trn fiscal stimulus bill in March starts to moderate but are still significant. We also believe that a passage of an additional sizable fiscal stimulus bill is likely to be delayed to as late as 4Q21.

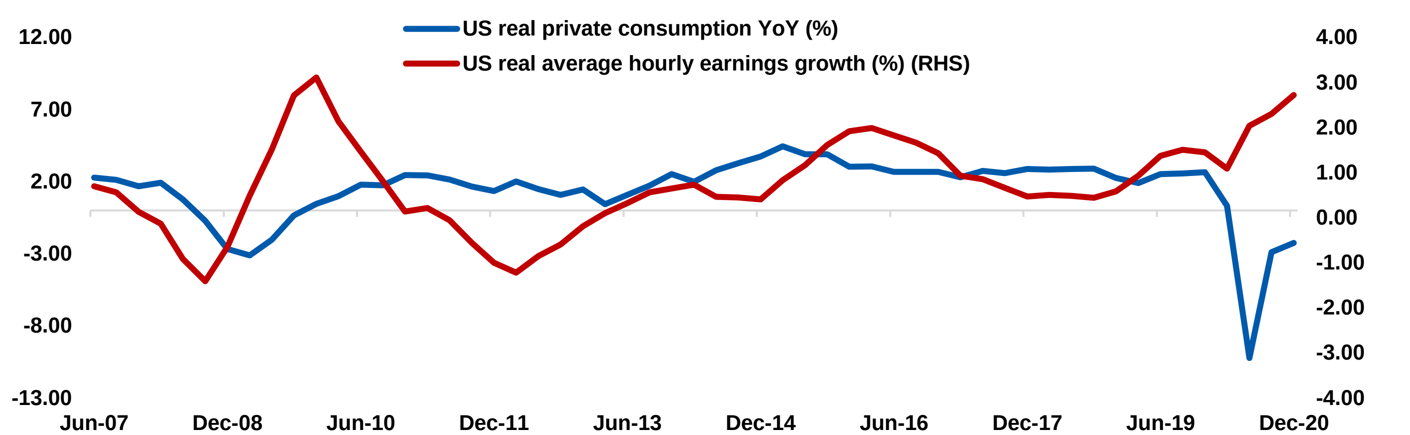
The other main driver of GDP growth in 2021 will be private investment spending. **We expect an acceleration in gross fixed capital formation for much of 2021.** These investments will mainly be concentrated in the industrial equipment, automobile, residential, and electrical and electronics sectors as capacity constraints are already starting to build. A 4Q20 survey of US corporate CEOs investment spending intentions suggests an uptick for the next 6 months.

Figure 14: RHB US real GDP growth forecasts revised up

	2020	2021f	2022f
Real GDP Growth New (%YoY)	-3.5	4.5	3.2
Real GDP Growth Old (%YoY)	-3.5	2.5	2.9
Bloomberg Consensus (%YoY)	N.A.	4.9	3.7

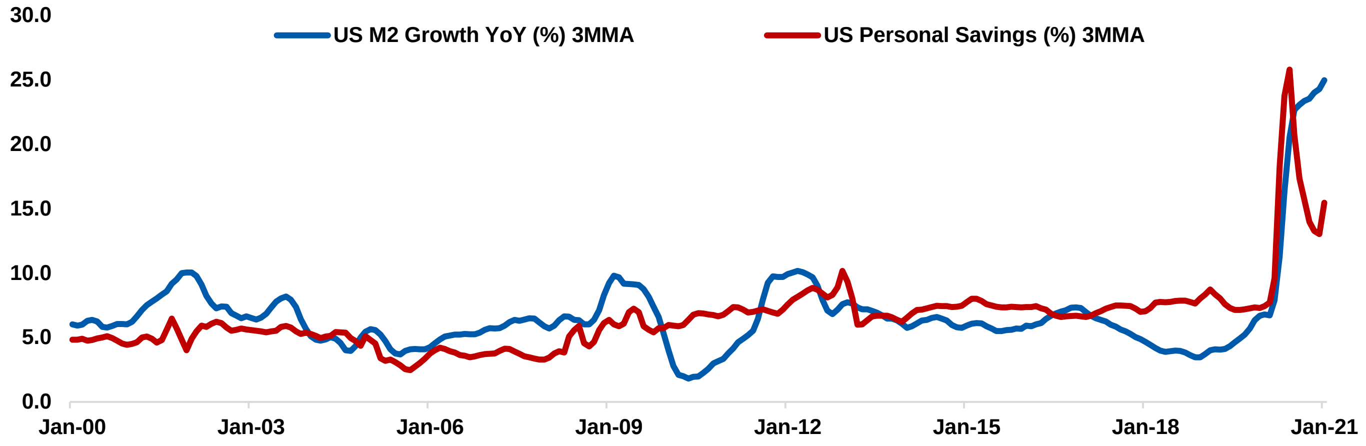
Source: Bloomberg, RHB Economics & Market Strategy

Figure 15: Real GDP growth mainly driven by consumer spending as…



Source: Bloomberg, CEIC, RHB Economics & Market Strategy

Figure 16: …consumer savings rate falling on back of robust M2 growth (which captures stimulus measures)



Source: Bloomberg, Federal Reserve Bank of St. Louis, RHB Economics & Market Strategy. The consumer savings rate is defined as savings as a percent of disposable income.

Risks To Our UST10YR Yields Outlook For 2021

The main independent risks, keeping the other risks fixed, to our UST10YR yields forecast are:

- US GDP growth slows in H121 and the output gap widens, thus causing core PCE inflation to fall rather than rise. Under this scenario, UST10YR yields could fall rather than rise in 1H21.

- Unanticipated sustained global macro or financial market risks emerge in the near-term, such as in China and Europe. This would restrain UST10YR yields from moving higher than current levels in H121.

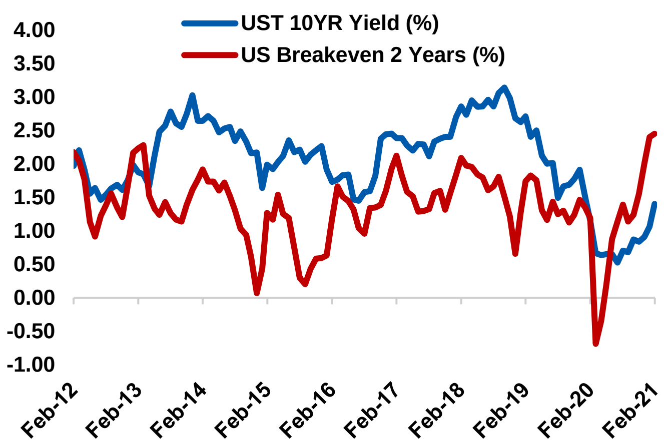
- Additional quantitative easing or yield control measures are announced unexpectedly by the FED or ECB sooner rather than later. Under this scenario, long term bond yields will fall rather than rise in 1H21.

- In H221, the main risk to our falling yields forecast is that the output gap continues to turn positive on a sustained basis as additional fiscal stimulus is announced in the summer of 2021. In this instance, UST10YR yields will rise rather than fall in 2H21.

- Our view of falling core PCE inflation in 2H21 is derailed by persistent demand side pressures on aggregate prices continuing beyond 1H21. Under this macro environment, UST10YR yields will rise rather than fall in 2H21.

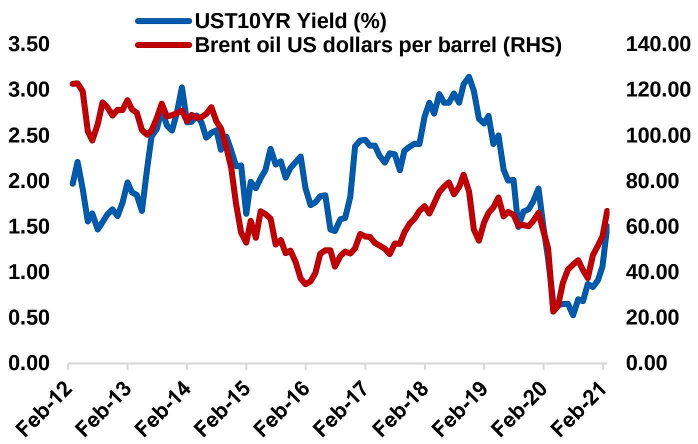
Appendix: Other charts to monitor to track UST10YR Yields

Figure 17: Watch the US 2YR Breakeven data and…



Source: Bloomberg, RHB Economics & Market Strategy

Figure 18: …momentum of oil prices



Source: Bloomberg, RHB Economics & Market Strategy

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KUALA LUMPUR

RHB Investment Bank Bhd
Level 3A, Tower One, RHB Centre
Jalan Tun Razak
Kuala Lumpur 50400
Malaysia
Tel : +603 9280 8888
Fax : +603 9200 2216

JAKARTA

PT RHB Sekuritas Indonesia
Revenue Tower, 11th Floor, District 8 - SCBD
Jl. Jendral Sudirman Kav 52-53
Jakarta 12190
Indonesia
Tel : +6221 509 39 888
Fax : +6221 509 39 777

SINGAPORE

RHB Bank Berhad (Singapore branch)
90 Cecil Street
#04-00 RHB Bank Building
Singapore 069531

BANGKOK

RHB Securities (Thailand) PCL
10th Floor, Sathorn Square Office Tower
98, North Sathorn Road, Silom
Bangrak, Bangkok 10500
Thailand
Tel: +66 2088 9999
Fax :+66 2088 9799