Global Markets Daily: A New Bond Market Conundrum

- Risks around the outlook for shorter term US rates shifted materially into the end of 2021, largely on account of Fed-related developments. With our economists now projecting 3 hikes by the end of 2022 (and a steady 3 hikes per year pace thereafter), we have revised up our forecast for 2y UST yields to 1.35% for YE22 (20bp higher than our prior projection).
- Despite the anticipation of stronger upward pressure on 2y yields, we have left our YE22 projections for 5s, 10s, and 30s unchanged at 1.8%, 2.0%, and 2.25% respectively on account of the market's reluctance to price a higher terminal policy rate this cycle. There are two possible explanations for this reluctance: a widely prevalent low terminal rate view, or that the price signal is distorted by supply/demand imbalance. We believe the latter explanation is the more compelling one, but one that will take time (and some rate hikes) to resolve, leaving the long end relative sticky over the course of the year even as front end yields reprice materially higher, resulting in a reprisal of then Chair Greenspan's 2004-06 bond market conundrum (albeit at lower levels). We expect most of the selloff in intermediate and longer term rates to be driven by a (relatively parallel) shift higher, and by real yields.
- For trades, we like buying Jan-23 TIPS given that the market is already priced for 3 hikes in 2022 while the inflation market is pricing a somewhat steeper decline than our economists' baseline implies (with omicron a potential source of further inflation upside risk). At the same time, we think terminal rate pricing is too low, with the market only pricing another ~2 hikes beyond 2022 before the forward curve flattens out. We believe shorts in EDZ3 are an attractive way to express asymmetry around the terminal rate outlook, though we would wait for better entry levels to initiate positions.

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A New Bond Market Conundrum

Since our last round of US yield forecast revisions in early November 2021, a series of developments have led us to rethink risks to these projections, particularly at the very front end. These developments are mostly central bank-related. First, the Fed doubled the pace of taper, allowing it to end asset purchases by March rather than June, opening the door to earlier policy rate hikes should conditions warrant. Second, the dot plot in the December FOMC meeting featured three median hikes (from just a half a hike in the September FOMC projections), suggesting a shift in

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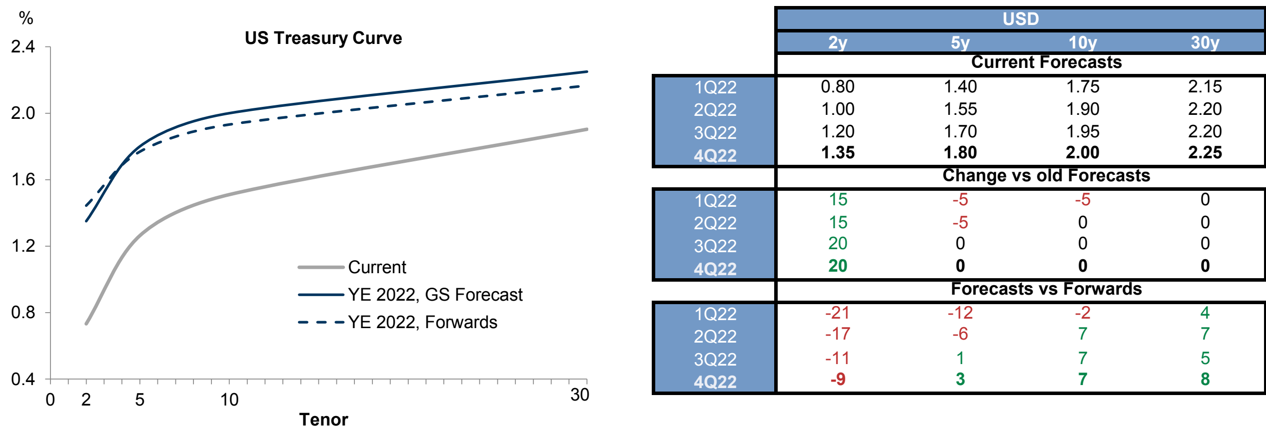
the Fed's views on risks around inflation. Third, in line with the evolution on inflation risks, the FOMC revised its statement to drop its previous intention to maintain an accommodative policy stance in order to keep inflation above 2 percent for some time. Our economists see this as an indication that most FOMC members believe the goals of the new average inflation targeting framework have been met, and that the reaction function going forward will feature a steadier pace of tightening. Further, at the subsequent press conference, Chair Powell sounded hawkish on both inflation and the labor market. As a result of the changes above, our economists expect the Fed to hike three times this year, starting at the March FOMC, and to continue hiking at this pace in subsequent years until the policy rate modestly exceeds its 2.5% long run projection. The economic backdrop, which should feature both a rapidly recovering labor market and elevated inflation despite declining odds of additional stimulus (in the form of President Biden's 'Build Back Better'), should allow the Fed to follow through with these changes.

Exhibit 1: Our revised UST curve forecasts



	USD			
	2y	5y	10y	30y
	Current Forecasts			
1Q22	0.80	1.40	1.75	2.15
2Q22	1.00	1.55	1.90	2.20
3Q22	1.20	1.70	1.95	2.20
4Q22	**1.35**	**1.80**	**2.00**	**2.25**
	Change vs old Forecasts			
1Q22	15	-5	-5	0
2Q22	15	-5	0	0
3Q22	20	0	0	0
4Q22	**20**	**0**	**0**	**0**
	Forecasts vs Forwards			
1Q22	-21	-12	-2	4
2Q22	-17	-6	7	7
3Q22	-11	1	7	5
4Q22	**-9**	**3**	**7**	**8**

Source: Goldman Sachs Global Investment Research, Bloomberg

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While forward yields are already pricing slightly more than 3 hikes this year, the market-implied normalization next year and beyond falls short of our projections for what is likely to be realized. Although we had incorporated some risk premium in our last yield forecasts to account for risks of a hawkish shift in the Fed's reaction function, the changes since that publication are material enough to warrant a change in our year-end 2y UST yield projection; we now expect these yields to end the year at 1.35%, 20bp above our prior forecasts. Our 5y, 10y and 30y YE22 yield forecasts remain unchanged at 1.8%, 2.0%, and 2.25% respectively (Exhibit 1), largely on account of observed market reluctance to price a higher terminal policy rate for this cycle. Indeed, the OIS forward curve starts to flatten as early as late 2023 at around 1.4%, with the terminal rate priced roughly between 1.4% and 1.7% even through the hawkish shift taken by global central banks late last year.

We see two possible explanations for this stickiness. The first hypothesis is that investors believe the normalization cycle is shallow and that a modest amount of monetary tightening will leave the economy in equilibrium. Of course, the receding fiscal stimulus implies substantial fiscal drag that may slow down the economy, but there remain offsets such as spending down of excess savings and inventory restocking

that should keep the economy operating around potential. That, combined with tighter labor markets and upside inflation risks, ought to translate at least into higher risk premia, if not into rate hike expectations, on purely economic grounds. Indeed, given the robustness of this recovery compared with the previous one, we find it especially odd that markets would be pricing a lower terminal rate than that seen in the last cycle. On the whole, we do not find this explanation particularly compelling.

A second explanation, which we favor, is that there is a supply/demand imbalance which is distorting the price signal at longer maturities. We have previously discussed some aspects of this mismatch that has resulted in a new version of the bond market conundrum—net of central and commercial bank purchases, other investors have had limited supply of low risk fixed income relative to demand driven by factors including excess savings, portfolio rebalancing, and immunization flows. While we expect this imbalance to dissipate over time, both on account of a higher policy rate eventually making FX-hedged yield pick-ups on UST levels unattractive and a changing balance as central banks globally begin to trim their balance sheets, we estimate the supply/demand picture will not change materially until next year. The persistent imbalance should keep longer maturity yields low, which in turn are likely working as a cap on terminal rates priced in the belly of the curve.

Irrespective of which of the hypotheses turns out to be true, we do not see the conditions as yet for markets to re-evaluate longer term rates materially (one risk to this view is global central banks run off their balance sheets or end asset purchases at a much faster rate than we currently anticipate). Instead, we expect a more modest reappraisal when compared to the front end. Still, it is worth noting that our unchanged YE22 forecasts for 5s, 10s, and 30s are all roughly 5bp above forwards, whereas our 2y UST yield projection is about 10bp *below* the forwards (also Exhibit 1).

What are the implications of the changes for our yield curve views? In 2021, the 2s5s curve steepened over the course of the year, and the rest of the curve (5s10s and 10s30s) flattened. This is not atypical of curve behavior in the lead-up to a rate hiking cycle. As the Fed begins to raise rates, however, even the 2s5s curve begins to flatten—our forecasts imply as much, with all segments of the curve ending the year flatter than current levels. Of course, the low level of yields at which curve flattening is occurring is unusual, so we would not rule out bouts of corrective steepening if the factors discussed above resolve sooner than we expect. However, in our baseline, we think the bond market conundrum will be resolved via near parallel shifts alongside the Fed's rate hikes. Accordingly, we have made small adjustments to the forecast path of yields in future years to reflect this trajectory (full path shown at the end of the note).

In terms of the mix of yield components at long maturities, we think the repricing will be mostly real yield led. Of the roughly 30bp increase we expect in 10y UST yields over the course of the year, we think roughly 15-20bp of the increase occurs in 10y real yields—this would however leave these yields around -0.7%, still firmly in negative territory. In line with our base case of no rapid reappraisal of the terminal rate, we expect 5y real yields to rise by a roughly similar amount to 10y real yields. On the whole, we expect only modest real yield curve flattening beyond the 5y maturity point.

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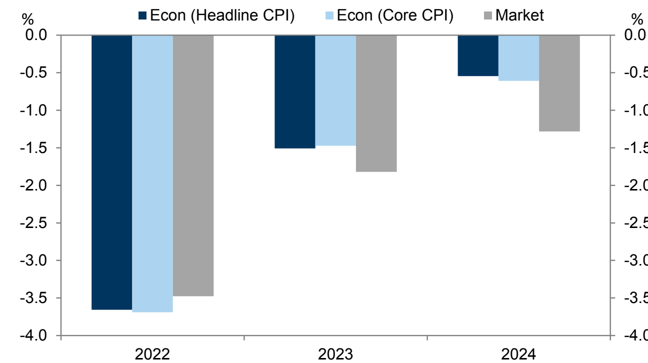
What about the front end? Our baseline view is that inflation will decline from current elevated levels towards levels closer to the Fed's target, although we acknowledge there are upside risks. Markets are pricing a slightly steeper inflation softening than our economists project, leaving 1y real yields somewhat *high*, in our view. As a result, we recommend buying Jan-23 TIPS; while 1y real yield levels are fairly negative (around -3.25%), roughly 3 hikes are already priced over the course of the year, and to the extent the Fed hikes more, it is likely because "underlying inflation" is elevated and rising beyond the Fed's comfort level. Being long real yields is essentially a view that the Fed is a reluctant hiker, at least over the course of this year, and that additional rate hikes beyond what's currently priced would likely lag the magnitude of upside inflation surprises.

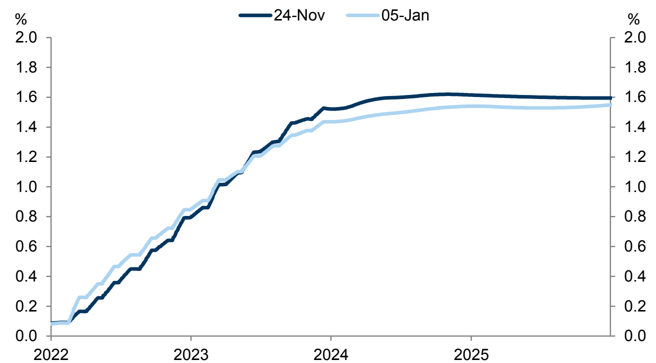
Exhibit 2: The market is pricing a higher real rate for 2022 than our economists' forecasts imply on account of a faster softening in inflation, but lower real rates further out
Calendar-year real* OIS implied by GS econ forecast and market pricing



*Reflects 1y nominal OIS forwards deflated by y/y CPI inflation, shifted to match market indexation lag

Source: Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 3: The forward curve flattens off dramatically around YE23
1m OIS forwards (last vs pre-Omicron news)



Source: Goldman Sachs, Goldman Sachs Global Investment Research

While we think 1y real yields may be "fully" priced, as noted earlier, we believe the terminal rate implied by front end forwards is too low. In particular, the nominal forward curve begins to flatten out in late 2023, making shorting this portion of the curve an attractive option to express a higher terminal rate view. By the end of this year, current market pricing would suggest that the Fed has only about two hikes remaining before the current cycle ends. Given our view that this stems from supply/demand distortions rather than from economic fundamentals, we believe being short December 2023 Eurodollars offers some asymmetry. If upside inflation risks are realized and persist into later this year, markets will likely price the need for more Fed tightening or simply require more risk premium. If, on the other hand, inflation normalizes in line with our economists' base case scenario, we would still see at least the five cumulative hikes currently priced given what we believe will be tight labor markets and an economy operating slightly above potential. Further, by keeping the shorts in nominal rather than real yield space, investors could avoid taking a strong view on how aggressively the Fed may respond to realized inflation outcomes. That said, the recent selloff has taken these forward yields close to the highs from last November, leaving the entry levels less compelling. We look to add these shorts on any material pullbacks.

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Full UST forecast path vs forwards

	GS Forecasts				Forecasts vs. Forwards			
	2y	5y	10y	30y	2y	5y	10y	30y
Current	0.83	1.43	1.71	2.09				
1Q22	0.80	1.40	1.75	2.15	-0.21	-0.12	-0.02	0.04
2Q22	1.00	1.55	1.90	2.20	-0.17	-0.06	0.07	0.07
3Q22	1.20	1.70	1.95	2.20	-0.11	0.01	0.07	0.05
4Q22	**1.35**	**1.80**	**2.00**	**2.25**	**-0.09**	**0.03**	**0.07**	**0.08**
1Q23	1.50	1.90	2.10	2.30	-0.03	0.08	0.13	0.12
2Q23	1.65	2.00	2.20	2.35	0.04	0.14	0.20	0.16
3Q23	1.80	2.10	2.25	2.35	0.10	0.19	0.21	0.15
4Q23	**1.95**	**2.20**	**2.30**	**2.40**	**0.17**	**0.25**	**0.23**	**0.19**
1Q24	2.10	2.30	2.35	2.40	0.28	0.33	0.25	0.19
2Q24	2.25	2.40	2.40	2.45	0.39	0.42	0.28	0.23
3Q24	2.40	2.45	2.45	2.45	0.51	0.46	0.30	0.23
4Q24	**2.50**	**2.50**	**2.50**	**2.50**	**0.57**	**0.49**	**0.33**	**0.27**
1Q25	2.55	2.55	2.55	2.55	0.60	0.54	0.36	0.32
2Q25	2.60	2.60	2.60	2.60	0.62	0.59	0.40	0.37
3Q25	2.60	2.60	2.60	2.60	0.59	0.60	0.38	0.37
4Q25	**2.60**	**2.60**	**2.60**	**2.60**	**0.57**	**0.60**	**0.36**	**0.36**

Source: Goldman Sachs Global Investment Research, Bloomberg

Best Trade Ideas Across Assets

For pricing, charts, and a list of previous recommendations, please visit our Trade Ideas page.

1. Stay long SGD vs short TWD, opened on October 29, 2020, at 20.95 (indexed at 100), with a revised total return target of 111, and a revised stop of 105, currently trading at 107.08.
2. Stay long 10-year OFZs, USD-unhedged, opened on August 26, 2021 at a yield level of 7.02% and with USD/RUB at 74.02, with total return indexed at 100, a target of 110 and a revised stop of 90, currently trading at 90.43.
3. Stay short AUD/MXN, opened on October 5, 2021, at 100, with a target of 106, and a revised stop of 101, currently trading at of 102.38.
4. Stay short 6m10y straddle, opened on 8 October, 2021, at 41bp (running premium), with a target of 25bp and a stop of 50bp, currently trading at 36bp.
5. Stay long 3-year SA inflation breakeven, opened on November 9, 2021, at 3.87%, with a target of 4.6% and a stop of 3.2%, currently trading at 3.86%.
6. Pay PLN vs receive CZK 5-year IRS, opened on November 9, 2021, at -0.24%, with a target of 0.5% and a stop of -0.6%, currently trading at 0.00%.
7. Stay long the iBoxx leveraged loan index vs. the iBoxx HY bond index at a 1.25 to 1x ratio, opened on November 9, 2021, at 0.0%, with a target of +1.00% and a stop of -1.00%, currently trading at -0.10% (value as of 4 January 2022).
8. Stay long the BBG US HY Energy Index vs. the BBG USD HY Corporate Index, both rates-hedged, at a 1 to 1.1 notional ratio, opened on November 9, 2021, at 0.0%, with a target of +1.00% and a stop of -1.00%, currently trading at 0.50%.

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9. Stay long AAA CLOs hedged vs. CMBX 10 AAA at a 1 to 1x notional ratio, opened on November 9, 2021, at 0.0%, with a target of +0.70% and a stop of -0.70%, currently trading at 0.13%.
10. Receive 2y vs pay 10y EUR OIS (2s10s steepener), opened on November 9, 2021, at 0.39%, with a target of 0.65% and a stop of 0.25%, currently trading at 0.52%.
11. Pay SEK 5y swaps outright, opened on November 9, 2021, at 0.59%, with a target of 1.00% and a stop of 0.40%, currently trading at 0.75%.
12. Add US 2s5s10s belly cheapening butterflies via 3m ATM payers, opened on November 9, 2021, at 0bp, with a target of 18bp, and a stop of -12bp, currently trading at -1bp.
13. Stay long MSCI EM vs. short EMBIG-Div, opened on November 9, 2021, at 100, and revised on 8 December to include duration (from hedged previously) together with a revised total return target of 120 and a revised stop of 86, currently trading at 97.47.
14. Stay long Egyptian equities, opened on November 9, 2021, at 11588, with an EGX30 target of 13500 and a stop of 10800, currently trading at 12043.
15. Stay long Dec-23 CME Copper, opened on November 9, 2021, at $9325/mt, with a target of $11,000/mt and a stop of $8,600/mt, currently trading at $9,525/mt.
16. Stay long Dec-23 Brent position, opened on December 2, 2021, at $64.6/bbl, with a target of $75/bbl and a stop of $60/bbl, currently trading at $71.3/bbl.
17. Stay long an equally weighted basket of HY oil exporters (Angola, Gabon, Nigeria, Iraq, Colombia, Brazil, Bahrain, Oman and Azerbaijan), opened on December 3, at 0.0%, with a total return target of 3.00%, and a revised stop-loss of +0.25%, currently trading at 1.07%.
18. Stay long an equal-weighted basket of CZK and PLN versus SEK, opened on December 3, at 100, with a target of 106, and a stop of 97, currently trading at 101.84.
19. Buy 3m EUR/SEK lower, EUR/USD lower dual digital option, opened on December 9, 2021, at 10.24 and 1.13, respectively, with a target of 10.0 and 1.11, currently trading at 10.29 and 1.13.

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We, Praveen Korapaty, William Marshall, Avisha Thakkar and Ravi Raj, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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